



Direct vs. Listed Infrastructure

Summary

Most investors now accept the advantages of an asset allocation to infrastructure within a portfolio. The challenge has been gaining access to the universe of infrastructure assets. In the past access has been very limited with most assets under Government ownership. Public private partnerships and privatizations have increased the number of investment opportunities to investors, whilst creating a choice of asset holding structures (direct investment versus public listed equity).

RARE believes that since the advantages of infrastructure investments are based on asset level characteristics; there should be no difference to investors based on choice of holding structure. However in the real world differences are observed. RARE notes that many of these differences become insignificant when measurement factors, such as valuation interval, are changed.

RARE considers that, in the long term, a portfolio of listed unique infrastructure assets can be considered as a *substitute* for a portfolio of direct infrastructure holdings. However, in the medium term, there is evidence that a combination of listed and direct infrastructure can be *complementary* and add to portfolio diversification and returns.

Underlying nature of Infrastructure assets

The value of infrastructure as an asset class to investors is determined by the extent to which these assets represent a unique investment opportunity that is uncorrelated with existing asset classes within the Investor's portfolio. RARE believes that infrastructure assets should exhibit lower volatility of earnings and cashflows compared with general equities. The primary reason is the relatively low correlation of infrastructure earnings to large macro economic risk factors such as GDP and inflation.

Fundamentally there should be little or no difference in the investment attractions of an asset according to the structure through which the asset is held. I.e. an equity interest in a pipeline should give the investor the same risk return exposure whether it is held directly, though an unlisted fund or through a publically listed entity.

However, in the real world, differences are observed. The most obvious difference is in the volatility of returns. Based on the periodic, and somewhat subjective, valuation points (generally semi-annual), returns from direct infrastructure investments are held to be more stable and less correlated to general equity markets. This apparent stability has often been used as an argument behind the higher valuations (and gearing) in direct infrastructure transactions compared with listed comparables. Interestingly this has created a situation at odds with the traditional concept of the 'illiquidity discount' – in this case direct investments attract a premium for the lack of measured volatility.

Observed differences between listed and unlisted comparable assets

	Average monthly return	Std. deviation	Correlation with MSCI Global
MSCI	0.4%	3.9%	1.00
Listed infrastructure	1.3%	4.9%	0.65
Direct infrastructure	0.9%	3.4%	0.23

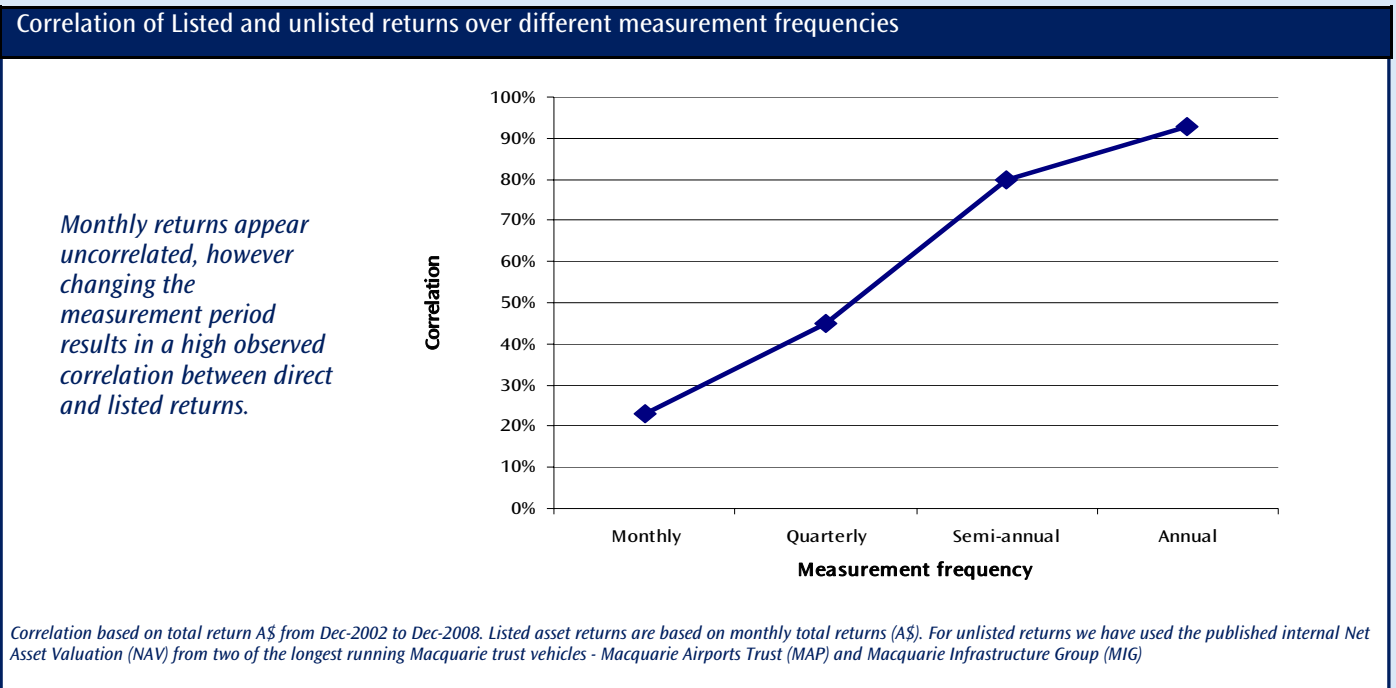
Direct infrastructure appears to have lower volatility and lower market correlation

