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NEWS ANALYSIS: US PENSION FUNDS EYEING DIRECT INFRA INVESTING

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Fund managers and investment firms could be facing competitive headwinds from heavyweight money managers in the coming years, as some of the largest retirement systems in the United States have begun studying a direct investment model for the asset class.

The California Public Employees Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) are both presently engaged in studies to become more involved in co-investments, separately managed accounts and direct investment models for infrastructure assets, with an incentive to save capital on expensive management fees and gain more experience with asset management.

Canadians have employed the direct model for a long time, and successfully so - just recently the Canadian Public Pension Plan Investment Board (CPPIB) announced they've saved over CAD 700m on management fees throughout 2017 by utilizing a direct investment model, highlighting the reward that comes with the pursuit and successful execution of the strategy.

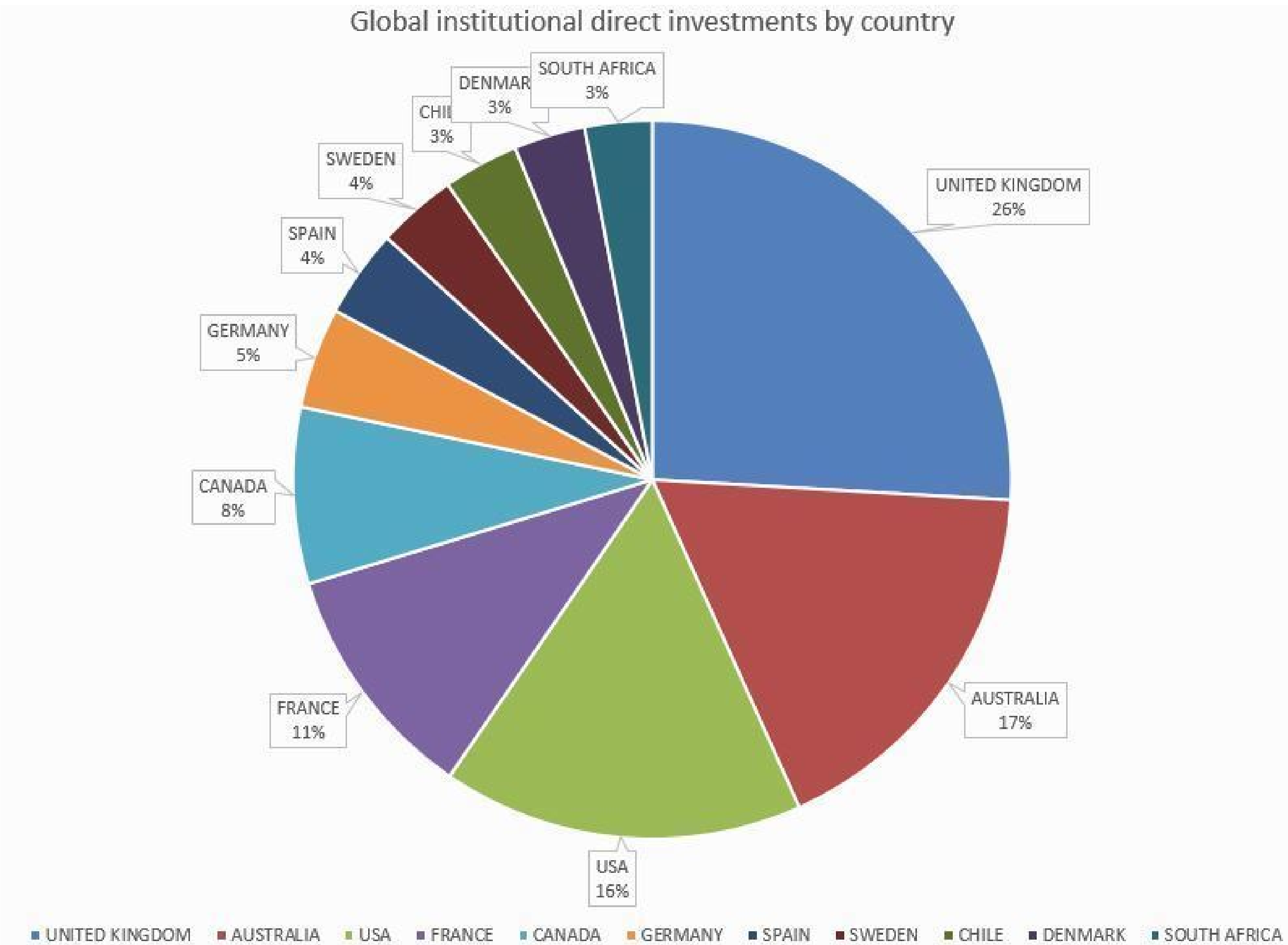
However even though the incentive is there to engage in the competitive bidding space for direct investments, getting to the point where you are a successful investor with stable, positive returns could present significant challenges to those who attempt to do so, according to multiple industry executives.

"The goal for CalSTRS is to develop our own investment model over time."

