

Challenges of Financing Infrastructure

ASFA Paper

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State of Play

According to research from Rice Warner, APRA regulated superannuation funds in Australia allocate around five per cent of their total asset allocation to infrastructure assets. Not all superannuation funds invest in infrastructure. Of the one-third of superannuation funds that do, infrastructure investment can make up between two and 10 per cent of the total portfolio.

It is projected that over the next 15 years the amount of funds in the superannuation system could rise to \$5 trillion. It is also likely that there will be a structural shift in the composition of the superannuation system as baby boomers move into retirement. It is projected that the percentage of assets in retirement products will increase over the next 15 years from a current 30 per cent of all superannuation assets to 35.6 per cent, or \$365,582 million to \$1,035,959 million.

As the superannuation industry's Funds Under Management (FUM) grows, we are also likely to see a consolidation in the number of funds, resulting in a smaller number of larger funds over the next 15 years. There is potential for regulatory changes that will result in the establishment of investment criteria based around meeting absolute returns. This would enable superannuation funds to focus on investment in assets in the real economy.

The projected changes to superannuation provide a strong potential for future investment by superannuation funds in infrastructure. Key changes that ASFA expects include:

- The growth of overall funds under management with similar levels of allocation to infrastructure investment will result in significant increase in the overall amount of funds invested
- Fund consolidation is likely to provide superannuation funds with greater ability to build expertise in infrastructure investment and enable investments of scale.
- Changing demographics will result in increased demand for retirement products that will be supportive for infrastructure investments with low volatility and long term investment horizons.

However while the potential for superannuation funds to invest in infrastructure is strong, there are no guarantees that this will come to fruition.

Blockages that prevent the optimal investment in infrastructure assets include:

- Costs of bidding for projects
- Sovereign Risk and Governance Risks
- Valuation issues at height of GFC
- Infrastructure investment expertise
- Pipeline of investment opportunities
- Regulatory changes that can impact investment risk including OHS, changes to taxation

Benefits of infrastructure investment to the national economy

Investment in infrastructure can play an important role in boosting national productivity. Research has demonstrated the potential for network effects to apply. That is, investment in infrastructure can have a system wide benefit by for instance improving the efficiency of the whole road system.

There is also the potential for infrastructure investment to facilitate the transition to a low carbon economy. This can be through investment in assets including pilot renewable energy power stations and public transport infrastructure.

Superannuation funds are universal owners, that is, they are invested in the whole economy. As such, productivity improvements that directly benefit the whole economy as a result of investment in infrastructure assets will benefit superannuation funds in other parts of their portfolios.

A lot has been said in the past about the potential role of superannuation funds to finance infrastructure. There is an element of Ground Hog Day in these conversations.

We are in danger of developing a national habit of seeing superannuation as the panacea to all the nation's problems. It is a common occurrence for there to be a call for superannuation funds to invest to solving national problems.

While there may be a role for superannuation funds to play in financing investments that contribute to solving national problems we shouldn't treat superannuation as the 'rich aunty' that will turn up when called for.

And that has been what has been happening.

When the Federal and State budgets were strong, governments chose to finance their own infrastructure. At that time the role of superannuation funds was minimal.

Rather than focusing on repeating the arguments around the potential for superannuation funds to invest in infrastructure it is worth focusing on the obstacles and examining some ideas as to how they can be overcome.

While the superannuation industry has demonstrated a willingness to invest in infrastructure assets the voice of the superannuation sector has not always been heard when it comes to future infrastructure investment opportunities.

ASFA believes that the superannuation sector needs to become a permanent partner at the table when there is talk of infrastructure investment. There is a need to move from looking at infrastructure investment by institutional investors on an asset by asset basis to developing a comprehensive national strategy based on a 20 year investment timeline.

The role of infrastructure in an investment portfolio

Australian superannuation funds have a long history of investing in infrastructure assets. The role of Australian super funds as early investors in infrastructure is one of the reasons why as a nation we have fund managers that have now taken their expertise to international investors.

Superannuation funds are subject to a number of changes that will impact on potential for future infrastructure investment:

Demographics: it is projected that the percentage of assets in retirement products will increase from a current 30 per cent of all superannuation assets to 35.6 per cent, or \$365,582 million to \$1,035,959 million, by 2025.

Fund Consolidation: The number of superannuation funds will consolidate over the next 15 years resulting in a smaller number of larger funds. Funds will have greater in-house capacity including infrastructure investment professionals.

MySuper: The introduction of MySuper as the default superannuation for members that do not make a choice will result in reduced fees. It is likely that there will be significant pressure on investment managers, including infrastructure investors to reduce investment fees.

Risk Profiles: A move away from describing risk according to asset class will enable new innovations that will enable infrastructure investments to be structured for different investment profiles.

The actual range of investments by a super fund depends on a number of factors. Some superannuation funds do not invest in infrastructure whilst others may invest over 10 per cent of their assets. Typical allocations range between 2 per cent of assets to over 10 per cent. More super funds invest in domestic infrastructure than overseas infrastructure assets. Where funds do invest in overseas infrastructure they also invest in domestic infrastructure. In addition to investing in listed and unlisted assets superannuation funds are also exposed to infrastructure through their investments in listed companies that invest in infrastructure assets.

Infrastructure investment only forms part of super fund investment portfolio. Only a minority of superannuation funds (less than a third) have significant exposures to infrastructure.

