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US pensions eye infra

Infrastructure project sponsors have long hoped to entice some of the nation's US$4.5tr in pension fund assets to participate in infrastructure projects as pension funds in Canada, Australia and some European nations have done. With the outlook for traditional assets sinking, US funds are finally listening. By **Deirdre Fretz**.

In its next meeting on June 4, the US$169bn California Teachers Retirement System will begin to discuss a new investment policy outlining the pension fund's involvement in fixed-asset financing. The fund could decide by mid-summer whether it will allocate funds to infrastructure deals as a new asset class.

Meanwhile, the California Public Employees' Retirement System expects to finalise its infrastructure investing policy as part of its new inflation-linked asset class. CalPERS intends to invest 1.5% of its US$250bn portfolio in infrastructure opportunities that can deliver at least 5% over CPI for 10 or more years.

Because their size drives a continuous search for ways to diversify their investments, the California state pension funds have often been in the forefront of US pension investment trends. To-date, just a few of the nation's public employee pension funds have begun to look seriously at infrastructure investing. But for state transportation officials, the move has been a long time coming.

Together, US states need to spend US$58bn a year to maintain their highway and transit systems, and US$119bn per year to make needed improvements, according to a recent report by the Transportation Research Board (TRB) a federal research academy. As these investment needs have grown in recent years, the federal government's willingness to fund them has receded, and states' departments of transportation have sought public-private partnerships to close the funding gap.

State DOTs have also been reaching out to the nation's US$2.74trn in public employee pension funds to partner with private toll road operators, or to directly take on the management of public transportation assets. Corporate pension funds manage an additional US$1.8trn.

Last year, the Texas Department of Transportation published a study that noted that the state's pension funds were "potential funding sources", adding that such investments offered pension funds "an estimated rate of return in the low teens, steady income, and the opportunity to invest in an asset that pension plan members might actually use on a regular basis".

But when the report was released not even the largest of the state's public funds, the Texas Teachers Retirement System (TRS) with US$100bn in assets, was ready to jump into the state's high-profile toll road deals, or other public infrastructure transactions. But sources say that the fund is now becoming more interested in the idea.

Lowell Clary, who retired from his position as CFO of the Florida DOT last year to launch his own consulting firm, noted that while he was at FDOT the agency approached the state's pension plan several times to discuss the idea of the their participation as equity players in the public-private partnerships now under way in the state. But, Clary says, "I never detected a lot of interest".

After all, Clary concedes, the Florida State Board of Administration, which manages the state employees' pension funds as well as that state's hurricane relief fund and other assorted trust funds created by the state totalling US$184bn in assets, includes one of a handful of US state pension funds that are fully funded, reflecting the funds' administrators success at maximising their returns to meet their constituents' needs.

But the earlier this year, pleas to invest in the state's overburdened transportation system turned into a demand, as the Florida state legislature introduced bills in both the senate and assembly mandating that one fund under the FSBA's umbrella take on a long-term lease of Alligator Alley. The bills were defeated, but sources say the debate spurred representatives from the FSBA to sit in on recent FDOT presentations on the pending monetisation of Alligator Alley.

In a presentation to the CalPERS board earlier this year, CalPERS chief investment officer Russell Read noted some of the reasons why pension fund administrators

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were taking a second look at infrastructure deals. Citing the "significant stress" in the US financial markets, Read said that the fund was able to stem losses by virtue of its diversified investments.

He added: "In terms of financial market opportunities, the key word is transformation. Capital is needed in far different sectors than in previous decades . . . Infrastructure needs for electricity, fuel, transportation and water are of particular interest."

CalPERS envisages construction ventures for roads, bridges, airports, utilities, water systems and other projects. In a statement released earlier in the year, Rob Feckner, president of the CalPERS board of administration, said: "For example, we might invest in a natural resource or energy-related power plant that could involve private equity, real estate, commodities, and bonds."

