GLOBAL LISTED INFRASTRUCTURE ORGANISATION

GLIO Journal

issue 06

GLI – an allocation whose time has come

The rise of listed infrastructure & REITs

GLI primers: Railroads, Telecom, Utilities

Institutional investors in listed infrastructure

Renewable energy investment environment

GLIO Index

The time has come

The relative case for institutional investors in listed infrastructure.

By James **A. ABATE**

All else being equal, an investment security or interest is worth more if it is readily marketable or, conversely, worth less if it is not, as investors prefer liquidity. We explore the value of these fundamental characteristics of listed infrastructure.

Infrastructure investing has become more popular. With the majority of investment capital going into private equity funds focused on unlisted infrastructure opportunities, it's important to examine whether the sheer excess supply of investment into private equity focused on unlisted infrastructure over the past few years has distorted the "normal" valuation hierarchy seen in other asset classes[1].

Although the data for private infrastructure is somewhat difficult to obtain, market intelligence firm Preqin highlights that the Enterprise Value to Earnings Before Interest Taxes, Depreciation & Amortization (EV/EBITDA) multiple for private infrastructure transactions, across industries, has averaged 19.4x over the years 2014 through 2017[2]. This compares to the EV/EBITDA multiple for the MSCI World Infrastructure (Listed) Index of approximately 9.7x as of December 2019 and averaged 9.0x for the year-end periods 2014 through 2017[3].

Moreover, for the airport concession industry (operate, maintain and develop) specifically, GLIO has accumulated a times series of data highlighting the significant premium associated with private transactions, 43 in total, relative to publicly trade comparable companies, see Figure 1.

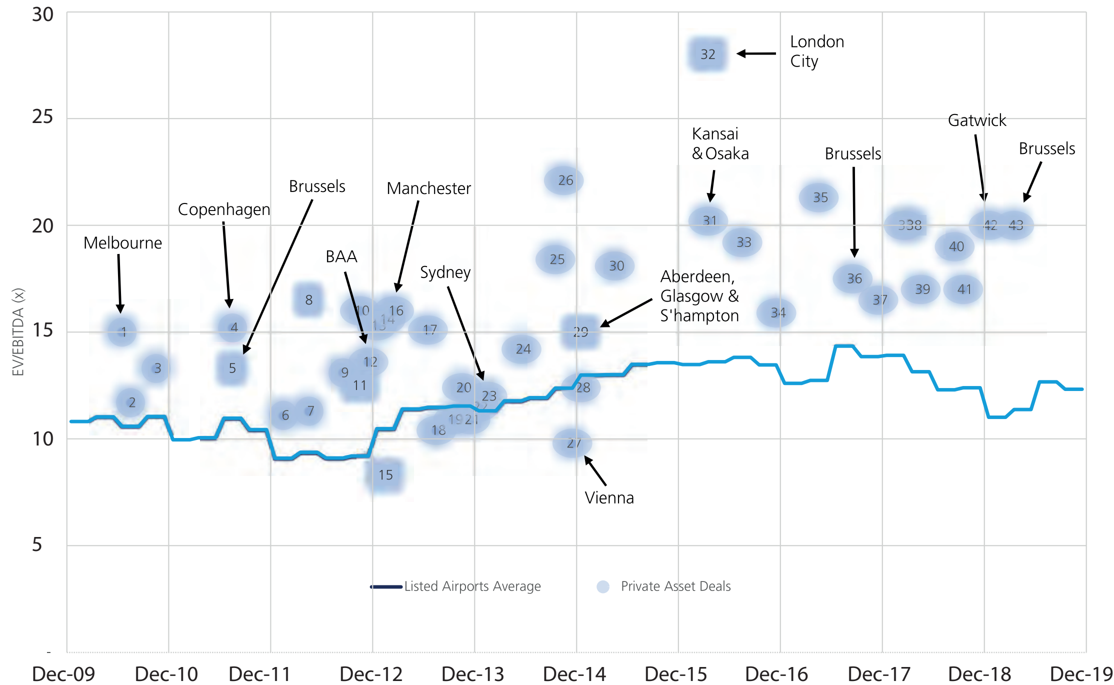
Where the value lies

Quite simply, there is a distortion in the infrastructure investment universe whereby listed infrastructure is relatively inexpensive (and by a significant amount) even after accounting for lack of control and applying a discount for lack of marketability to the observed private transactions. Furthermore, the excess supply of investment capital into unlisted infrastructure has all but likely guaranteed disappointing long-term prospective relative returns to investors in private equity funds focused on unlisted infrastructure.

