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Infrastructure investment in Australia – the road ahead for institutional investors

December 2017

With large-scale privatisations slowing and intense competition for assets that do come to market, institutional investors are looking to non-traditional assets to provide similar long-term, stable and predictable returns. Our Funds Sector team spoke with institutional investors and infrastructure fund managers about the outlook for infrastructure investment and issues relevant to institutional investors. Here are our key observations on trends and opportunities.

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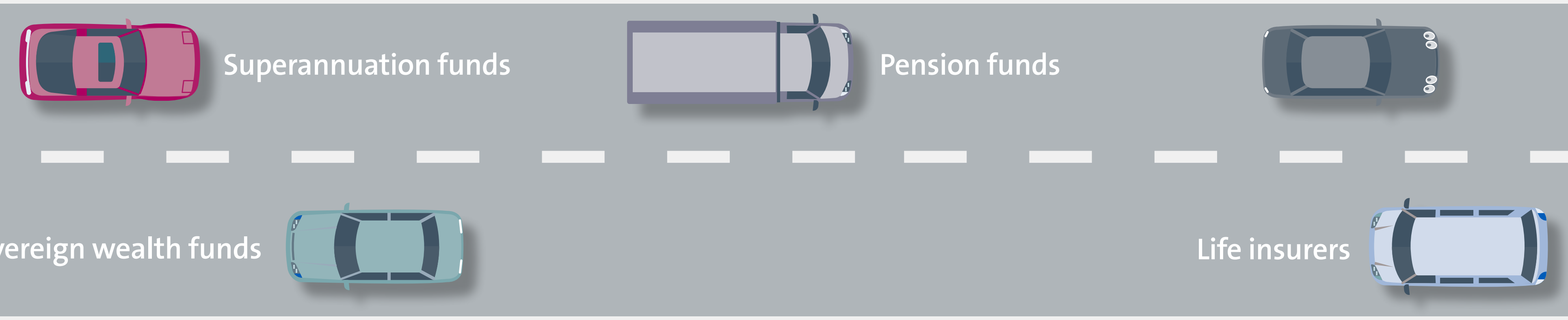
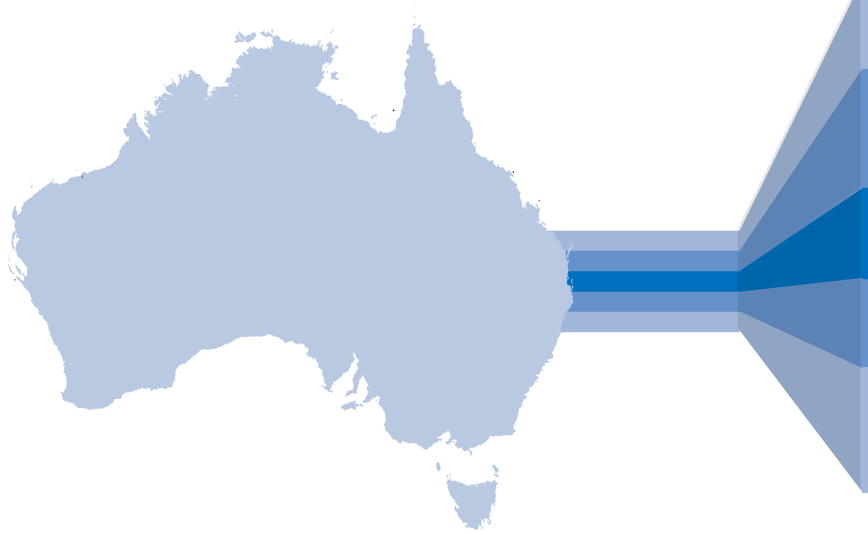
Institutional investors



After a bumper year in 2016, 2017 has been another active year for institutional investors in Australia. Endeavour Energy was partially leased to a consortium comprising Macquarie Infrastructure and Real Assets, AMP Capital, British Columbia Investment Management Corporation and the Qatar Investment Australia for $7.6 billion. We have also seen the lease of land titles registries in New South Wales and South Australia, in competitive sales processes that attracted substantial interest, and the process for the partial sale of the $16.8 billion WestConnex roads project has kicked off in earnest.

