Where next on the road ahead?

Deloitte Infrastructure Investors Survey 2013

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Introduction

Welcome to the third edition of our in-depth analysis of the infrastructure investors market.

In this publication, we share insights and findings from interviews with a wide cross-section of infrastructure investors (80% from infrastructure funds and 20% from other direct investors), and put forward our predictions on how we see the sector evolving over the coming years. Once again, our thanks go to the investors that contributed to our survey. We trust you will find this an engaging and thought-provoking read.

In 2010, when we conducted our last survey, the sector was reeling from the effects of the financial crisis. The heightened activity of 2006 and 2007 had been tempered. Instead, notwithstanding the plentiful availability of debt, it was a case of finding deals to be done. Questions were also being asked around whether the infrastructure fund model would last as LPs started to find themselves long on infrastructure allocations. This was partly driven by early investors viewing infrastructure investment as offering equity returns with bond type security. This perception arguably encouraged the implementation of highly leveraged structures that resulted in significant downward pressure on returns following the financial crisis, particularly in cases where assets in a portfolio were strongly correlated to the macro-economic environment.

But that was then. Today, the results of our survey show that the infrastructure asset class has successfully weathered the economic storm, with many investors citing that their investments have remained resilient during the financial crisis. Approximately 70% of investors that we interviewed stated that their investments are currently achieving or exceeding target internal rates of return (IRR).

Following their experience of the downturn, investors are bullish about the sector's prospects, with the majority stating a clear focus on investment in core infrastructure assets located in the safe haven geography of Western Europe.

Interestingly, there has been a notable shift in the competitive landscape since our last survey dominated by the increased number and stabilisation of direct investors, which has resulted in the larger funds now consistently seeing direct investors as their direct competition. In addition, the industry is currently characterised by a lack of supply of the right assets coming to market, as certain large asset disposal programmes announced by major European utilities and governments have yet to transpire.

This has compelled the funds to re-evaluate their investment thesis. Strategies vary between the investors, but include a significant focus on asset management as investment managers seek to generate differential IRRs through value enhancements. Encouragingly, the majority of investors expect their investee companies to embark on significant capital programmes over the next few years.

The investors' view is that there is currently a good level of access to debt capital. As a result, although most investment managers would not be averse to using debt issued by specialist infrastructure debt providers (if competitive terms and tenure were offered), the appeal is greatest at the junior/mezzanine levels of the debt structure. We also noted little appetite to diversify into raising specialist debt funds.

Not many investment realisations have happened since our last survey and this trend is expected to continue until the first generation funds reach maturity. Notwithstanding this, it also points to the fact that infrastructure investors have been good stewards and long-term owners of assets.

So for those who sounded the death knell for infrastructure funds as an asset class a few years back, we are pleased to say that the investors have emerged stronger and wiser from the experience of the downturn. The asset class has since performed strongly, stood up to its name of providing stable secure returns and is very much here to stay.

Approximately 70% of investors that we interviewed stated that their investments are currently achieving or exceeding target internal rates of return.

The infrastructure investors market today

A number of overarching market characteristics and trends across the infrastructure investors landscape emerged from our interviews as defining the sector today:

1. Funds are performing well against IRR targets – Approximately 70% of the investors stated that they are performing at or above their target IRR, which typically range between 12-14%. There has been limited contraction of target returns even though there has been a significant increase in the number of fund managers. This bodes well for the sector and indicates that confidence has returned to the infrastructure market following the financial crisis.

2. Increasing focus on asset management to deliver returns – the majority of fund managers stated that assets within their portfolios have been resilient during the economic downturn, as a result of an increased focus on asset management, and in particular, pro-actively managing leverage. There has been a shift towards investors now employing dedicated asset management teams, as they view this as fundamental to maximising IRR performance. Encouragingly, the majority are expecting their investee companies to increase capex investment over the next few years, as this is often viewed as an easier strategy to drive IRR performance than M&A activity.

3. The direct investors are now well established – the general view in 2010 was that most direct investors would not have the capability to source and execute deals, and manage assets across a variety of sub-sectors, and therefore they would not pose a real on-going threat to infrastructure funds. It was widely expected that direct investors would revert back to investing in infrastructure assets as LPs of the funds. Conversely, however, direct investors have significantly increased their expertise and resource pool, often through recruiting experienced personnel from the funds themselves. This has resulted in the larger US and European funds, which look to invest in the largest deals, seeing direct investors as credible competition given the significant amounts of capital at their disposal and as their cost of capital is typically lower. This competition has been particularly evident for regulated assets given their perceived lower cash profile and larger ticket size.

4. Lack of supply – the market is characterised by "deal-hungry" infrastructure investors who have significant capital at their disposal but who are continually hitting a "road block" in terms of finding the right asset to invest in. This lack of supply of assets is driven by the fact that many of the large disposal programmes announced by major European utilities and governments have not commenced, as they focus on more immediate priorities. This has led to some of the investors focussing much harder on relationship development with corporates in order to secure bi-lateral opportunities.

5. Regulatory risk remains the key concern – high on the topical agenda, regulation is seen by the investors as the key risk, both from an investment and asset management perspective. What was once seen as a key attraction for investing in infrastructure assets is increasingly being treated with trepidation. This follows several high profile regulatory regime changes, some of which have been applied retrospectively. The view, however, from the direct investors was that although this was an area of focus, they would be able to survive any "road-bumps" given their long-term investment period. However, this has yet to be fully tested given their relatively short investment holding periods to date.

6. Focus on 'tried and tested' – the majority of investors have maintained their focus on core infrastructure assets which demonstrate essential characteristics, such as high barriers to entry and monopolistic features, often combined with the business being regulated and/or offering long-term contractual protection of revenues. In addition, although there is clear appetite to invest in jurisdictions outside of Europe (particularly due to the Eurozone crisis), in terms of actual deals completed, Western Europe continues to be the preferred jurisdiction for most investment managers.

7. Fundraising is subject to greater diligence from LPs – LPs' focus on diligence has increased significantly, with greater time and attention directed to analysing investment approaches, and many LPs wanting direct access to the deal team. In terms of priorities, LPs view the performance of existing funds, the offer of co-invest rights (even if these are not taken up) and asset management capabilities as the principal areas to assess prior to committing capital. By comparison, while still scrutinised, focus on fee structures has fallen as the "2 and 20" model that was prevalent in the first generation funds has generally been transitioning to nearer the "1 and 10" model.

8. Debt markets are in good shape for infrastructure investment – availability of debt is strong and expected to remain so, particularly for core infrastructure assets located in Western Europe. Lenders are attracted to this asset class thanks to the stable cash yield characteristics, with many of the investors commenting that they expect debt financing terms to improve over the medium term. Therefore, although the majority would consider using junior or mezzanine debt from infrastructure debt funds in transactions, there is little appetite from investors to launch their own debt platforms given the favourable availability, pricing and terms currently offered by the mainstream banks.

9. Exits have been scarce but will pick up in the next few years – there have been relatively few exits and this trend is expected to continue until some of the first generation funds approach maturity. Where exits are planned, the preferred route to market is via an auction process to secondary or trade buyers in order to maximise coverage, competitive tension and price. It will be interesting to see if the recent uptick in appetite for IPOs by traditional private equity translates to the infrastructure sector over time.

