

## Infrastructure Learns Lessons For a New Era

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Warren Buffett once told his investors that only when the tide goes out can you see who's been swimming naked. For the infrastructure sector, the financial and economic crisis that began in 2008 was the equivalent of the tide going out. In its ebb stood market participants and market practices that weren't much to look at.

General partners were sometimes woefully unaligned with limited partners. Economic forecasts were far too optimistic. Borrowing levels could be so high that debt service became a burden or impossibility on some assets, and debt maturities threaten to engulf others in the not-too-distant future.

*InfraNews* asked market participants what lessons are being drawn as this relatively young asset class emerges from its first full-blown crisis.



"Two things can be gleaned from the entire infrastructure experience of the past five or 10 years," said Dana Levenson, (right) the Chicago-based head of infrastructure banking, Americas, for RBS. "And they really have everything to do with the recent severe economic downturn. One, infrastructure assets are not recession proof. They are recession resistant. Two, leverage can be as much your enemy as your friend and you find that out in an economic downturn."



The realization that assets and leverage can have a downside is one of the common denominators of infrastructure decision-making today. Everybody is more alert to risks. The fund managers who behaved as though the bet was one way are the ones most likely to stagnate or disappear in the coming years. If there's another point of consensus, it's that limited partners are becoming much more demanding of fund managers.

Limited partners are said to be seeking all sorts of changes to the infrastructure investment model: they want long-term funds, they want to invest directly or co-invest, they want lower fees, they want less leverage, they want low-risk, regulated assets, they want infrastructure funds with seed assets, they want to see realized investments, and they want open-ended funds. Their wish list goes on.

The immediate reality is looking more pedestrian. The limited partners want infrastructure fund managers incentivized to deliver returns to investors. They don't care very much what fund or deal structures are deployed to do so, but they've become alert to signs the infrastructure funds have other priorities.

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"The problem in the beginning was that there were not so many managers available," said Robbert Coomans, adviser to Dutch pension fund APG Asset Management and adviser to its infrastructure team. "People were maybe more easily convinced that the manager was the right choice."

One test of who's measuring up, of course, is the ability to raise funds in the current climate. Those funds that went to market in 2008, 2009 and even 2010 and successfully raised capital must have done something right. The market certainly wasn't in a welcoming mood.

In recent months, *InfraNews* and *InfraAmericas* reported successful fundraisings by Alinda Capital Partners, DIF Infrastructure II, Antin Infrastructure Partners, Brookfield Americas Infrastructure Fund, and Cube Infrastructure Fund. What's the measure of success? They reached or exceeded their targets.

By contrast, Goldman Sachs Infrastructure Partners II, HSBC Environmental Infrastructure Fund and Barclays Integrated Infrastructure Fund fell short of their targets. Santander exited the infrastructure fund management business before it even got started, much to the annoyance of some of its limited partners.

Without question, such a distinction between successful and unsuccessful meets scepticism. Goldman Sachs shows why. It raised US\$3.1bn, more than all but one – Alinda was the exception – of the successful funds named above. No one who spoke to *InfraNews* calls raising USD\$3.1bn a failure, however distant it is from the USD\$7.5bn goal.

### Bank Sponsored Funds

But there is also no question that funds closely linked to banks have an extra hurdle to climb with limited partners. One reason is Macquarie and Babcock & Brown, institutions that win virtual unanimous acclaim as the poster boys for infrastructure's early mistakes. Their fund activity generated plenty of fees and left plenty of resentment among investors.

"The problem was that the incentives were to get assets under management and do transactions, pay aggressively for assets," said a US-based fund manager. "How do you outbid the next bidder by a billion dollars? What's the motivation there: to win the deal or deliver the deal for the investment bankers?"

Macquarie Infrastructure Group (MIG) and Cintra led a consortium that bid USD\$1.82bn for the Chicago Skyway. The next highest bid was for USD\$700m. The Chicago Skyway, along with other assets that weren't performing well, was bundled into Macquarie Atlas Roads in 2010, sometimes known as bad MIG. The better assets were put into Intoll, sometimes dubbed good MIG.