This may negatively impact the >

1. Also see: 'Dude where's my illiquidity premium' – GLIO Journal – Issue 3
2. Source: Preqin, Goldman Sachs, Bloomberg and Cohen & Steers.
3. Source: Bloomberg, MSCI.

Figure 1: GLIO Global Airports (EV/EBITDA Multiples)



Source: GLIO/Inframation

> *There is a distortion in the infrastructure investment universe whereby listed infrastructure is relatively inexpensive even after accounting for lack of control and applying a discount for lack of marketability to the observed private transactions.*

asset class' current growth of investment allocation share towards infrastructure as a whole, if unblended by investors in complementary listed infrastructure funds – which in our opinion represent a better value for most investors at this time. Valuation is always the most critical element in making successful investments.

Having trained and worked professionally as a valuation specialist and business appraiser prior to transitioning to investment management, discounts for lack of marketability and premiums for control are attributes that weigh of significant importance to me as an analyst and investor. Furthermore, the lack of genuine "mark to market" in unlisted private equity has somehow been used, somewhat disingenuously, by pension consultants and others to demonstrate low volatility and low correlation with public markets during the financial crisis of 2008 and other periods of public stock market stress.

The adoption of Financial Accounting Standard 157 (FAS 157) as well as the new International Private Equity and Venture Capital Valuation (IPEV) Guidelines likely don't go far enough as evidenced by the disconnect between what happened in the private energy markets and what we know happened in the public energy equity markets during the most recent commodity price collapse. Namely, during the steep oil price fall of 2015-2016, the market value of small energy companies with publicly-traded shares fell to about half of what it was in 2011-2012, yet the implied mark-to-market value of private equity energy assets, which should be broadly similar, was flat for many funds, or even up[4].

The argument that the underlying investments held within a private equity fund are less exposed to public market volatility as it is less affected by macro events and other factors unrelated to fundamentals is simply nonsense. Value is value – a stale price based off original cost or the latest round of funding is not value, just ask WeWork.

How much is control?

More specifically, a key issue to examine is whether private market valuations, which are currently higher than public market valuations due to the perceived level of control more than offsets the illiquid profile of unlisted investments. With very limited liquidity, private infrastructure investments tend to be suitable for institutions with long investment horizons, with most investments having lockups for up to 12 years.

4. Financial Times, "Private equity's mark-to-make-believe problem", April 6, 2016 by Matthew C Klein.

Value is value – a stale price based off original cost or the latest round of funding is not value, just ask WeWork.

Given that the majority of institutional investment into unlisted infrastructure is in the form of minority, limited partnership type or share interests, and not controlling ownership as direct project developers, operators, or even co-investors with some degree of portfolio control, we would argue that there should be little to no premium attributable to private equity investments when made via limited partnership or similar interests. Thus, in the absence of control over project governance or enablement of a liquidity event, the focus of an apples-to-apples comparison should be on the marketability or liquidity of the respective investments.

One of my favorite quotes is from a conversation during the 2011 European sovereign debt crisis with a very large institutional investor in our funds who, after boasting of their long-term investment horizon, quickly segued into asking "how did the fund perform yesterday?" Under the stress of financial market duress that make bare the sometimes mismatching of duration between assets and liabilities by investors as well as potentially the amplification from leverage, the discounts for lack of marketability become even more acute.

