Newcore Capital

Clarifying and pricing the different types of risk when investing in infrastructure

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In the capital raising round for our latest UK social infrastructure real estate fund, which closed in May 2023, several investors asked us the question: "Is Newcore infrastructure or real estate?" as they considered from which bucket of their own capital allocation to analyse our proposition. Explaining how we answered it might be helpful to others considering the same question and to shed light on the different risk/return attributes of areas of infrastructure investing, which are often overlooked or misunderstood.

I will start with some examples - this could be from social infrastructure or economic infrastructure as the investment rationale is relevant to both. By social infrastructure, simply put, I mean the assets and services that allow society to function on a day-to-day basis (childcare, education, healthcare and funeral services for example).

By economic infrastructure, I refer to the assets and services that allow society to mobilise (e.g. fibre networks, electricity transmission, fuelling pipelines, water utilities). There are some examples where social and economic infrastructure cross - for example: energy storage and production; energy from waste; airports; and container ports. Furthermore, these definitions are Newcore's interpretation and not sacrosanct – some investors for example consider certain housing types to be social infrastructure.

I will use early years education/childcare (clearly social infrastructure) for my analysis. It is possible to gain exposure to returns from a business providing educational services and its underlying assets, in four primary and distinct ways, which I set out below in order of risk/return profile.

Motorway Service Area, Cardiff NSS IV LP

RISK/RETURN OPPORTUNITIES IN EARLY YEARS' EDUCATIONAL INFRASTRUCTURE

A) Invest in the equity of the operating company itself (it may or may not have borrowings and may or may not own its freehold assets);

B) Own (and lease to the company) the property that the company uses to provide the services (with or without leverage);

C) Lend to the operating company in the form of secured or unsecured corporate debt; or

D) Lend to the property owners above in the form of senior or junior secured debt.

Each of these has a different risk profile and therefore required rate of return for investing.

Private or public equity investors in the first **bracket (A)** might require say 15-17% p.a. returns to reflect the risks inherent for providing their capital - and with good reason. If the CEO of the operating business departs, they must find another one; their executive management team will be forever recruiting teaching and care staff; if there is a scandal, they must sort it out; if numbers of pupils fall, they need to address this. If the company (as many are) is leveraged operationally and leases its assets, then that all adds to the risk premium and target required return for the equity investor.

Bus depot, SW London, NSS IV LP

Newcore Capital invests firmly in the next **bracket (B)**. Our strategy is to own sustainable real estate assets that we lease to our roster of tenants across our sub-sectors. We provide lower cost real estate equity capital; and our tenants provide the expertise in running our buildings for the benefit of their stakeholders, including us to whom they pay rent. Our target unlevered return might be 8-10% p.a. for core holdings and higher if we are taking additional risks of refurbishment or planning. We have no dealings in the running of the operational business; and we very much hope our tenants go on to make strong returns for their investors with sustainable long-term business models. A lot of our due diligence at outset goes into understanding whether that is likely to happen. If the tenant does go bankrupt though, we have no obligation to take on the operation or its liabilities and we can relet the building to another occupier with the same or a different use.

"Infrastructure *per se* is not an investment class – but rather the critical societal functionality to which it is possible to gain investment exposure in different ways"

SEN School, SW London, NSS V LP

The corporate debt markets are a well-established investment market for credit and there are plenty of lenders to companies across social and economic infrastructure (**bracket C**). Following through my example, investors might in the current market seek 7-9% p.a. returns for lending to corporates, depending of course how strong their balance sheets, how cash positive and how well-established/positioned they are. These lenders do also have the risk that if the company's equity erodes, they may end up owning the company themselves if they want to recover their principal, which makes this form of lending riskier than a mortgage loan to the property owner, where the lender can take possession of that property in the event of a default as its main security.

To complete the picture for investors, it is possible to lend to property owners like Newcore who lease their assets to tenants providing social and economic infrastructure and indeed many banks do (**bracket D**). We have active relationships with the main UK clearers and other well-regarded and well-capitalised lenders (both banks and insurers). Likely returns to lenders to core real estate in this area are currently around 6-7% p.a. dependent of course on a multitude of micro-economic factors, as one would expect.

In summary therefore, the different forms of exposure to social and economic infrastructure are not *per se* treatable in a single risk band - so there is no answer to the question "are you real estate or infrastructure?". We invest in the property assets of the social infrastructure that is much needed by UK society and delivers a return between equity and credit, as one would expect from real estate.

Social infrastructure real estate examples

There is a considerable difference too between the risks of investing in a company that provides clean water, deals with waste-water and handles all that comes with it - for example, the environmental issues of river pollution, customer complaints and the like; and the investment risks of owning property leased to it.

And the corollary to this, somewhat worryingly, is that in the last 20 years as the infrastructure investment marketplace has grown, investors and managers in infrastructure have sometimes conflated these risks (hence that original question). Infrastructure funds often market themselves on the basis of providing stable cash flows to investors – targeting 6-8% p.a. net returns say, but in fact end up owning assets, per my examples above, that need to generate much higher returns than are offered. Additionally, where they own companies providing infrastructure-linked services that do have stable cash flows (and there are plenty that do), these are then often leveraged to high LTV levels (north of 70%) often ignoring future capex requirements for modernisation/environmental upgrades, a significant amount of which is coming up the track.

Herein lies both opportunity and threat for institutional investors already invested or thinking about investing in this space. It is critical in doing so to be clear from outset about which risk/return category you want exposure; and then target it explicitly. The risks of leasing a property asset to a funeral provider on a long, index-linked lease are very different to the business of selling funeral services, caring for and burying the dead.

Getting it wrong may indeed then end up as the last nail in the coffin for your strategy in more ways than one!

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