Privatisations aside, state governments buoyed by the proceeds from asset sales, supplemented by funds from the Federal Government's asset recycling scheme, are proceeding with a host of large-scale infrastructure projects. The upcoming wave of spending on these projects has been described as Australia's next boom.

Top 5 market observations for 2018

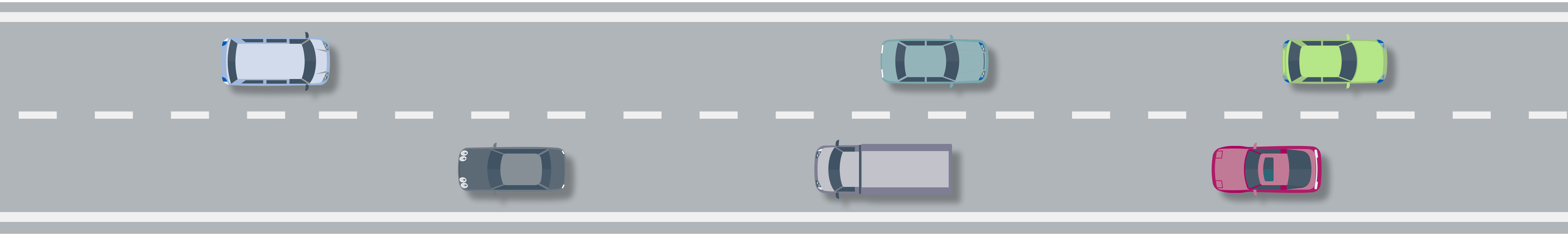


- With ever-increasing funds under management, institutional investors will continue to invest significantly in infrastructure assets.
- Interest from institutional investors in 'core-plus' assets such as land titles registries, data centres and smart metering assets will likely increase as traditional 'core' assets become scarcer.
- We expect investors to focus on getting more out of their existing assets, with technological change playing a large role in this behaviour.
- Tighter capital adequacy rules for banks present an opportunity for institutional investors to contribute to infrastructure investments through project finance and other forms of investment.
- The role of external managers will continue to evolve, with some Australian institutional investors internalising the investment management function, looking to make more direct investments, and taking more active roles in the managed funds they invest with.

Recent highlights

We have advised (or are advising) on the following transactions involving institutional investors.

- Partial sale of the $16.8 billion WestConnex roads project, which is underway.
- The acquisition by Sunsuper of an interest in Birmingham and Bristol Airports.
- The long-term lease of Endeavour Energy to Macquarie Infrastructure and Real Assets, AMP Capital, British Columbia Investment Management Corporation and the Qatar Investment Australia for $7.6 billion.
- The lease of the New South Wales Land and Property Information business to Hastings Fund Management and First State Super for $2.6 billion.
- The long term lease of Ausgrid to IFM Investors and AustralianSuper for $16.2 billion.
- The $9.05 billion acquisition of Asciano by a Global Infrastructure Partners, Canada Pension Plan Investment Board, CIC Capital Corporation, GIC and British Columbia Investment Management Corporation.
- The sale of AGL Energy Limited's digital metering subsidiary to Ausgrid.
- The issuance of private placement notes, A$ medium term notes and other long term instruments, including in respect of Ausgrid, Endeavour Energy and WestLink M7.
- The long term lease of Port of Melbourne to the Future Fund, QIC, Global Infrastructure Partners and OMERS for $9.7 billion.



What attracts institutional investors to Australian infrastructure?