Dec 2002 to Dec 2008 AUD total return

Source: MSCI and listed returns, Bloomberg; Direct composite group: published NAB valuations from listed tollroad and airport holding companies

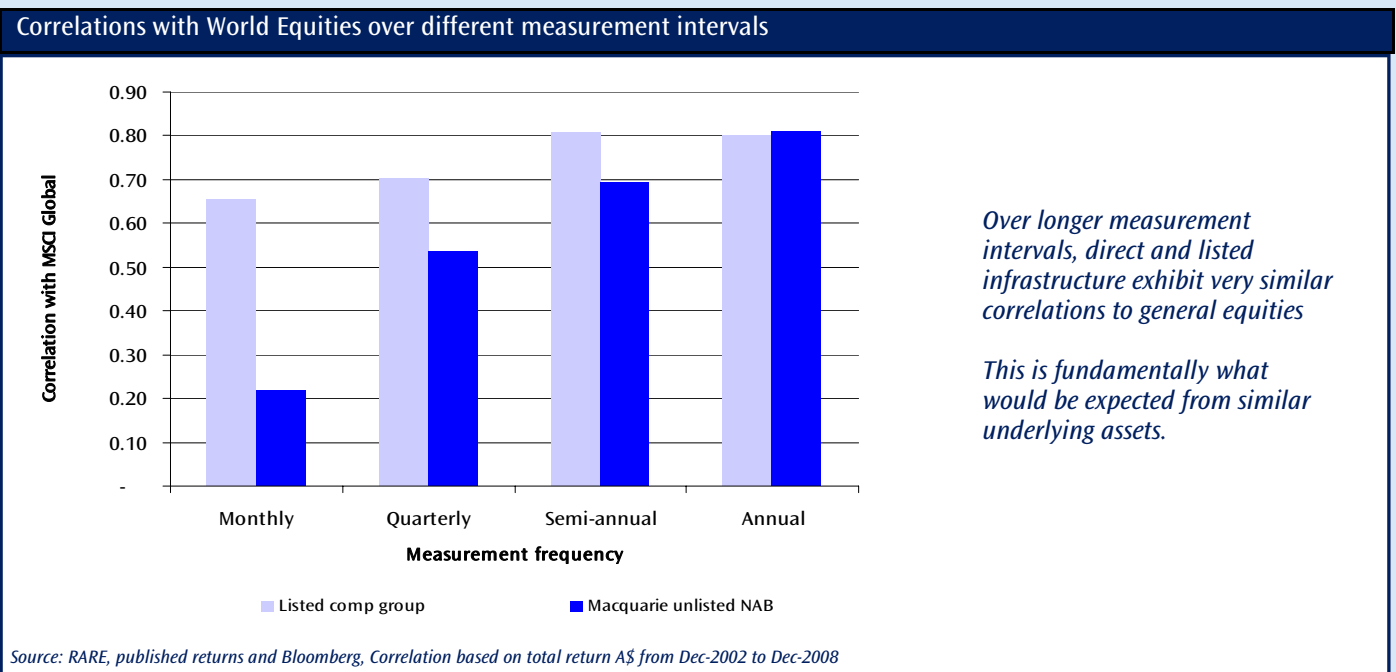
The influence of measurement interval and holding period on returns

RARE has conducted a comparison analysis of historic returns from direct vs. listed assets. RARE constructed a return series from both groups over different time intervals, from monthly to annual. The chart below shows the correlation between the two series returns over each measurement interval.



