Realities and Opportunities in Real Estate and Infrastructure Investment Today

Notes for remarks by:

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The 2009 Schulich Perspectives Lecture
October 29, 2009
Toronto, Canada

CHECK AGAINST DELIVERY

Introduction

Good evening, ladies and gentlemen. It's a pleasure to have this opportunity to talk with you about the current investment environment as we see it at the CPP Investment Board. More specifically, I'll be discussing this question in the context of two asset classes that, while they may not be part of your own personal portfolios, constitute an important source of growth for the CPP Fund and other investors in the public and private pension sector. I refer, of course, to real estate and infrastructure investment, which are essential building blocks in our overall investment mandate to help sustain future pensions for 17 million Canadians.

Now before making some comments about these asset classes, I'll first provide some background about the CPP Investment Board itself.

The CPPIB was created as part of the successful reforms of the Canada Pension Plan in the mid-1990s. Just over 10 years old now, the CPPIB was formed for the sole purpose of managing the assets of the CPP Fund. Those assets are not part of the government accounts; they originate from direct contributions of every worker and employer in all provinces with the exception of Quebec.

The CPP Fund is large, $117 billion as at June 30, 2009, as Phil pointed out, not just by Canadian standards, but in a global context as well. It is projected to reach $200 billion within the next 5-6 years and will continue to grow well beyond that mark into the future.

The CPPIB has also grown significantly since its inception 10 years ago. We are now a multi-faceted investment management organization with approximately 535 employees, mostly located here in Toronto, but also within our offices in London and Hong Kong.

We report to an independent professional board of directors intended to shield us from any political involvement in our activities, and this governance structure has worked exactly as planned from the outset. We operate according to a purely commercial investment mandate – maximize the rate of return without undue risk of loss. In practical terms, this means that we

have to generate a minimum return of 4.2% real in order to do our part to keep the Canada Pension Plan sustainable at its current contribution rate. In this regard, Canada is the envy of the vast majority of countries around the world in that Canada's Chief Actuary has consistently re-affirmed the CPP's sustainability throughout the 75 year periods of his forecasts. This stands in sharp contrast to countries such as the United States where social security has yet to be reformed and is clearly unsustainable as currently constituted.

One of the CPPIB's key advantages as an investor is our long time horizon. Most market participants, be they mutual funds, hedge funds, institutional money managers and the like, are forced to have short investment horizons by virtue of their business models, how they are evaluated and how they are compensated. In our view, the vast majority of the considerable intellectual capital devoted to money management is focused on a 0-24 month time frame. In contrast, the nature of the CPP Fund allows us to effectively have a 75 year investment horizon for our decisions and results. Now in practical terms of course we aren't making all investment decisions using a 75 year analysis, but we are able to focus on return streams well beyond the typical investor.

This extended investment horizon makes categories such as real estate and infrastructure particularly attractive to us since these are by nature long duration assets. Because we want to acquire and hold these assets for long periods of time, we are particularly drawn to operating as a direct investor in the private markets rather than through listed companies or fund structures. In addition, the private markets for real estate and infrastructure are vastly larger than other alternatives and also allow us to meet our scale objectives as well as exploit our comparative advantage as a large investor. Also, direct investing allows us to negotiate and control the governance structure of the private entity in a way that's not possible with a public company. Of course to succeed as a direct investor in the private markets we need to have the required skills, expertise and experience housed within our organization and this has been one of the key drivers for our growth as an organization over the past few years.

As a long term investor in real estate and infrastructure, what we essentially focus on is the stream of future cash flows the "hard" assets we acquire will generate over the long periods of

time. Like all investors, we will periodically have to fair value those assets and their valuations will be impacted by factors such as current cap rates or public company comparables. But for us, it really is the level and relative certainty of the future cash flows and the price we have to pay to acquire them that are our key investment criteria.

