Brookfield

INFRASTRUCTURE

Not All Infrastructure Is Created Equal: Defining ‘Core’

As allocations to infrastructure have grown, many investors have become familiar with the labels used to describe these investments, including “core,” “core plus” and “value add.”

Yet unlike other private market asset classes like real estate, where there is a consensus on the classifications of these risk profiles, the various categories of infrastructure are less precise, and significant differences are often found in how these labels are used.

As an asset class, infrastructure has proven its resilience throughout market cycles. However, periods of market volatility have highlighted how these risk profiles can be misleading—and have served as a reminder that not all infrastructure is created equal.

The cash flow stability and performance of some assets classified under the same risk profile label have varied during periods of market volatility. And, depending on the magnitude and nature of the variability, value may have been affected as well.

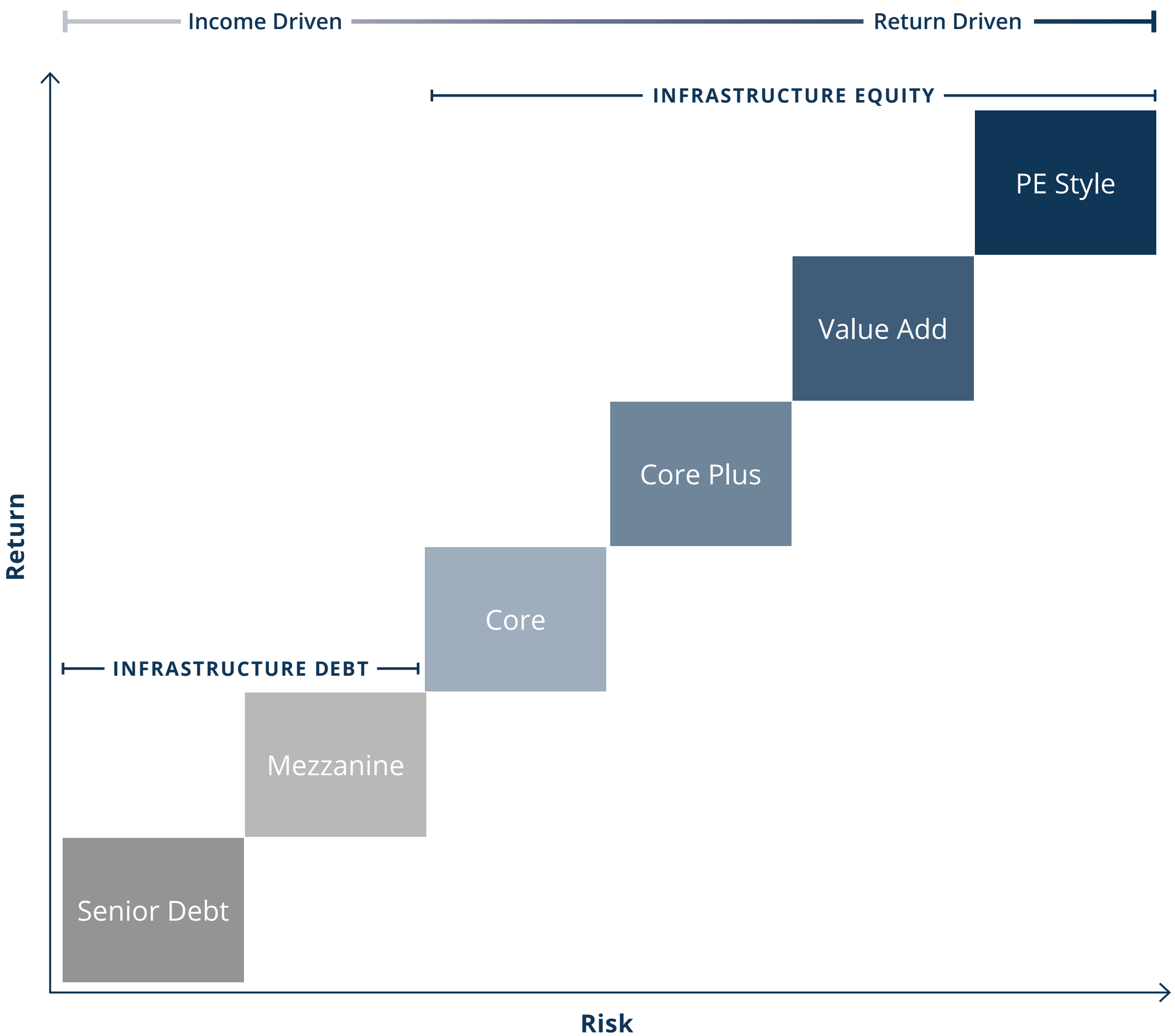
Today, many infrastructure managers describe their investment strategies as core, yet the target gross returns they state can range from less than 8% to over 15%. Clearly, they cannot all have the same definition of core.

Investors, therefore, should not rely on these labels and assume that one strategy’s definition of core is the same as another’s. Instead, they must dig deeper to truly understand the underlying risk profile of a particular strategy (see Figure 1). This is especially relevant in today’s low interest rate environment, where some institutional investors have shifted allocations from fixed income to core infrastructure.

Brookfield invests across the infrastructure risk spectrum, and defines core as investments in lower-risk essential assets with long-term visibility of cash flows. It also includes specific attributes that make the investments resilient in most economic environments and should produce strong-risk adjusted returns.

FIGURE 1

What's in a Name?



The Infrastructure Universe

Infrastructure assets are the networks and systems that provide essential services, facilitate economic activity and enable the movement or storage of goods, water, energy, data and people.

