

# Infrastructure unearthed

ALAIN RAUSCHER and MARK CROSBIE provide a view from Europe on what they call the 'myths of infrastructure investment' on the Continent.

As an asset class in Europe, infrastructure is still maturing; its origins date back no further than a decade or so. Despite our fast trains and world leading utilities, we have been very much 'late starters' compared to the Australian and Canadian markets in terms of private investment in the sector. However the region now offers an abundance of opportunities and has attracted the full spectrum of financial players; from steady yield-seeking 'buy and hold' investors targeting cash plus returns, to dynamic private equity-like players implementing active management strategies and targeting Internal Rates of Return (IRRs) in the mid-teens. Therein lies the source of various misconceptions about European infrastructure investment – the market contains participants with very different expectations as to what infrastructure investment can bring to a portfolio.

## IT'S TIME TO SET THE RECORD STRAIGHT

Amongst investment communities, there are many misconceptions about infrastructure investment. We've heard them all too many times:

- "Infrastructure is a boring, risk-free asset class which pays nice yields"
- "Regulated infrastructure assets are less risky and command lower returns"
- "Infrastructure investing requires much less financing and operational skill than a buyout fund; it's more of a bond-like investment"
- "European infrastructure is an integrated market"
- "European infrastructure is a market with too many players and too few assets"
- "Hold off on European infrastructure – the macro risks are too great"

## 'LOW-RISK' BUT NOT 'NO-RISK'

It will soon become apparent why we find infrastructure anything but boring, but first let's dig into why infrastructure investment is not risk-free. The unique characteristics of core infrastructure should offer high visibility over cash flows, low volatility of earnings, inflation-linked revenues, and low correlation to traditional asset classes. Well chosen assets and well structured investments should typically not leave the buyer exposed to any material construction or demand/usage risks. So far so good. However for any given asset, there may be other risks such as political, regulatory or environmental for example. In overheated markets, these risks are often mispriced by hungry buyers, particularly in the bidding wars for Europe's 'trophy assets' such as major airports and energy networks. One must also not forget that above all, these are not just assets we are buying but shareholdings in real companies, each of which carries its own company-specific risks.

Investors should also be aware of any currency risk exposure if an infrastructure fund's portfolio assets are held in a different currency to that of the fund. This has been the case with several European infrastructure funds raising commitments in Euro only to invest significantly in the UK or other non-Euro countries (and at a time when the Sterling was overvalued). Despite these aforementioned risks, the infrastructure asset class is, nevertheless 'low-risk', so long as the buyer actively addresses and mitigates risks in their portfolio on an ongoing basis. Currency risk can be largely avoided with investment discipline and careful portfolio construction.

**WHY REGULATED ASSETS ARE NOT LESS RISKY**  
Regulation is often mistakenly perceived as

a safety net, whereas we would argue that it is a risk which is markedly heightened in light of the European sovereign debt crisis. One need only look to the recent example of the Spanish renewables sector to see that in certain markets, regulation can be swiftly changed (to the detriment of asset owners) in times of financial crisis, resulting in reduced tariff revenues and sudden pressure on financing structures. Regulatory risk needs to be carefully analysed and appropriately rewarded through return. It can also be significantly mitigated through the selection of assets where the end consumer (and not the government) bears the cost of any subsidy, as well as through appropriate portfolio diversification.

## ACTIVE INFRASTRUCTURE INVESTMENT REQUIRES A DIVERSE AND DEEP EXPERTISE

In order to deliver superior returns, a 'buy and hold' strategy is rarely sufficient. Driving real value creation requires very active management and includes activities such as financing/refinancing structuring and negotiation, implementation of new strategies, identifying and executing value-accretive acquisitions and divestments, implementation of management incentives, and dealing with vital human resources issues such as strengthening management teams when required. This requires a diverse team with skills encompassing mergers and acquisitions, private equity, debt structuring, tax, legal, and infrastructure corporate experience.

## THE IMPORTANCE OF LOCAL 'KNOW HOW'

In addition to this skill set, a European manager also needs an investment team with local knowledge and well established relationships. This 'know how' simply cannot be absorbed from afar. It is somewhat surprising therefore,

that the UK remains the most prominent general partner (GP) location within Europe, accommodating 46 per cent of infrastructure fund managers (according to Prequin). In order to really capitalise on the European infrastructure opportunity, we would argue that there is a true 'on the ground' advantage to a GP being based on the European continent. Dealflow is frequently derived through long established relationships, with many assets not auctioned. Further, proper risk assessment of European transactions requires a thorough understanding of local regulations (and their propensity to change), country politics (and their propensity to interfere), and local economic dynamics.

