THINKSTOCK

THE REAL DEAL

Investments in infrastructure and real estate are on the rise. How can smaller pension plans make inroads into these asset classes?

By ***Brooke Smith***

Life is a highway, but so is institutional investing—literally. More pension plans are investing in infrastructure and real estate as a means of diversifying their portfolios.

Pension investors are looking at these asset classes as a way to get away from equity risk, says Janet Rabovsky, director with Towers Watson. "They want the returns that *look* like equity but don't want the variability associated with it—the market volatility. The volatility [of real estate and infrastructure] is generally in between bonds and equities."

Jeff Mouland
Executive Director &
Co-Head of Infrastructure

David Vickerman
Executive Director &
Co-Head of Infrastructure

Q: Where are you seeing the best value in infrastructure assets?

For our clients, we feel the mid-market infrastructure space provides the best value proposition, both in terms of certainty of execution and "right-price" acquisition. With larger infrastructure managers and pension plans often targeting equity investments greater than $400MM, the number of investment opportunities available to this investor group are limited and sporadic. This results in intense competition through a bidding process to acquire the assets.

Our view is that an investment vehicle focusing on equity investments of $25MM - $150MM provides access to a more attractive opportunity set whereby deals are sourced through working relationships rather than a broad competitive auction process. The ability to proactively manage an acquisition from both a timing and valuation perspective allows investors to gain infrastructure exposure at the right valuation and in a timely manner.

Q: How does infrastructure align with the long-term objective of investors?

Investors are looking to Infrastructure to provide long term asset-liability matching, allowing for a predictable cash yield to meet corresponding pension liabilities. Our view advocates the use of open-end funds which provide a long-term vehicle with no predetermined asset divestiture date. Historically, infrastructure funds available to investors have evolved from the private equity model, typically structured as closed 10-year funds. A closed structure entails a defined investment period, regardless of opportunities available, as well as a set termination date, which typically does not align with the long term nature of the asset or investors.

GREYSTONE
MANAGED INVESTMENTS INC

According to BlackRock's *Global Survey of Institutional Investors,* just over 40% of respondents indicate they will increase their investment in real assets in 2014. And data from the Canadian Institutional Investment Network indicate that pension investments in both real estate equity and infrastructure have increased significantly year over year. Real estate equity increased to $86.51 million in 2012 from $55.43 million in 2008, while infrastructure increased to $43.66 million in 2012 from $20.15 million in 2008.

Yet, despite these jumps, Canadian pension plans with assets of less than $24.9 million allocated just 0.6% of their assets to real estate equity in 2012 and only 0.3% to infrastructure. By contrast, very large Canadian plans (those with more than $10 billion in assets) allocated 10.5% and 5.8%, respectively, in the same year.

Clearly, there's a size divide. Not all pension plans can invest in these asset classes the way the large plans do: directly (e.g., the pension plan owns the building or highway). "Larger institutions that are doing it directly realize that this is a very human capital-intensive business if you want to do it right," says Steve Iorio, head of portfolio management for AllianceBernstein's real estate investments group.

If smaller pension plans do not have enough of that capital, then how can they get access?

Getting the Green Light

What has helped is the evolution in infrastructure investing, Rabovsky explains. "Infrastructure funds originally were similar to private equity funds, created with a 10-year life. There was a big mismatch between the life of the asset and the life of the fund."

And managers used to use high levels of leverage, but leverage levels have gone down now, Rabovsky says, maintaining that good managers don't need to use as much. "What you really want is operational capability within the manager."

Manager fees have also decreased. Core real estate used to be priced at 1.5%, but now, pension investors should be able to get it for 1% or below, Rabovsky adds, depending on the size of their commitment.

In addition, smaller plans have the option of investing in listed real estate and listed infrastructure (i.e., publicly traded securities issued by companies that own and/or operate real estate or infrastructure assets). Smaller plans typically invest in infrastructure through the listed space simply because it's much less complicated, says Darren Spencer, director, alternative investment consulting - Americas institutional, with Russell Investments. He adds that the majority of the plans he sees at Russell choose this option. "It's just a much more efficient way of doing it," he explains. "You could invest in global listed infrastructure and have a global diversified portfolio of assets that provide good liquidity and good transparency."

Another way to invest is through open-end funds (in which investors can ask for their capital back, typically on a quarterly basis) or closed-end funds (in which there is not necessarily a set time for investors to remove their capital). There still aren't a lot of open-end funds in infrastructure, but they are very common in real estate.

"Open-end, for both real estate and infrastructure, means that it's a lot easier for smaller to mid-size plans to access because it's a vehicle that, from a governance perspective, is not going to imply an excessively burdensome administrative task," says Peter Muldowney, senior vice-president, institutional strategy, with

Connor, Clark & Lunn Financial Group. "Many closed-end funds have a specialist focus. Plan sponsors may be required to invest in multiple closed-end funds to obtain suitable diversification compared to that typically available through open-end funds, which adds to the administration burden."

