



Patience is a virtue

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Minister of the Year 2010

Searching for the right formula

The aim of achieving perfect alignment of interest still has infrastructure fund managers and their investors scratching their heads – leading many institutions to consider investing in infrastructure directly instead of through funds.

Andy Thomson explores the issues

WHAT IS THE appropriate fund structure for infrastructure investment? This is not a test. If an answer does not spring readily to mind, you can rest assured that you are not alone. Investment professionals setting out to raise a new fund will certainly ponder it. And it may even give them sleepless nights as they struggle for an answer.

Simon Gray is a senior partner at London-based Babcock & Brown spinout Arcus Infrastructure Partners. In an interview with this magazine in May this year, Gray revealed that Arcus had around €700 million of its €2.2 billion debut fund left to invest. The firm had reached the stage, he said, where it was “looking at the fundraising market with interest”. Hence, the question posed at the outset is a pertinent one as far as Gray is concerned.

“It’s a young and evolving asset class where there are only six or seven years of experience,” he reflects. “To begin with, people

“Going forward, I think LBO funds and infrastructure funds will deliver comparable returns, but with infrastructure you get cash yields from day one” - Rauscher

adapted what was available and took the existing [private equity-style] template because it was well understood by investors. That template inevitably had to evolve because this [infrastructure] is not a simple business.”

To briefly recap, many infrastructure brownfield funds were launched during the boom period up to 2008 that looked like private equity funds structurally but also charged the same fees and carried interest – the traditional “2 and 20” model. This is

no longer seen as credible, since the Crisis exposed brownfield funds as overly reliant on leverage in order to deliver the returns investors were expecting.

YIELD AS PROXY

So what next for infrastructure funds? Of course, one option is simply to retain the private equity model while reducing the level of fees and carry – and some GPs in the market over the last year or two have done precisely that. (As an aside, greenfield funds may be able to make a better case than brownfield for “2 and 20” given their different risk/return profile). But the need to address the issue has also encouraged innovation – including the idea of linking fees more closely to asset yields. Yield is, after all, a defining characteristic of infrastructure investment. Why not recognise it through manager compensation?



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“Fundamentally, a proxy for the health of an asset is dividend yield,” says Gray. “But whether linking fees to yield is the right approach depends on the particular asset and your investment strategy. If it’s a wind farm, a significant part of the business is contracted. What you can do as a manager to improve or enhance returns is not enormous. You can’t do much about the off-take, the feed-in, or how much the wind blows. To be paid from dividend yield might be sensible in that case. But for other assets, where there are many different operational levers available, you may need to adjust your thinking.”

To take up the last point made by Gray, where a fund manager has “operational levers”, does the prospect of yield-derived compensation potentially compromise objective decision-making when it comes to the running of the asset? “Managers cannot let the fee drive investment decisions,” asserts Kyle Mangini, head of global infrastructure at listed Australian investment group Industry Funds Management (see p. 36). “When cash yield creates an incentive for certain decisions, it may not be in the best interests of investors. For example, an airport needs a new runway.

That will require a significant investment of capital, so you shouldn’t be taking cash out of the business. There could be a conflict for a manager who is motivated by cash yield.”

This is not the only issue investors in infrastructure funds are wrestling with. Lachlan Douglas, a managing director at Sydney-headquartered placement agent Principle Advisory Services, highlights issues around performance fees based on the valuation of unrealised assets in open-ended funds. “When performance fees are based on unrealised gains, valuation issues become very important. But infrastructure asset valuation is a very inexact science and there’s always a risk that investors are coming in and going out of funds at valuations that might not properly reflect market value.”

Issues around alignment of interest between GP and LP are vitally important for the health or otherwise of the infrastructure fundraising market. Until they are resolved satisfactorily, infrastructure may continue to give pause as an immature asset class to be approached with caution. In the first half of 2010, figures from San Francisco-based placement agent Probitas Partners showed a recov-

ery in infrastructure fundraising, with a total of \$9.9 billion collected (see chart p. 26). This was not far short of the \$10.7 billion raised in the whole of 2009. But it could still be argued that such a total is relatively trifling – not only in relation to the fundraising peak of more than \$34 billion in 2007, but also in light of the huge potential for private capital to invest in infrastructure globally.