Performance

Portfolio performance

Infrastructure as an asset class has largely weathered the economic crisis, supported by the fact that approximately 70% of investors that we interviewed stated that their portfolio's actual IRR was either performing at or above target. This is reflective of:

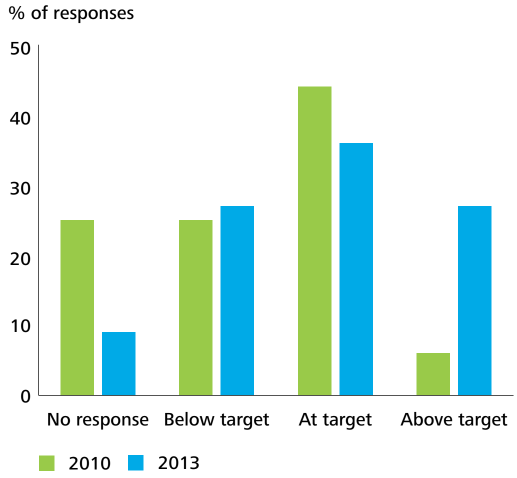
- The "essential service" and "predictable cash flow" characteristics of infrastructure assets have, as intended, generally proved to be resilient to the downturn; and

- A greater focus on asset management in order to drive value enhancements, particularly around managing leverage and optimising the cost base.

  – **Leverage:** The key development in strategy following the downturn is that investors are being more prudent on the use of leverage structures in order to protect against scenarios where an asset needs to be restructured and, more importantly, avoiding the need for capital calls in the event that an equity cure is required.

  – **Optimisation of the cost base:** In addition to removing any "fat" from its investee companies, investors are continually seeking to minimise any variability in the cost base. For instance, many of the investors with airport assets are now benefitting from hedging strategies locking in the price of fuel in the face of recent price increases.

Figure 1. Portfolio IRR

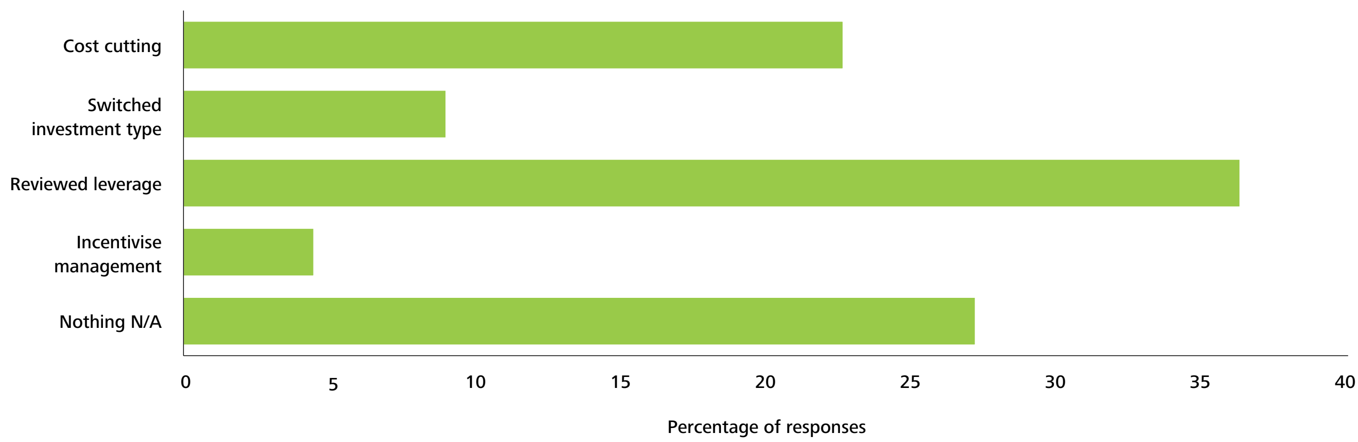


Source: Management information

For those investors that have been performing below target, this has been primarily due to portfolios that comprise of GDP-correlated assets which were purchased prior to the financial crisis, and where growth assumptions priced into the valuation have not materialised.

The majority of infrastructure investors are targeting an IRR of 12-14%, which is consistent with the findings in our previous survey in 2010. Surprisingly, there has been limited contraction of target returns in new funds raised even though the market is significantly larger than in 2010, demonstrating the resilience of core infrastructure assets and indicating that confidence has returned to the sector, despite the continuing difficult economic environment.

Figure 2. What measures have you taken to protect performance?



Looking forward, it will be interesting to see what IRRs will be achieved on the realisation of the first generation funds over the next few years, given that the current IRRs of most funds are driven by asset valuations on account of the limited exits to date.

The investors targeting the lower end of the return spectrum, i.e. less than 12%, primarily comprise of direct investors and the specialist PPP/PFI funds. The funds seeking returns in excess of 14% are those which, as well as being attracted to the stable cash generation profile of infrastructure assets, have an appetite for construction and demand risk and are more akin to "Private Equity Funds" in their outlook – that is, looking for an angle to operationally improve the asset or to pursue a more aggressive growth strategy in order to extract higher returns.

Asset performance

IRR expectations for the various asset sub-classes were similar between the funds; with any outliers due to specific factors. For example, some investors view airports as steady cash yielding investments, whilst others see the opportunity for traffic growth and higher returns. Unsurprisingly, the highest sub-sector IRRs were in the demand risk transport and waste sectors, and tangential infrastructure assets such as the infrastructure services sector. The lower target returns were quoted for water, other regulated utilities and PPP/PFI assets.

A large proportion of investors are targeting a cash yield of 5%-7%, and given that the majority are meeting their IRR targets, it is no surprise that they are also achieving these cash targets.

Figure 3. Please state your target internal rates of return (IRR)

% of responses

Figure 4. How does your target IRR compare between asset sub-classes?

Average IRR

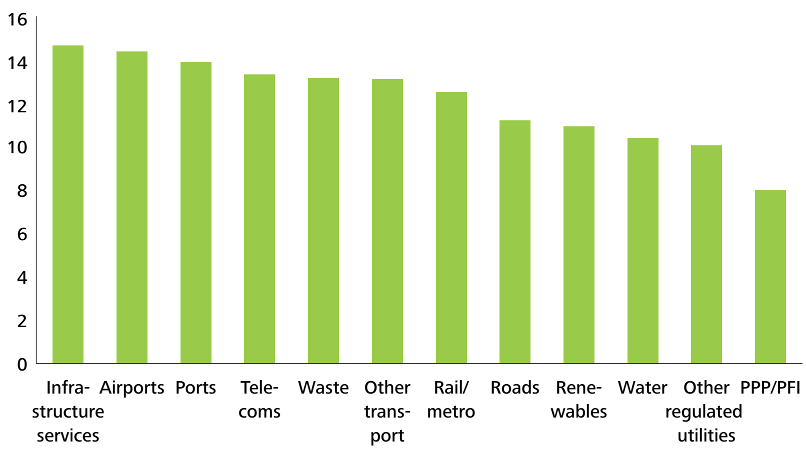


Figure 5. What is your target cash yield to date?

% of responses

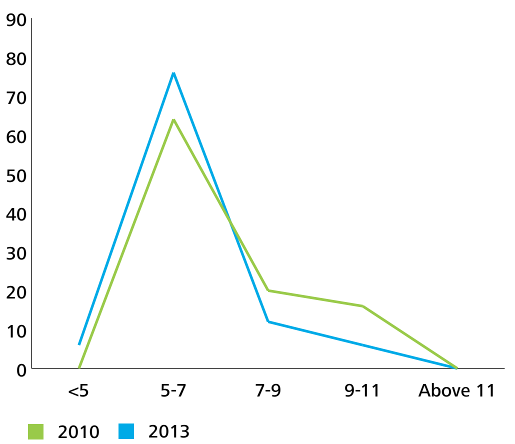
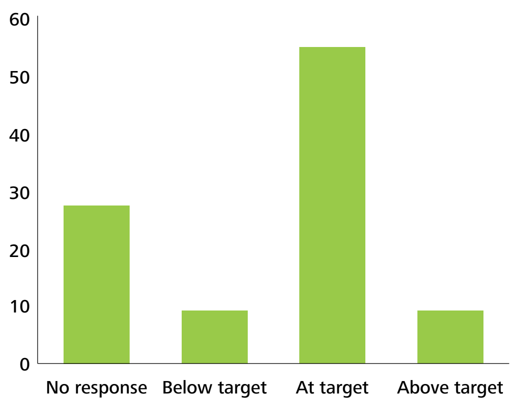


Figure 6. What is your actual cash yield to date?

