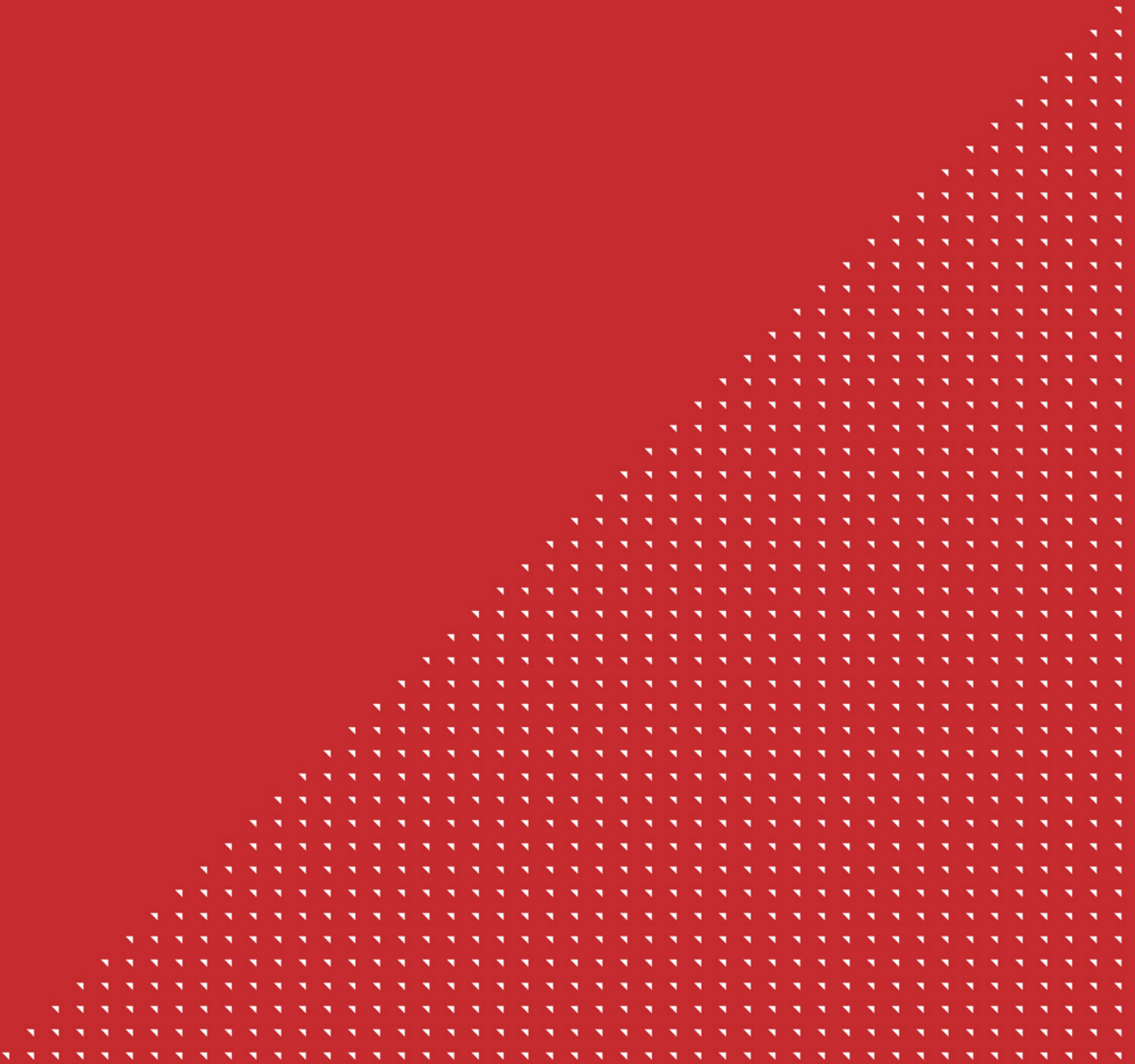


Red Paper – Investing in infrastructure debt

**A good opportunity in tough market
conditions**

November 2008



Snapshot

- The slowdown in global economies together with the prospect of higher default levels have led debt investors to seek investment opportunities with a stable underlying credit profile.
- Infrastructure debt investments typically exhibit strong credit characteristics due to their steady cash flows, high barriers to entry and ability to withstand economic downturns.
- Infrastructure has historically delivered high risk-adjusted returns that are not highly correlated with other sectors, and these characteristics are likely to lead to increased investor demand.
- Difficulty in accessing global infrastructure loans has prevented smaller investors from participating in this asset class.
- The credit market sell-off over the past year has been relatively indiscriminate, and this has provided significant opportunities for experienced investors to buy infrastructure loans at a discounted price.
- Accessing infrastructure debt via leveraged loans provides a number of advantages over high yield bonds.

