The fork in the road ahead
An in-depth analysis of the current infrastructure funds market

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1. Introduction

In 2007, we interviewed the managers of 17 infrastructure funds and mapped out how we thought the sector would evolve in our report *The road ahead*. A great deal has changed in the last three years and we have been back talking to the funds to get their perspectives on what the future holds. This time around, over 30 leading fund managers across Europe contributed, many of whom manage, advise or act on behalf of multiple funds. So apart from the very obvious rapid growth in the number of fund managers in the industry, what else has changed and what does the future hold in this brave new world?

Back in 2007, the road ahead for infrastructure funds could be characterised as a clear, eight-lane toll road with no traffic and plenty of slip roads. New entrants found it relatively easy to raise funds, resulting in a number of new funds having multiple billions of equity capital to invest. At the same time, assets were being disposed of by governments that were privatising those assets they thought were better owned by the private sector, corporates (particularly in the energy sector) were disposing of non-core assets, and private equity funds were completing disposals of assets designed to appeal to this new class of investor. For their part, hungry infrastructure funds eagerly snapped up every transport, energy, telecommunications and Private Public Partnership/Private Finance Initiative (PPP/PFI) asset that was put on the market. Infrastructure funds were able to reach the high prices being sought by vendors because they had significantly lower return hurdles (i.e., cost of capital), and they were able to supplement their purchase price with the huge amounts of available debt. All of this activity delivered large profits to vendors, whilst the infrastructure fund investors or limited partners (LPs) were satisfied that they were investing in businesses that would generate stable, secure, long-term cash flows.

Unfortunately, infrastructure funds hit trouble in 2008 when the speed limit and traffic flow ground to a halt due to massive obstacles presented by the global financial crisis. Debt that was once readily available disappeared almost overnight. LPs retreated into their shells, finding themselves over committed to infrastructure and other alternative investments due to bond and equity markets being in free fall (the denominator effect). Therefore, fund-raising by infrastructure fund managers essentially ceased.

As a result of the credit crunch infrastructure funds were forced to adapt, and for those with unspent committed capital, minority stakes (with attached first and last rights) became the way in which transactions could be completed, in most cases simply to avoid triggering change of control debt refinancing clauses. However, few transactions were now being closed because vendors were still holding out for the high prices they had previously achieved. The infrastructure funds could no longer reach these historical high prices, because the cost of term debt (assuming it could be obtained – which was a big assumption) had increased in some cases by over 800% and the equity bid models were now building in arguably more sustainable debt refinancing assumptions.

When markets began to recover during 2009 and 2010 LPs slowly re-entered this market, but began questioning whether or not the infrastructure fund model and the costs associated with it were the right vehicle for them to invest in this sector. As a result, some LPs and pension funds decided to go it alone and make their own direct acquisitions, with investors based in Canada leading the way, closely followed by some in Australia. This shift has created a whole new dynamic that the market is only now beginning to process. But, more about that later.

First, let's look at where all the above events have left the sector in 2011 …

Infrastructure funds were forced to adapt … vendors were still holding out for higher prices … cost of term debt had increased … markets began to recover in 2009 and 2010, LPs slowly re-entered this market, but began questioning whether or not the infrastructure fund model was right.

2. Infrastructure funds – A changing market

Over the last three years, there have been significant developments in the infrastructure fund market, as the sector and its investors mature – both in terms of their appreciation of the risks of infrastructure investing, and the vehicles through which investments are made.

Each of the following key findings represents a significant market shift, affecting both the shape and the dynamic of the infrastructure investment market.

1. **Infrastructure is now seen as a distinct asset class** – There was a unanimous view among fund managers that infrastructure is now seen as a separate asset class within the alternatives space. However, there is a different level of understanding of the asset class among LPs in different areas; with Australia and Canada leading the way, followed by the UK and the Netherlands. While the rest of Europe is catching up, elsewhere, for example, within Asia, there is continuing education to familiarise LPs with the characteristics and appeal of the sector.

2. **The investors' changing approach to market** – As a result of the global financial crisis and the pressure now being applied, LPs began stress-testing their investment hypotheses by challenging fund models, both in terms of fees charged and the value added by asset management teams. As a result, some LPs are now allocating more and more of their funds under management to infrastructure, but in some cases that allocation is now split between investing in strong infrastructure fund managers and direct investments by those same fund investors.