The fund expects to make investments alongside other partners, as part of a project consortium. While it notes that California alone has a multi-billion shortfall for needed infrastructure investments, the fund will not limit its infrastructure plays to the California, or even the US market, but will also take a look at opportunities in Latin America and elsewhere, basing its investment decisions on whether a given opportunity can deliver its return over inflation goal.

Patrick Krolak, managing director of Marquette Associates Inc, an independent investment consulting firm headquartered in Chicago, says: "This could be the most exciting new asset classes to come up in the last five years. It has really created a stir with consultants and trustees."

On the most basic level, Krolak notes, infrastructure plays are long-term investments that match pension funds' long-term liabilities. Elaborating, he says: "There is an inflation protection component, the stable, predictable consumer demand, and the fact that usually the assets themselves have a strategic competitive advantage in that they operate as monopolistic, or near monopolistic, service providers in an area with high barriers to entry."

Krolak adds that public employees as well as private union funds, called Taft-Hartley funds in the US after the legislation that provides for their regulation, are also keen to become investors in assets that employ them, or they have helped to build. Ownership in these assets can pave the way for public employees and unions to become activist investors in assets that are newly operated by the private sector.

As a pioneer among US pension funds investing in infrastructure, Bill Atwood, executive director of the State Employees' Retirement System of Illinois, says he has fielded questions from colleagues at the helm of other state pension funds looking to make their first commitments in the infrastructure space.

"A lot of funds are starting to make deployments in infrastructure, and a lot more are waiting for large public deals, like the lease of the Pennsylvania Turnpike, to happen. While they see infrastructure investing as a compelling investment story, they want to follow how some of these big public-private deals develop. I think as more deals happen, the comfort level will go up," Atwood says.

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In 2007, the State Employees' Retirement System of Illinois made a commitment to invest up to 5% of its US$12.3bn in assets under management in infrastructure investments, reallocating money that otherwise would have been invested with the system's fixed income asset managers.

Since then, the board has made a series of investments in funds specialising in US infrastructure managed by Macquarie and Alinda Capital Partners. The most recent investments were approved in a special board meeting in May, committing an additional US$100m to Alinda and US$100m to two Macquarie-run funds, to bring Illinois SERS' infrastructure investment to US$400m.

Atwood says that while SERS is just beginning its infrastructure investments, it is difficult to see the pension system taking a more active approach to infrastructure investing. At just a fraction of the size of US$108bn Ontario Teachers' Fund or CalPERS, Atwood says Illinois SERS doesn't have the administrative staff to dedicate to direct investments in infrastructure, and with only US$600m-$700m to invest in the asset class, would not be able to get sufficient diversity in its investments if it took a direct stake in a local transportation project.

In addition to Illinois SERS, the New York City Retirement System and the North Dakota State Retirement Fund have also dipped into infrastructure funds.

The uptick in interest among pension funds has been one factor in the wave of new investment funds that focus on infrastructure. Joining industry veterans such as the Macquarie infrastructure fund family, Goldman Sachs Infrastructure Partners, AIG Highstar Capital and the independent Alinda Capital Partners, late last year toll road operator Transurban created its infrastructure development vehicle DRIVE, which attracted the Harvard Endowment Fund as one of its first investors. John Buehler, a managing partner of Energy Investors Funds, notes that in 2007, infrastructure and power funds raised more capital than the entire global venture capital market.

Since the beginning of 2008, a number of new entities have launched new infrastructure funds, and market veterans have launched additional funds. When Morgan Stanley launched its Morgan Stanley Infrastructure Partners, it raised US$4bn, about twice the amount of capital that it had originally sought. The Carlyle Group has recently launched its first infrastructure fund, and Citi, Credit Suisse and GE have also launched new funds. Kohlberg Kravis Roberts announced that it had lured the former head of Lazard's global power and energy investment banking to lead an effort to raise money for the private equity giant's first infrastructure fund.