Blending opportunities

Lynn Strongin Dodds explores the investment opportunities created by the increasing cross over between infrastructure and real estate sectors

Summary

- Real estate and infrastructure are converging in certain sectors such as energy transition and social services.
- The benefits are the same – income, inflation protection and diversification.
- The risks are also similar in terms of illiquidity, volatility and long-time horizons.
- Theme investing such as smart cities is evolving although will take time to develop.

Over the past three years, the investment lines have blurred between infrastructure and real estate sectors. This has opened the door wider to new opportunities and the ability to make an impact but the risks inherent in illiquid assets also need to be carefully examined.

"There are several mega economic and secular trends within infrastructure that are having an impact on traditional real estate assets," says Russell Investments head of strategic client solutions, David Rae. "These include digitalisation and transformation, energy transition, renewable energy and changes to social requirements. Historically there would have been a more rigid allocation to individual asset classes but today investors want more flexibility as long as it achieves their objectives and outcomes."

A trend old and new

Although this convergence may seem novel, it is in fact, decades old, with North American private investors looking at infrastructure projects as a way to capture underlying value from real estate investments. However, as the industry progressed, firms began to specialise, and divisions were drawn between the two.

As PATRIZIA head of strategic investments, James Muir, notes, real estate and infrastructure have co-existed under the umbrella of 'real assets' for some time, but the adoption of this term has grown significantly of late. One reason is the spurt of M&A activity, with PATRIZIA acquiring Whitehelm Capital in 2021, which broadened its reach into areas such as digital infrastructure, energy transition, water and environmental services, and social infrastructure.

More recently, BlackRock purchased Global Infrastructure Partners for around $12.5 billion in cash and stock, a move that has substantially boosted the $10 trillion money manager's footprint in alternative assets. It has given the world's largest fund manager approximately $150 billion in infrastructure assets across a portfolio that ranges from the US liquefied natural gas export market to wastewater services in France to airports in England and Australia.

The acquisitions are also a reflection of the overall growing interest in real assets, according to a recent study by Time Investments, which surveyed 200 UK wealth managers, financial advisers, discretionary fund managers, fund selectors and investment analysts. It found over three-quarters expect to increase their allocation to real estate over the next 12 months, with 74 per cent targeting infrastructure.

Mercer chief investment officer, James Lewis, also sees a growing interest in real assets, with its latest large asset owner barometer survey showing that, for example, over 70 per cent plan to increase or retain their infrastructure investments. "There is a real interest in assets that have an intrinsic link to the value of the economy," he adds. "They are attractive because they offer protection against inflation, diversification and can help dampen volatility."

Diversification

In addition, Hymans Robertson investment research senior consultant, Asad Rashid, says clients are also focusing on net-zero targets and having inflation-linked income streams in an uncertain economic environment. He believes that real assets are an important tool in client portfolios and tend to be a bigger part of larger and more sophisticated pension scheme portfolios. On average, real assets make up around 5-25 per cent of a pension scheme's portfolio.

JLL head of capital markets research in EMEA, Tom Mundy, also notes a much more granular focus on diversification, as well as managing cashflows. "We are in a different economic cycle now and there is a greater awareness that investors have to future proof their portfolios and drive excess returns, due to the high cost of capital," he adds. "This means not being overly exposed to one sector and instead balancing traditional core real estate with infrastructure."

To date, energy transition projects are one of the most popular because they enable investors to deploy at scale, adds JLL lead – energy and infrastructure advisory EMEA, Steve Jack. The investments include solar, wind and battery storage to help manage intermittent renewable energy generation.

As for specific projects, Muir points to the Maasvlakte distribution centre, one of the Netherland's largest single logistics assets as well as Europe's biggest rooftop solar installations. He says the combination of real estate and infrastructure not only facilitates an industrial-scale renewables project, but it also delivers significant upside potential for the underlying asset, which now makes a meaningful contribution to the energy transition.

He also says a similar story can be seen in the electric vehicle (EV) space where charging infrastructure has been installed in car parks and at roadsides. In isolation these assets are relatively simple to manage, but rolling out a pipeline of ultrafast EV chargers across a portfolio of prime food-anchored retail stores requires a much broader skillset.

Social infrastructure is another area where both sectors intersect. Market participants often define it as real estate that maintains and strengthens social services. It typically involves buying and potentially renovating or developing, real estate that is then let to service providers to operate from. This comprises facilities for primary, secondary and further education, as well as nurseries and special educational needs facilities. There is also healthcare such as hospitals, medical and specialist care facilities, as well as social housing, supported living and homelessness, extra care facilities, key worker housing and student accommodation.

Meanwhile, the Kings Cross development is a prime example of urban mix use regeneration encompassing both real estate and infrastructure. The once 27-hectare derelict area in London has been transformed into a vibrant area with office, retail and residential buildings alongside new schools and a university. It is also well-connected to transport facilities, education, health and leisure facilities.

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Future

Looking ahead, Muir believes that investment themes such as smart cities will gain traction. He says at the moment the attention is on digital infrastructure like fibre networks to help communities become better connected. However, it could also mean investing in tech-enabled real estate like smart buildings that plug into this underlying digital infrastructure.

"A thematic strategy like smart cities generates real value by leveraging a general partner's (GP) footprint and expertise across multiple real asset disciplines, such as sustainability, technology and real estate," he adds. "So, when successfully combined, you have a product that plays a leading role in driving the major transitions to digitalise and decarbonise our expanding urban communities."

There are of course the risks that come with these assets such as illiquidity, the need for a long-time horizon and often specialist fund managers. However, with themes such as smart cities Muir says investors should assess how limited partners (LPs) are structured, with individual real estate and infrastructure teams commanding separate allocations. "Without a clearly defined core offering of either infrastructure or real estate, a blended strategy risks finding itself without capital from either pot," he adds. "But merging LP teams to have one real assets allocation would certainly support thematic investing."

Some consultants though think the concept of smart cities is not yet developed and it will take time in general for real estate and infrastructure to be viewed under one umbrella. Rashid contends that they remain quite distinct asset classes with different investment strategies.

Rashid points out that real estate focuses on getting the highest rent out of a particular piece of land, whereas infrastructure focuses on stable long-term income from providing an essential service from an asset. He adds that the opportunities span across the digital sector, such as fibre networks and data centres, transport/logistics sector – rail, ports, and roads as well as social services including waste management, hospitals, schools and energy-power generating assets, utility networks, pipelines.

"Given the breadth of infrastructure sectors, there will be some crossover with other asset classes, but it is limited crossover and calling it convergence is a step too far in our opinion," Rashid says.

Written by Lynn Strongin Dodds, a freelance journalist

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