% of responses



IRR remains the performance measure of choice as this is used to market and benchmark funds. However, cash yield is increasingly seen on an equal footing. This reflects that, for many direct investors and, indeed, pension fund LPs, cash yield is "king" given they are looking to service long dated liabilities with a steady cash return, coupled with the fact that direct investors have a longer-term holding period over which fluctuations in asset performance have less influence on IRR. Conversely, insurance companies, the other key group of direct investors and LPs, consider IRR the key benchmark as they are required to mark to market their investments for statutory reporting purposes.

Role with investee companies

A number of investors have been recruiting dedicated asset management teams. Our analysis shows that 41% of investors have recruited dedicated asset management teams which, on average, now comprise just over a third of their total workforce, a significant investment of resource (see Figure 7).

In our last report we predicted that more retired industry CEO's and consultants would be hired by the investors to sit on portfolio boards so they could draw on their deep operational experience. We have seen some investors starting to employ these measures, however, this has not yet been as prevalent as we anticipated.

Figure 7. Workforce composition of those with a dedicated asset management team

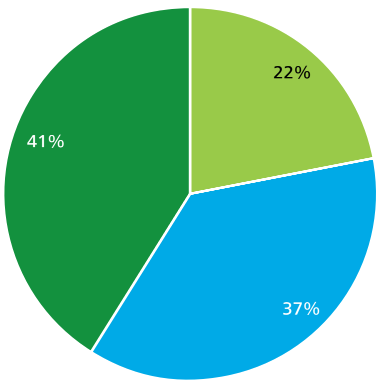
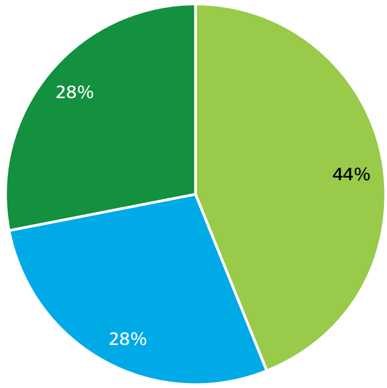


Figure 8. In your investee companies, which area of management do your teams become most closely involved with and why?



Unsurprisingly, when we asked the funds if they were heavily involved with their investee companies, the unanimous response was "yes". The main areas of focus are:

- **Finance:** debt financing, banking models and capital programmes;
- **Strategy:** development of business plans, identification of synergies, significant asset investment decisions, M&A activity; and
- **Operations:** optimisation of cost base, including assessment of the management team. The general view amongst the investors is that they are not averse to changing management teams, but this would only be undertaken where absolutely necessary e.g. in the case of underperformance or to drive growth, given the significant disruption that this would incur.

Other popular value enhancement initiatives included more effective management of regulatory settlements. On another positive note for the sector, the vast majority of investors are expecting their investee companies to increase capital expenditure over the next few years.

For topical reasons, **corporate governance** is high on the agenda of many investors and is strongly monitored, with the majority considering the processes within their investee entities to be very good. Particular emphasis has been placed on obtaining the right balance between executive and non-executive directors to ensure accountability and transparency in management. This trend is expected to continue and, if anything, become more of a focus under increasing LP and regulatory scrutiny.

An increasingly competitive landscape

Three's a crowd?

There has been a marked shift in the competitive landscape since our last report, with the emergence of three distinct market segments:

- **Large US and European funds:** multi-billion currency funds with a global scope seeking to invest in deals with enterprise values typically above £500m;
- **Mid-market funds:** usually have a jurisdictional focus (e.g. OECD countries) and are looking to invest in deals ranging between £100m-£500m; and
- **Direct investors:** large institutional investors such as pension, insurance and sovereign wealth funds which are investing in infrastructure assets directly, rather than through infrastructure funds as LPs, with a focus on the larger equity cheques given the level of capital they have at their disposal.

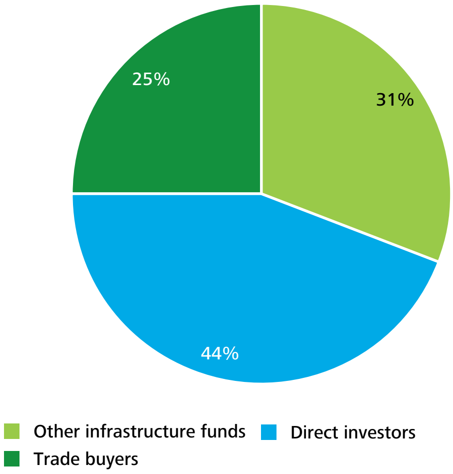
In our previous survey, funds expected investment activity of the direct investors to diminish over time on the grounds that they didn't have the requisite experience in both deal execution and asset management across the different sub-classes of infrastructure assets. Therefore, the prevailing view was that, over time, direct investors would revert back to investing as LPs in the funds themselves.

However since then, **direct investors have significantly increased their investment capability** through a combination of recruiting experienced infrastructure investment professionals and growing their teams. They are now comparable in size to a number of the infrastructure funds, enabling them to compete on a level playing field.

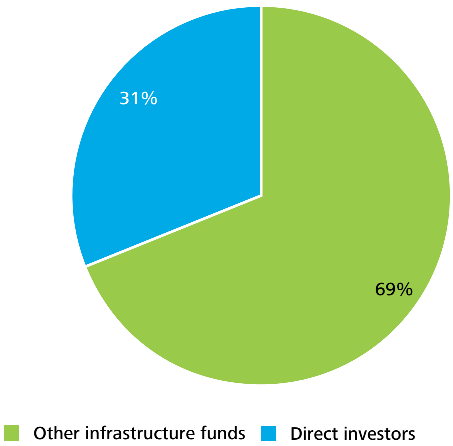
Larger US and European funds increasingly view direct investors as genuine competitors for assets. However, this trend is not reciprocated by the mid-market funds. These smaller players still view infrastructure funds of a similar size as their main competitors, reflecting the fact that direct investors typically seek to compete for the larger assets. Interestingly, the broad sentiment across the funds we interviewed was that trade buyers were not seen as a real threat as they seldom compete for the same assets. Where this does occur, however, and there was a clear synergy case, the infrastructure investors would consider withdrawing from the deal process on the grounds of being unable to compete on price.

Figure 9. Who do investors see as their principal competitors?

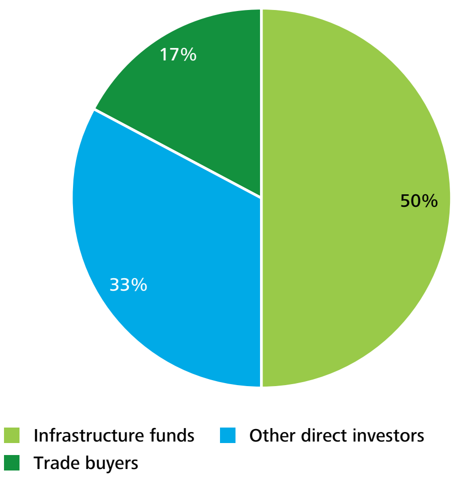
Large funds



Small/Mid funds



Direct investors



In short supply

A key characteristic of the competitive landscape is the interplay between the demand and supply side drivers of infrastructure assets. The global financial crisis has recently led to reduced activity levels, leaving infrastructure investors "deal-hungry" and looking to deploy their multiple billons of capital. However, the commonly held view amongst funds is that there has been a significant **lack of supply of the right assets coming to market** and, when assets do come, it is often via an auction process where competition has inflated asset values making it uneconomical to invest and leading to questions about appropriate pricing of risk, particularly around regulation.

