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10 Questions to Address in Evaluating Infrastructure Managers

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In my white paper, "Infrastructure: No Longer a Niche Option," I discussed the characteristics of the infrastructure asset class, both listed and unlisted, and outlined the considerations that institutional investors need to weigh as they consider an allocation to this asset class or evaluate an existing one.

(Estimated reading time: 3 min 56 sec)

In this blog post I provide additional detail about infrastructure manager selection and describe the questions that should be a part of the evaluation process to ascertain managers' views on overall strategy, portfolio construction, and risk management:

1. **How Are the Assets Regulated?** Some infrastructure assets have high public sector involvement in areas such as permitting, rate setting, ownership, and oversight of assets, which makes all facets of operations more complex. A regulated asset in a geography that does not exhibit stable policies can be riskier than an unregulated asset in a stable economy. Managers have experienced difficulties with assets where regulatory environments and/or jurisdictions have not demonstrated they can implement reform, resolve disputes, or handle pressure from citizens and legislators.
2. **What Is the Impact of Inflation?** Infrastructure investments with inflation-linked revenue streams can potentially provide additional stability for the asset's revenue. It is important to understand how inflation risks have been factored into each asset's forecasted cash flows and contracts to adequately assess the risk from inflation. Utilities and transportation assets may have built-in price index mechanisms to allow operators to pass through higher costs. Power-generation assets typically have long-term contracts that are fixed price and do not allow operators to pass through cost changes as quickly.
3. **How Is the Asset's Revenue Characterized?** Infrastructure assets with demand-based (sometimes known as GDP-linked) revenue can be more risky in the event of another Global Financial Crisis, where demand for the service is reduced and cash flows may be severely impacted. Conversely, GDP-linked infrastructure can allow the owner to pass through price increases more easily than a regulated asset in which a government body has to approve rate changes, which may occur on a lagged basis of three to four years.
4. **What Is the Risk from Commodities?** It is important to understand how managers view commodity risk in their portfolio construction. Commodity risk may exist as part of an input cost to deliver a service at a fixed price, and if an increase in commodity

prices cannot be passed along to the consumer, this can hurt the performance of a given infrastructure investment.

5. **Is Currency Hedging Used?** Infrastructure managers differ in their philosophy on currency hedging. Unhedged international investments can lead to more volatile returns and have the potential to affect investment performance depending on when the investment was made and when it was realized.
6. **How Strong Is the Public Sector Partnership?** Infrastructure assets have an inherently local impact, and an infrastructure owner benefits from good relationships with local regulators, customers, and communities. Has the manager indicated it will pursue these types of investments and does it have any unique credentials in this regard?
7. **Are Tax Credits or Tariffs Used?** Some investments rely on tax credits or feed-in tariffs to achieve projected returns, and changes in those credits or tariffs can impact the outlook for investment performance. This is more common with investments in the renewable energy sector.
8. **Is Leverage Used?** Financial engineering has created difficulties in the past for infrastructure fund managers. Many infrastructure funds do not have specific leverage limitations at the asset-level, and these funds generally do not employ fund-level leverage. Leverage should be appropriate for the asset class, asset-specific condition, and type of revenue generated by the asset. Assets with highly contracted revenues, such as availability-based infrastructure (e.g., roads or government facilities with 20+ year operational contracts) may have leverage in excess of 80%. Assets with a higher share of GDP-linked revenue should be significantly less leveraged.
9. **What Is the Ownership Structure of Assets?** Infrastructure assets can be sizeable (e.g., ports and airports) and therefore difficult to be owned by one party. Does the manager tend to own 100% of all assets, or does it have partners? How has it exited assets in the past? It is illustrative to ask the manager about governance and sale provisions it uses when making investments.
10. **How Does the Manager Approach Exits?** Investors should ask how managers view the holding period for assets, and what kind of exits they have achieved in the past. Understanding the manager's view on asset ownership timelines and the potential for divestment is especially important for closed-end funds as well as debt-focused vehicles.

For more on this issue, you can find my paper here .

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