XPS Investment

Open-ended Infrastructure

How your pension scheme can benefit

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Open-ended Infrastructure

Last year the UK government called for there to be an 'Investment Big Bang' in UK infrastructure. But for some reason historically infrastructure seems to have been off the menu for many small and medium sized pension schemes.

In this note we observe some of the reasons why pension schemes have previously been reluctant to invest in infrastructure and why that could all be changing for the better with a relatively new and growing breed of open-ended infrastructure funds.

The merits of open-ended infrastructure in a nutshell:

1	Equity-like returns
2	Diversifier to traditional asset classes
3	Resilience to inflation
4	Moderate governance
5	Cashflow income
6	Illiquidity premium with liquidity akin to open-ended property funds
7	Scope to adopt sustainable theme within overall strategy

Introduction

Infrastructure is defined to be physical and organisational structures and facilities needed for the operation of society or enterprise. Different forms of infrastructure investment are available to pension schemes including private market equity, private market debt and listed assets.

This briefing note focuses on private market infrastructure equity which has been widely considered to be an asset class that is ideally suited to pension scheme investors. Notably its long-term nature and ability to provide stable cashflows. By their design, infrastructure projects are large in scale and long term in nature, requiring patient capital and in return, offering investors an illiquidity premium.

Within other pensions systems such as in Canada, private market infrastructure investments have been used much more extensively than in the UK. So, if infrastructure investing is so well-aligned with pension scheme goals, why haven't more UK pension schemes invested in it?

Traditionally infrastructure investing was something that only large schemes with complex strategies would consider, as the available funds would typically be closed-ended, highly illiquid and would also often be geographically concentrated requiring numerous funds to create a diversified exposure. Further, high target returns and high management fees stemming from the heavy use of leverage detracted from the investment case for many pension schemes.

In short, despite the merits of the underlying asset class, there has been a scarcity of suitable funds with the overall characteristics that pension schemes sought.

Categories of infrastructure

As with property classifications there are several broad categories of infrastructure investment:

		Manager's Target Return
Core	**High quality brownfield investments** (brownfield: relates to assets where construction costs are already covered and assets are fully operational). • Long term in nature and returns primarily driven by income, with limited downside risk and modest upside potential. • Often regulated or monopolistic such as electricity networks or toll roads.	**5-10%pa**
Core plus	**Mostly still brownfield assets** but with greater uncertainty over cashflow and some scope for capital appreciation. • Revenues are more susceptible to factors beyond their control such as inflation. • Returns, on balance, driven by income.	**8-12%pa**
Value Added	**Scope for significant upside potential** • Returns driven by capital appreciation in addition to income. • Includes brownfield sites with significant repurposing or development required along with certain greenfield investments (greenfield: relates to assets with development or construction risk).	**10-15%pa**
Opportunistic	**Returns driven heavily by capital appreciation** • May relate to risky development opportunities, risky geographic location or entities in financial or operational distress.	**15-20%pa**

