EM infrastructure build prompts race for profit

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Developing countries' drive to support their domestic economies through investing in infrastructure has sparked a series of fund launches and fresh capital raisings by managers hoping to profit.

First State Investments and BNY Mellon's affiliate ARX Investimentos in Brazil have launched portfolios with exposure to emerging market infrastructure, while Lutetia Capital in Paris and Macquarie in Australia have sought fresh capital for existing products.

They expect to benefit through investing in projects directly, or indirectly through firms building these projects.

Additionally, they welcome the entrance into the sphere of private equity firms and other rivals, in anticipation they may pay a premium for later-stage involvement.

Addressing the balance

Western governments may also welcome infrastructure plans in developing nations as imports by developing countries for large projects helps global trade imbalances. The amount emerging economies are expected to spend on public infrastructure is eye-watering. Over the next 10 years, India will inject around $680bn into infrastructure projects, Mexico $260bn, and Brazil $800bn, according to Claude Tiramani, whose Lutetia Emerging Opportunities fund highlights infrastructure as one of its three key themes.

What China could spend "is anyone's guess", said one manager. "Any slowdown in economic growth and Beijing will pull another project from the bottom drawer." Tiramani said: "In China, a lot of infrastructure was already put in place 20 years ago, which is why the country is ahead of other emerging nations economically."

Building infrastructure in India is "essentially about expanding economic capacity" to catch up, said Tiramani, who is investing in Indian banks he expects to help finance 40% of the country's projects.

Legislation

New Delhi has also moved recently to change property laws, making it easier to push through public infrastructure projects.

Peter Meany, manager of First State's £190m Global Listed Infrastructure fund, said: "China understands investment in infrastructure can improve long-term productivity.It understands more than most taking its trade surplus and reinvesting in infrastructure delivers better long-term growth. Contrast that with many Middle Eastern countries, which have wasted an incredible oil resource."

Meany said listed infrastructure in Asia has grown 17% annually for years, comprising 12% returns and 5% growth from new companies.

He recently hired Mandarin-speaking analyst Jin Xu in Hong Kong to better cover mainland China, and said it is important to invest in projects and companies there that understand return on capital.

"Beijing can tell a province to deliver 10%-15% growth this year, but the provincial government builds one road next to another one. In China and the Middle East the cost of capital is so low, a government is happy if it can build infrastructure and get 5% return on capital.

"Investors want 12%, so you have to be careful you are investing in a country that understands that. Just because a country is building lots of assets and delivering economic growth, it does not mean the assets themselves give you the right kind of returns."

Meany has 10% of Global Listed Infrastructure in EMs, but believes it is prudent to be cautious on these markets.

"We are looking to provide stable returns and lower volatility, and we look for inflation hedges in income streams from stocks we invest in. It is more challenging to get that in emerging markets – you have to be selective."

Elsewhere, such as Russia, Indonesia and Bolivia, Meany is sceptical about whether the law will protect his fund if governments try to seize assets.

"You need confidence you own the monopoly. In some places, legal systems are not there to support you if governments step in."

The BNY Mellon ARX Latin America Infrastructure fund, launched in August, is 70% in Brazilian securities and 30% in Peru, Mexico and Chile.

Latin America's appetite for infrastructure resembles Asia, with the region expected to spend $450bn by 2015, said Alex Gorra, BNY Mellon ARX's head of international platform. The 99 projects underway in Brazil will be worth about $100bn to the private sector.

In the past, South America's governments responded to increasing domestic consumption by hiking rates. Threats of this put constructors off getting involved in long-term projects like infrastructure.

"Now we are seeing decades of infrastructure build-out in Brazil happen in tandem with a consumption boom."

Gorra added Latin and South American authorities leave projects to private companies, unlike Asia's more government-led programmes.

"LatAm firms have good governance, and are focused on shareholder gains," he added.

Gorra believes these facets mean Brazil's equities have performed better.

Expanding universe

He added it is not just the Olympic Games and World Cup spurring Brazil's $161bn infrastructure spend by 2013, although they lend impetus to a high-speed rail link between Rio de Janeiro and Sao Paolo.

The BNY Mellon ARX fund invests in companies linked to infrastructure, such as capital goods, telecoms and energy.

Gorra expects the size of the fund's universe to double by 2015 as more companies float.

Manager Bruno Garcia's largest holdings include toll road and rail operators, industrial firms and utilities.

Garcia's approach to investing in shares diverges from Meany's at First State, as Meany prefers projects and long-term concession agreements over them. Real assets have higher barriers to entry, and give owners pricing power, he reasoned.

"Companies can bring skills and capital to the table, which may be welcome, but there is a life on that because, at some point, China or Brazil will work out skills to do it themselves."

Lutetia's Tiramani expects China, through higher R&D activity and M&A, to compete on equal footing with US rivals like Caterpillar by 2016.

He said a separate fillip for emerging infrastructure expansion is that advanced economies will welcome them.

"Buying goods from, say, Caterpillar, helps an emerging nation like China build its dams and reduces the emerging market current account exposures, and this relieves the FX market indirectly, at a time people say developed currencies are too cheap.

"Emerging market countries spending on infrastructure therefore kills two birds with one stone," he added.