Among those good assets in Intoll is the 407 ETR, a stretch of highway near Toronto that is often mentioned by infrastructure market participants as one of the market's successful road transactions. The 407 ETR has regularly paid dividends, most recently CAD\$110m. Cintra, SNC-Lavalin, and Capital d'Amérique CDPQ, a subsidiary of the Caisse de dépôt et placement du Québec, won the CAD\$3.17bn monetization of the road in 1999. MIG bought into the asset in 2002. Crucially, in 2005, the road successfully defended its right to set the tolls.

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Most of the market sees changes in Macquarie's behaviour today.

Babcock & Brown has disappeared altogether, into a range of institutions that took over parts of its business. But as first entrants to the market, they set the standard that others followed. And their record left a taint that bank-sponsored funds still confront.

"They all used the same model," said a New York-based fund manager. "Fees went into a big pool that paid bonuses. Staff weren't compensated for investment performance but paid from a bonus. Bonuses were based on deal flow. People were just doing stupid deals."

The taint left by some funds, however, isn't mortal. Antin and Cube are both associated with banks, the first with BNP Paribas and the second with Natixis, and both exceeded their fundraising targets. The reason appears to be that they avoided the characteristics of the worst of the bank-sponsored funds.

Fund managers who remain on the payroll of the bank, deliver carry fees to the bank, often before any money has been invested, or otherwise have a greater incentive to work for the bank rather than the investors are among the brightest of red flags today. So are fund managers who buy assets prohibited by the limited partner agreement.

"LPs are obsessed with conflicts of interest between the manager and its sponsor and they are frustrated to see fees charged by the fund going to the sponsor," said Alain Rauscher, the Paris-based managing partner of Antin Infrastructure Partners (pictured at the top of this article). He said three of Antin's 15 staff came from BNP, but all resigned their positions to join the fund. The managers own 60% of the company. The bank has no representatives on the investment committee. The bank does not receive any share of the management fees. The limited partner agreement spells out what kind of assets Antin will invest in.

Lesson One for the limited partner is to check who benefits most from the fund managers' decisions.

### Track Record

Infrastructure funds' performance isn't often the subject of public discussion, but the San Diego County Employees Retirement Association (SDCERA), which has money in Macquarie Infrastructure Partners II and Global Infrastructure Partners, pulled the curtain back last month when a staff member told the board that MIP II was delivering a gross internal return of 2.4% while GIP was delivering 17.4%.

**Macquarie Infrastructure Partners II is delivering a gross internal return of 2.4% and Global Infrastructure Partners is delivering 17.4%. – San Diego County Employees Retirement Association**

GIP, incidentally, is widely understood to be raising its second fund or gearing up to do so. Its performance is thought to be sufficient to overcome any doubts caused by Credit Suisse's backing in the first fund.

"What raises a fund is a realised track record," said Richard Awbery, London-based principal of Atlantic-Pacific Capital, a placement agent. "That's the thing that investors take to their investment committee. That said, even if the team has a track record, it's still very difficult to raise a fund in this market." Atlantic-Pacific helped DIF raise its second fund.

Lesson Two is to deliver good returns, but don't promise the moon.

### Long-Term Investment

Infrastructure market participants like to distinguish between infrastructure and private equity, the long term and the short term, the asset flippers and the asset holders. The idea is that limited partners – pension funds and insurance companies with long-term liabilities – want assets to match. But the idea isn't gaining much of a foothold in the real world.

To be sure, there are funds like Industry Funds Management and JP Morgan that are open-ended. IFM, reflecting its Australian origins, had access to long-term investors and plenty of assets to choose from, making open-ended an easy option. The open-ended funds also mean the manager won't be motivated to sell investments in good long-term assets, said Alec Montgomery, IFM's New York-based head of infrastructure for North America.

But Rauscher thinks Antin's 10-year fund is a better approach. "I know where I will be in 10 years," he said. "I will be working and therefore you can trust me. I will do my best to deliver good returns for investors. Where will I be in 25 years? I hope I won't be working any longer. The 10-year horizon obliges managers to be accountable for what they do."