3. **More infrastructure funds** – One of the most significant developments has been the big increase in the number of fund managers active in the market. Looking back five or six years, there were probably only two or three investors that were actively educating and encouraging investment by LPs in their funds; with Macquarie Group managed funds recognised as the market leader. Today, there are over 40 distinct infrastructure fund managers in Europe alone, who actively invest on behalf of their LPs, and who primarily invest in operating or secondary infrastructure assets (as opposed to 'green-field' or new build infrastructure assets).

   While some of these infrastructure fund managers are independent operators, many are still backed by the large investment banks.

4. **Infrastructure funds are reacting to the changing investment approach of LPs** – As a result of this dramatic increase in competition for investors' funds, infrastructure fund managers have had to change their fund structures to accommodate the more aggressive stance being taken by LPs. This has ranged from substantial falls in asset management fees and 'carry', to the creation of more co-invest rights. But, most noticeable is the elongated timescale it now takes for infrastructure funds to move from producing a fund-raising memorandum, to appointing a placement agent, to delivering road shows, to finally getting to a first close.

5. **The emergence of independents** – Many LPs, particularly North American pension funds, began experiencing pressure from their stakeholders to reduce operating costs, with concerns raised over the level of asset management fees being paid away. The same LPs also came under pressure to address the perceived inefficiencies and conflicts of interest created when fund managers appointed their own investment bank backer as financial advisor. One US-based infrastructure fund manager has been particularly successful recently in raising a substantial new infrastructure fund by pushing their independence credentials. There have also been a number of examples of fund managers backed by investment banks withdrawing from the sector having failed to raise funds.

   However, there is strong evidence to suggest that most infrastructure funds that are backed by investment banks will seek out the most qualified financial advisor on transactions, rather than simply directing deal flow to their own investment bank. Many emphasise this approach to avoid even the appearance of a conflict of interest. Conversely, there remain a smaller number of funds that will regularly appoint their investment bank backer as financial advisor and share the efficiency benefits with their LPs. Such benefits include better access to the investment bank's global network, and offers to underwrite transaction abort costs for the infrastructure fund and their LPs.

3. Infrastructure funds asset focus

In terms of appetite for infrastructure assets, there has been a shift from the preferences we witnessed in our 2007 report. Of the infrastructure funds we surveyed at that time, there was a relatively uniform focus on what might be considered core infrastructure assets including transport assets like roads, airports and ports, regulated utility assets, operating renewable assets with tariff protection, and telecommunications infrastructure assets. However, one of the key findings was the increasing desire for a number of the infrastructure funds to shift investment into tangential infrastructure assets or in some cases infrastructure services businesses which would offer the infrastructure fund higher returns. Examples of these types of assets include both on-street and off-street car parking businesses, motorway services station businesses, and essential services businesses for core infrastructure assets. The latter category includes facilities management (FM) or contract providers, aviation services businesses, and storage businesses including both fossil fuels and goods under contract.

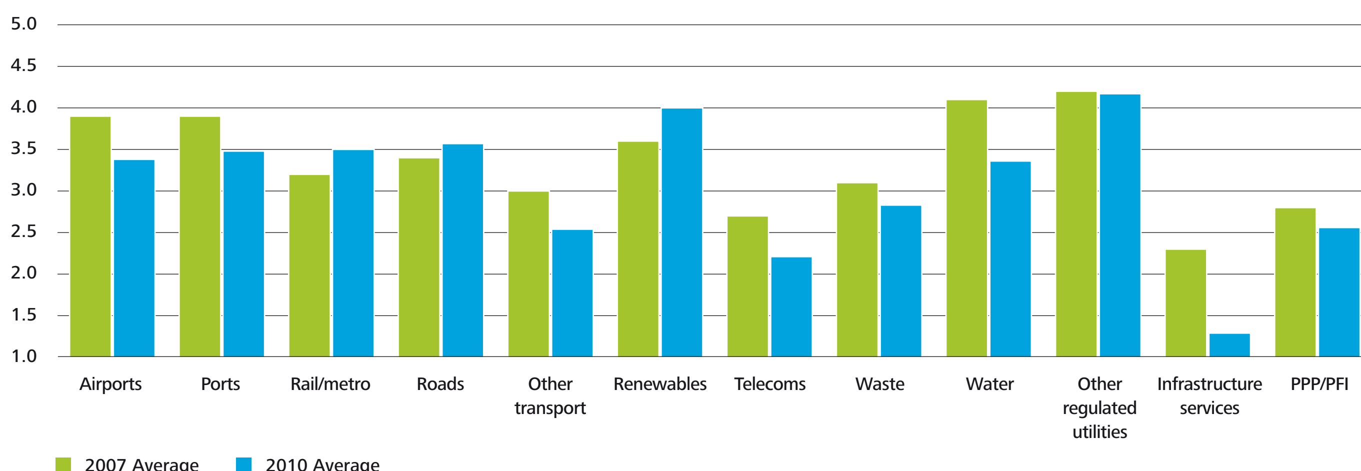
It would appear the investment strategy of the infrastructure funds has clearly and purposely shifted back towards core infrastructure. In fact, a number of the funds are now pricing demand assets which do not have regulatory or contract price protection with significantly more conservative growth assumptions, that reflect today's reality of lower GDP growth (particularly in western economies). Today's funds are being significantly less aggressive in their refinancing assumptions; the days of building in re-gearing gains for equity as part of a bid model appear to be long gone.