Infrastructure Debt

Background

Debt investors are facing ongoing financial market turmoil, with a slow down in global economies and the prospect of higher default levels over the remainder of 2008 and 2009. In this environment, debt investors are increasingly seeking opportunities that exhibit a stable underlying credit profile. Due to their steady and often regulated cash flows, high barriers to entry and non-cyclical nature, infrastructure debt investments have historically shown low credit rating volatility (evidenced by lower ratings transitions compared with corporate bonds over a set time period) and above-average debt recovery levels in a distressed debt environment.

Infrastructure is the physical assets that are required to provide essential services to the general population. The assets are essential to enabling the economic growth and development of the society. Economic infrastructure includes sectors such as utilities, toll roads, airports, pipelines, power stations and wind farms. Social infrastructure sectors include healthcare facilities, education facilities and correctional facilities.

Infrastructure as an asset class has been attracting increasing investor interest in the past decade. The need for governments to fund new infrastructure projects, as well as maintain existing assets, has been influential in the development of the infrastructure market. Decisions about the type, quantity, method of delivery and maintenance of infrastructure are the responsibility of central or local governments, and governments have traditionally funded these projects through general taxes. The increasing need for new infrastructure in every location around the world has seen projects increasingly funded through user-pays structures and/or through partnerships formed with the private sector.

Many infrastructure assets are funded through the loan market, which is the focus of banks and professional investors, and the current market environment has provided an opportunity for experienced investors to access infrastructure loans at a discounted price.

Infrastructure debt as an asset class

Infrastructure assets have historically delivered high risk-adjusted returns that are not highly correlated with other sectors, including Australian equities, Australian bonds, listed property and international equities. This is due to a number of factors:

- Infrastructure projects have high barriers to entry given their scale, long-lead times, significant development costs and required resources. In many cases, infrastructure assets have either long term contracts or exclusive long term concessions from governments. There are also numerous legal and environmental approvals required to build, own and operate an infrastructure asset. For these reasons, operators are typically either in a monopoly position or enjoy significant competitive advantage. In addition, infrastructure businesses typically have low operating and management risks.
- Demand for essential infrastructure services is usually minimally affected by price rises or a slower economy. Consequently, demand is relatively predictable and the cash flow generated by infrastructure business is generally stable.
- Income streams from infrastructure assets are frequently regulated and/or underpinned by the government, providing investors with greater certainty. Furthermore, infrastructure assets such as toll roads, airports and electricity transmission companies typically have their regulated revenue increases linked to inflation-based formulas.
- Infrastructure assets typically have a long-term investment horizon. For example, some concessions granted by governments in mature markets tend to have an investment timeframe greater than 30 years.
- Given the asset's essential nature, there should be little risk of redundancy or technological obsolescence.

The high risk-adjusted returns of infrastructure debt that are lowly correlated with other sectors can enhance an investor's overall portfolio. The addition of high quality infrastructure debt investments will become more important in portfolios, especially portfolios that have a need for long-dated assets (e.g. superannuation funds), and investor demand for these types of assets is likely to increase.