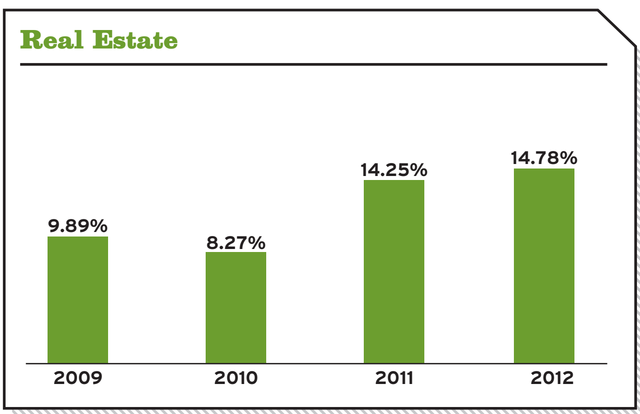
Another approach is to invest through a consortium, which investors may choose because they're trying to get access to lower costs, Rabovsky explains. Pension plans in Australia, the U.K. and Canada—think Halifax Regional Municipality Pension Plan and the New Brunswick Investment Management Corp. joining together with the Canada Pension Plan Investment Board for the 407 toll road deal in Toronto—have had success with this strategy. However, it's not the most popular way to invest, as consensus on policies and procedures can be challenging when more than one player is involved. "You've certainly seen it, but I don't think you've had a wholesale uptake in that approach," says Spencer.

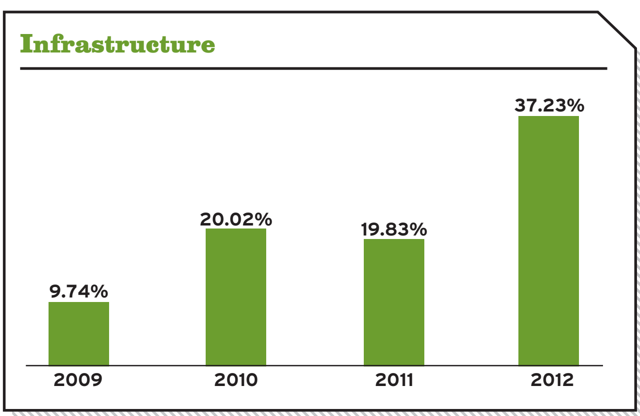
Common Roadblocks

One of the complexities of real estate and infrastructure is the administration required. "These are management-intensive assets," explains Brahm Cramer, co-head of real estate investments with AllianceBernstein. "Owning real estate around the world has different consequences. For example, any tax-exempt institution in Canada may not be tax-exempt in many structures in buying real estate in the U.S."

Canadian Pension Plan Allocations

Year-over-year rate of increase (in dollar value)





Source: Based on the top 1,000 pension plans in the Canadian Institutional Investment Network's database as of Dec. 31, 2012 (excluding the Canada Pension Plan Investment Board)

Jamie Storrow
Managing Director and Co-Head,
Northleaf's Infrastructure Investment Program

Q: How do you find attractive infrastructure deals in this competitive market?

Having a flexible mandate with broad portfolio guidelines is important, especially when particular regions or sectors become highly competitive and overheated. The ability to evaluate opportunities across geographies, sectors and alongside a diverse set of investment partners is important to being able to seek relative value. For example, while the Canadian infrastructure market is currently very competitive, other developed market jurisdictions offer more asset variety and better dynamics, leading to more attractive deal structures and returns.

Most "core" assets currently offer relatively low returns, and fund managers must have extensive relationships and active sourcing programs to identify the most promising opportunities – ideally those that lead to exclusive transactions alongside appropriate investment partners.

Q: With some core infrastructure transactions pricing tightly, how do you get comfortable with the projected net returns of assets that you are considering?

Every assumption counts. It is extremely important to focus on your underlying "base" investment case and associated downside protection embedded in the transaction. Ensuring that assumptions are conservative – and the upside potential outweighs possible downside scenarios – provides comfort in achieving a fair, conservative return.

Another important consideration is manager fees. The projected transaction return will not necessarily represent what the underlying investors will earn. Investors need to understand the fees that fund managers are charging as they create a meaningful drag on returns to investors. In particular, fund structures with carried interest-style performance fees are not well suited for investment strategies focused on core assets.

In addition, managers need to be strategic with the number of transactions on which they spend significant due diligence dollars and conscious of the stage at which money is spent. Limiting due diligence expenses to exclusive, late stage transactions limits the drag on investors' net returns.

Cinnamon Russell
Vice President,
Institutional Investments

Q: What trends are you seeing with clients in managing their real estate allocations?

In the past, Canadian plan sponsors that have incorporated real estate into their portfolios have typically opted for Canadian real estate. Although Canadian real estate has had strong performance in the past, competition in Canada remains fierce, thus continuing to push prices higher. As demand for limited stock of Canadian real estate continues to increase from domestic investors this should inevitably lead to downward pressure on capitalization rates.

An investment focus exclusively on the domestic Canadian market also severely limits the opportunity set as Canada represents just 5% of the developed real estate markets. We are seeing many plan sponsors looking to diversify their real estate allocations outside Canada by adding an investment in global real estate. We are also seeing particularly strong interest in U.S. direct real estate.

