Providing the right infrastructure

Sandra Haurant looks at the opportunities for pension funds to invest in infrastructure

Summary

• Infrastructure as an asset class encompasses a wide number of sectors, from transport links to renewable energy.
• Pensions schemes are frequently well-suited to infrastructure, which tends to involve long-term investment.
• The past few years have had an impact on the asset class, but some crises can only be solved through infrastructure changes – creating, by necessity, new opportunities.
• Some projects – notably in the field of renewables – are being brought forward as a result of the need to create self-sufficient energy sources (and avoid the need for Russian gas).
• While some schemes are well-placed to invest in these long-term, and urgent, projects, this depends on the life stage of the scheme; those closer to buyout may be keener on assets offering greater liquidity.

"The UK needs investment in infrastructure, particularly in projects that have a direct impact on how we live and work," said Legal & General Group chief executive, Nigel Wilson, in the firms' 2020 report, *The Power of Pensions*. "These investments are key to the long-term competitiveness of the UK economy." Indeed, L&G's predictions suggested that a £1 trillion infrastructure funding gap would open up in the UK between 2020 and 2030; a gap which, Wilson argued, pensions could well help to fill.

The world of infrastructure is a wide one – in effect, the term encompasses all those areas that provide and make up the essential framework that keeps a country working. According to L&G, the UK's own infrastructure priorities, for example, include retrofitting "over 20 million old homes to deliver significant reductions in energy consumption", building three million new energy-efficient homes, transforming public and private transport to become electric and green, with "vastly reduced diesel and petrol-powered cars and buses," while affordable housing, renewable energy, improved regional transport networks, and digital infrastructure all also require urgent attention and, most importantly, funding.

Broad appeal

That infrastructure needs proper funding is a certainty. But to put it bluntly, when it comes to investing, what's in it for pensions? According to BlackRock head of UK LGPS and BlackRock Alternatives Specialists UK, Alexander Orr, a number of elements make the fit a good one.

"The long-term investment horizon of pension funds, and other institutional investors, makes them well-suited to make investments in less liquid, long-term assets such as infrastructure," Orr says.

"Whilst the specific anticipated benefits of investing into infrastructure will vary depending on the approach taken – greenfield vs. brownfield, local vs. global, diversified vs. sector specific – the most common reasons we see pension funds allocating to infrastructure are for portfolio diversification, inflation linkage, long-term stable cash flows, return enhancement and explicit ESG impact."

Indeed, adds Schroders Greencoat managing partner, Richard Nourse, today's shifting economic environment provides more reasons for an interest in infrastructure. "Pension funds have long-term liabilities linked to inflation. Many of them now increasingly mature," says Nourse: "Infrastructure – especially renewables – provides secure income, often with direct inflation linkage, at a significant premium to investment grade bonds."

And the "explicit ESG impact" Orr refers to holds significant potential. "The right projects deliver tangible environmental and social impact, often at a locally specific level, which is a priority for many asset owners," Nourse says.

Access all areas

Ways into infrastructure investment vary according to the size and scope of a scheme, says PiRho Investment Consulting director, Phil Irvine, who says that schemes are generally: "Either accessing in a bespoke illiquid structure (with long lock-ups) or via a closed-ended, investment trust route."

"Historically, pension schemes – indeed most institutional investors – gained exposure to infrastructure via listed markets (both active and passive strategies) and fixed income investments," Orr adds. "Whilst this remains a popular way to access the asset class, in the past few decades, investors have increasingly favoured investment in private infrastructure, with many investors having a standalone allocation to this type of investment, typically between 5 – 15 per cent."

This comes with its own issues, though, says Orr. "Whilst some of the largest and most sophisticated private infrastructure investors may seek to build a team to directly source, own and operate direct infrastructure investments, this approach does present some challenges."

One of those challenges, he says, is a lack of diversification – brought about simply by the fact that there is a very large single asset size involved. Another is finding the necessary resources for a management task such as this, which requires a sophisticated, specialised, team.

As a result, many pension schemes opt instead for unlisted commingled infrastructure funds. "An investment manager (general partner) aggregates commitments from multiple institutional investors (limited partners). These aggregated commitments are then invested across multiple assets, ensuring the pension schemes gain access to a diversified portfolio of infrastructure assets," explains Orr. "Specifically, the Long-Term Asset Fund *[a new FCA-regulated fund designed specifically to help investment in assets including venture capital, private equity, private debt, real estate and infrastructure]* will provide easier access for UK DC schemes to enter this space, offering attractive long-term net returns and providing better outcomes for members."

Selecting the right managers is essential, says Nourse, and particularly in areas that require an real in-depth understanding of a given sector, such as renewables. "There is no shortage of managers that can price a wind farm or solar project, but much more valuable to investors is market coverage and a finger on the pulse of changing market price indications," he says. "I would advise investors to choose managers that are real specialists and have a deep technological understanding of the assets they are pricing, and how that could change. You want to see a complete dedication to the market, given it is the fastest-growing component of the broader infrastructure sector."

Performance problems?

Few are the sectors that have avoided the turbulence of the past few years, and while underlying core assets have continued to deliver for pensions, says Irvine: "The fact that many of these assets are illiquid has caused issues for schemes during periods of liquidity crisis during the gilts chaos of September/October 2022."

However, argues Nourse, there has been a marked push to speed up certain environmental projects. "The tide has gone out as a result of Covid and increasing energy costs, and some types of infrastructure investments have suffered from this," he says. "In the renewables sector, the invasion of Ukraine led to a new focus on energy security and affordability – both secured by societal investment in renewables. Combined with net-zero plans being rolled out at a national level around the world, we are seeing national timelines for renewables deployment being brought forward substantially – meaning there are a lot of investment opportunities."

On both sides of the Atlantic, says Nourse, renewables are seen as a way of decreasing dependence on Russian gas – clearly a pressing need. "As a result, much of what would have otherwise happened in the mid 2030s is being brought forward to the late 2020s," he says. "That is in addition to significant investment in hydrogen, EV charging networks and other forms of sustainable infrastructure. Already a multi-trillion dollar industry, renewables' contribution to the generation mix is expected to grow by more than $100 billion annually for the next 10 years due to rapid buildout."

Liquidity and life cycles

While infrastructure and pension schemes enjoy a certain symbiosis, the question of pension schemes' own internal structures could arguably prevent certain funds from pouring resources into this asset class. "The good news is that there are still many areas that need substantial investment in infrastructure (electrification of transportation, green energy, etc)," says Irvine. "The bad news is that many pension schemes have moved far closer to buyout over recent years, and insurers wish to take liquid assets such as gilts and cash, rather than private, illiquid assets."

Still, Nourse remains positive about the future of infrastructure for pensions, particularly in light of the ongoing green energy revolution: "Globally speaking, renewable generation is already a multi-trillion-dollar investment opportunity and is predicted to grow by more than $100 billion annually in the next decade," he says. "The US and Europe seem to have begun competing for green investment, which is a brilliant catalyst for the sector. We're hugely optimistic about the future and believe that renewable energy generation represents one of the fastest growing and most exciting aspects of both the infrastructure universe and the sustainability transition."

But even if opportunities abound, different schemes are at different life stages, and as such this is an area that will, by necessity, not have an across the board appeal. Illiquidity may suit the long-term investor, but it's not for everyone – and looking to the future, says Irvine: "The underlying assets will probably do as expected in terms of income generation, but there may be a number of pension schemes looking to exit these investments as they prepare for buyout."

Written by Sandra Haurant, a freelance journalist