BLIP ON THE SCREEN

Kelly DePonte, a partner at Probitas, can see the potential. He acknowledges that infrastructure is a “blip on [pensions’] radar screens” with the exception of Australia and Canada. But, aside from the much-touted long-term liability matching that infrastructure appears to offer pensions, DePonte sees fear of inflation as a dynamic driving commitments to infrastructure in the period ahead. “Investors see inflation coming down the line and they look at areas like infrastructure, timber and commodities. That’s especially true of experienced investors.”

Alain Rauscher is chief executive of Paris-based fund manager Antin Infrastructure

Partners, which announced a third close of its debut fund on €700 million in May this year on its way to a €1 billion target, which market sources say is likely to be reached soon. He is also optimistic that pensions will invest “big time” in infrastructure in the future.

Some of this optimism is based on the belief that at least some of the capital institutional investors would have allocated to leveraged buyout funds in the years ahead – had the good times kept rolling – may now find its way into infrastructure instead:

“There has been a shift from LBO funds to infrastructure funds,” he says. “Some investors still dream of old-time private equity returns and say 15 percent is too low. That’s surprising, because in my view the days of 25 percent LBO returns are gone. Multiple expansion was a big source of value creation for LBO funds but that’s more marginal these days as the market has become more efficient. Leverage recaps have also provided for great value creation, but they are much tougher to complete due to more stringent lending policies. These are likely to remain so in my opinion in the medium term due to the banks’ constraints. Going forward, I think LBO funds and infrastructure funds will deliver comparable returns, but with infrastructure you get cash yields from day one.”

Rauscher is not the only infrastructure professional to speak confidently of the large volume of capital that should theoretically find its way into the asset class. Such views are supported by Probitas’ fundraising research, which found that, in the first quarter of this year, some 89 closed-end funds were in the

“While bad experiences may lead some investors to withdraw from the asset class – or at least approach it with more caution – others conclude that they could do a better job themselves”

market seeking a combined \$72 billion of capital. Not all of this may end up being raised – but even a healthy percentage of it would move the asset class to a new level.

However, this “wall of capital” theory does not go unchallenged. The Australian market is one where it is tempting to make easy assumptions, given the steadily increasing percentage of employee salaries required to be invested in the country’s superannuation (pension) funds – and the consequent swelling of their coffers. This has led some to conjecture that infrastructure and other investment categories in Australia currently benefit from an excess of liquidity. Lachlan Douglas challenges this notion, saying that “a

lot of investors have been burnt as they have not managed agency risk well”.

While bad experiences may lead some investors to withdraw from the asset class – or at least approach it with more caution – others conclude that they could do a better job themselves. Hence, one of the biggest threats to a flourishing infrastructure fundraising environment is pensions deciding they can invest directly and, in so doing, bypass funds to some degree if not completely.

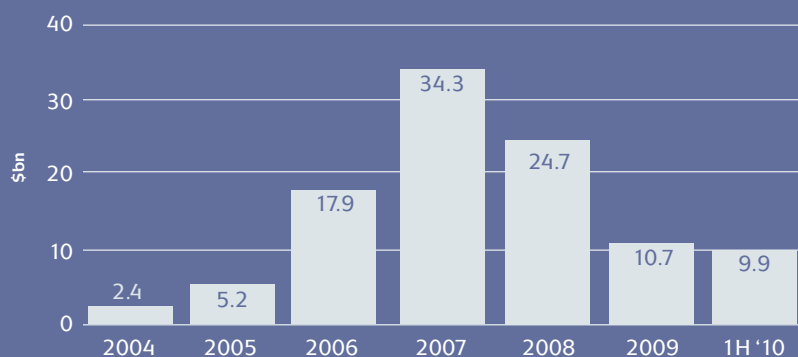
Douglas acknowledges that “plenty of institutional investors want to do direct investment” but argues that, unless an asset is a simple one to acquire and manage, they could find themselves under-resourced. “You can’t really go into it [direct investment] in a big way unless you have a big team,” he says. “And you can’t normally adopt a passive attitude – in most cases, you need to have someone more resourced to handle complex acquisition processes and manage operational risk.”

LACK OF RESOURCE

Douglas feels that pensions’ lack of resource and direct investment experience may lead them to overpay for assets. He cites one example of a bid made by a client that was 30 percent less than a rival bid initially accepted from a consortium of institutional investors. Eventually, says Douglas, the consortium fell apart due to disputes between the various parties, leading his client to re-submit its bid and win the deal. He points out that direct investing can be a false economy if you end up paying over the odds. “The elimination of management fee drag on that asset would never have made up for the 30 percent more they were prepared to pay. It’s not just about fees, it’s about after-fee returns.”