The precise definition of core infrastructure differs from fund to fund. Nonetheless, there remains a generally similar focus on regulated energy and water assets, airport and port assets that are either regulated or have positions of market dominance, and operating renewable projects that have contracted tariff protection arrangements. Demand based toll roads have been hit hard, with a number of distressed shadow and real toll road assets in Europe being put up for sale or not reaching financial close.

While the analysis indicates a decreased appetite for water assets, we do not think this shows a shift in sentiment toward the sector, but is instead reflective of the fact that many funds have acquired UK water assets since 2007 and are therefore constrained on competition grounds from making further acquisitions in the UK.

Even with this shift back towards core infrastructure, the overall 'target' returns of the infrastructure funds have not really shifted from the mid-teen Internal Rates of Return (IRRs) that were being targeted back in 2007. Most infrastructure fund managers believe this shift back towards core infrastructure exposes their own funds to less risk compared to other infrastructure funds. Our findings suggest that while this may be true when compared to the historic risk profile of other funds, the general shift in the market means there is actually less differentiation in terms of risk profile for the different funds than fund managers perceive.

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



Interest in PPP/PFI assets has not really changed since 2007. Primary bids for green-field developments are dominated by the construction houses and specialist PPP/PFI funds. For secondary assets (and portfolios of secondary assets), again, the specialist PPP/PFI funds dominate the landscape, retaining their focus on low risk/low return concession assets. Accordingly, the vast majority of infrastructure funds tend to not want to compete for these assets due to the very low risk/return thresholds.

This thinning definition of what constitutes an infrastructure asset and the broadening number of infrastructure funds interested in this same smaller class of assets, has led to a few funds seriously considering a move up the value chain.

Some funds are showing an increased willingness to take on development and construction risks, particularly in respect of renewable assets, and thus expose themselves to sustained periods of minimal or no cash yield. The aim here is to enable a higher overall blended return for the infrastructure fund.

Other funds are seeking to obtain higher returns by investing in assets that require operational improvement or which present opportunities for consolidation to achieve cost synergies. We think these themes may become more prevalent as fund managers start to raise their follow on funds and seek to demonstrate to prospective investors the value that they can bring.

There has been a clear shift by the majority of fund managers back to focusing on more traditional infrastructure assets and away from 'tangential' infrastructure assets or services businesses that were being pursued by fund managers back in 2007.

4. Competitive environment

Competition for infrastructure assets has varied substantially over the last few years. Our research indicates a number of reasons behind this development.

Firstly, the earliest participants or 'first mover' fund managers who raised their first generation infrastructure funds relatively easily, have been experiencing a very different environment for their second or in some cases their third funds. This has resulted in an elongated timeframe to get to the first close of these new funds. Furthermore, this has reduced the number of funds aggressively bidding against each other for infrastructure assets when compared to the competitive landscape of 2006 and 2007.

Secondly, the vast majority of infrastructure funds operating in this market have either raised Euro or US Dollar denominated funds. As a result, they will typically only have a mandate or willingness to invest a certain percentage of the fund in assets denominated in other currencies. With a significant number of UK assets trading in 2006 and 2007, interest from infrastructure funds in Sterling denominated assets has steadily reduced over the last three years. Accordingly, a number of funds now find themselves 'overweight' in UK assets as a proportion of their overall portfolios.

Thirdly, a number of the infrastructure funds have pulled back from certain markets altogether.