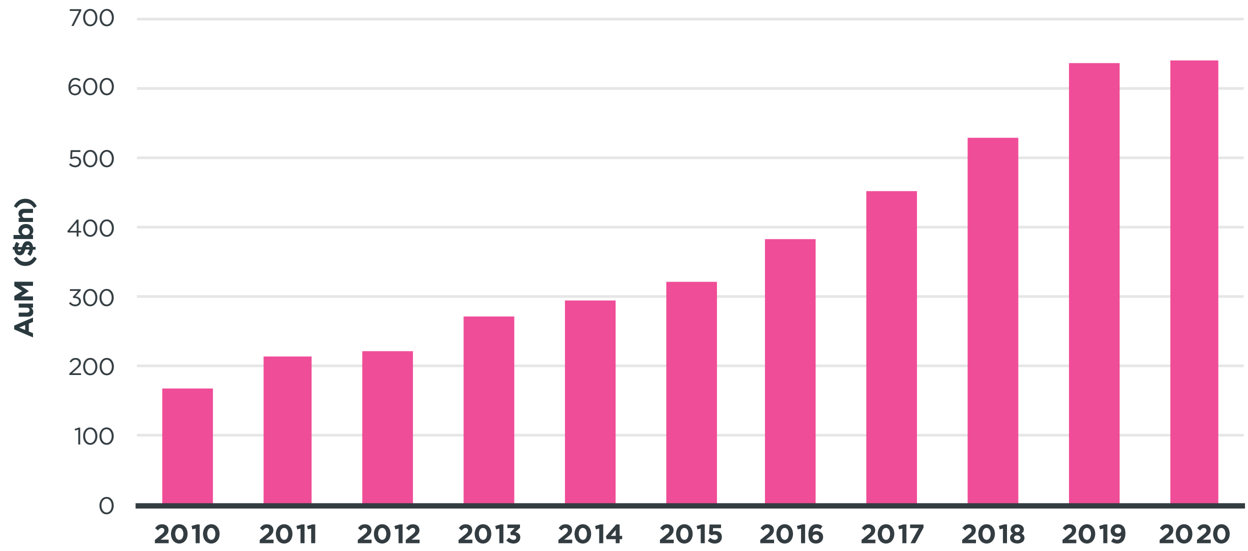
Rakhee Raja-Mistry
Investment Consultant

With more capital entering the market, infrastructure fund managers may seek to climb up the risk spectrum to deliver higher return targets. Proper assessment of managers including their processes and track records can help investors get a clear idea of the type of assets held and the manager's discipline.

Growth within infrastructure investing

Chart 1 below shows the growth in sums invested in unlisted infrastructure since 2010:

Chart 1: Unlisted Infrastructure Assets under Management



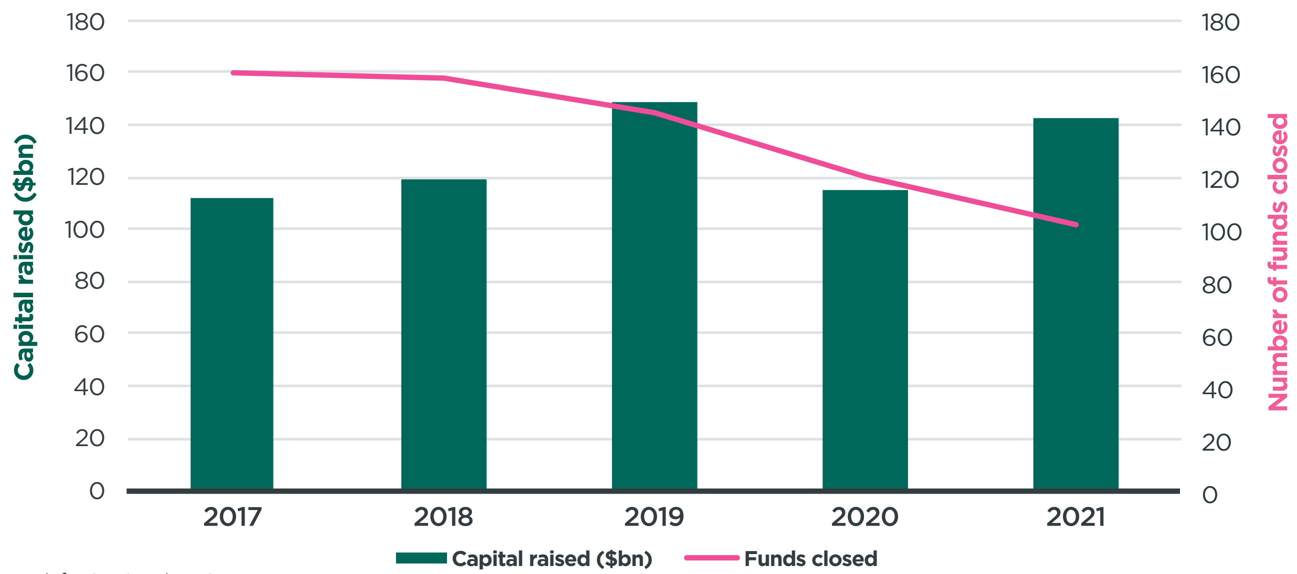
Source: Preqin Pro

From around $160bn of infrastructure investment in 2010, we can see that up to 2020 assets under management in the private sector have steeply progressed to just under $650bn.