The investors we spoke with all predict significant increases in their assets under management (with some suggesting a twofold increase in the next five years). This will result in significant dry powder pursuing and competing for appropriate investments. One theme that was clear from our conversations is the importance of investing through cycles and taking a long-term view. Infrastructure naturally fits this, with its long-term, stable and predictable cash flows (although technological and other change does pose increasing risk, as we note on page 7). For example, one Australian industry superannuation fund has commented that infrastructure is intended to serve as the 'bedrock' of its portfolio:

> *We look to infrastructure investments, particularly core investments, to provide our members with their bedrock return.*

Strong interest in Australian infrastructure assets continues. Australia has long been seen as an attractive investment destination and continues to punch above its weight, offering a stable economic and regulatory environment and a larger proportion of high-quality, investable infrastructure when compared to other countries.

Some foreign pension funds are interested in growing their exposure to Australian assets and have set up Australian offices to be close to local opportunities. The attractiveness of Australian infrastructure and the small number of large-scale assets coming to market has resulted in highly competitive bid processes and increased prices, but many investors are undeterred. As observed by one Canadian pension fund:

> *Compared to five years ago you have to pay more to buy a business, you have to move faster and take on more risk. Deals are more competitive but there is still value to be found.*

Source: "Canada's OPTrust hunts for deals", Carnie La Frenz, 14 September 2017, AFR

What's left for traditional infrastructure investments and privatisations?

The pace of large-scale privatisations is slowing, which some investors believe will result in a diminishing pipeline of traditional infrastructure investment opportunities of scale in Australia. A recent Infrastructure Partnerships Australia report[1] suggests that investors consider political risk, the cost of bidding, getting value and competition for assets as the most significant challenges to investing in Australian infrastructure. There are concerns that regulatory uncertainty, including in relation to energy policy, the Australian Taxation Office's review of the treatment of stapled structures and the heightened focus on foreign investment (including the establishment of the Critical Infrastructure Centre), may have taken some shine off Australia.

However, other investors are more optimistic on the short to medium term pipeline. A sale process for the Basslink interconnector is reported to be underway, as well as investment opportunities in the current WestConnex privatisation process, Western Sydney Airport and Melbourne Metro. State governments are also thinking more broadly about the types of assets they are bringing to market, with the Victorian State Government following its New South Wales and South Australian counterparts expected to put the Victorian land titles registry up for sale. The Queensland and Western Australian State Governments are obvious candidates to follow suit. While both have been resistant to privatisations (with the Queensland State Government being particularly vocal on its anti-privatisation agenda), the Western Australian State Government has recently suggested that it will move forward with the sale of its TAB wagering services businesses and that it is considering the sale of its land titles registry. Arguably, it is a question of when and what these two state governments may look to sell to facilitate rejuvenation of their infrastructure stock and to remain competitive with the other states.

In the face of the political unpopularity of privatisations, the New South Wales State Government has led the way in demonstrating the benefits of the asset recycling program and earmarking infrastructure projects to benefit from the proceeds of the state's poles and wires, with a strong program of projects announced and underway, including Sydney Metro, Parramatta Light Right, Metro West Rail and extensions to WestConnex. Similarly, the Victorian State Government is applying the proceeds from the Port of Melbourne lease to support transport initiatives such as the Melbourne Metro and the Western Distributor. The iconic Snowy Hydro is another asset that some investors see as having potential for privatisation, although the proposed $2 billion expansion announced by the Federal Government this year might kill off that possibility in the short to medium term. As state governments look to apply the proceeds from recent privatisations and the asset recycling scheme, there could be potential for increased investment in PPP projects.

1 Australian Infrastructure Investment Report 2017

Shift towards alternative infrastructure investments in 'core-plus' assets?