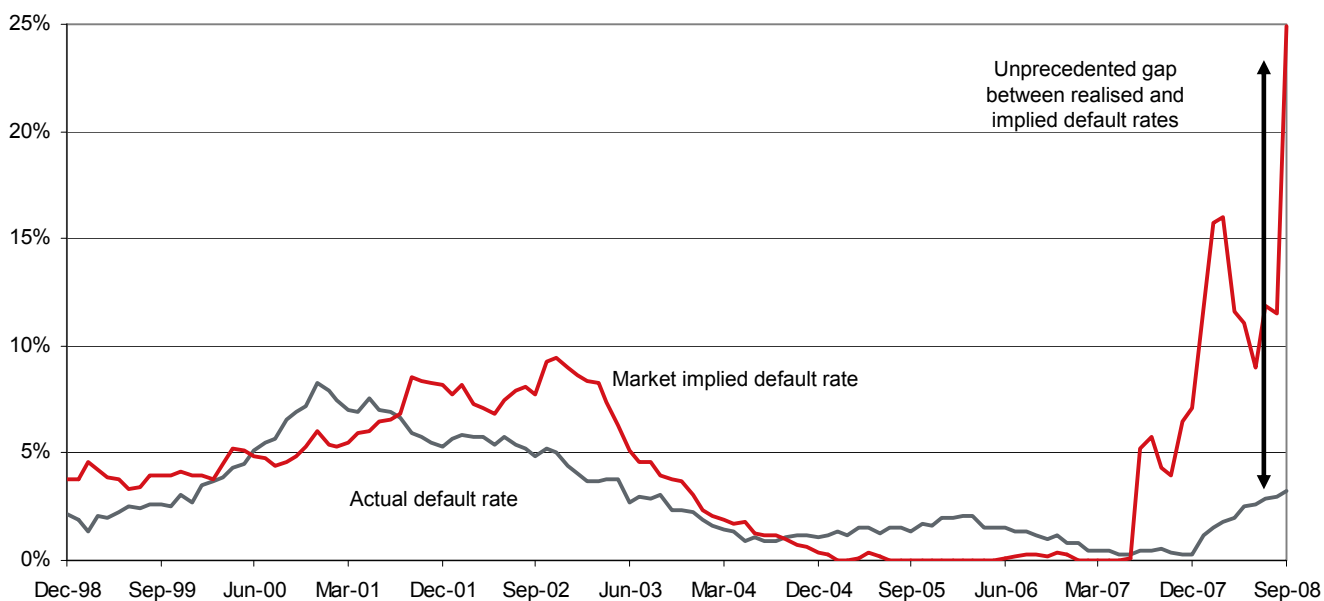
The current opportunity

Over the past several years, the loan market has provided a significant source of capital for infrastructure projects. Apart from the traditional bank lenders, institutional buyers and structured products have been large participants in the infrastructure loan space.

During the credit sell-off we have experienced over the past year, loans, including infrastructure loans, have not escaped the price depreciation experienced by the broader credit market. This is mainly because many of the traditional buyers of the high yield product have exited the market. To further exacerbate the price action, there has been forced selling from hedge funds, banks and other market participants.

The recent market volatility has highlighted an opportunity to invest in high quality infrastructure loans at deeply discounted prices. The current opportunity is highlighted by the following chart which shows that an annual default rate of nearly 30% is being implied by current loan prices. This implied default rate is tracking significantly above the actual default rate (as at 30 September 2008), as well as above even the most bearish view of loan defaults over the next year.

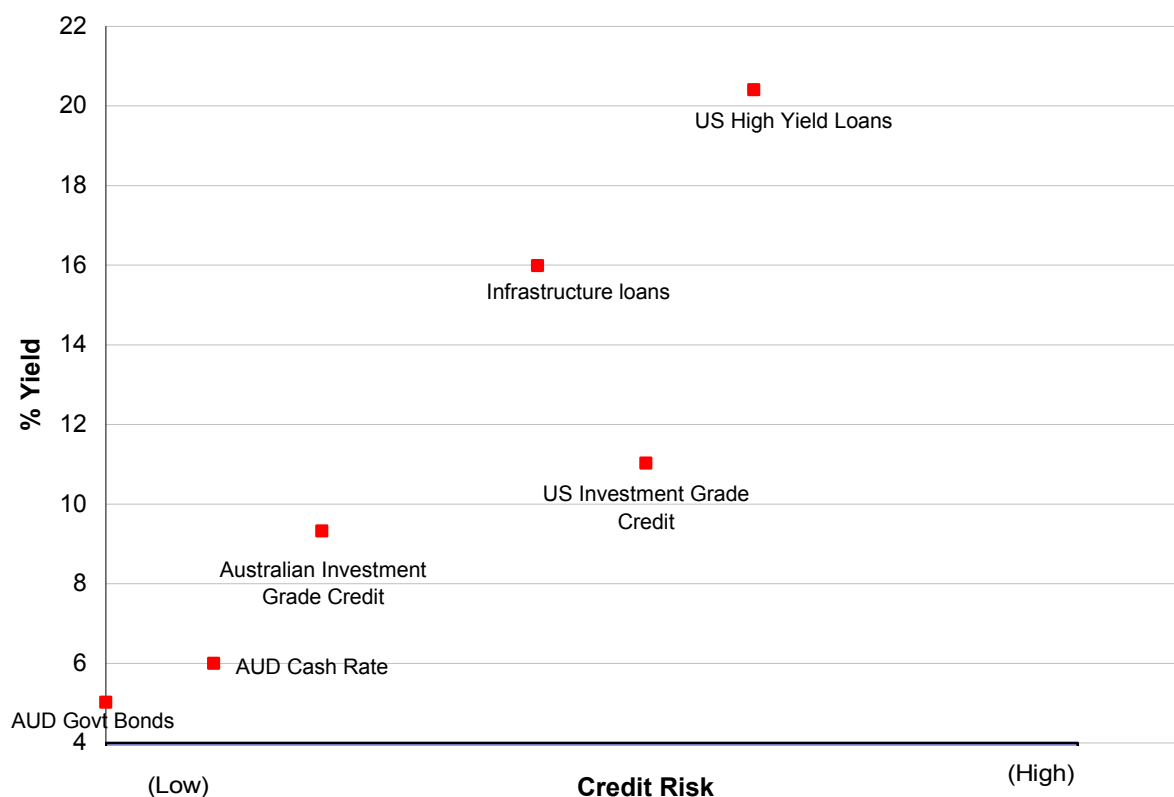
Dislocation between Realised and Implied Default Rate