And in that respect, we certainly don't consider either real estate or infrastructure as homogeneous asset classes. In our view, hotels should clearly not be treated the same as a core office building from an investment or portfolio construction perspective. Similarly, there is a great difference in the risk of future cash flows for investment in the well established and dominant retail mall in Canterbury, England, that we own for example, than our Greenfield development of a retail mall in Istanbul, Turkey.

The same is true for infrastructure which is a label that is applied to a very broad range of assets. We view assets such as airports and toll roads that tend to have a sensitivity to GDP quite differently than our ownership interest in an essential services utility like Anglian Water Group which delivers water and sewage services to the Southeast part of England.

We also further adjust our calibration of risk according to the amount of leverage or debt in the capital structure of our holdings. That practice has stood us in good stead over the last few years in particular as we avoided investing in structures with high embedded debt levels and dropped out of auctions when prices reached levels that were only supported by extremely high levels of underlying leverage.

One question we are often asked is what specific percentage allocations of the CPP Fund we have made for real estate and infrastructure. In that respect, we are different from the vast majority of fund managers in that we don't have fixed allocations to either real estate or infrastructure. It's our view that fixed allocations can often compel investing regardless of market conditions. They can also result in perhaps making the best incremental infrastructure investment, for example, that might not be the best incremental overall investment opportunity for the fund, and as well sometimes lead to sub-optimal decisions in order to re-balance the portfolio to fixed weights. We think our practice of breaking down infrastructure and real estate

according to their underlying risk and return attributes and constructing the overall portfolio in a similar manner leads to more informed investment decisions.

Turning to our real estate investments, let me first take a moment to describe our portfolio. As Phil noted earlier, we began our real estate investing program 4 years ago and we now have a team of 35 investment professionals overseeing a real estate portfolio that totals $7.0 billion in equity investment and $10.6 billion in total asset value. In addition, we have committed a further $3.7 billion in equity investments with our existing partners which have yet to be invested. In terms of real estate sectors, we are focused mainly on office, retail and industrial properties in a select number of geographic markets.

At CPPIB, we divide the global real estate market into two segments: developed markets and emerging markets. In developed markets, we are focused on the 6 largest and most transparent real estate markets in the world: Canada, the U.S., U.K., Western Europe, Japan and Australia.

Within North America, where our real estate investments are primarily held on a direct basis through joint ventures, we currently own interests in 44 properties totaling over 26 million square feet in gross leasable area. To provide you with a sense of our Canadian portfolio, we are the largest class A and AA office landlord in Edmonton and we own close to 20% of the class A office market in downtown Toronto. With respect to our shopping centre portfolio, we own interests in over 7.5 million square feet of retail properties in Canada, ranging from regional shopping centres to power centres.

In each of our target markets we seek to identify strong local partners who have deep knowledge and expertise within their home markets. Unlike some other Canadian pension funds, we act solely as an investor and portfolio manager and not as a property manager which eliminates potential conflicts and gives us additional flexibility to forge partnerships.

As we look ahead, we believe that there will be a lot of opportunities to acquire high quality real estate assets at attractive prices especially in the U.S., U.K. and Australia as a number of trends play out:

We see that the time delay between the onset of the economic downturn and its impact on tenant demand is just now becoming evident. The considerable refinancing risk in the next 18-24 months will force owners in highly levered structures to put prize properties on the market. And any increase in short-term interest rates as the economy comes out of recession will further exacerbate the refinancing dilemma for many levered real estate holders.

With respect to emerging markets, we believe that they can afford attractive real estate investment opportunities given their rapid economic growth and developing middle class which in turn are driving the need for modern, high quality development. Here the need to identify strong local partners with aligned interests and shared principles is even more important than in developed markets given the lack of transparency within those markets. Consequently, we have decided to focus on just four countries – Brazil, Mexico, China and Turkey – for the foreseeable future, so that we can be a meaningful partner within these select markets and also deepen our own knowledge of how they operate.