Much has been made of a shift in focus towards 'core-plus' assets, as opposed to traditional, core infrastructure assets such as roads, airports, ports, and electricity and gas transmission and distribution. In 2017, we have seen institutional investors interested in land titles registries, data centres and smart metering assets – with targets such as Asia Pacific Data Centres, Metronode's data centre business and Origin Energy's smart metering business (and with the sale of AGL's smart metering business having recently been announced). Each of these asset classes exhibits 'infrastructure-like' characteristics. This reflects global deal trends in non-traditional infrastructure, particularly in the UK and Europe where, as with Australia, it is considered that the peak of availability of large-scale traditional infrastructure investment opportunities has passed.

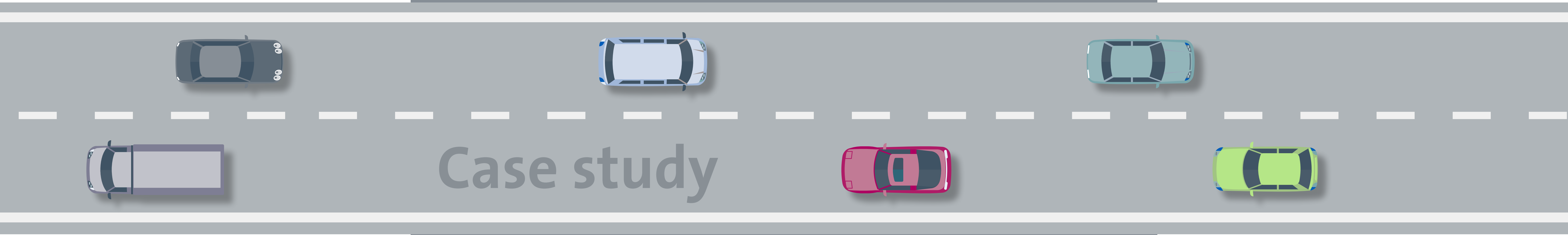
While commentators have focused on the distinction, it is clear that 'core-plus' means different things to different investors. In broad terms, core-plus assets are subject to a higher degree of merchant, political, competition, technological, regulatory or contracting risk than traditional, core assets, but retain an element of protective regulation and longer-term, stable contracting. For many investors, there is no bright line test for what constitutes a core-plus asset – 'you'll know it when you see it'.

It is also simplistic to pigeonhole assets as belonging to a class – for example, data centre assets can display characteristics of infrastructure, real estate and private equity, depending on a particular asset's specific characteristics.

Ultimately, institutional investors classify and characterise investments based on returns, and risk and certainty of returns, which are paramount in driving investment decisions.

An increased focus on core-plus assets appears to be a function of the diminishing availability of large-scale, traditional infrastructure assets, rather than an attempt to seek higher returns from infrastructure assets (which are better sought through other asset classes, such as private equity and venture capital). This means that institutional investors do not see themselves as chasing core-plus or non-core infrastructure assets as specific opportunities – they are not focused on such rigid characterisations or underlying asset classes and are instead focused on the risk/return profiles of specific opportunities, with the aim of achieving the desired risk/return profile for their portfolios as a whole.

One of the Australian superannuation funds we spoke to commented that they would not be prepared to change their infrastructure risk profile materially and suggested their managers would need to be clear about any new



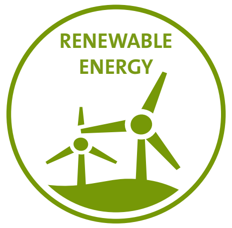
active strategy for pursuing core or non-core infrastructure opportunities. Similarly, one foreign pension fund commented:

> *We will not move along the risk curve to core-plus for the sake of it (greater risk means that the returns should be greater, not just infrastructure-type returns).*

Whether core or non-core, investors expect infrastructure investments to achieve stable, low-risk returns over the longer term, albeit with variants in the risk/return spectrum, depending on the precise nature of the asset.

While the return on core-plus assets may be higher than for traditional infrastructure assets, another notable characteristic is that they tend to lack the scale of their core counterparts. As such, one development we may need to see is the aggregation of these smaller opportunities (such as hospitals, housing and schools), in order to provide a more compelling investment proposition for institutional investors.