Consequently, the prevailing view is that the key reasons for this lack of asset supply are:

- The large disposal programmes announced by a number of the major European utilities to reduce their debt burden have yet to fully materialise. This includes assets such as regulated gas pipelines which are the "bread and butter" of infrastructure funds. This is because these utility companies have:

  - managed to either continue to comply with their debt covenants or successfully refinanced their existing debt;

  - looked to manage shareholder return expectations through a combination of higher return operations, such as generation and exploration, balanced with lower return yielding non-core regulated assets – resulting in the latter not coming to market; and/or

  - had higher expectations on price than potential buyers, and abandoned sales processes on the expectation of achieving a higher price when the economy fully recovers.

- Although many European governments have put a number of their national assets up for sale to raise cash, many anticipated sale processes have not materialised as governments focus on resolving domestic issues such as high unemployment, managing fiscal and monetary policy and, in some cases, how the sale of national assets would be perceived in the run-up to an election has been prioritised.

- First generation funds continue to hold their investments as originally intended, particularly for the highest performing assets, given their lack of suitable reinvestment opportunities and strong performance of asset portfolios.

New markets and models?

To counteract the lack of deal flow, many investors are beginning to seek alternative and innovative strategies:

- The majority of investors are increasingly focussed on sourcing **bi-lateral opportunities**. This has required greater networking and the development of stronger relationships with corporates than was the case before the financial crisis. Many infrastructure funds consider that they have an advantage over direct investors in this area, as they have been active in the market for longer.

- A small number of investors, in particular those that are more willing to take on demand or construction risk, are now considering **playing on the periphery** of what is deemed as core infrastructure assets and transitioning towards the private equity model of sourcing assets where there is an opportunity for operational improvement;

- Where geographical restrictions allow, some investors are looking for deals in markets **outside of Western Europe** such as Poland, Croatia, Turkey and the Czech Republic – if the right asset and return profile criteria is achievable;

- A small number were considering increasing their fund allocation to **greenfield** investment, given the competition in the secondary market; and

- Funds are even looking to be innovative in where they invest in the capital structure. In one vendor distressed situation, one fund has even sought to invest via a **convertible debt instrument** with certain conditionality attached, which if triggered, would result in the asset being acquired by the fund!

Risks

In our last survey, when we asked the funds to outline the key risks when considering an investment, they identified regulatory, political and macro-economic factors, with many commenting that it was difficult to prioritise between them. These have re-emerged in our latest survey, but with **regulatory risk very much front-of-mind for most investors.**

It is not hard to see why this is the case. In the last few years, for example, the Norwegian Government has unexpectedly announced plans to substantially reduce the tariff levels on the Gassled system from 2016, the Spanish Government has lowered the solar feed-in tariffs and there has been much debate around the approach being considered by OFWAT, the UK water regulator, for the upcoming price review. These events, amongst others, have clearly caused concern amongst infrastructure investors and many consider that the regulatory environment has become more difficult in the last few years. Interestingly, however, this sentiment was not given as much prominence by the direct investors who tended to view regulatory changes more as "bumps" in the road that would reverse at some stage during their long term ownership.

Looking forward, the regulatory environment in Northern Europe, and particularly the UK, is expected to continue to evolve significantly, whilst remaining broadly stable in Italy and Spain. That said, the majority of investors already consider the regulatory regimes in Italy and Spain to be extremely challenging and likely to remain so. And whilst Northern Europe is currently seen as more attractive, regulation is expected to become more difficult here too.

Political and macro-economic risk continues to be an area of concern for investors due to the evolving Eurozone crisis, coupled with the lack of investor confidence in "safe haven" government bonds. This is leading to many cash-strapped governments resorting to significant austerity measures. Many investors cited enacted or potential unfavourable tax changes and the impact on investment returns as a particular cause for concern.

In order to mitigate these risks, a number of investors stated that, as well as understanding asset specific risks, it was more important than ever to be able to accurately assess those risks which are outside of their control. Funds cited their ability to price these externalities as a key differentiating factor between them and other investors, preventing them from overpaying for assets. However, our findings suggest that all the funds adopt this approach and it may, therefore, be less of a differentiating factor than fund managers perceive.

Risks facing investee companies
When asked to identify the major challenges facing investee companies, the majority of investors noted regulatory risk as the principal concern.

Figure 10. When considering whether to invest, what are the key risks which concern you?

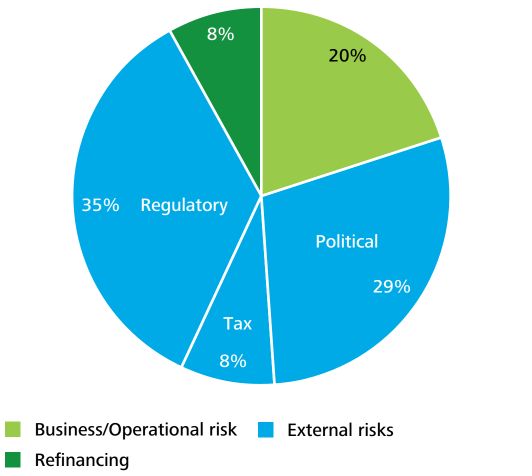
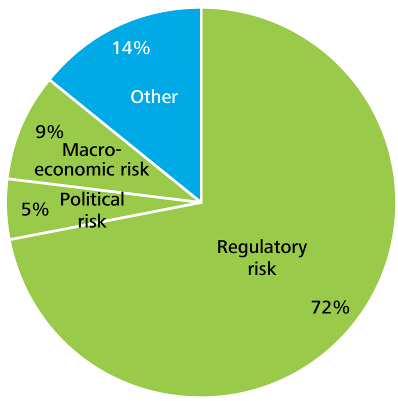


Figure 11. What are the major challenges faced by your investee companies?



Fundraising

In our 2010 report we noted that the fundraising environment was characterised by considerable pricing pressure. The "2 and 20" private equity-style fee structures prevalent in first generation infrastructure funds were being replaced with more favourable terms for LPs. Fee structures implemented by new funds typically featured a 1-1.5% management fee and 10% preferential carry.

In 2013, there continues to be **a great deal of scrutiny on fees but fee structures have not evolved significantly since 2010** and, in particular, have resisted further downward pressure, perhaps indicating that previous concerns around value for money have been addressed.

There continues to be a variety of fund structures in the market, both in terms of the basic model and duration. The unlisted model, whether a closed-end or evergreen fund, continues to dominate for most infrastructure fund managers across Europe, with little apparent appetite for new listed funds (other than in the renewables sector). The balance between closed-end and evergreen funds has remained broadly consistent between 2010 and 2013.

Certain funds, in particular those which have experienced difficulty in the fundraising market, are considering shifting their services towards providing a managed accounts offering. The premise here is that, rather than investing in infrastructure assets via an infrastructure fund, LPs would directly own the assets, but without the burden of sourcing, executing and managing the asset post transaction. Instead these tasks would be undertaken by experienced fund managers and their teams in return for a management and performance-based fee.

Priorities for LPs

In terms of securing LP investment we noted the following:

- Performance of existing funds, co-invest rights and portfolio management capabilities are most important to LPs when considering fund selection.

- Preferential co-invest rights and fee structures are key incentives offered to attract cornerstone investors. Typically, no board representation of the actual fund manager is available to any LP, regardless of investment quantum.