#### WHY 'NICE YIELDS' DON'T NECESSARILY MEAN NICE RETURNS

It's very easy to deliver a steady 10 per cent yield. You give me \$100, I give you back \$10 each year, for 10 years! Unfortunately there is nothing left to distribute at the end, resulting in a money multiple of 1.0 x and an IRR of zero per cent. For this reason, it's worrying to see that some manager compensation structures are based solely on yield. That being said, yield is a very important part of delivering value and serves to de-risk the investment by returning cashflows over the life of the holding period. However, strict money multiple discipline is required to ensure that the cash yield outflows do not detract from the target IRR.

#### EUROPE AN INTEGRATED MARKET? NOT SO.

Now let's tackle the fallacy that Europe behaves as one single, integrated entity. This idea was largely brought about by the introduction of the Euro currency, but one need only visit a few European countries to determine that each is very different by way of language, culture and behaviour. The same is true of each country's infrastructure markets. The regulatory, banking, legal, political and tax environment in each European country can vary significantly and requires a thorough understanding of the risks prior to investment. Take the solar PV (photovoltaic) market as an example, where we believe the Italian market offers more attractive features than that of Spain, although each has high levels of irradiation (exposure to radiation). Firstly, Italian incentives for renewable energy sources are paid by the final consumers through a (very small) component of consumers' electricity bills (unlike Spain). Secondly, we believe there is greater certainty over the stability of the Italian tariff structure following

the Decree published earlier this year. In contrast, the Spanish Government has clearly favoured CSP (concentrated solar plant) technology over solar PV energy, announcing severe (retroactive) reductions to PV tariffs in late 2010 while leaving solar CSP relatively untouched.

#### ARE THERE REALLY TOO MANY PLAYERS?

There is actually a lot less competition than one would think in continental Europe due to its complexity, with the non-Continent-based GPs typically pursuing the more highly visible 'trophy' assets, which are invariably auctioned, leaving GPs like ourselves to secure exclusivity early on for the many other opportunities in the marketplace. We'd appreciate it if you keep this quiet – we're quite enjoying this opportunity set!

#### AN OPPORTUNITY-RICH REGION, DESPITE THE CURRENT MACRO ENVIRONMENT

Europe currently offers an attractive environment for buyers, with many assets for sale that would never have been available in the peak of the previous cycle. Large European utilities and transportation companies (in each case world leading corporates) are in the process of an aggressive divestment of high quality assets in order to deleverage and restore their balance sheets, as well as recycle capital into new projects. Add to this the continuing impact of Europe's 'unbundling' policy which is forcing further asset sales by energy utilities as well as the dealflow associated with the Trans-European Network (TEN) projects (designed to integrate and improve the quality of European transport, telecommunications and energy networks), and the EU leaders' '20-20-20' targets (20 per cent of EU energy consumption to come from renewable resources by 2020), which has opened the door for further private sector investment in renewable energy. On top of this, there is an increasing number of public-to-private asset sales by European governments who are overburdened with debt and in desperate need of new and replacement infrastructure, particularly in the Iberian Peninsula (Spain and Portugal), the Nordic countries and, of course, Ireland and Greece. All in all, there is a diverse opportunity set.

So where do we see sector-specific opportunities? Energy assets continue to provide opportunities particularly in midstream and renewables. Transmission and distribution opportunities also abound. However, the latter such assets need to be approached with caution in light of the recent aggressive bidding which has

led, in our view, to overly generous entry prices. In the transportation sector, there is a resurgence of opportunities in airports whether through privatisation, as in Spain and France, or due to forced disposals from regulatory decisions, as in the UK. We are also continuing to see opportunities arising in port assets and toll roads. In the telecoms sector, tower and dark fibre opportunities are on the rise as Europe continues to upgrade its telecom networks to allow for faster data transmission.

Country-wise, we are exploring opportunities across the Continent, however we are avoiding the likes of Greece in light of the country-specific risk environment and we are wary of some of the emerging European markets with their heightened political and governance risks.

The macro risk of the Eurozone cannot be overlooked and the sovereign debt crisis is clearly straining the Euro. However, at the core of the European Monetary Union remain some very strong economies. Northern European countries including France and Germany should recover strongly and some of the countries outside of the historical core have proven to be resilient in a crisis (eg Poland). In addition, there are diversification benefits inherent to a European portfolio where a GP can diversify broadly by country, thereby reducing the overall country/political risk.

#### CONCLUSION

Infrastructure is not boring, nor is it a risk-free asset class. It requires a highly diverse skill set to deliver superior returns and in Europe - a local touch. The fragmented European market has less competition than perceived, with many proprietary transactions available for those whose local networks open the right doors. Behind the stormy macroeconomic backdrop of the Eurozone in fact lie many positive drivers across all core sectors of the infrastructure market, providing experienced managers with a fertile opportunity set in which to invest well during this part of the cycle.

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*Alain Rauscher and Mark Crosbie are Managing Partners of Antin Infrastructure Partners, an independent European infrastructure fund manager based in Paris.*