Using a monthly time series yields a very low correlation between the returns, producing the odd situation of low correlation between fundamentally similar assets. However this situation largely disappears as the measurement interval increases, suggesting the underlying returns are more highly correlated.

RARE also measured the correlation of both sets of returns with the MSCI Global (proxying for general equities). The chart below shows the correlation between the infrastructure group and the MSCI Global over different measurement intervals.



Obviously correlations fluctuate over time (and have recently increased over many asset classes due to the credit crunch). However RARE believes that there is good evidence that much of the measured difference between direct and listed infrastructure can be ascribed to measurement timing and interval.

Other practical differences that could cause disconnect between the performance of the underlying asset and the performance of the investment include fees, agency costs, diversification and financial structure. For listed infrastructure the key issues which have led to more return volatility (and more market beta) are diversification and exposure to non-infrastructure, non-regulated assets. As a result RARE's investment approach is to focus on 'pure' infrastructure assets and to avoid complex, diversified structures which can add volatility.

Combining Direct and Listed Infrastructure as an investment strategy

RARE sees three potential benefits from an investment approach that used both listed and direct infrastructure:

- Correlation – over shorter time periods there are some diversification benefits to holding both listed and direct Infrastructure given the low (0.2) correlation between the assets
- Liquidity – an allocation to listed Infrastructure will ensure a minimum level of liquidity and enable investors to manage exposure levels to the sector
- Supply and demand arbitrage – given the small size of the direct market it is more susceptible than most asset markets to supply / demand imbalances. This has the potential to create valuation bubbles and troughs (and indeed current evidence is that we are still trending downwards from a large bubble). For investors with both listed and direct infrastructure this offers the opportunity to create additional returns through arbitrage between the two assets.

Short term correlation

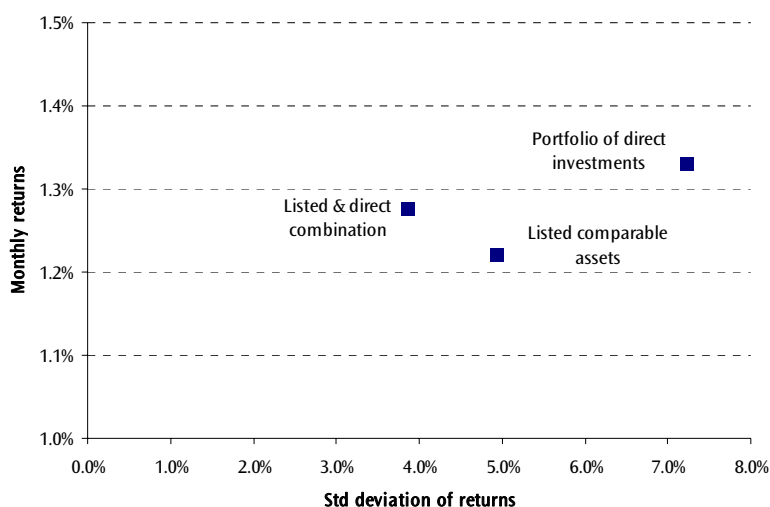
Analysis of the difference between long term risk and return of direct versus listed infrastructure suggests that, from a portfolio construction perspective, they can be considered as substitutes. However there is also evidence that, over short time periods, there is the potential to earn an incremental return through managing exposure through both listed and direct infrastructure assets.

The chart below shows the risk return profile (as measured by monthly returns vs std deviation of monthly returns) for a pure portfolio of direct assets (using the proxy direct return series from the previous section), a pure portfolio of listed assets (using the comparison group from the previous section) and a 50:50 combination of the two.

As expected, when measured using monthly returns, there is a clear diversification benefit from holding both listed and unlisted.

Risk return profile of a combination of listed and direct infrastructure (Dec-96 to Dec-2008)

Over shorter time periods there is a diversification benefit from holding assets with lower correlations