For example:

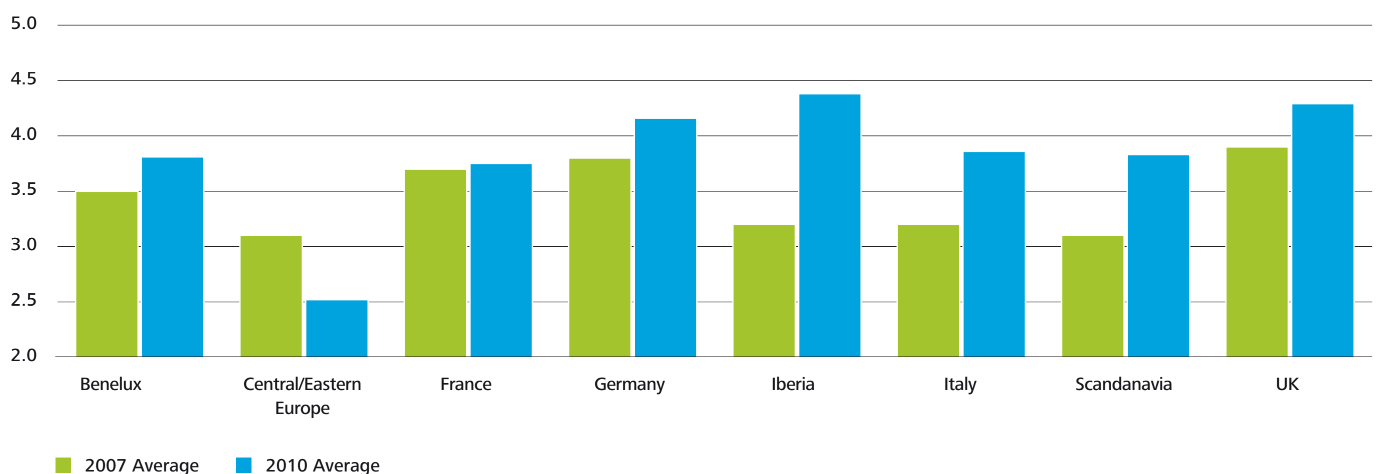
- Central and Eastern Europe now appear to be of minimal interest to the bulk of infrastructure funds, due to perceived issues of economic and political uncertainty.

- The Iberian peninsula is out of favour with some of the funds due to recent concerns around government support for renewable developments being withdrawn in Spain, and the general weakness of the economies. However, for other funds, this market is an area of particular focus.

- In specific Western European countries, where locally managed infrastructure funds are thought to have a politically-based competitive advantage, a number of global and European funds will only contemplate entering these markets provided they can do so alongside a strong local investor.

However, there was no real consistency on these points. Some funds had a strong focus on a particular jurisdiction, whereas others had an equally strong desire to avoid the same market. In the same way that funds have refocused on core infrastructure assets, our conclusion is that the tried and tested countries for infrastructure investment, those that have seen the most activity over the past few years (e.g., UK, Spain and Germany), will be the jurisdictions where funds will generally focus most of their attention over the next few years.

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



When we asked funds to name their main competitors for assets, one theme which did emerge was the clear beginnings of stratification of the infrastructure fund market. We believe that the market is now loosely grouped into the following broad categories:

- **Global funds** – These are multi-billion Euro or USD funds that typically have a mandate to invest globally and will seek out deals requiring larger equity cheques.
- **Major European funds** – These are also multi-billion Euro funds that typically have a mandate to invest in Western European OECD countries and will seek out mid to large equity cheques.
- **Mid-market funds** – These are smaller funds, often with a more specific focus on select geographies or sectors.
- **Specialist sector funds** – The most common examples are designated renewable energy funds and PPP/PFI funds.

The infrastructure market has matured such that there is now a clear stratification of investors between PPP/PFI focused funds, general economic infrastructure funds and the higher return risk model seemingly favoured by recent private equity entrants.

Generally, funds are competing infrequently with trade buyers. This is driven by constraints on utility company balance sheets, as those companies are obliged to sell assets to assist in deleveraging and the funding of strategic green-field projects. It is also true that infrastructure funds will often be deterred from bidding where they sense there is strong strategic interest from trade buyers. In addition, the predominance of private equity has diminished substantially.