Other alternative asset classes we have started to see trending in Australia include:



See the case study about the Powering Australian Renewables Fund

The launch of Stage 2 of the Social and Affordable Housing Fund in New South Wales

Recent sale of water utility service provider Trility Group to Beijing Enterprises Water

Case study

Renewables: 'the next goldrush'?

Against the backdrop of the recent Finkel Report, which provides a possible blueprint for Australia's energy markets, renewables have been described by institutional investors as 'the next goldrush'. We expect continued strong activity in the development of new wind and solar plants in order to reach the Federal Government's Renewable Energy Target by 2020 (aiming for large-scale renewable energy generation of 33,000GWh in 2020, which means 23.5 per cent of Australia's electricity generation in 2020 will be from renewable sources). Given regulatory changes flowing from the Finkel Report, the viability of those projects will be predicated in part on the ability of renewable generators to 'firm' their capacity, for example by investing in battery storage or contracting with dispatchable facilities (eg gas or pumped hydro). However, policy uncertainty in the post-Renewable Energy Target period may act as a disincentive to those institutional investors seeking to gain or increase their exposure to renewable energy assets. It will be interesting to see how the National Energy Guarantee proposed by the Turnbull Government takes shape.

Powering Australian Renewables Fund

We advised on Australia's first unlisted renewable energy fund, the Powering Australian Renewables Fund (PARF), a landmark partnership created by AGL to develop, own and manage approximately 1000MW of large-scale renewable energy infrastructure assets and projects, by developing and operating a mix of renewable technologies across Australia. The PARF was launched in July 2016 with $1 billion of committed equity from AGL, the Future Fund and the QIC Global Infrastructure Fund. With debt, PARF is expected to be a $2 – $3 billion fund.

Since its establishment, the PARF has acquired the 102MW Nyngan and 53MW Broken Hill solar plants, the 453MW Coopers Gap Wind Farm project (which will be the largest wind farm in Australia on completion), and the 200MW Silverton wind farm. In addition to acquiring and developing existing AGL assets, the PARF is also open to acquiring projects from other developers.

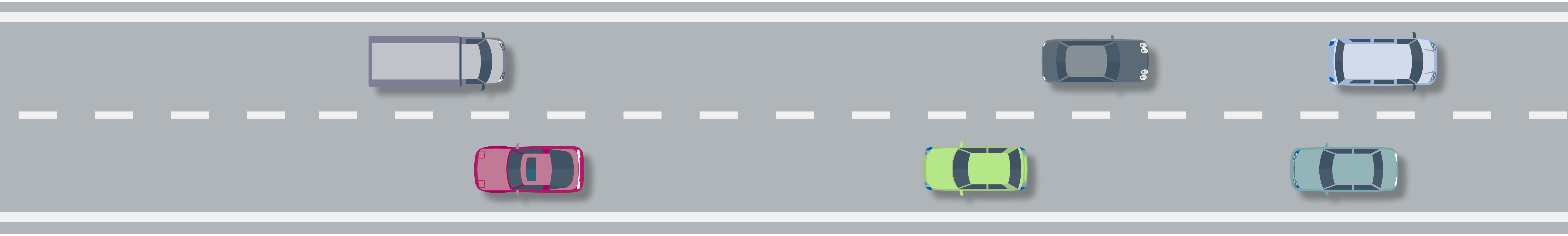
Given the Federal Government's Renewable Energy Target, others have looked, and continue to look, to replicate the success of the PARF (including reports of Synergy's launch of a renewables fund modelled on the PARF), and we expect similar offerings to come to market in the short to medium term.

In particular, water and other utility assets are examples of core-plus infrastructure assets for which there has been increasing deal activity globally, particularly in the UK. Institutional investors have shown interest in the state government water utility assets, but there is no expectation that these assets will come to market in Australia in the short term, particularly in light of perceived political difficulties with assets of this nature.