Figure 12. Please indicate the importance of the following characteristics to LPs in the fundraising process?
(5 being very important and 1 being very unimportant)

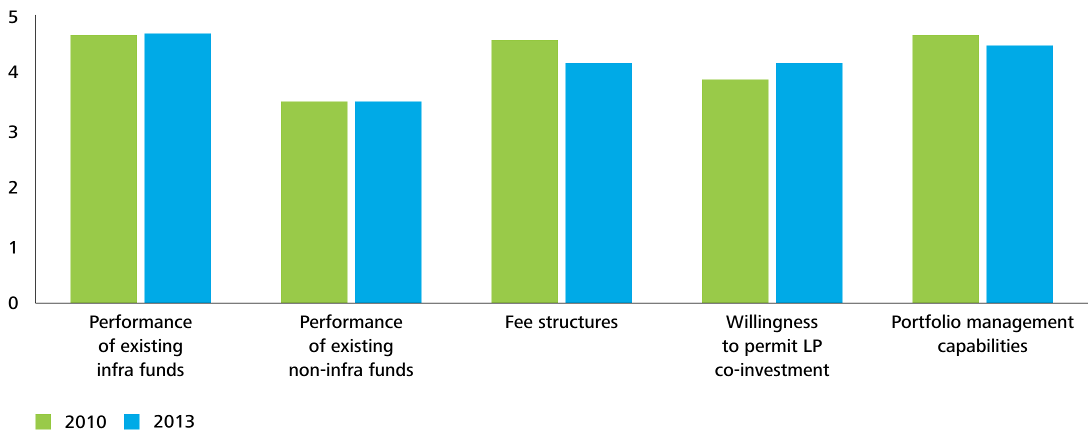
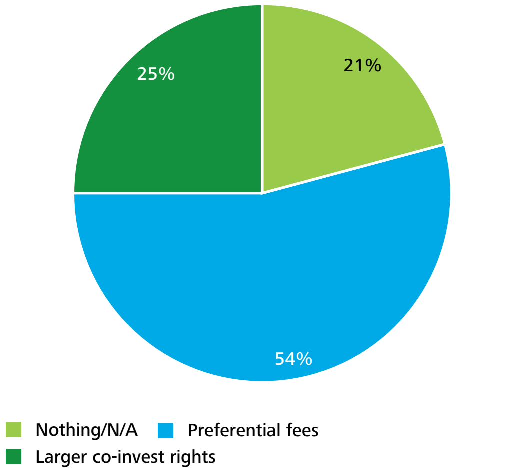


Figure 13. What incentives do you offer to attract cornerstone/pre-first close investors e.g. board representation, lower fees, larger co-invest rights etc?



- There was a wide range in co-invest equity percentage offered to LPs, which was influenced by factors such as size of investment and deal specific considerations. Co-invest rights in the 25% to 40% range appeared typical.

- Funds observed that LPs are now undertaking significantly more diligence before making commitments than has been the case in previous fund raisings. LPs are also not satisfied with only appraising documentation in a virtual data-room, they expect meaningful access to the deal team.

- Consistent with past experience, forex remains an important issue in fundraising and deal execution. The exposure is primarily managed through hedging at the asset level with LPs not requesting any fund level hedging strategies.

Figure 14. How has the approach of LPs to fund due diligence evolved from pre-crisis times to now, particularly with respect to the time taken for due diligence and the level of information required?

Number of responses

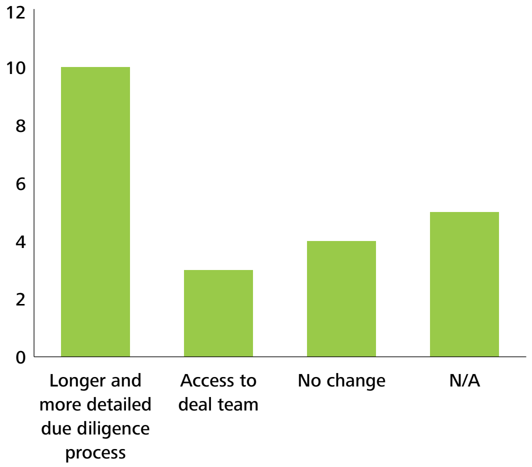
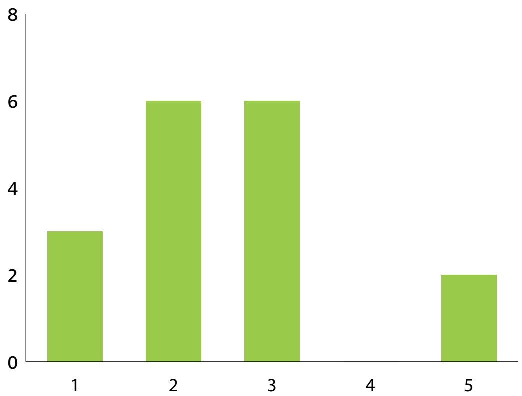


Figure 15. On a scale of one to five (one being a key issue and five being no issue at all) to what extent is forex risk an issue in fundraising and deal execution?

Number of responses



Deal execution and debt financing

Beyond expectations

At the time of our last survey, lending was showing signs of recovery in the aftermath of the financial crisis, bolstered by the bank bail-outs and a strengthening bond market. However, while investors were confident that financing for infrastructure deals had stabilised, they remained cautious about any short-term improvements in availability or pricing.

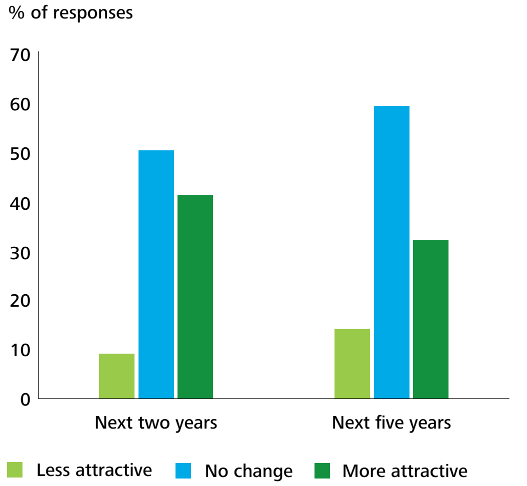
Since then, **the condition of the credit markets has continued to improve, surpassing expectations.** Appetite amongst lenders has been particularly strong for regulated and other core infrastructure assets, especially those located in the perceived more stable Western European countries.

Pricing has become more competitive, especially in 2013, with evidence from transactions in recent months of pricing pushed down to the 200 bps level, compared to 250 to 300 bps which was the norm at the time of the last survey. Similarly, fees have reduced slightly from their range of 2% to 3% in 2010. Availability of debt financing for infrastructure deals has also improved from the six or seven times multiples in 2010, but is still somewhat less aggressive than multiples seen in 2006 and 2007. In addition, in our experience, investors are not pushing debt multiples as aggressively for investments, given experiences in recent years.

Furthermore, **infrastructure investors expect both availability and terms of debt financing for infrastructure deals to continue to improve** over the next two years and beyond.

Figure 16. How do you expect the following to evolve over the next two years, and five years?

a) Debt financing terms (e.g. credit spreads, fees, covenants etc)



b) Availability of debt financing terms (e.g. debt/EBITDA multiple limits, due dilligence hurdles etc)

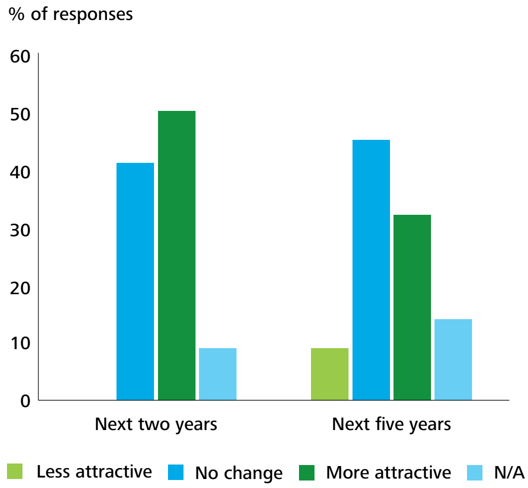
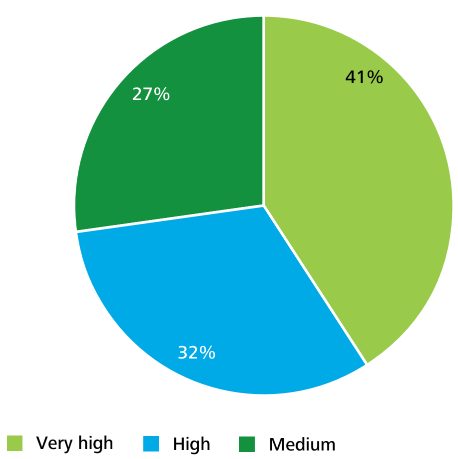


Figure 17. How do you assess lenders' current appetite for infrastructure relative to other asset classes?