The rationale behind adding U.S. direct real estate is quite compelling. The U.S. represents a much larger market than Canada, which enables plan sponsors (or investors) to get access to a wider investment opportunity set. Additionally, allocating outside of the domestic economy provides stronger risk diversification in terms of economic and liquidity risks.

We see plan sponsors funding this investment in U.S. direct real estate by reallocating a portion of their existing real estate allocation, while others are increasing their initial allocation by diverting funds from allocations to fixed income.

Q: What are some things that plan sponsors should look for when investing beyond the Canadian real estate market?

When investing in real estate outside of Canada, plan sponsors should be looking for established real estate managers with structures that help address tax and reporting considerations associated with an investment in U.S. real estate.

Invesco

And manager selection can be challenging, since pension plan sponsors need to be prepared to ask the right questions. "For infrastructure, it's about how you get your deals—how you get that money invested—because price impacts returns," says Muldowney. "It's not just about getting the deal; it's how much you pay for it. It's important to understand how the investment manager generates their deals, which will impact how soon they will invest your cash, as well as understanding the potential return that they see going forward and reasons for why it may be different from the level of returns achieved historically."

Governance can also be a challenge, particularly through the consortium approach. "You've got to be in a position to effectively underwrite and do the tax and legal structuring on individual deals," Spencer says, adding that pension plans need the right partners that can do that effectively. And, even if the right governance structure is in place, there is still the issue of commonality. "Say you've got 10 different investors pooling—how does that get translated into a common strategy, a common governance framework?" says Spencer. "What's their exit strategy? How are they going to manage these assets operationally? All these things have to be taken into consideration."

World Tour

While most countries are receptive to the idea of investing in a bridge or a toll road, for example, the U.S. has proven to be the exception to date. "There's been a big reticence in the past to consider public-private partnerships other than energy," says Rabovsky. "Energy infrastructure has always been big in the U.S., but will things like transportation come to market?"

Still, while Australia and parts of Europe are seeing increased institutional investment in infrastructure, Rabovsky says the industry is also starting to see more investment in the developing countries. "They haven't had much of an investment focus—where they're concerned about investor rights, for example—but it's starting to change a little bit. Management teams are starting to understand that they have to consider their investors if they want to raise further funds."

As far as Canadian institutional investors are concerned, they still have a bias toward Canadian real assets. "Canadian plans hold a number of their assets in hard Canadian real estate investment," Cramer affirms. However, even with strong returns in Canada, Rabovsky says some of her clients are considering U.S. real estate assets, given the sector diversification they provide.

Going forward, industry experts predict returns in the high single digits. Global listed infrastructure is expected to deliver a return of 7% over the next 10 years, and private infrastructure, roughly 6.5% in the same time period. Core real estate will likely be around the 6% or 7% mark, and for core infrastructure, the expected return is 8% (net of fees).

With the current popularity of real estate investment, is there any fear that the days of double-digit returns are gone for good? Gary Whitelaw, CEO of Bentall Kennedy, sees returns moderating. "It is a less volatile asset class than others, but it still follows a cycle. Because of the financial crisis, we saw a short-term drop in valuations in Canada, followed by a very strong recovery in recent years. The long-term total return is just under 10%. As the Canadian business cycle moderates, we expect commercial real estate returns to revert to the long-term average. So we expect that high single-digit returns—with most of that coming from current

TOP 5 | REAL ESTATE MANAGERS

CPA = CANADIAN PENSION ASSETS
ASSETS (MILLIONS) AS OF JUNE 30, 2013

		2013 CPA	2012 CPA	% Variance
1	Bentall Kennedy (Canada) LP	$12,167.0	$10,940.0	↑11.2%
2	Morguard Investments Ltd.	$9,897.1	$8,996.0	↑10.0%
3	Brookfield Asset Management Inc.	$6,862.0	$7,357.0	↓6.7%
4	Greystone Managed Investments Inc.	$6,685.5	$5,573.3	↑20.0%
5	LaSalle Investment Management	$2,789.6	$2,809.2	↓0.7%

Source: Based on Canadian pension assets allocated to real estate investments per the Canadian Institutional Investment Network's fall 2013 money manager survey

income—will be more the norm for us in Canada for a while."

Even if returns do drop, Iorio still sees real estate as a positive investment. "While the pricing may creep up and the potential returns tick down to some extent, you could argue that it is a less-risky asset class in a sense that there's more liquidity to ultimately exit the investments."

The world is opening up for smaller pension plans to invest in infrastructure and real estate assets. The strategy takes thought and careful preparation, but that isn't stopping smaller plans.

"Because our big plans in Canada have actually been big investors in these areas, there's a certain comfort there," says Rabovsky. "[Smaller plans] have seen the success [that] Teachers', OMERS, CPP, bcIMC, AIMCo have had. They think, 'If they can do it, I can do it, too.'" BC

Brooke Smith is managing editor of *Benefits Canada*.
brooke.smith@rci.rogers.com