Why do superannuation funds leverage their infrastructure investments?

Infrastructure is flavour of the month with superannuation funds. Recent high profile Australian transactions include Port Botany, Port of Brisbane, Queensland Motorways and Port of Newcastle. These transactions involved over $15 billion at an eye-watering average EV/EBITDA multiple of 26 times. A key theme is that all involved superannuation funds (domestic or foreign) as part of the winning bid.

Why do superannuation funds love infrastructure? Infrastructure offers the promise of stable long term inflation linked cash flows. Superannuation funds hope that increasing investment in infrastructure:

- reduces exposure to equity risk (i.e. short term volatility) without the give up in returns of investing in bonds;
- provides yield/cash income which is particularly attractive for pensioners and members near retirement (particularly given the cash yield should rise with inflation over time); and
- provides some protection against further falls in long term interest rates (as lower bond yields should push the value of long term cash flows up). This is particularly appealing to defined benefit funds. It is important to remember this is a two edged sword, rises in bond rates (and bond yields are very low in a historic context due to QE) would be expected to drive down the value of infrastructure assets (and any other asset involving long term cash flows).

The history of infrastructure assets, even including the GFC, supports these characteristics on an ungeared basis. For example, through the GFC both Sydney Airport and Transurban showed steady growth in underlying operating earnings (EBIDTA). But this steady growth of underlying earnings was in marked contrast to their equity returns over the period – both entities share price more than halved during the GFC. Hardly consistent with a picture of steady underlying earnings growth!

Why did infrastructure equity investments get hit in the GFC? They underperformed because the cost of debt increased substantially and for highly levered investments, this substantially cut cash flows available for equity. It was a case of the underlying asset performing, but equity getting smashed by leverage.

Since the GFC, listed infrastructure companies have changed their approach to debt. For example, Transurban now only pays equity distributions out of underlying operating cash flows (rather than by juicing returns by increasing debt over time). Similarly, Sydney Airport has reduced leverage from over 10x EBITDA to around 7x.

This caution stands in contrast to recent unlisted transactions. For example, the Port Botany and Port of Newcastle transactions both involved more than 10x debt/EBITDA. This raises the question whether these investors have truly learned the lessons of the GFC?

A further contradiction is that at the same time superannuation funds are investing in leveraged infrastructure equity they also allocate a significant part of their portfolio to fixed income. Couldn't they achieve the same result – and save a lot of fees and credit margins to the banks – by investing in infrastructure on an ungeared basis and holding a little less fixed income?

Possible explanations:

- without the leverage deals wouldn't meet investor's expectations of returns. Yes, but if this is the case, will investor's expectations of infrastructure offering low risk returns be delivered?
- leveraged deals are more likely to deliver performance fees to fund managers … but is this in the best interests of fund members?
- Super funds need their fixed income to be highly liquid but unlevered infrastructure would be illiquid. Yes … but funds typically hold 15-20% in fixed income … does all of this need to be liquid?

Maybe when Australian superannuation funds were a lot smaller, and fewer were investing in infrastructure, leverage made sense to allow medium sized funds to invest in large transactions while maintaining diversification. However, in today's world, where the largest investors seem to struggle to be fully invested in the asset class, does this still make sense?