Chart 2 below shows how since 2017, the amount of capital raised by funds has been relatively stable but the number of funds has decreased quite considerably. There appears to be a consensus in the infrastructure industry that there is a trend in the market towards what is described as 'mega funds'.

An area of particular interest for pension scheme looking for steady returns would be core and core plus strategies which raised $56bn in 2020 versus $6bn in 2012* – almost a 10x increase in eight years.

Chart 2: Year-on-year fundraising



Source: Infrastructure Investor

*__Source:__ First Sentier Investments

The opportunity within infrastructure including sustainability

The economic rationale of continued investment in infrastructure remains strong. Advancements in technology have increased the number of opportunities for replacement and renewal of existing infrastructure.

Infrastructure has an important role to play in the climate transition and the development of clean energy sources to reduce reliance on fossil fuels. In 2021 investment in the low-carbon energy transition totalled $755bn** globally. This was an increase of over 25% on investment in 2020.

Renewable energy has been one area of highly visible growth, with wind farms and solar farms replacing the common sight of coal fired power stations. These along with enhanced transmission lines and power tunnels to supply our increasing 'clean' electricity needs reflect only one of a number of sectors that require considerable investment in coming years.

It is important to appreciate however that renewable energy and other transition related areas don't guarantee that underlying companies are being run with a well balanced approach to ESG. Therefore investment managers should also be able to demonstrate how they factor in wider ESG considerations when making investment decisions even within these sectors.

However in addition to the sustainability theme, many other areas will also have critical roles in the ongoing development of the economy. These include transportation including roads and ports; social infrastructure like schools and hospitals; through to digital related infrastructure such as data transmission and data storage facilities.

****Source:** Bloomberg's New Energy Outlook

How to access infrastructure?

This is the area that arguably has created most new opportunity for pension funds of late. Traditionally infrastructure investment has been predominantly accessed via closed ended funds. But the growth in popularity and availability of open-ended funds, with some funds now very well established, enable far greater access by small and medium sized pension schemes. Developments in both mean they now offer wider scope for both geographical and entity level diversification than was historically available.

We contrast the two approaches below:

Closed-ended funds

Closed-ended funds are commonly used for many private market investments as the defined illiquidity over the term of the fund aligns well to illiquid assets.

All investors make commitments to invest during a relatively narrow investment window of 1-2 years before the fund has its 'final close'. This limits the size of the fund to the number of investors who can be corralled within that tight timescale.

Capital is then 'called' from investors gradually over the investment period (typically 2-3 years) when underlying investments are made. Proceeds of the investments are then distributed over following years when the assets are sold. Funds have a life of typically 10-12 years with some beyond 20 years.

The overall structure means that a fund gradually builds up the investment over time and subsequently gradually reduces towards the end of the fund's life as proceeds are paid out. In the meantime investor stakes cannot be bought and sold easily and so the investment is either held for the fund's entire life, or sold at a large discount in the secondary market in the event an investor needs to exit earlier than planned.

Open-ended funds

Open-ended funds are the typical way most investors access pooled liquid equity and bond funds but are also commonly used for illiquid assets such as property and some alternatives funds.

All assets are invested at outset and the manager needs to ensure there are sufficient liquid assets available to meet the liquidity terms of the fund. Market values need to be reliably estimated for the assets that can't be sold, for the purposes of performance monitoring and accurate valuation of units. This can in turn create challenges for ensuring equitable treatment of investors in the event that more investors want to leave the fund than can adequately be covered by the fund's liquidity buffers.