Liquidity and valuation issues can limit the attractiveness of infrastructure investment for funds which have daily unit pricing and/or significant volatility in inflow and outflows of account balances. Infrastructure investment is much more common in larger industry and public sector funds which have reasonably predictable (and positive) net contribution flows. A fund also has to be reasonably large to achieve sufficient diversification when investing in infrastructure and/or needs to invest through a consortium to help spread the risks of any one investment.

It is important to understand how infrastructure is defined in an overall portfolio context. At an asset class level, infrastructure has the following features:

- Diversification – infrastructure tends to have a low correlation over time with other asset classes.
- Low performance volatility – given the long-term nature of infrastructure assets, performance should be less impacted by short-term market sentiment.
- Illiquidity – unlisted investments are considered illiquid with only limited options for investors to realise their investments. Individual funds may have defined liquidity events.
- Cash yield – in the case of mature and operational assets, the predictable and stable cash generative ability of infrastructure assets is likely to mean that the assets can return consistent cash yields to investors.

Infrastructure investments have an expectation of delivering an investment return in the order of 15-25 per cent per annum. The investment return expectation is based on a definition of risk of infrastructure investment as a growth investment.

Superannuation funds currently define risk in terms of asset classes. Asset classes include property, equities, fixed interest and cash. Infrastructure is generally described as an alternative investment, a grouping of growth investments that also includes hedge funds.

There is currently a debate in the superannuation industry around the definition of risk. There is broad recognition that there is a limitation to describing an asset class in terms of risk. For instance fixed interest is defined as having a lower risk of a negative return than equities. However it is quite possible to have fixed interest investments – Greek bonds for instance – that are more risky than certain equities investments.

The work that the superannuation industry is doing to move away from an asset class definition of risk has implications for future structure of infrastructure investments, enabling investments to be structured that suit individual investment profiles.

There is the potential that infrastructure investments can be structured to suit a variety of different investment profiles. For instance, low risk infrastructure investment opportunities can be structured to be suitable for retirees looking for low volatility whilst high growth investment opportunities that contain construction and development risk can be tailored for those with more aggressive investment expectations.

Future infrastructure investment should be structured to:

- Enable smaller investors to access infrastructure investments via a variety of different products
- Create opportunities that suit a variety of investment profiles including retirees who will require different investment products that provide lower volatility and steady investment returns

Achieving the above two objectives will require a significant shift in the way that infrastructure deals are structured.

Currently deals are structured principally through consortiums made up of constructors and banks that parcel up investments that are off-loaded to the final investors. There is the potential to structure future infrastructure investments in a way that results in a better outcome for long term investors in infrastructure assets.

National Investment Pipeline

An ongoing complaint of the superannuation sector is the absence of a long-term pipeline of investment opportunities.

From an investment perspective when super funds can't find investment opportunities in Australia, they will find them elsewhere.

Australian infrastructure investment funds now actively pursue infrastructure investment opportunities overseas. This is a good thing in terms of diversification but from a policy perspective there is a benefit in maximising Australian super funds investment in Australia.

It cannot be assumed that superannuation funds will be as willing in the future to invest in infrastructure assets as they have in the past.

One of the reasons that superannuation funds have been able to finance large, lumpy infrastructure investment is because superannuation funds are still in an accumulation phase and are experiencing strong cash-flows.

Over the next 20 years as baby-boomers move into retirement phase it is to be expected that the cash-flows of superannuation funds will change. This will not make it impossible to fund investments, but it will mean that superannuation funds will need to plan ahead for any lumpy investments.

There are currently two conversations around infrastructure pipelines. The first is the pipeline for construction constructors. The second is the pipeline for investors. The issues involved are different and need to be treated separately.

ASFA believes that there is the need to reach agreement on the role that investors will play in financing infrastructure over a 20 year investment horizon.

Establishing a national investment pipeline would help superannuation funds to plan future infrastructure investments that are notoriously lumpy.

ASFA believes that there is merit in Infrastructure Australia establishing a permanent infrastructure financing working group that brings together investors with government. The group would provide a place for exchange of views outside the negotiation of a particular deal and would enable the development of standardised approaches to investment and sharing of best practices in an open, transparent forum.

Infrastructure Investment Centre for Excellence

Most of the conversations that take place around infrastructure investment take place amongst people with vested interests. Government has a view on how it wants infrastructure investments to operate and investors have a view on how infrastructure investments will fit in their portfolio.

An independent national centre for excellence, perhaps housed in our universities would create a place where best practice can be explored and innovations developed with the aim of developing new innovative financing models, exploring new greenfield investment opportunities and developing a new generation of infrastructure investment expertise. The centre would have the benefit of being independent of all parties, but with involvement through collaborative partnerships of all. If we are genuinely serious about there being a long term role for superannuation funds to play in infrastructure investment then we should be prepared to develop supporting infrastructure.

Conclusions

In conclusion ASFA is recommending:

- The superannuation sector needs to become a permanent partner at the table when there is talk of infrastructure investment. It is recommended that a permanent infrastructure financing working group be established that brings together investors with government on a national basis with participation of all state governments.
- The establishment of a 20 year national investment pipeline that would help superannuation funds to plan future infrastructure investment.
- The development of a new approach to infrastructure investment that will enable smaller investors to access infrastructure investments and create opportunities to suit a variety of investment profiles including retirees who will require different investment products that provide lower volatility and steady investment returns.
- The establishment of a national centre for excellence for infrastructure investment that would create a place where best practice can be explored and innovations developed with the aim of developing new innovative financing models, exploring new greenfield investment opportunities and developing a new generation of infrastructure investment expertise.