

Lazard Insights

Conference Call Series

25 August 2010

Summary

The Unique Characteristics of the Global Infrastructure Asset Class

Featured Speaker: **Warryn Robertson**, Portfolio Manager/Analyst

The Infrastructure Asset Class

Infrastructure is the building blocks of the modern economy, and includes transportation, such as toll roads or airports; energy, including gas and electricity transmission, distribution, and generation; water pipelines and treatment plants; communication, such as broadcast, satellite, and cable networks; as well as buildings that provide social functions like hospitals, schools, or prisons.

In recent years, there has been a shift toward private sector ownership and management of infrastructure assets due to benefits such as long life, low risk of capital loss, inflation-linked revenues, and correlation benefits relative to major asset classes.

One example of this shift is mature toll roads, which are typically leased under long-term (i.e., multiple decades) contracts (concessions) by governments. A mature toll road has a low risk of capital loss and robust capital streams, as the majority of people continue to drive cars even in poor economic environments. Mature toll roads enjoy very high margins, which, coupled with strong cash flows, help to defend against capital loss. They also often have the right to raise tolls at a sometimes greater-than-inflation rate. Further, most monopolistic infrastructure assets have low correlations versus equities and fixed-income securities, providing diversification benefits.

However, like every other asset class, there are risks involved in investing in infrastructure. As infrastructure assets are necessary to the functioning of society, they can be considered

essential services. As a consequence of being monopolistic essential services, these assets often attract the attention of governments and, consequently, have high levels of political and regulatory risk. The management of these types of risks will greatly impact the long-term returns of these investments.

Another type of risk relates to leverage. As infrastructure assets tend to have stable revenue streams and robust operating cash flows, many banks are enthusiastic to lend to these types of companies. An investor should be conscious and cautious of a company's gearing/leverage and debt levels.

Last, while infrastructure investments may protect against inflation, they are susceptible to the risks of movements in real interest rates.

Critical Investment Parameters

There are three main parameters to consider that help to guard against the potential risks of infrastructure investing: revenue certainty, or stable revenue streams; profitability, or the ability to translate revenue streams into profits; and longevity, or the capacity to achieve stable revenue streams over the long term. These key parameters are aided by the monopolistic characteristics of infrastructure companies, which are, in turn, aided by transparent and consistent regulation. Good regulation is characterized by a regulatory authority that is distinct and separate from the current government and legal system. Inconsistent or opaque regulation results in the political/regulatory risk mentioned previously.

Not All Infrastructure is Created Equal

In our opinion, the best way to illustrate the differences between infrastructure companies is to compare a regulated utility with a merchant electricity generator.

The regulated utility is a natural monopoly that owns the poles and wires that provide power to businesses and homes. Given this monopoly position and inherent pricing power, governments typically choose to regulate this type of infrastructure. Regulated utilities receive a guaranteed return profile along with explicit or implicit inflation pass-through in the rates that they charge their customers. These three factors—the monopoly asset, regulated return, and inflation pass through—provide investors with a very stable and consistent pattern of returns over a long period of time.

In contrast, the merchant power generator does not own the poles and wires it utilizes, and is therefore not a monopoly asset. It competes with many other merchant electricity generators, the price it receives for electricity is highly dependent on commodity prices, and the majority of its cost structure is fixed. Combined, these factors create a volatile pattern of returns in the short and long term.

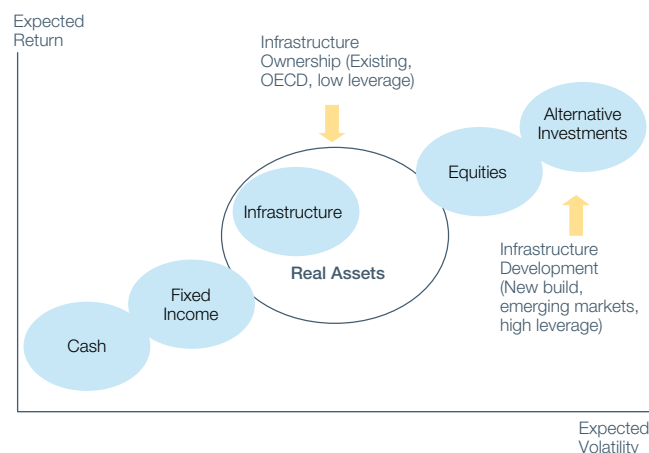
The differences between the two companies are stark. We believe the critical factor to ascertain when considering an investment in infrastructure assets is how cash flows are earned.

Infrastructure in an Asset Allocation Framework

As illustrated in Exhibit 1, there are key differences between infrastructure ownership and infrastructure development. If an investor considers the infrastructure asset class in terms of risk and reward, it fits right between the equity and fixed-income asset classes—a space often referred to as the “real asset” bucket, or assets with inflation protection attributes that can be described as asset-rich (e.g., timber, commodities, or property).

However, a distinction should be made between existing infrastructure assets with defined patronage that are based in developed countries with proven regulatory systems, and the greenfield infrastructure assets in emerging markets. As it is impossible to determine the utilization levels of brand new or in-construction infrastructure assets or the regulatory uncertainty in emerging markets, greenfield projects in these countries have much different risk/return profiles than established, regulated, monopoly infrastructure. Infrastructure companies that have high levels of leverage are also in the higher-risk category.

Exhibit 1 Asset Allocation Framework



Source: Lazard Asset Management Pacific Co.

For illustrative purposes only.