Source: RARE calculations, published unlisted NAVs and Bloomberg

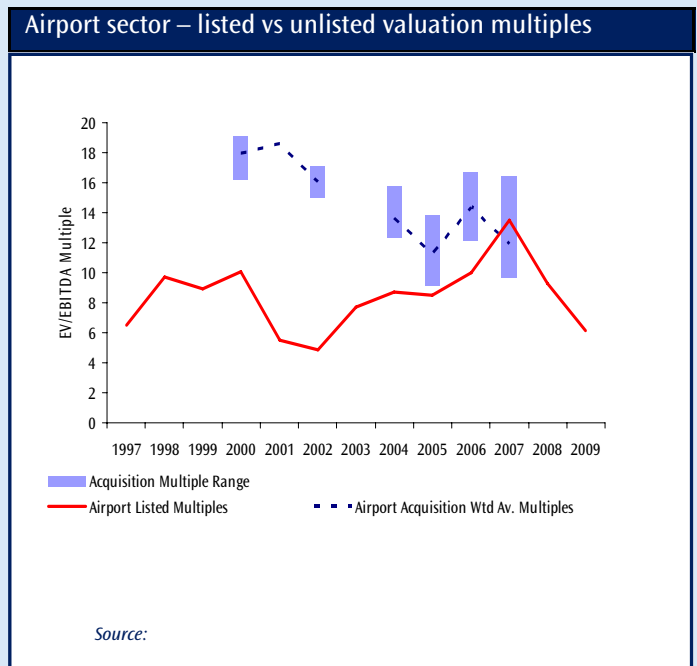
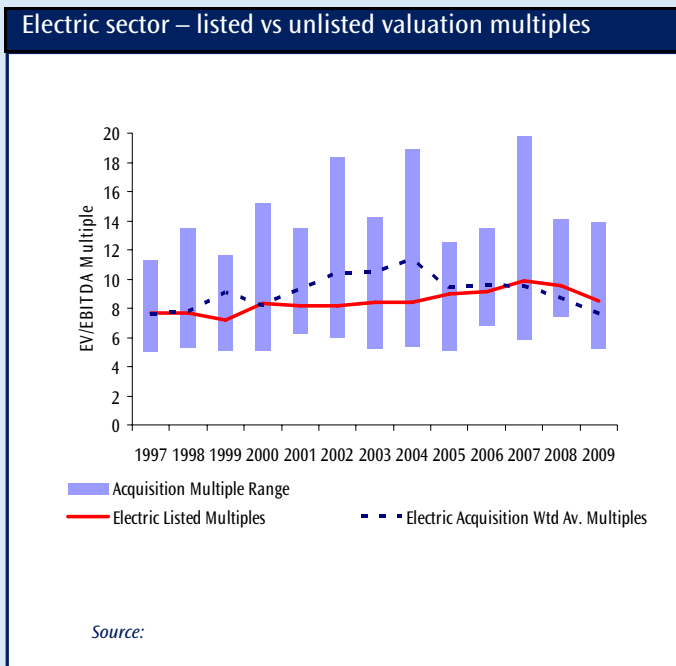
Liquidity

An added benefit of a combination of listed and direct infrastructure is additional liquidity. Low liquidity in direct investments can present a problem when managing overall portfolio exposures. The timing of capital contributions or returns are infrequent and often not at the discretion of investors. Hence investors in direct infrastructure can find themselves materially over or underweight the asset class for extended periods of time. In this case a combination of direct and listed infrastructure could be used to construct and maintain a target exposure that can be effectively managed within a portfolio.

Supply and demand arbitrage

Lack of liquidity in an investment can cause problems when trying to sell. However it can also cause problems when trying to buy, especially if there are a small number of potential assets and a large number of willing buyers. When this is combined with a lack of alternative investments, prices can quickly exceed 'fair value'.

The charts below compare the history of direct asset acquisition valuations versus comparable listed valuations for the electric and airport sectors.



RARE believes that the apparent arbitrage opportunities in the Airport sector (and conversely the lack of arbitrage in the electric sector) is a result difference in the relative balance between the availability of assets and the number of direct asset investors.

RARE believes that it is possible for investors to take advantage of valuation arbitrage opportunities arising from supply / demand imbalances in direct asset investment. An investment strategy that combined both listed and direct investments could potentially add returns through selective switching between direct and listed according to the stage of the supply / demand cycle.

Conclusion – long term substitutes, medium term complements

Over the long term, there should be little difference between returns of listed vs direct investments in similar assets. However in the medium term there are good reasons to believe that an investment strategy that combines listed and direct infrastructure can add incremental value to a portfolio compared with direct or listed alone.

- Correlation – over shorter time periods there are some diversification benefits to holding both listed and direct Infrastructure given the low (0.2) correlation between the assets
- Liquidity – an allocation to listed Infrastructure will ensure a minimum level of liquidity and enable investors to manage exposure levels to the sector
- Supply and demand arbitrage – given the small size of the direct market it is more susceptible than most asset markets to supply / demand imbalances. This has the potential to create valuation bubbles and troughs (and indeed current evidence is that we are still trending downwards from a large bubble). For investors with both listed and direct infrastructure this offers the opportunity to create additional returns through arbitrage between the two assets.

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