Adopting a broader approach to infrastructure investment

Institutional investors are wary of the intensely competitive auction processes (and the associated bidding costs) that prevail in Australia. An alternative is to seek value by adopting a broader and more flexible value-add approach to existing infrastructure investments and focusing more on improving the returns on those investments or adapting them for change requirements.

An obvious example of this lies in the potential for technology to be a disruptor for traditional infrastructure investments. As is the case across all industries and sectors, technology's impact on infrastructure investments cannot be ignored. The risk is heightened with infrastructure investments, that typically come with long-term investment arrangements: a 99-year lease of the Pony Express might have looked a poor investment when the telegraph was subsequently installed. Institutional investors are factoring this into their valuation and risk assessments when deciding whether or not to acquire an asset, and are thinking about how that asset might be used in future and how it might need to be developed to move with technological developments – they are in effect being asked to imagine the future at a time of enormous change. For example, smart monitoring technology, lane management and driverless vehicles may offer potential for innovation in the operation and maintenance of road infrastructure, but the cost of adopting an asset to take advantage of these developments would need to have been factored in at the outset.



Institutional investors have also suggested that increasing their focus on developing greenfield assets, investing in special situations and entering into reputable partnerships to access expertise may provide them with good platforms for growth. This trend is exemplified by Caisse de dépôt et placement du Québec's acquisition of an interest in Plenary Group.

Geographical diversification

The growth in size of Australian institutional investors means they are starting to explore investment opportunities in emerging markets. The diminishing pipeline of core infrastructure investment opportunities in Australia and the impact of increased competition on prices and returns means overseas investments may present greater opportunities for exclusivity and the potential for bilateral sales processes. Moreover, with the vast majority of the world's urban population now in emerging markets, there is a large and ever-growing need for new infrastructure and improvements to existing infrastructure in those markets.

The emerging markets of particular interest to institutional investors appear to be in developing Asia and Latin America. For example, one Australian superannuation fund commented that:

> *In South-east Asia we have invested in renewables. We think the risk/reward is significantly better than Australia; the returns were fantastic. We recently did a big top-down piece of research on Brazil – analysing the political situation – but you need a bottom-up approach as well to assess the deal opportunity to make it happen.*

Source: IIF Australia: Top 10 Takeouts, Information News, 12 September 2017

It was recently reported that IFM Investors expanded its Latin American portfolio through its acquisition of OHL Concessions, which controls a portfolio of toll roads, ports, an airport and a light rail asset. This exemplifies the opportunities for investment in core infrastructure of scale outside of more hotly-contested developed markets such as Australia. IFM Investors said that:

> *They are all core infrastructure assets. It is exactly the type of deal we target in terms of size and will give us slightly more geographic reach in Latin America.*

Source: "IFM extends Latin American infrasturcture push", James Frost, 17 October 2017, AFR

Nevertheless, institutional investors are still taking a cautious approach to emerging market investment, and some investors will still only consider investments in OECD countries, given the heightened risks and uncertainty in emerging market jurisdictions.

Outside emerging markets, new opportunities may present themselves in the United States, where the success of Australia's asset recycling program has been promoted globally. IFM Investors, Hostplus and others have been involved in high-profile delegations to the US and discussions on the benefits of Australia's asset recycling initiative (which have been referred to as 'public-pension partnerships'). This has formed part of the dialogue on the Trump Administration's announced US$1 trillion infrastructure spending program, including with particular interest in transport infrastructure such as airports and ports. However, despite the pressure to build and improve infrastructure, there is little expectation of a deluge of large-scale assets coming to market in the short-term in the US: assets are often state-owned and regulated and would therefore require significant cooperation between relevant authorities to implement any Washington-led initiative. Additionally, the Trump Administration's inability to accomplish its legislative agenda (as evidenced by its multiple efforts to repeal and replace the Affordable Care Act) means that investors we have spoken to do not foresee an imminent acceleration of the US privatisation cycle.