One source of competition, particularly for global funds and some specialist funds, was the advent of direct investment by pension funds. For now, the direct investment activity of pension funds in larger assets seems to be focused at the lower end of the risk spectrum, often where there is less scope to optimise performance through active asset management.
An example of this was the investment of Borealis (the infrastructure investment arm of the Ontario Municipal Employees Retirement System), and Ontario Teachers' Pension Plan, in the High Speed 1 privatisation process run by the UK Government. Here, the competition was rumoured to include various consortia featuring direct pension fund investors, including the Universities Superannuation Scheme, the BT Pension Scheme, and Canada's Public Sector Pension Investment Board.

Where pension funds have taken direct investments in more complex assets, this has usually occurred through the syndication of equity by an infrastructure fund following the completion of a deal. This was the case with GIP's sale of stakes in Gatwick Airport to Australia's Future Fund, the National Pension Service of South Korea, and Calpers. As with more traditional co-invest arrangements, in these situations the pension fund benefits from the fund manager's experience in navigating the acquisition process and their ability to optimise asset performance.

5. Risks and returns

Through our discussions, we asked each infrastructure fund to outline the key risks they consider when deciding whether or not to invest in infrastructure assets. As one would expect, the answers varied and were closely linked to the specific asset classes and geographies that the funds focused on.

However, some common themes emerged amongst the funds, in that the majority identified regulatory risk, political risk and macro-economic risk as being front-of-mind, and many commented that it was difficult to prioritise between them.

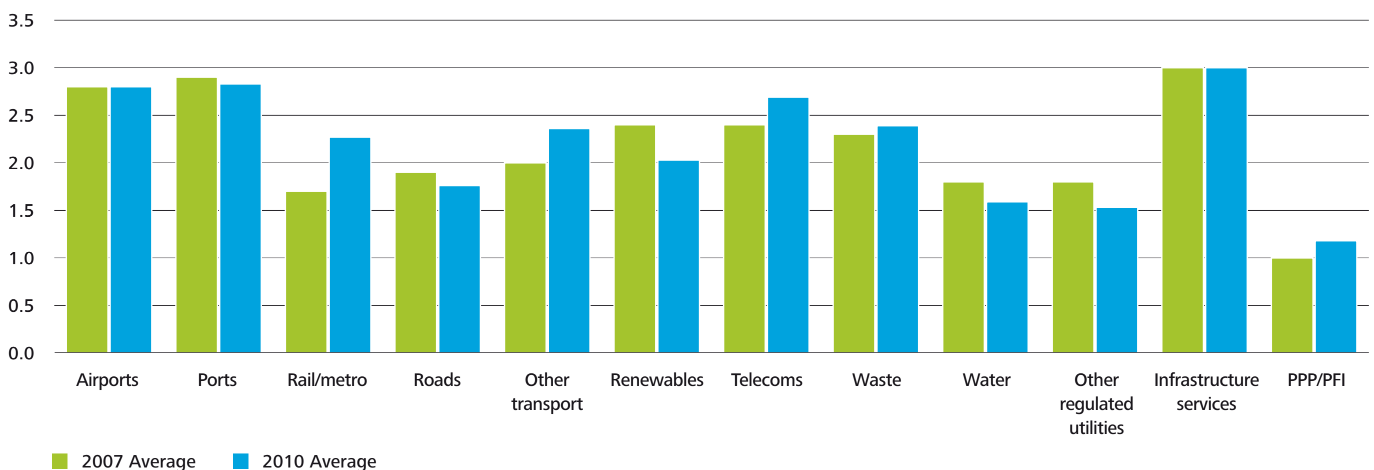
For obvious topical reasons, regulatory risk is high on the agenda of many funds. The recent developments in Spain, where the Government has taken steps to make retrospective adjustments to tariffs for certain solar photovoltaic (PV) projects, have caused a stir amongst infrastructure investors and financiers. Clearly, funds that have already invested in the Spanish renewables sector are concerned about the financial impact, but there is a wider issue with investors losing confidence in the underlying regulatory framework and the knock on effect this may have throughout the rest of Europe.

Political risk is arguably more of a concern in the current economic climate; more and more governments are under pressure to try and reduce their sovereign debt positions and are implementing cost cutting austerity measures. The response by infrastructure investors is to ensure that there is broad political support for their investment in order to avoid serious repercussions down the line.

When listing macro-economic risk, a large number of funds related this directly to demand risk and the associated underlying drivers – whether in relation to traffic for a toll road or the number of passengers travelling through an airport. As a result of this risk, a number of the funds are migrating away from assets such as certain ports and airports, which in 2007 were considered by fund managers to be core infrastructure assets.