Paul Shantic is Director for CalSTRS' USD 4bn Inflation Sensitive portfolio, of which infrastructure is a major component, whose allocation target is currently valuated above

USD 8bn. In an interview with *Inframation*, Shantic expressed the difficulties posed with direct investments, and the system's plans to utilize co-investments, the separate account model and other unique investment structures to more effectively to gain insight into asset management practices.

"Direct investing requires specialized capabilities and they give some unique legal challenges in the United States," Shantic explained, "and for now, infrastructure assets will always have a manager between us and the assets. We have a long history of working with managers to understand their processes for investment selection, management, and disposition. The goal for CalSTRS is to develop our own investment model over time based on what staff, our board, and our consultants believe can be reasonably achieved."



Shantic, along with Michael DiRe, the director of real estate and Margot Wirth, the director of private equity, presented an initiative last month at an Investment Committee meeting to move towards a co-investment, separate account, and other unique structural investment strategy model for infrastructure and other private assets, and explained that the benefits could include "lower (or no) fees and expenses being paid to outside parties."

Before making any significant forays into direct investment schemes however, the team recommended that the retirement system should adopt the "collaborative model," a strategy coined by two researchers from Stanford University that focuses on developing innovative platforms and strategies to invest more efficiently in private market asset classes.

CalPERS, the nation's largest pension plan with over USD 355bn assets under management, is taking a similar approach to future infrastructure investments. The retirement system is in the midst of partnering with an unidentified infrastructure investment manager that it will allocate capital to in a separately-managed account on an annual basis.

Paul Mouchakaa, Managing Investment Director for Real Assets, added that the pension will continue to explore direct investments alongside the new account. The pension's USD 3.8bn+ infrastructure portfolio is one of the most active direct infrastructure portfolios in the United States, with current holdings in high-profile assets such as the Indiana Toll Road, Port of Melbourne, and Gatwick Airport.

"We are bullish on infrastructure and see it as a growing piece of the institutional investor landscape."

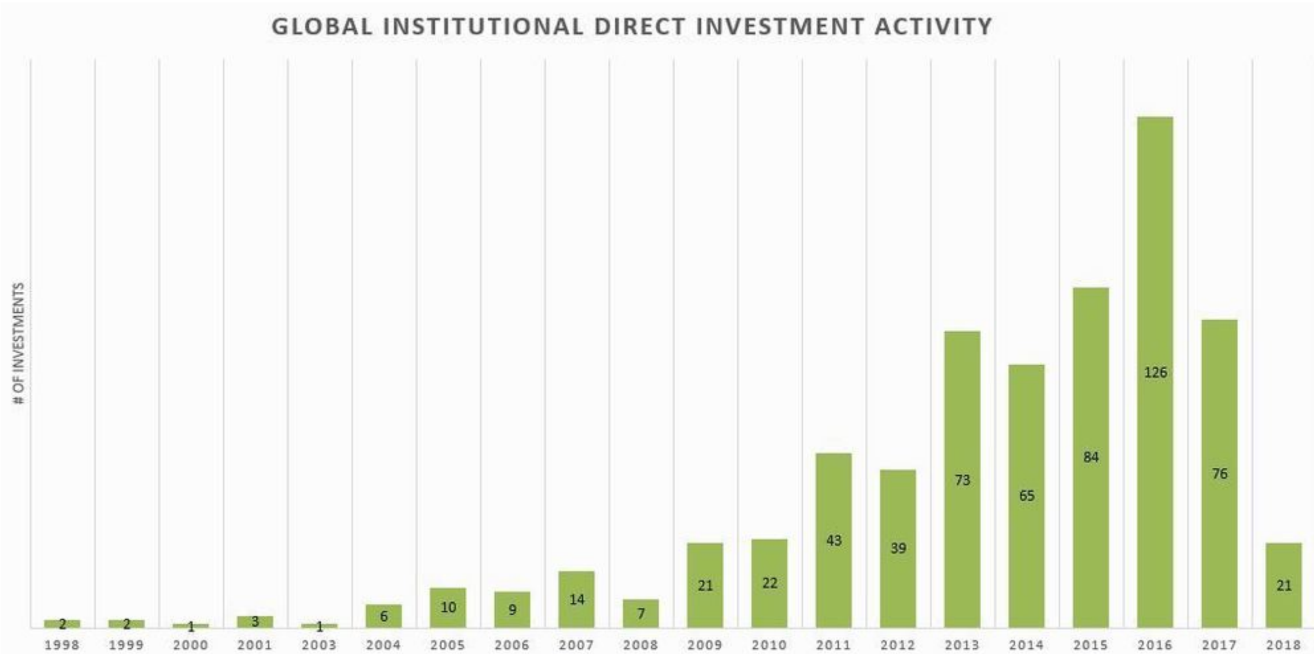
The size and scale of CalSTRS and CalPERS could levy a residual influence on other public pension plans in the United States, potentially inspiring others to do the same if their endeavors are successful. "Anything that they do is going to influence the market. The question becomes how large of an impact," said Matt Nadworny, a partner in Kirkland Ellis investment funds group.