Role of infrastructure debt funds

Another topic which has become increasingly prevalent in our conversations with infrastructure investors in the context of financing is the role of specialist infrastructure debt funds.

The emergence of specialist infrastructure debt funds is a relatively new phenomenon in the market and, at present, only one of the funds we spoke to has a designated debt fund.

Significantly, **only a small number are currently considering launching a debt fund**. This may well be reflective of a competitive wider lending market, which is consistent with the recent reductions in pricing and fees as described above, and therefore a perceived limitation on returns available by establishing their own debt fund offering.

So it appears that there is currently only modest appetite amongst infrastructure funds to establish their own infrastructure debt funds. However, when asked about specialist infrastructure debt funds as a potential source of capital for financing infrastructure deals, the story is more positive. Instances of infrastructure investments being partially financed with debt borrowed from specialist debt funds are still relatively rare. Only two of the funds surveyed have investments in their portfolio financed in this way and, in each case, the underlying asset has been a regulated utility or another established core infrastructure asset. Of the two, only one had plans to draw additional debt. But **the majority of the investors we spoke to would consider looking at infrastructure debt fund financing as a source of capital** to finance future investments, particularly as a tranche of mezzanine or junior debt.

The message does seem to be that there is a niche market for infrastructure debt in which the right fund could establish itself, but there is currently a lack of clarity around role and risk in this regard and as such there is a lack of candidates putting themselves forward. For those that do look to explore this opportunity, the key metrics against which potential clients will assess the attractiveness of their offering are, unsurprisingly, price and tenure. It will be interesting to see how this particular market develops in the coming years as the debt funds increasingly seek to differentiate themselves in an already competitive space.

Figure 18. Would you approach debt funds/platforms for capital in your deals?

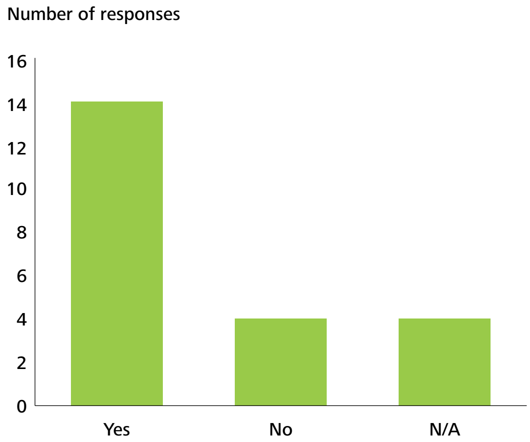
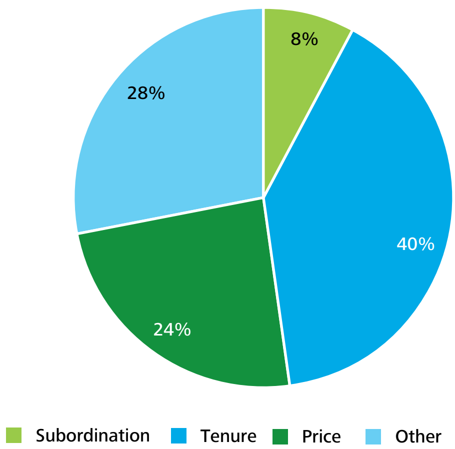


Figure 19. What features of debt do you think funds/platforms will need to offer to be attractive/successful: subordination, tenure, price, other?



Looking forward – asset and market focus

Core infrastructure assets

Following their experience during the downturn, almost all of the investors we interviewed stated that they have a resolute focus on investing in core infrastructure assets over the next two years, which continues the trend seen in our 2010 survey. Although there are still instances of successful investments in, and continuing appetite towards, tangential infrastructure assets, such as car parks and motorway service stations, this is on a significantly reduced scale.

While the definition of what constitutes an infrastructure asset differed between investors, common themes are apparent, and include high barriers to entry, monopolistic, regulated, essential services, stable cash generation and yield. **The clear investment focus for the majority of investors over the next two years is largely "more of the same"**.

Regulated utility and transport assets continue to be highly attractive investments; however, there is clear concern around the regulatory environment with a number of funds pointing to the impending tariff reductions being imposed on the Gassled system in Norway and the lowering of the solar feed-in-tariffs in Spain in recent years, as examples.

Interestingly, some infrastructure investors, and in particular those which target IRRs in the mid-teens, have started to shift their sentiment away from regulated assets, citing that they want to avoid being drawn into a cost of capital "shoot-out" with direct investors who typically benefit from relatively lower cost of capital requirements.

There is a noticeable reduction in appetite for PPP/PFI assets, which remain the domain of specialist PPP/PFI funds, as the majority of infrastructure investors are put off by the lower returns on offer. It remains to be seen whether this is a barometer for potential investment in the UK Government's Pension Infrastructure Plan (PIP), which is seeking to attract £2bn of private sector finance for UK infrastructure projects.

Other notable trends are that the waste sector continues to be less appealing for investment. Cost-cutting measures implemented by many governments have resulted in fewer waste collections and lower industrial and commercial waste volumes due to reduced economic activity. In contrast, telecoms, particularly tower infrastructure, is seen as more attractive thanks to the typically high barriers to entry and long-term contractual nature of many of these businesses.

Figure 20. From an investment perspective, please indicate the level of focus you will have on the following infrastructure sub-classes over the next two years (5 being very high and 1 being very low)

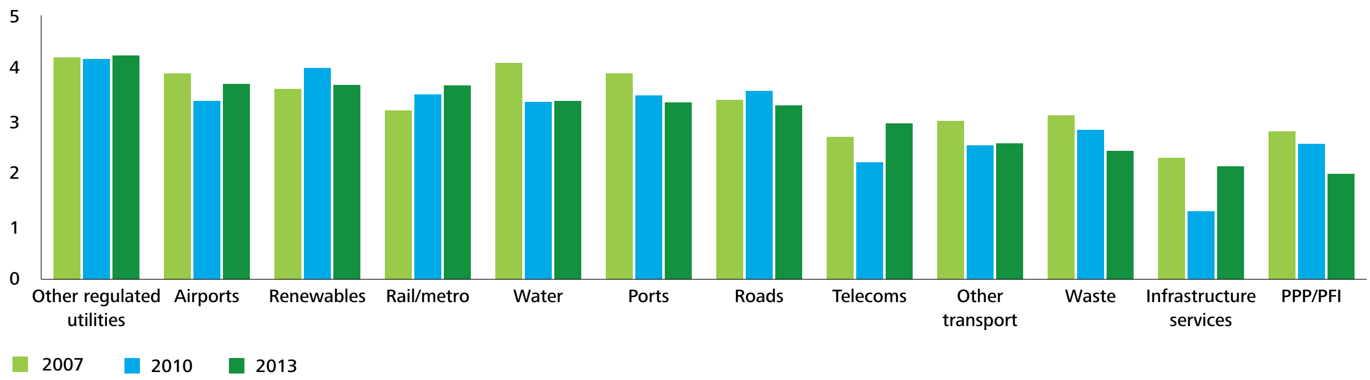


Figure 21. From an investment perspective, please indicate the level of focus you will have on the following markets over the next two years
(5 being very high and 1 being very low)