When asked if these risks were likely to change over the next three years, all the funds surveyed agreed that the above factors would remain key risks for infrastructure investment assessments. A few funds thought that refinancing risk could become more of a focus in the short-to-medium term, when large chunks of the term debt packages associated with acquisitions finalised in 2006 and 2007 come up for refinancing in 2011 and 2012.

How does IRR compare between asset sub-classes? (3 being high and 1 being low)



While the fund managers we spoke to were happy to express their views on targeted IRRs across the spectrum of assets illustrated, for some of those with a higher return profile (e.g., infrastructure services and telecoms), they were equally adamant that they did not fit within their fund's definition of infrastructure.

The relative target return expectations from different asset sub-classes have moved little since 2007.

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The picture becomes more complex for assets where there was a wide range of quoted target returns. However, this reflects the fact that the sub-classes can contain assets with fundamentally different business models and risk profiles. For example, the range of IRRs quoted for roads was between 9% and 16%; reflecting the differing models adopted, from low risk availability-based concessions, to real and shadow toll roads where the owner takes significant risk on unproven traffic volumes. Similarly, the range of 10% to 18% for renewables reflects factors such as the degree of construction and development risk that investors are willing to take.

For other assets such as water and regulated utilities, there was a more focussed return expectation with the responses all clustered around 10% to 14%.

6. Deal execution

Lending has recovered somewhat since the height of the credit crunch, partly due to the bank bail-outs, restructurings and a revitalised bond market, but it has certainly not returned to the approval levels seen prior to the global financial crisis.

With this in mind, we asked the funds for their views on the evolution of the credit markets in connection with financing of infrastructure deals. A number of interesting points were noted:

- The general consensus on debt-financing terms was that there would be little change in the short-to-medium term with fees, credit spreads and covenants broadly remaining unchanged. A majority of the funds expected pricing to be constant, ranging from 250 to 300 bps, and fees to remain stable, ranging from 2% to 3%.
- Availability of debt financing was expected to continue to remain within a rather conservative range of six to seven times EBITDA, which is significantly less aggressive than multiples seen in 2006 and 2007.
- A large number of funds felt that lending banks would continue to focus on detailed due diligence and be proactive in negotiating the scope of work up front in order to ensure that key risks associated with debt service/covenant breaches were covered.
- In general, lending banks are seen to have a good appetite for the sector and are gradually increasing their allocations. The key question is around the quality of the underlying asset – the right asset, with the right characteristics, will attract more aggressive leverage structures. For example, renewable assets are not overly popular at the moment, perhaps reflective of the current uncertainty associated with various regulatory regimes.
- There has been a trend with banks willing to lend (sometimes aggressively) against known long-term cash flows, while expecting equity to fund growth assumptions in underlying demand drivers and value enhancements. This clearly excludes growth capital expenditure where the rebuttable assumption is that any expansionary capital expenditure will generate incremental known cash flows.

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For now, funds appear confident that the financing environment for infrastructure deals is stable, but cautious about any short-term improvements in availability or pricing.

The general view amongst the funds is that successful deal execution is possible, but it is 'hard work' relative to times prior to the global financial crisis. There is a price expectation gap between sellers and buyers which is somewhat exaggerated by the consequence of needing increased equity levels combined with relatively more expensive debt – resulting in an inevitable price reduction.

7. Portfolio management and performance

Most infrastructure funds are targeting low to mid-teen returns for their investors. Back in 2007, it was difficult to undertake a meaningful analysis of the returns being generated by infrastructure funds (at least in Europe) because of the relatively small number of funds that had substantial experience with capital deployment. In fact, most fund managers had only deployed a small part of the capital at their disposal.

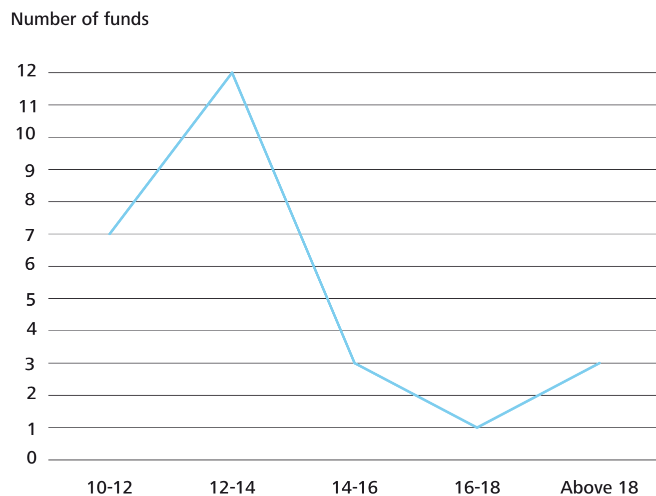
Excluding the specialist funds, (e.g., the secondary PPP/PFI funds) that have lower return expectations and who are generally already meeting these target returns, there is a spread of experience with regard to performance relative to target. Some of the funds performing less well are those who invested heavily in 2006 and 2007, and particularly those who made investments in demand-based infrastructure assets whose performance has been adversely impacted by the macro-economic environment.