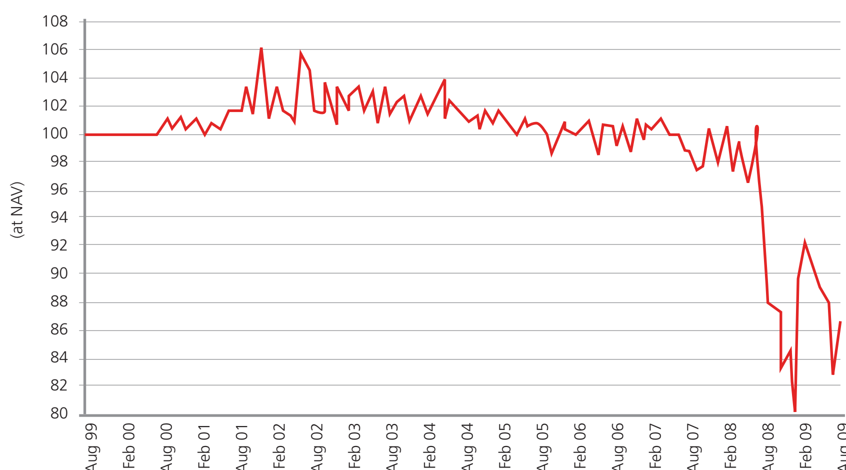
The tumultuous market environment of the late-2008 through 2009 period saw the use of gates, extreme liquidity issues, and new sets of investor demands on hedge funds. The period preceding this from 2001 through 2007 saw an unprecedented amount of institutional investment capital directed to all styles of hedge funds, much like with private infrastructure funds today. The supply of investment capital allocated to hedge funds was so strong versus the available funds deemed suitable for investment, that the secondary market trades for limited partnership interests prior to the financial crisis indicated an average premium of approximately 8.1% to net asset value[5] as tracked by Hedgebay, SecondMarket and CogentMarkets.

As the financial crisis gained traction however, the desire for ready marketability saw investors who wished to transfer/sell their interests no longer were willing to pay a premium, but instead seek liquidity at discounts of 20% to net asset value on average according to Hedgebay's Secondary Market Indicator shown on Figure 2. And much more so when including distressed sales[6].

Real estate comparable

Aside from hedge funds which invest typically in relatively liquid underlying investments within their portfolios, we also look to the real estate sector for guidance on appropriate discounts for lack of marketability as it's similar to infrastructure, whereby what is being valued is the ownership interest, not the collective operating assets owned by the real estate or infrastructure-related company. Empirical data from Partnership Profiles, based on rates of return for non-controlling interests in real estate >

Figure 2: Hedgebay Secondary Market Indicator (ex-distress)



Source: Hedgebay Trading Corporation

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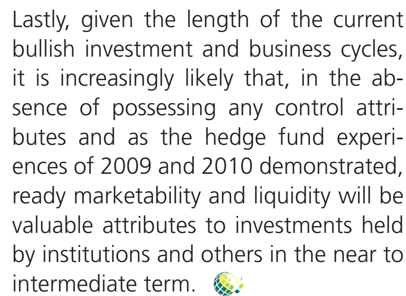
5. The Secondary Market for Hedge Funds, Tarun Ramadoraiy, March 2008.
6. Source: Hedgebay Trading Corporation. The Hedgebay Secondary Market Index is a proprietary, asset-weighted index that describes the average premium or discount paid for hedge funds that trade on Hedgebay's secondary market platform in any given month.

entities, suggests a discount between 15% and 20%. This is consistent with research that estimated discounts for lack of marketability of private equity funds using option-pricing theory at around 21.5%[7].

Without the controlling benefit to enact an exit of an entire portfolio or even an individual portfolio investment through a sale to a strategic buyer, another financial investor, or a partial sale to public markets, we believe that institutional investors who have been solely focused on private equity limited partnership investment options should look at the merits of a listed infrastructure fund allocation. This approach can offer a liquid alternative or complement to private equity infrastructure investments at more attractive valuations at this stage of the investment cycle.



This also allows investors to achieve their long-term return and income objectives while, if history is a guide, reducing volatility relative to broadly diversified equity indices as well as add relative downside resilience.

Lastly, given the length of the current bullish investment and business cycles, it is increasingly likely that, in the absence of possessing any control attributes and as the hedge fund experiences of 2009 and 2010 demonstrated, ready marketability and liquidity will be valuable attributes to investments held by institutions and others in the near to intermediate term.

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7. Review of Financial Economics February 28, 2016, "How Much Can Lack of Marketability Affect Private Equity Fund Values?"

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