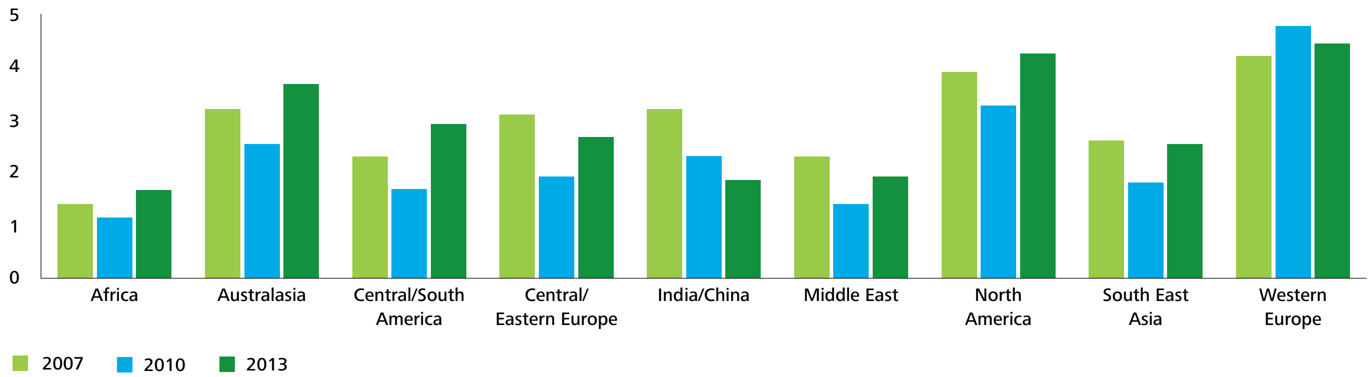
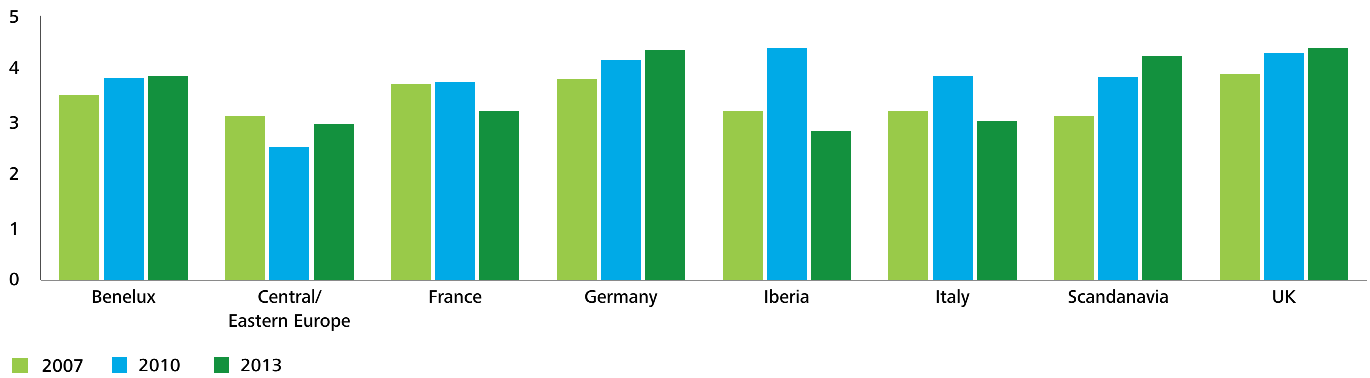


Figure 22. From an investment perspective, please indicate the level of focus you will have on the following markets over the next two years
(5 being very high and 1 being very low)



'Safe haven' markets

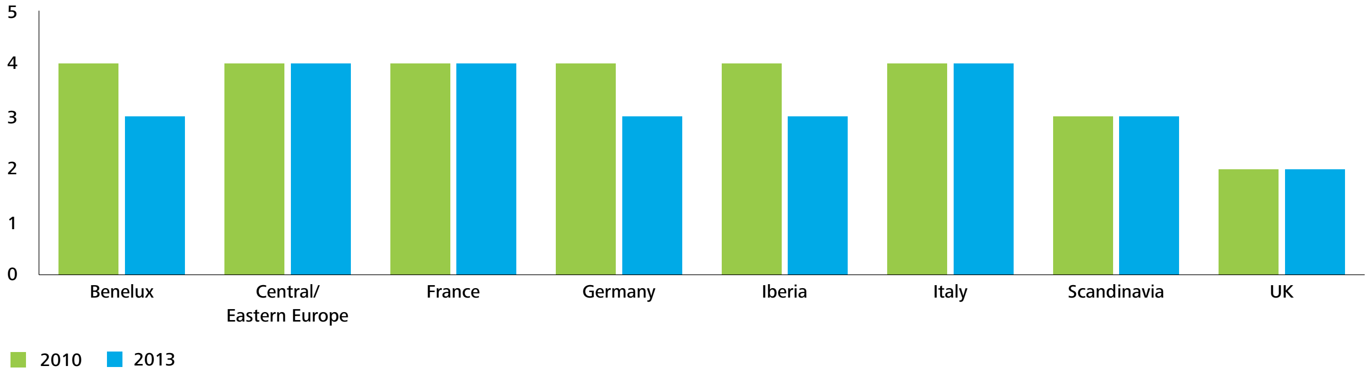
As with the findings in our previous survey, Western Europe continues to attract the strongest investment focus by the vast majority of investors. However, increasingly, there is more appetite to deploy capital outside of Europe, with the exception of India and China. Former darlings of the global economy, these jurisdictions appear to have become increasingly less attractive to investors as their high economic growth of recent years has slowed.

The increase in investment focus outside of Europe has been driven by concerns relating to the Eurozone crisis, which has increased the inherent country and currency risk, principally for Southern European countries such as Italy and Spain. These countries were also commonly perceived as being "closed markets", which has meant many infrastructure investors have largely steered clear while they assess when the bottom of the market for these jurisdictions will come.

That said, although there is a growing appetite from the majority of investors to invest further afield, the number of deals actually completed outside of Europe is limited (although this is in part a function of the survey investors' geographical restrictions), confirming that Western Europe, and in particular the UK, Germany and Scandinavia, remain the core investment countries for deploying capital.

Western Europe continues to attract the strongest investment focus by the vast majority of investors. However, increasingly, there is more appetite to deploy capital outside of Europe, with the exception of India and China.

Figure 23. From an investment perspective over the next two years, please indicate how important local partners/consortium members are to successfully entering European markets? (5 being very important and 1 being very unimportant)



Partnering
The majority of investors view partnering with corporates either as fundamental to their strategy or where the opportunity arises, a key avenue that they would pursue.

When asked to comment on the key benefits of partnering with corporates, a number of fund managers cited the additional source of potential deal flow. However, the overwhelming response was access to operational expertise and insights, particularly for investors without dedicated asset management teams and those focussed on the higher end of the return spectrum. This view is consistent with the increasing focus on asset management to drive returns by improving operational performance.

Furthermore, there is a **strong correlation between the importance investors attach to partnering with corporates and successful entry to certain European markets**. In the tried and tested jurisdictions of Western Europe, and notably the UK, the funds viewed teaming with corporates as less important than, for example, in France and Italy, although we note the necessity to partner in Germany, Iberia and Benelux has also reduced over time, presumably driven by greater familiarity with these markets.

Interestingly, despite the perceived benefits, there are relatively few instances where infrastructure investors and corporates have partnered on transactions. A recent example is the acquisition of TIGF, the former Total gas transport and storage business, by a consortium comprising Snam, the Italian gas transport and storage operator, GIC, the Singaporean sovereign wealth fund and EDF, the French utility. Several factors were cited as examples of why these partnerships are hard to secure, including differing investment strategies adopted, difficulty in aligning key investment objectives such as return expectations and exit horizons, and concerns over cultural fit between respective organisations.

What is more commonplace, however, are transactions where infrastructure investors partner with each other, an example being Allianz and Borealis teaming to purchase Net4Gas. In our view, this is because financial investors have a common goal, which is to deploy capital successfully, and relatively consistent objectives for the target asset, making this structure the easiest and quickest way to purchase larger and more expensive assets.

Do all the funds have the same asset and market focus?