The Alaska Permanent Fund Corporation (APFC) is already making direct investments in infrastructure, as part of a "three-pronged approach" inclusive of fund commitments and co-investments. Director of Real Assets & Absolute Return Investments at the APFC Marcus Frampton told *Inframation* that direct investments currently constitute about 20% of their infrastructure portfolio. However he added his team would ideally have 40% of their portfolio be direct opportunities, as those ventures alongside co-investments currently outperform their fund investments, Frampton said. "I believe that the trend toward limited partners increasingly pursuing direct investments will continue."

The bull market

The confluence of funds in the market, combined with pension funds looking at direct investing could create the perception of a very crowded marketplace for infrastructure investing. However, asset managers have atleast created some opportunity by expanding the conventional infrastructure definition.

"Before, you didn't have as much of the transportation and other types of P3 opportunities in the US market as you have today, or you didn't have the convergence of telecom opportunities from real estate and private equity to infrastructure due to recurring revenues [from these assets] that are being converted into longer term contractual revenues based on increasing demand for data by customers," Marietta Moshiashvili, previously Managing Director and Group Head for TIAA/Nuveen's equity infrastructure program and currently CEO of Upper Bay Infrastructure Partners.



However despite the evolution, the "potential to create a supply/demand imbalance is real," said Moshiashvili, adding that "we've seen that with foreign institutions coming into the market - a lot ultimately depends on how much money they allocate to the sector. That is when your experience as an investor is tested."

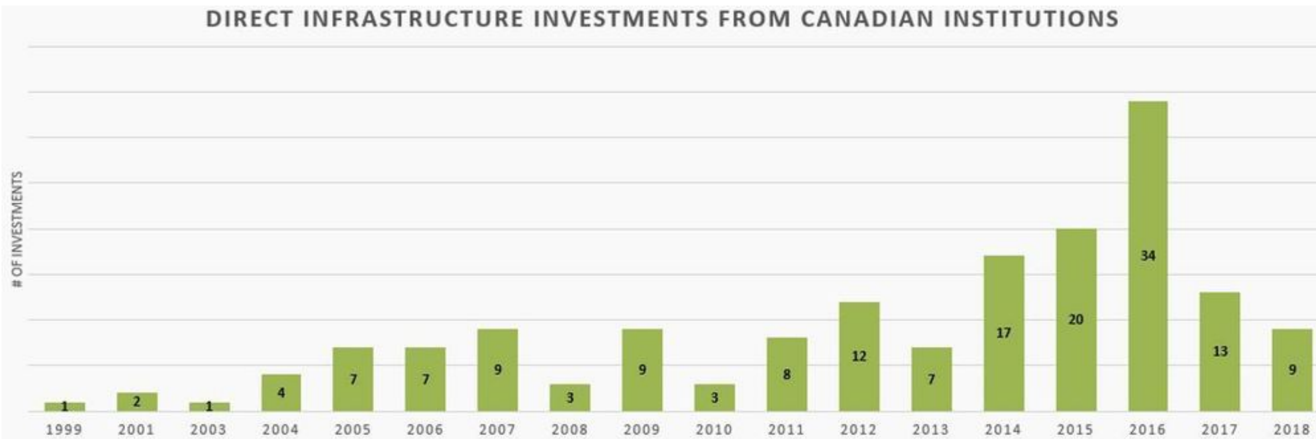
Northern exposure

Historically, and in rough contrast to their southern counterparts, Canadian public pension plans have managed to synthesize and maintain robust direct infrastructure programs. ~~Stephen Dowd previously m~~anaged the Ontario Teachers' Pension Plan Board's (OTPP) CAD 11bn infrastructure and timberland portfolio between 2006 – 2016, and attributes the asymmetry between the two nations' investment strategies to the Canadian tendency to secure top talent, amongst other reasons, such as the Canadian governance model.

Dowd told *Inframation* "the fact that there's an independent board and the focus is purely on getting the right results to pay pensions for those organizations. A lot of the US plans are burdened by a governance structure with less clarity, and don't always have independent boards so it can be more difficult, with other agendas mixed in rather than just an investment agenda."

Paul Shantic shared "these [Canadian] plans recognized that capturing risk premium early in markets leads to outperformance, and that the complexity of these investments coupled with a long term view allows a fund to capture these excess returns over time."

"One advantage is their ability to partner with others when they felt the need. It also requires the ability to move fast with experienced staff, in a model that is not as constrained in terms of decision-making and includes the ability to work quickly under tight deadlines to hire and work with experts in terms of the overall project due diligence."



Dowd added that "Canadians have built out very large teams, sometimes between 30-40 people, and they have external directors and networks of people working with them. It's quite a significant organizational effort and investment."

"Retaining and recruiting skilled investment professionals is our top challenge today," Marcus Frampton said.

"There's enough opportunity to welcome pension plans into the market, another source added, and even if the trend takes off, "only a handful of LPs will have the interest and resources to develop truly independent investment arms in the infra space. Some of the Canadian pension plans and a few sovereign wealth funds have done so, but they are the exception, and even some of them continue to make meaningful fund investments along with their direct programs."

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