Those who invested later or avoided assets with material demand risk, have fared better and are generally at, or above, their targeted level of return.

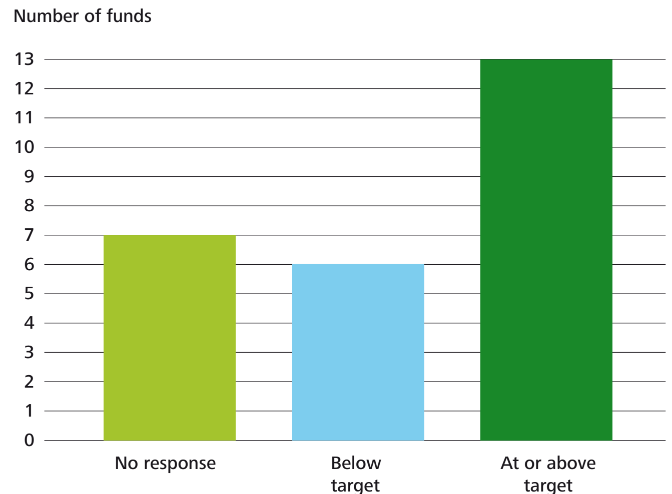
The vast majority of funds are targeting annual cash yields in the 5% to 9% range. Many are already paying cash yield at or above that range. Overall, the current IRRs of most funds are still being heavily driven by asset valuations, because at this stage of the fund lifecycle there have been very few actual realisations of assets.

IRR continues to be a key indicator of the overall performance of funds and carries weight with fund managers because of the profile given to IRRs in the original marketing of the funds. However, there has also been a noticeable shift of attention paid to the level of cash yield being generated.

Fund's target IRR



Performance of funds



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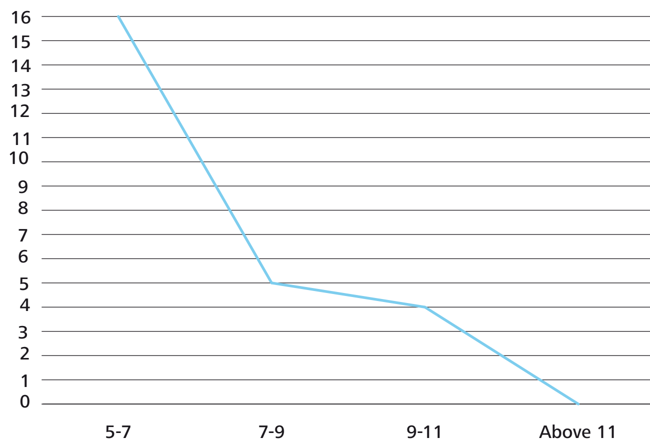
Fund's target cash yield



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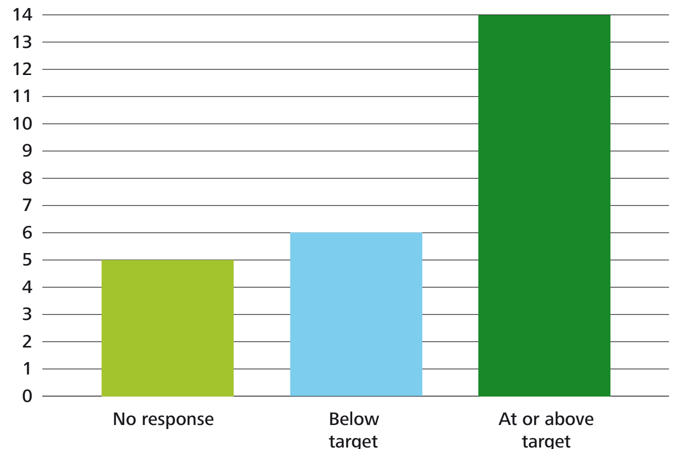


From an LP's perspective, there is some differentiation of view. Pension funds are focused on cash yield, but for insurance companies IRR remains the key performance parameter because of the need to mark their investments to market from an accounting perspective.