Evolving role of managers

Institutional investors are now even less inclined to park their money in managed funds as passive investors. They are increasingly looking to make direct investments (sometimes with a separately managed account arrangement) or, as a minimum, to take a more active role in the fund investments they do make. Whereas a decade ago it was not common for investors to seek co-investment rights, those rights are now relatively standard for larger institutional investors. One Australian industry superannuation fund has commented that:

> *We see an important role for managers in our investment strategy and have been deliberate in adopting an outsource model, but we are still an active co-investor together with our partners.*

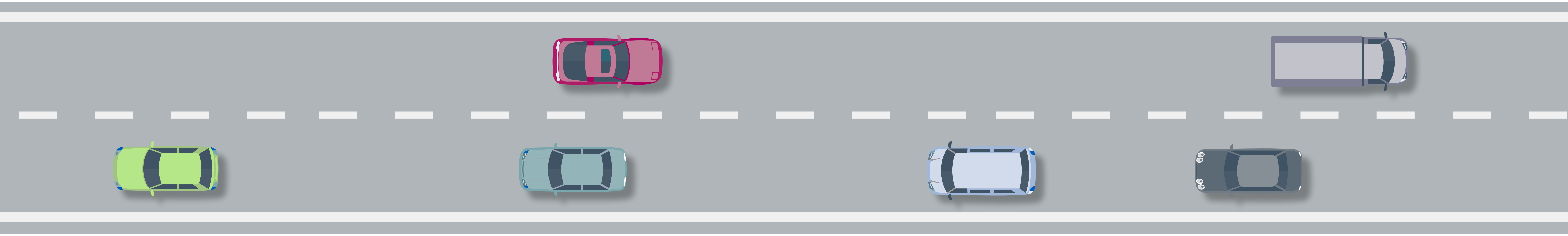
Many investors have also been busy building their in-house capability, which they have achieved through strategic hiring but also through the use of secondment or other knowledge transfer arrangements with fund managers with which they are invested. However, this trend is not as uniform among Australian institutional investors as we had thought and investors are clear that they still see an important role for managers to play. In some cases this is because investors may be mandated to use external managers. In other cases we see two reasons.

First, institutional investors see the risks in moving towards an entirely internalised model, which can fragment the market and make those investors less adaptable to change (which can happen when an investor builds capability in certain assets classes only to find the focus switching to other asset classes). As one Australian industry superannuation fund put it:

> *Complete internalisation of management fragments the market (instead of a few competent managers acting for their pooled clients, it results in less competent teams of investors acting for themselves) and it may be difficult for in-house teams to keep up with market changes.*

Second, investors appreciate the role of external managers as origination and management experts – this is particularly true of investors which lack global reach, ready access to assets, broad asset knowledge, or the ability to pull experts from around the world to work on a matter or integrate an asset. Continuing this theme, some managers are also able to add value through the acquisition of complex assets that are more 'proprietary' (ie requiring more management time and more involved post-acquisition restructuring or streamlining, moving perhaps towards a more private equity-type model rather than a traditional infrastructure investment model). Global Infrastructure Partners is perhaps an example of this trend, as is the entry by private equity fund managers such as Blackstone and, if rumours are true, Pacific Equity Partners, which is reported to be raising a new $1 billion infrastructure fund targeting 'active infrastructure', described as a hybrid of private equity-style investments and infrastructure assets.

It is clear that managers still have an important, albeit evolving, role to play – in sourcing and executing deals, playing an active role in managing acquired assets and realising value, but with increased oversight and involvement from investors and with a willingness to offer co-investment opportunities with attractive blended fee rates.



Financing trends

Non-recourse project finance has contributed, and will continue to contribute, significantly to funding the development of new greenfield infrastructure projects and to funding brownfield investments (whether as part of privatisations or private auction processes). For institutional investors, understanding what makes an infrastructure project development or operating asset bankable from a debt perspective is not only critical to securing debt from the project finance market but it also provides an opportunity for a new investment category for institutional investors in the Australian market.