Through its investment scorecard process (a systematic approach to researching and analysing investment opportunities), QIC believes that much of this price action has been overdone and the market has been indiscriminate in selecting loans to sell and reduce risk. We see this as an interesting opportunity for investors to be selectively buying discounted, high quality assets in the secondary market. In addition, the primary market is bringing new loans with stronger underwriting standards, which could also offer compelling value. Experienced investors who understand infrastructure will be well placed to take advantage of the current opportunity to access infrastructure loans at a discounted price. Due to the high barriers to entry already discussed, it will be more difficult for less experienced investors to gain access to these markets.

The following chart shows where a portfolio of infrastructure would sit relative to other debt instruments. Infrastructure loans are one of the highest returning instruments, but are relatively low risk when compared to similarly rated bonds and loans. Importantly, the returns are significantly above investment grade securities but are not significantly riskier.

Credit Opportunity Set (as at October 2008)



Leveraged loans versus high yield bonds

QIC invests in global infrastructure debt largely through leveraged loans. Loans provide a number of advantages over high yield bonds:

- A leveraged loan is senior secured debt. This means that the creditor has a first-line security over the company's assets. A high yield bond is an unsecured claim on the company and will have recourse to the assets only after all the senior creditors have been paid.
- Due to their stronger security, leveraged loans have historically had higher recovery rates than high yield bonds. The market average recovery rates on a leveraged loan are 70% compared to 40% on a high yield bond.
- Loans also typically have more covenants (i.e. protections written into the contract) that require the borrower to meet minimum financial performance measures (e.g. must maintain quarterly compliance with debt coverage ratios), otherwise the loan will technically default. The purpose of this is to ensure that default is triggered while there are still sufficient assets to repay the creditor in full.

The loan market has grown substantially in the last five years and, while it is still not as liquid as the high yield bond market, its liquidity has improved substantially.

QIC's investment approach

Infrastructure projects often require a large one-off investment and, as they generate stable, predictable cash flows, they can take on a significant level of debt. That said, the high level of debt increases interest rate risk, regulatory or political risk and vulnerability to external shocks such as natural disasters. Therefore, it is important that a thorough analysis is conducted before investing in these types of assets.

QIC currently provides a range of innovative infrastructure debt solutions to clients, and has developed extensive capabilities in sourcing global infrastructure deals, assessing their relative value and undertaking rigorous bottom-up research. QIC's robust and disciplined micro research process assesses the business and financial risks of the company, with a particular emphasis on cash flow generation, liquidity, covenant position and sensitivity analysis. QIC also undertakes rigorous analysis of documentation, tax and legal issues to ensure the long-term viability of the asset and its suitability for the client's portfolio. QIC's portfolio management also involves hedging strategies to help mitigate the risks associated with investing in these types of assets.

For further information about how infrastructure debt investment could benefit your portfolio, please contact either Scott Cornfoot, Director of Business, Active Management, Global Fixed Interest, on ph. 07 3360 3942 email: s.cornfoot@qic.com or Ryan Gordon, Business Relationship Manager, QIC Global Fixed Interest, on ph. 07 3020 7016 email: r.gordon@qic.com

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