There are a various investor protections that can be employed to mitigate this such as queuing and fund gating, where funds temporarily close to trading. Strong internal controls are required to avoid some investors being disadvantaged. These protections have been tested with UK property funds following Brexit and COVID-19. However there have been a small number of high profile examples where large numbers of redemption orders combined with inadequate protections have led to investor detriment. Therefore this is a critical area that XPS assesses in considerable detail when assessing funds, to ensure potential scenarios can be managed appropriately. Whilst open-ended funds offer scope to be more liquid than their closed-ended counterparts, they are still an illiquid investment and should be considered as such.

Open-ended funds can have an indefinite investment time horizon and offer scope for a fund to continue to grow in size as new investors bring new capital over time. This creates scope for large funds with greater diversification as the investor base can build up over a period of decades.

Summary of the characteristics of closed and open-ended funds

The table below sets out a high-level summary of the key comparators when looking at the differences between closed and open-ended infrastructure funds:

Feature	Closed-ended funds	Open-ended funds
Fund structure	Limited liability partnership interest	Open-ended investment company, investment trust etc.
Liquidity	Typically lock-in period of 10+ years	Quarterly dealing with an initial lock in period of say 3 years
Performance measurement	More complex as capital is not invested at the outset. Internal Rate of Return (% IRR) and Multiple of capital invested are common measures	More straight forward as capital is invested at the outset. Traditional time-weighted % return on capital invested commonly used
Number of holdings	8-25 typical holdings, although fund of funds can be very highly diversified	Scope to access over 100+ underlying investments
Regional concentration	Funds offering single region or diversified exposure across UK, Europe, US and Asia	Funds offering single region or diversified exposure across UK, Europe, US and Asia
Expected return	Very high – range of return IRR of 8% to 14%+ p.a.	High – range of return IRR of 4% to 8% p.a.
Minimum investment	High – range from £10m to £20m	Low to medium – range from £250,000 to £10m
Management fees	Fees likely to be relatively high – e.g. 0.8% to 1.5% base fees with performance fees of 10%-20%	Fees slightly lower – e.g. 0.5%-1.0% with performance fees ranging from zero to 15%

In recent years we have witnessed a steady but notable increase in the number of open-ended funds coming to the market which invest in diversified global infrastructure projects across a range of target return categories often focusing on the core and core plus end of the spectrum.

This has brought with it an increasing opportunity for pension schemes to incorporate infrastructure equity within their strategy. We have had good experience of open-ended infrastructure funds over recent years and XPS recently conducted a full market search to identify funds that specifically pursue sustainable and impact investment. We have a full suite of funds including traditional and sustainable versions to meet a range of requirements.

Tom platt
Investment Consultant

Whilst many might think that investing in open-ended funds is an attractive approach due to the scope for greater liquidity, conversely their appeal for many pension schemes comes from the ability for capital to be invested for *longer* periods without having to recycle proceeds into new funds.

What role could open-ended infrastructure play in a portfolio?

A driver for returns

Overall returns similar to listed equity markets. The underlying investments whilst commonly high quality, are still relatively illiquid which allow investors to benefit from the illiquidity premium from locking money away for a period of time.

Diversification from equities

Infrastructure as an asset class tends to be less correlated with public equity markets.

Resilience to inflation

Some underlying revenues can be linked to inflation which provides greater organisational stability in a high inflation scenario.

Modest governance

All capital is invested upfront without need for drawdowns and distributions.

Stable cashflows

Investments often distribute income received from the underlying holdings which provide stable cashflows for schemes.

Alignment with ESG policy

There is scope to pursue sustainable and impact themes via a specific infrastructure investment.

Summary

There has been a clear progression in terms of the availability of funds to meet a wider range of pension scheme requirements ranging from more accessible diversified infrastructure through to sustainable and impact funds.

These assets remain illiquid investments, but with good quality offerings catering for a wider range of requirements, the scope for pension schemes to benefit from investing in infrastructure, and share the benefit that this will create for society, is significant.