On the face of it, it would appear that the majority of the investors we interviewed have a broadly similar focus in terms of asset and geographical preference and that they are keen to partner with corporates on the right opportunity. But do our survey results show the whole picture? To answer this question, it is useful to consider the competitive landscape (see page 8) and how they are seeking to differentiate themselves in order to successfully source and execute deals.

Exit strategy

There have been relatively few exits from existing investments by infrastructure investors in recent years. However, this seems likely to change. Several first generation funds are closing in on maturity, and expect their disposal programmes to accelerate over the medium term.

Secondary sales or trade sales are still seen as the most likely exit routes by funds and, for those selling, organised auction processes are still very much favoured as a route to maximise coverage and control of the sale, and therefore price. Conversely however, an increasing number of the investors we spoke to strategically avoid participating in auction processes for precisely the same reason, as well as the obvious caution about sinking large amounts of cost into chasing an asset where the chances of success at auction are low. Unless they are confident that they have sufficient competitive advantage or a particular investment angle to stand a strong chance of winning at auction, the preferred strategy is to identify assets where they can leverage relationships to engage in a bi-lateral process.

Although secondary or trade sale exits are expected to remain at the fore, at the time of writing we are seeing signs of an apparent increase in **IPO activity** across the wider investment market. It will be interesting to see firstly whether this can be sustained over the next couple of years as the first generation funds move closer to maturity and, indeed, if it translates into the infrastructure sector, particularly in respect of regulated utilities which could mean asset ownership going full circle. For assets located in the US or the UK, with access to the New York and London markets, IPOs are seen to be a more realistic possibility for exit. However with just 13% of respondents favouring an IPO, this is expected to remain a minority exit route.

We expect that **exits will become more prominent** as funds move closer to maturity over the next few years with few considering a roll-over of their fund, not least due to problems with internal valuation and conflicts of interest. It will be interesting to see how demand and supply dynamics, and, in particular, the interaction of pricing expectations on each side, evolves against this timeline.

Figure 24. How many assets are you considering exiting in the next year, short term (2-3 years), medium term (5-7 years)?

Average of responses

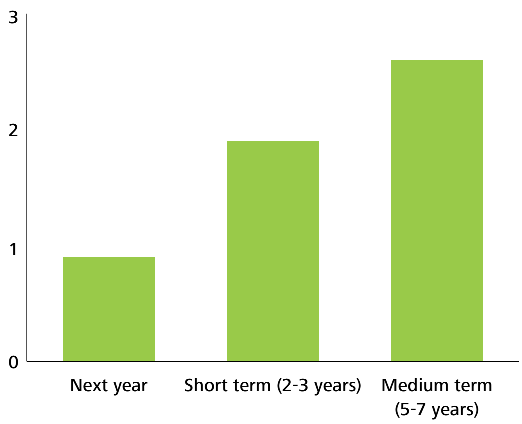
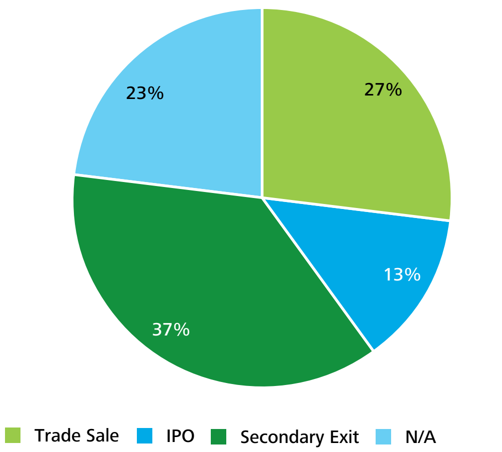


Figure 25. What is your preferred method of exiting your current investment portfolio?



Predictions

At the publication of our last report, some industry commentators were questioning whether the infrastructure fund model would last as LPs started to find themselves long on infrastructure allocations. In just a few short years, investors have emerged stronger and wiser from the economic crisis and momentum across the sector continues to build with the establishment of direct investors and greater interest from new international entrants. So, in the midst of this rising competition, how will the sector continue to evolve?

1. Exits ahead – we will see a greater number of exits over the coming years as first generation funds reach maturity.

- Many of these exits will be positive for funds, achieving values which are consistent with those held on their books and providing further evidence of the IRR confidence demonstrated in our survey. However, some may struggle to meet expectations, where assets have been overvalued, and the underlying returns of these funds will be lower than planned, making future fundraising more challenging.

- IPOs? There is currently considerable activity in the broader IPO market – will the infrastructure funds look to access this when it comes to exiting? While this may seem counter-intuitive, given that the public markets have been targets and a source of deal flow for funds in the past, we expect to see at least one exit of a transport or renewables asset to IPO in the next three years.

2. Secondary sales – following this wave of exits, we expect to see a bubble of secondary sales of assets. Many more direct investors will bid where funds have proved the stability of returns over the course of their ownership.

3. An imperative to innovate – the rise of the direct investors will push funds to pursue more innovative strategies to differentiate themselves. These may include targeting peripheral infrastructure assets and geographical markets outside of Western Europe that other investors have found traditionally more challenging. Better partnering with corporates will also be important and those that manage to unlock this, where peers have had little success in the past, will perform well.

4. Asset management will become even more of a focus for investors, as they polish assets to maximise value at exit. The recruitment of dedicated asset management teams will therefore continue, particularly as many funds are reaching maturity and owning an increasing number of assets.

- Capital expenditure: investors will continue to support investee companies in greater capital expenditure where the business case is strong. However, investment will be stopped where the regulatory risk is considered too great.

5. New entrants – the population of buyers in the market will continue to expand, with the emergence of two new groups in particular:

- Asian directs: Over recent years we have seen Japanese investors enter the market, the Chinese are now joining and we may shortly see Korean investors follow suit. It will not be long before these new Asian direct investors are as sophisticated and active in this market as the Canadian, British and Australian funds are now. Consequently, we may also see asset auctions extend their traditional six-week processes to better suit these Asian players.

- An emerging class of investor: European insurance companies and other principal financial institutions will continue to take a greater interest in the market.

6. Implications for pricing? The supply of assets coming to market will increase as planned government and utility divestment programmes restart and the original funds begin disposing of their assets. However, this will be off-set by the entrance of the new investors above, coupled with the consideration of whether regulatory and political risk has been appropriately priced in the past. On balance, therefore, there will continue to be an excess of capital chasing core infrastructure assets, and so prices will remain high, particularly as leverage is currently so affordable.

7. Departures? The number of deals will rise, but not at the same rate as the number of new investors entering the market. Moreover, some of these new entrants will either have a strategic rationale for acquiring assets (i.e. the internationals investors) or a lower cost of capital than the incumbent funds. Therefore, those incumbents who fail to differentiate themselves through their track record, team expertise and their markets, may struggle to compete, and we expect to see some turnover in fund managers.

Contacts

Deloitte's infrastructure investors team advises clients across the M&A and fund lifecycle, providing dedicated end-to-end support, from the moment the funds are raised and opportunities are identified, to the conclusion of the transaction and onwards through the life of the asset.

If you would like to discuss any of the findings raised in this report, please do not hesitate to contact us.

Jason Clatworthy
Partner, Joint Lead,
Infrastructure Investors M&A
020 7007 6505
jclatworthy@deloitte.co.uk

David Scott
Partner, Joint Lead,
Infrastructure Investors M&A
020 7007 2502
dscott@deloitte.co.uk

Darren Graves
Partner
020 7007 1098
dgraves@deloitte.co.uk

Charindra Pathiwille
Partner
020 7007 8456
cpathiwille@deloitte.co.uk

Oliver Holder
Partner
020 7007 8688
oholder@deloitte.co.uk

Douglas Watkinson
Partner
0117 984 2988
dwatkinson@deloitte.co.uk

Andrew Durrant
Partner
020 7007 0638
adurrant@deloitte.co.uk

Nick Prior
Partner, UK Lead,
Infrastructure & Capital Projects
020 7007 9858
nprior@deloitte.co.uk

Notes

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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