At APG, Coomans (below) is looking for an alternative that encompasses long term and less long term views.



"You can't expect a fund manager to wait for 20 years to get his performance fee," he said. "You want long-term investments and long-term stable cash flows, but you have to be realistic. That's a balancing act. If we want long-term funds, something has to be done. One of the things we're looking at is a performance fee based not only on value, but also on the yield generated."

Lesson Three is therefore that an argument can be made for long-term and less-long-term funds.

Lesson Four is that neither case is likely to prevail on its own.

### Direct Investing

The Abu Dhabi Investment Authority (ADIA), the California Public Employees Retirement System (CalPERS), and South Korea's National Pension Service (KNP) have bought syndicated stakes in Gatwick airport since GIP bought that airport asset in 2009. Canada's big pension funds routinely buy stakes in assets or Hoover up listed infrastructure companies. The Dallas Police and Fire Pension System joined Meridiam Infrastructure and Cintra to take a direct equity stake in Texas's two big road procurements in the past 12 months.

Much is made about pension funds – and sovereign wealth funds – investing directly, or at the very least investing next to infrastructure funds to which they've also made a capital commitment. But the reality is that it is exceptional, and will remain exceptional. The vast majority of pension funds are simply too small to do the due diligence required, especially on an asset half way around the world. Some funds will find it easier to invest directly locally, in assets they understand, but such opportunities may not be plentiful.

"We haven't had any co-investments made by our fund investors, but we're discussing it with them," said Montgomery. "It's certainly a possibility. It increasingly comes up with some of our large Australian investors."

Antin offers even more detailed evidence of the real interest in co-investing. About 35 investors committed capital to the EUR1.1bn fund. Rauscher said only a handful indicated serious interest in directly investing next to Antin.

Lesson Five is that big pension funds will do more direct investing and co-investing in the future, but that the practice won't be a threat to the infrastructure funds because the vast majority of pension funds won't have the size to justify the time and effort of doing so.

### Seed Assets

If you're starting a fund and want to raise capital from limited partners, the best way is to buy some assets to show them. Just as the easiest way to create the chicken is to find an egg. Seeding a fund with assets isn't so simple if you don't have the capital to buy the assets. The bank-sponsored model, in which the bank puts its own capital at risk, overcomes this hurdle.

For those fund raisers without a bank to pay for the early assets, the challenge is bigger. One source who is currently raising funds said the trick is to identify deals to take to LPs. "Find LPs that you have the best and closest relationship with," the fund manager said. "Over a period of time, you win their trust. Pick off five to get to first closing to buy that asset. Once you've done that, you're off to the races."

**The institutions that endure will be the ones who didn't get too caught up in the froth of infrastructure's first generation.**

Coomans recognizes the dilemma. Seed assets mean the fund is sponsored. The assets are good, but it means the fund managers' independence has to be assessed. Those without the seed assets need to have a real pipeline, something that the Coomans of the industry can use to decide where they will put their money.

Lesson Six is therefore to learn to juggle while balancing on a ball with explosives scattered around the stage and the Securities and Exchange Commission often in the audience.

### Exercising Discipline

At the core of the lessons drawn from infrastructure's early years is basic investment discipline. Don't overpay and don't borrow too much. Either mistake can quickly come back to haunt the investor, as the economic slowdown and the increase in interest rates are demonstrating today. High fees, unaligned interests, short-term thinking, and much else that now looks unacceptable might not be attracting attention at all if investors were still getting the steady returns they sought.

Lesson Seven is don't let the financial and investment climate distort your judgment about what an asset is worth and how much debt it can service. The institutions that endure will be the ones who didn't get too caught up in the froth of infrastructure's first generation.

Lessons in the financial world, of course, tend to be unlearned almost as fast as they are learned. The price of money has much to do with both. Infrastructure market participants acknowledge that much of what has been learned in the past several years is still vulnerable to the next period of low borrowing costs.



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