Even so, these are challenging markets to navigate. Using Brazil as an example, in early 2008, when we began to analyze the local market and potential partners, we concluded that the Brazilian real estate values overheated due to a large influx of foreign investors that also limited our ability to negotiate terms with potential partners.

But when the global markets went into crisis last year, many of these foreign investors retrenched, having to deal with other issues back home in the U.S. and Europe. Without this pool of foreign capital, property values began to soften and local operators had an increased willingness to offer more favourable partnership terms. As providers of long-term and patient capital, we saw this as an opportunity to act as we believed the country's property fundamentals remained intact and its long-term outlook continued to be very positive. Accordingly, we capitalized on the current downturn by joining forces with another large global institution and together secured a joint venture that saw each of us commit US$250 million with Cyrela Commercial Properties, a leading developer in Brazil. The size and terms of our commitment will allow the venture to develop very high quality office and retail properties, and avoid the

fractured ownership structures that have previously prevailed within Brazil.

Now that we've looked at our real estate program, let's turn to some specifics about the dynamics of investing in infrastructure.

Just before I do that, let me first describe our infrastructure portfolio. Since launching our infrastructure investing program in 2006, we now have a team of 23 investment professionals overseeing a global portfolio of infrastructure assets that total $5.9 billion. We have significant positions in a range of infrastructure assets such as: electrical and gas transmission systems, water utilities, toll roads and communications providers. A number of these transactions were large and complex and we were able to transact due to having an internal team with deep expertise.

That gives you an idea of our current infrastructure portfolio. As you can see, we have chosen to be primarily a direct investor in private infrastructure assets globally.

Our key focus is on "brownfield" infrastructure assets – that is assets that are well established – as opposed to "greenfield" assets which bear a certain amount of construction risk. We look for "brownfield" assets with monopolistic characteristics that are domiciled in locations with strong, predictable, political, legal and regulatory environments. The most attractive jurisdictions have the first two elements combined with transparent and predictable regulatory environments for each specific industry.

The ideal regulatory system should have clear rules and processes for ascertaining the cost of capital; predictable, independent periodic rate reviews; an incentive mechanism for delivery of efficiency gains to consumers; automatic inflation-linked tariffs; and last but not least, rights of appeal for decisions to which we as investors may object.

Since opportunities in existing infrastructure investment are usually dependent on the privatization process, getting the regulatory environment clearly established first will achieve the highest value for any government considering privatization, as uncertainty always increases the

cost of capital. Similarly, improving the transparency and efficiency of regulation of existing infrastructure will lower the cost of capital and result in lower prices for consumers.

Our commitment as an infrastructure investor is to provide high-quality services to consumers at a fair price funded through a combination of efficient capital expenditure and more efficient operations, at the same time expecting to receive a fair return on our investment.

As a global infrastructure investor, our size and scale are even more important advantages than they have been in the past. Many market participants, especially those who have relied on high degrees of leverage, are being forced to sell assets and to do so at lower valuations. This is largely because financing options have dried up and asset values are continuing to decline. Nonetheless, this is creating opportunities in terms of both the number and quality of assets for sale. Perhaps for obvious reasons, these days there are few buyers at the table, which makes us truly uniquely positioned to benefit as high quality infrastructure assets are progressively becoming more available.

We also tend to see the very best of the international deal flow. It's commonly known that we have the liquidity and patience needed to make large, long-term capital commitments. It is this combination of opportunity and strong analytics that are helping to ensure that infrastructure investment will contribute significant long-term value creation for the CPP Fund.