They include, among others, utilities (electric, gas and water networks), renewable power assets (hydro, wind and solar generation), transport assets (seaports, airports, toll roads and rail), midstream networks (pipelines, processing and storage), data infrastructure (telecommunication towers, data centers and fiber) and social infrastructure (hospitals, schools and public facilities).

These assets exhibit similar key characteristics. They are capital-intensive with high barriers to entry, have low demand elasticity, have a long operational and useful life, and generate relatively stable long-term cash flows.

Despite on the surface looking similar, virtually no two infrastructure assets are alike. They span the globe, cover many different sectors, are at different stages of project lifecycle and vary widely regarding revenue frameworks, cash flow profiles and risk profiles.

Defining the Risk Profile

What distinguishes core infrastructure investments is their lower risk profile relative to other infrastructure investments. For core infrastructure investments, investors must look for essential assets with specific attributes that we believe make a core infrastructure investment more resilient in any economic environment (see Figure 2).

FIGURE 2

Risk Attributes of an Infrastructure Asset

	← Lower — RISK	— Higher →
Cash Flow Profile	Regulated or contracted	Dependent on volume and price
Geography	Developed Markets	Emerging Markets
Volume and Pricing Sensitivity	Low	High
Operational Maturity	Mature	Under Development
Restructuring Requirements	Stable	Restructuring Required
Initial Asset Yield	Majority of target return	Less-stable or no distributions prior to cash generation

ESSENTIAL SERVICES OR GOODS

Plays a critical role in the economy in an industry with high barriers to entry.

LONG-TERM USEFUL LIFE

Has a long productive life under perpetual ownership or long-term concession agreements.

LOWER-RISK COUNTRIES

Primarily in developed markets, such as North America, Western Europe and Australia.

CURRENT YIELD

Has sustainable, high operating margins supporting a majority of the returns from current yield.

STABLE CASH FLOW PROFILE

Has predictable revenues supported by regulatory frameworks or long-term contracts that mitigate price or volume risk with highly creditworthy counterparties.

Includes direct or indirect inflation escalators, or embedded growth.

OPERATIONAL MATURITY

Has an established operating history with less inherent operational complexities and assets with highly cash-generative characteristics that provide greater revenue visibility.

CAPITAL STRUCTURE STABILITY

Is a conservatively capitalized business with nonre-course financing and investment-grade credit metrics.

The Portfolio Benefits of Core Infrastructure

Core infrastructure assets tend to be resilient, with consistent performance at all points of an economic cycle. This is true when times are good, but it is more evident in times of market disruption.

INCOME

Mature cash-flowing assets can provide a consistent yield.

DOWNSIDE PROTECTION

Regulated and highly contracted businesses provide long-term visibility into cash flows with less exposure to merchant price and volume risk.

LONG DURATION

The long operational lives of underlying investments can help investors with long-term portfolio asset-liability matching.

INFLATION PROTECTION

Asset-level revenues often have embedded growth and are linked to inflationary increases through contractual indexing or natural links to inflation that exist due to the essential nature of the underlying business.

DIVERSIFICATION

Correlation and volatility are low compared with traditional and alternative asset classes.

SUSTAINABILITY

Operators of long-life assets should have strong environmental, social and governance frameworks to ensure the preservation of value over a long-term ownership horizon.

What Are the Key Risks?

Given the characteristics of core infrastructure investments, two key risks are regulatory risk (for regulated assets) and counterparty risk (for the long-term contracted components).

To mitigate these risks on the regulatory side, investors can look for a track record of a stable and transparent regulatory environment that fosters economic activity. For counterparty risk, looking for highly creditworthy counterparties can help ensure a higher likelihood that the contracts will be honored. Focusing on lower-risk countries that have a long-established rule of law is another way to potentially mitigate counterparty risk.

These are important mitigating factors because they act as the first line of defense. Ultimately, however, the protection is the essential nature of the infrastructure asset itself. Lower-risk core assets are critical pieces of infrastructure that simply cannot be shut off without a functioning alternative. This means that regardless of what might happen to any single consumer in the supply chain, other market participants should step in and utilize the infrastructure so that the economy continues to function.

Unlike other infrastructure assets, core infrastructure assets generally have limited or no GDP, commodity price and volume exposure.

A Cornerstone Long-Term Investment

The demand for lower-risk core infrastructure continues to be very strong as investors view the characteristics of these investments as providing several portfolio benefits, a good match for their liabilities and the potential to deliver attractive risk-adjusted returns.

Governments and corporations continue to seek private sector solutions to ever-increasing debt loads as borrowing costs normalize from historical lows. Many traditional utility and telecom operators, for example, are inviting institutional investors to invest alongside them in highly contracted or regulated assets. They use the proceeds to meet capital requirements, such as reinvesting in older operating assets or to help them meet decarbonization targets. Across the infrastructure universe, we expect traditional operators to look to partner with investment managers that can provide capital and operating expertise to meet their goals. All this means that core infrastructure can be a cornerstone investment in portfolios for many years to come.

When considering an allocation to a core infrastructure strategy, we believe investors should look to identify investment managers that use a definition of core infrastructure that is consistent with their risk and return objectives. These managers should have operating expertise in a variety of sub-sectors and regions with intimate knowledge of various regulatory frameworks, as we believe this will help them underwrite and later manage these assets. A lower-risk core infrastructure strategy should deliver a consistent cash yield with attractive risk-adjusted returns—regardless of economic cycles.

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