Whilst open-ended infrastructure gives some element of flexibility around this aspect it isn't a means of bypassing the fundamentally illiquid nature of the underlying investments. However, where there is a role for a longer term assets with a higher return profile, open-ended infrastructure is a worthy contender, with a strong economic case and favourable attributes that align with pension schemes.

The immediate opportunity would appear to be primarily for Defined Benefit (DB) schemes, given more structural challenges that the Defined Contribution (DC) market is in the process of seeking to overcome in terms of providing mainstream investment in illiquid assets. However, there is scope for open-ended funds to be modified for DC investors, through the addition of greater cash balances and other modest operational adjustments. This has been seen in practice with DC property funds and demonstrates the wider benefits that are likely to flow from the greater availability of open-ended funds.

Actions for trustees

- **Review your current portfolio:** consider if the portfolio would benefit from an equity-like return with diversification from equities and some illiquidity premium
- **Consider liquidity in your strategy:** test the liquidity profile of your investments and the impact an infrastructure investment would have on overall risk
- **Long term targets:** look at the longer term evolution of your journey plan and consider how an illiquid asset will complement your strategy both now and in the future
- **Undertake training:** looking at the features of specific funds that might be considered
- **Fund selection:** The final step would be an exercise to appoint a specific fund that meets your needs

If you would like to find out more on how you can pursue further opportunities in infrastructure please contact Simeon Willis, Rakhee Raja-Mistry or Tom Platt:

Simeon Willis
Chief Investment Officer
t 020 3967 3895
e simeon.willis@xpsgroup.com

Tom Platt
Investment Consultant
t 0118 918 5722
e thomas.platt@xpsgroup.com

Rakhee Raja-Mistry
Investment Consultant
t 0118 918 5413
e rakhee.raja-mistry@xpsgroup.com

@xpsgroup
company/xpsgroup

Alternatively, please speak to your usual XPS Investment contact.

About us

XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 968,000 members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 51 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £140bn of assets under advice.

Contact us
xpsgroup.com

Belfast
T: 028 9032 8282

1st Floor – Flax House
83-91 Adelaide Street
Belfast
BT2 8FF

Birmingham
T: 0121 230 1900

1 Colmore Row
Birmingham
B3 2BJ

Bristol
T: 0117 202 0400

One Temple Quay
Temple Back East
Bristol
BS1 6DZ

Chelmsford
T: 01245 673 500

Priory Place
New London Road
Chelmsford
CM2 0PP

Edinburgh
T: 0131 370 2600

3rd Floor – West Wing
40 Torphichen Street
Edinburgh
EH3 8JB

Guildford
T: 01483 330 100

Tempus Court
Onslow Street
Guildford
GU1 4SS

Leeds
T: 0113 244 0200

1 City Square
Leeds
LS1 2ES

London
T: 020 3967 3895

11 Strand
London
WC2N 5HR

Manchester
T: 0161 393 6860

10th Floor Chancery Place
50 Brown Street
Manchester
M2 2JG

Middlesbrough
T: 01642 030 718

Building Two
Centre Square
Middlesbrough
TS1 2BF

Newcastle
T: 0191 341 0660

4th Floor – Wellbar Central
Gallowgate
Newcastle
NE1 4TD

Perth
T: 01738 503 400

Saltire House
3 Whitefriars Crescent
Perth
PH2 0PA

Portsmouth
T: 023 94 31 11 66

One Port Way
Port Solent
Portsmouth
PO6 4TY

Reading
T: 0118 918 5000

Phoenix House
1 Station Hill
Reading
RG1 1NB

Stirling
T: 01786 237 042

Scotia House
Castle Business Park
Stirling
FK9 4TZ

Wokingham
T: 0118 313 0700

Albion
Fishponds Road
Wokingham
RG41 2QE

Please direct all email enquiries to:
E: enquiries@xpsgroup.com

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2208002_4