I'll quickly take you through a recent infrastructure investment that illustrates my points. Over the summer of 2009, we announced a major deal with the Macquarie Group in Australia to acquire three companies controlled by Macquarie Communications Infrastructure Group or MCG for a $2 billion investment. We had actually looked at – and bid on – some of these assets previously. This was a large and complex transaction resulting from the fact that MCG had a well publicized need to recapitalize and wanted quick resolution to its capital needs. In addition, the vendor needed a purchaser willing to assume a certain amount of corporate debt to delever the transaction. We were able to underwrite the entire deal ourselves, which certainly got it done more quickly and more cost-effectively – because we have the internal capabilities to execute transactions of this size. What's also compelling from our point of view is that it took Macquarie

seven years to acquire these assets one by one, and at much higher valuations. In one transaction, we were able to acquire next generation assets that are transformative for our infrastructure group and underscore the fact that patience can be – and is – rewarded.

Improving the Climate for Infrastructure Investing in Canada

Let me now say a few words about the need for a policy framework in order to attract private sector infrastructure investing. It is important to realize that there is an inescapable policy aspect to all infrastructure investing. There can be no private sector infrastructure investment without a policy commitment on the part of governments to privatize assets; without a satisfactory regulatory environment to oversee these assets once privatized; and without a consistent and level playing field to ensure that investors are appropriately rewarded for the risks they undertake.

In this last section, I'd like to comment on improving the climate for infrastructure investing in Canada. This is a concern many institutional investors such as the CPP Investment Board face in terms of a mismatch between public policy and investment opportunities. In Canada, there are lots of opportunities for us to invest in attractive commercial real estate. However, with Canadian infrastructure, opportunities exist in only a few jurisdictions. Globally, opportunities are also constrained by policy issues.

And so although we see significant need for infrastructure investment around the world there remains a fundamental disconnect between economic requirements and the ability of investors to commit billions of dollars to fund infrastructure. Ultimately, this is a policy question.

The global infrastructure deficit is well known; we've also seen how it plays out in Canada. Critical infrastructure is aging and decaying and must be replaced. But other jurisdictions, including the U.K., Australia and even to an extent the U.S., are ahead of the curve here and certainly ahead of Canada.

If policy makers in Canada were willing to privatize these assets, investors such as the CPPIB

and the other major Canadian public pension funds would be willing to invest with the right regulatory framework. We believe that CPPIB is an attractive partner and a good investor in these kinds of assets because we will hold these investments for decades and are motivated to invest for the long term life of the asset.

This could also serve as a powerful magnet to attract global capital. Such policy decisions could produce attractive investment returns to help support pensions, which is our job, and improve economic competitiveness by renewing aging infrastructure, which is the job of government. We believe that Canadians could also be more receptive to privatization initiatives if they knew that these investments would help support their future pensions.

The government of British Columbia has provided leadership with the best model for attracting investment for infrastructure in Canada, and we applaud this approach.

But more could certainly be done.

Opponents of public/private partnerships argue that governments can borrow more cheaply than the private sector. But perceived cost issues, such as the cost of funds, are only one part of the puzzle. This is not just about the cost of capital; it's also about managing, operating and continuing to invest and upgrade these assets for decades and generations to come.

The global institutional investment community is willing and able to invest in large-scale infrastructure projects. We ourselves are prepared to commit in the C$300 million range on a project-by-project basis for Canadian infrastructure – even more, depending on the circumstances. But I hope that an opportunity is not being missed. The moral of the story is this: capital can always find a home, but if the policy environment is unattractive, capital will not come; conversely if the environment is attractive, capital will indeed come.

Closing

In closing, I'd like to reiterate several key points from my remarks this evening:

Real estate and infrastructure investments remain an important and significant part of our investment program at CPPIB;

Canadian pension funds have deep and knowledgeable investment skills in these areas. For the CPPIB, our comparative advantages enable us to make strategic investment decisions through the lens of a long-term investor with significant size and scale; and

While we see some signs of a market recovery, we will remain patient and disciplined investors as we continue to explore attractive opportunities in real estate and infrastructure both globally and in Canada.

Most importantly, we remain focused on our long-term strategy to help sustain the CPP fund for decades and generations and support the future pensions of 17 million Canadians.

Thank you very much. Now I welcome your questions or comments.