The demise of the monolines during the GFC, and with them the credit-wrapped products that underpinned the Australian project bond market from 2005 to 2007, has been well-documented. Project finance banks stepped up to fill the void left by the monoline insurers, and quickly became the dominant source of debt financing for Australian infrastructure projects. Bank debt remains a vital ingredient for infrastructure financing in Australia, particularly for greenfield projects, but also for refinancings of brownfield projects. Presently, competition in the bank market for infrastructure assets in Australia is intense, bringing project sponsors both liquidity and pricing benefits. In many respects, the re-emergence of a project bond market, and the use of alternative sources of debt in Australia, has been held back by such liquidity and competitive pricing in the bank market.

The local project finance bank market, however, remains a short-term debt market. The manner in which Australian banks fund themselves means that project finance banks in the Australian infrastructure market favour shorter-term lending – and Basel III capital adequacy rules only exacerbates that. There is only a limited number of offshore banks operating in the Australian market willing to provide tenors beyond seven years, after which point liquidity falls away markedly. Some longer term bank debt has become available from certain Japanese banks, which have shown capacity to provide longer term financing, most particularly for regulated assets. At a macro level, a question looms as to whether the bank market is capable of satisfying the debt-funding task ahead, at pricing levels and tenors satisfactory to sponsors and government procuring agencies.

In this context, sponsors are seeking longer-term funding solutions, and are increasingly looking at ways to access both domestic and offshore institutional investors. Accessing long-term capital for long-term assets is not a new concept, given that longer-term financing options are a 'natural fit' for project financing because they better match the tenor of project revenues and the investment horizon of underlying investors. When project bonds were last part of the scene in Australia, pre-GFC, however, the only way to access debt financing from institutional investors such as pension funds and insurance companies was through the public bond markets. We are now in an environment where disintermediation has resulted in more direct funding options being available to sponsors. As tighter capital adequacy rules affect banks globally, institutional investors are provided with an opportunity to contribute, and will likely be required to contribute, to investments through project finance and other forms of debt investment rather than more traditional equity investments.

Increasingly, we are seeing Australian infrastructure sponsors looking to adopt flexible debt platforms that facilitate access to multiple sources of debt. This is in part being driven by issuers and sponsors looking at longer-term funding options, a diversification of debt sources and wanting to ensure they can access domestic and offshore institutional investors as and when the opportunity arises. The ability to take up these opportunities relies heavily on understanding the needs of different markets and investors, and how they can live together from an intercreditor perspective.

Where to from here?

While the peak of the latest privatisation cycle has likely passed, there are actual and prospective large-scale assets in the short to medium-term pipeline, and Australia remains an attractive (albeit slightly more challenging) destination for both local and offshore investors. Investors are willing to adapt by looking at alternative, non-traditional infrastructure or infrastructure-like assets as a means of achieving similar long-term, stable returns, by exploring emerging market investment opportunities, by looking to do more to sweat the assets they already own, and by evaluating the role that managers play in allowing investors to achieve their investment goals. While technological change is a risk of which investors are cognisant as they seek to achieve the almost impossible task of predicting what our cities and infrastructure will look like in 15 or 10 years, investors are also aware of the opportunities that technological advancement may present.

Despite the positive outlook for Australian infrastructure investment, political, legal and regulatory uncertainty is anathema to institutional investors. It is important to Australia's continued appeal that we have a speedy resolution to the Federal Government's review of stapled structures, and that the Critical Infrastructure Centre and foreign investment review in general continue to be viewed by overseas investors as additional, but objective and manageable, hurdles to investment.

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The Allens team, in alliance with Linklaters, has unrivalled experience helping superannuation funds, pension funds, sovereign wealth funds and life insurers invest around the world. We provide a seamless international service to our clients wherever they may be. Please contact one of the team if you have any questions.

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