Accessing Global Infrastructure

There are two primary ways to invest in global infrastructure assets: private equity or publicly listed markets. The underlying assets in both approaches are the same, but the investment structures around the assets differ, as illustrated in Exhibit 2. We believe that diversification, opportunity size, and return profile are three of the key factors to consider when choosing an approach to infrastructure investing. The choice will vary depending on each investor’s preferences.

Exhibit 2 Private versus Listed Infrastructure

	Private Equity Fund	Publicly Listed Markets
Diversification	5-10 Assets	25-50 companies (~300 assets)
Time to Invest	~3-5 years +	Immediate
Liquidity	Illiquid; lock ups	Daily
Leverage	High	Low
Fees	High; performance based	Low; asset based
Universe	Approx \$100-200 billion	Approx \$1,500 billion
Return profile	Smoothed, vintage risk	Short-term equity market noise

As of 31 December 2009

Myths of Listed Infrastructure Investing

One of the common myths is that infrastructure is simply a “dressed-up” equity. In reality, infrastructure assets that possess the positive underlying characteristics discussed previously (i.e., that are monopolistic and regulated) have a long-term equity beta of approximately 0.5, or half of the equity market. However, if other types of infrastructure assets are considered (i.e., merchant power generators with high fixed costs in competitive markets), the equity beta can reach above 1.0. Many infrastructure indices have betas that are closer to 1.0, which is due to the inclusion of these unfavorable types of infrastructure assets. This, again, illustrates that it is important to distinguish between infrastructure assets.

Another common myth is that infrastructure assets are volatile. While it is true that the share prices of infrastructure companies will fall or rise with the markets on any given day, the underlying return structure of regulated, monopolistic assets has a lower risk profile than equities. Typically, the standard deviation of the absolute return of regulated and monopoly-like infrastructure assets is half that of equities. Again, if merchant power generators with higher risk profiles are considered, the standard deviation may rise above that of equity markets.

Infrastructure Investing Amid Uncertain Times

Parts of the global listed infrastructure market are currently trading at highly attractive valuations. Share prices imply asset risk premiums far higher than what is justified for regulated monopoly, essential service assets. Many attractive infrastructure assets are trading at lower multiples than equities in general, but with a much higher dividend yield.

Today, investors face a high level of uncertainty as they try to plan their portfolios for a new financial era. Industrials, financials, and other general equities are currently facing significant earnings headwinds in the short to medium term. We believe infrastructure is a high-quality investment option during the current economic environment for several reasons: infrastructure companies offer essential services with stable and predictable demand and sit in monopoly positions with pricing power, inflation protection, generous operating margins, and manageable debt profiles.

Opportunities for Infrastructure Investment

Exhibit 3 outlines some parameters we consider when investing in infrastructure. We prefer developed-world, monopoly-like infrastructure assets with proven patronage profiles versus greenfield investments. There is a greater opportunity set when considering global infrastructure companies instead of using a local approach. Global investing also makes it easier to diversify away from a single political and regulatory environment. We believe OECD countries with proven regulatory environments offer more attractive investments versus the more uncertain and unproven infrastructure assets in emerging economies, and prefer to access the asset class via listed assets instead of private equity.

Exhibit 3 Parameters for Infrastructure Investing

Ownership not development	Can provide match to pension liabilities
Stable returns	Long-life, low-risk, inflation-linked returns
Global not Local	Greater opportunity set, diversify exposure
OECD not emerging markets	Political risk, insufficient risk/return
Listed not direct	Access, diversification, liquidity, value
Risks can be managed	Regulatory/political, gearing, real rates, equity market noise

Important Information

Published on 7 September 2010.

This summary is being provided for informational purposes only. The information and opinions presented does not constitute investment advice and has been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions and estimates expressed herein are as of the date of the conference call and are subject to change. This summary is not intended to, and does not constitute, an offer to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management and shall not be consider as an offer or solicitation with respect to any product, security or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss.

Certain information included herein is derived by Lazard in part from an MSCI index or indices (the "Index Data"). However, MSCI has not reviewed this product or report, and does not endorse or express any opinion regarding this product or report or any analysis or other information contained herein or the author or source of any such information or analysis. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any Index Data or data derived therefrom. The MSCI Index Data may not be further redistributed or used as a basis for other indices or any securities or financial products.

Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging market securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging market countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in emerging market countries.

Securities and instruments of infrastructure companies are more susceptible to adverse economic or regulatory occurrences affecting their industries. Infrastructure companies may be subject to a variety of factors that may adversely affect their business or operations, including additional costs, competition, regulatory implications and certain other factors.

Past performance is not a reliable indicator of future results.

© 2010 Lazard Asset Management LLC. **Australia:** Issued by Lazard Asset Management Pacific Co., Level 39 Gateway, 1 Macquarie Place, Sydney NSW 2000. **Germany:** Issued by Lazard Asset Management (Deutschland) GmbH, Alte Mainzer Gasse 37, 60311 Frankfurt am Main. **Japan:** Issued by Lazard Japan Asset Management K.K., ATT Annex 7th Floor, 2-11-7 Akasaka, Minato-ku, Tokyo 107-0052. **Korea:** Issued by Lazard Korea Asset Management Co. Ltd., 10F Seoul Finance Center, Taepyeongno-1ga, Jung-gu, Seoul, 100-768. **United Kingdom:** For Professional Investors Only. Issued by Lazard Asset Management Ltd., 50 Stratton Street, London W1J 8LL. Registered in England Number 525667. Authorised and regulated by the Financial Services Authority (FSA). **United States:** Issued by Lazard Asset Management LLC, 30 Rockefeller Plaza, New York, NY 10112.