Regardless of the impact of direct institutional investment, Kelly DePonte believes that this year will be a good one for infrastructure fundraising, with the total for 2010 probably reaching somewhere around \$20 billion. He does caution, however, that this hinges on the economic outlook. “Even with a slow economic recovery, there will be interest in infrastructure. But if we get a double-dip recession, all bets are off because of the impact it would have on institutional portfolios.” ■

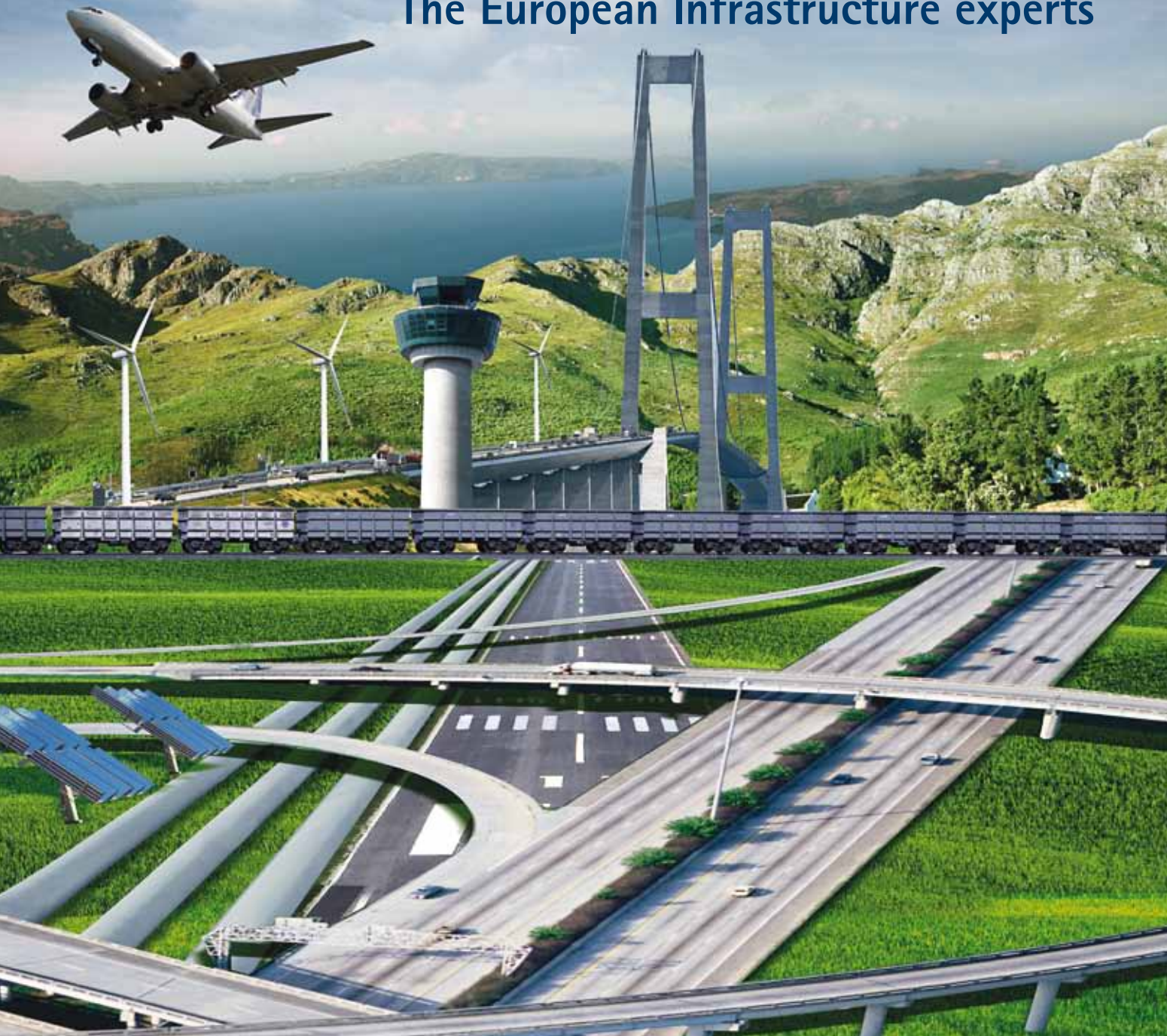
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