Back in 2007, our sense was that most funds saw executing the right deals at the right prices as the key drivers of those returns. As a result, the skill sets of their investment professionals were orientated towards deal execution. We now see funds seeking to pay more attention to managing and optimising asset performance. In part, this may be a response to the downturn; as opportunities for new deals slowed, it was natural for teams to increase the time they were spending with, and intensify their challenge to, the incumbent portfolio management teams.

This has been accompanied by some recruiting of designated portfolio directors and teams, with the result being that, generally, infrastructure funds now have more asset management capability than private equity funds. However, there is still a propensity for following the private equity model, where deal teams continue to monitor the assets they acquire and are ultimately accountable for their performance.

We see a logical progression, particularly as many funds become fully invested, for more ex-senior industry executives and consultants to be engaged by the infrastructure funds and installed on the boards of their portfolio companies with a mandate to apply their practical operational experience.

Looking at asset performance by subclass:

- PPP/PFI assets have performed in line with expectations, except for a very small number where complications have arisen through the failure of FM providers.

- Regulated assets have generally performed at or around expectation; the main challenges being posed by instances of negative inflation and price reset reductions being sought by the regulators, reflecting either the fall in the risk free rate of return or optimistic assumptions around operating efficiencies.

- Demand based transport assets and assets dependent on Gross Domestic Product (GDP) performance have struggled through the downturn. Some sponsors have responded by deleveraging their assets through equity injections to pre-empt any possible banking issues. Even within this category, instances of forced sales or banks taking control of infrastructure assets have been minimal, so far.

- Renewable assets have exhibited a wide range of performance dictated by geography and technology. The most successful have delivered very strong performance. Others have struggled for a variety of reasons, for example, prolonged periods of below average wind speeds or the failure to achieve anticipated levels of re-gearing.

8. Fundraising and the role of direct investors

If the environment for deals has changed since 2007, the same is certainly true of the fundraising market. New infrastructure funds are still being raised by fund managers. Operators like Alinda, Antin, Blackstone, Goldman Sachs, First State, HSBC, Highstar and KKR were among those to reach a first or a final close for their new funds during 2010. Many others are still trying to raise new funds. However, there have been some big shifts in the approaches of LPs and fund managers since the boom times of 2006 and 2007.

Pricing has come under considerable pressure as an early response to a more difficult fundraising environment, with the outdated private equity model of '2 and 20', that was prevalent in the first generation infrastructure funds, being replaced with better terms for LPs. Typically, these terms are of the order of a 1% to 1.5% management fee and a 10% preferential carry (note: '2 and 20' refers to a management fee of 2% of capital under management and a preferential 20% return for the fund manager once a specified return hurdle rate has been met).

There continue to be a variety of fund structures in the market both in terms of the basic model and duration. For example, listed and unlisted, and closed-ended and evergreen. On the whole, fund managers are comfortable with, and advocate strongly for, the particular structures they have adopted.

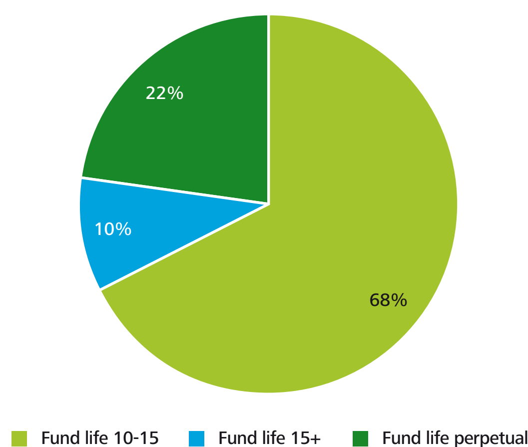
While there has been a general swing away from the listed model over the last three years – with some high profile Australian listed funds, firstly internalising their fund manager and sometimes going private completely – the UK public markets continue to be receptive to the specialist PPP/PFI funds that follow the listed model. HSBC Infrastructure Company Limited and International Public Partnerships both successfully completed equity placements in 2010, and new entrant John Laing successfully listed its debut secondary infrastructure fund.

However, without question, we see the unlisted model (whether that be a closed-end or evergreen fund), continuing as the model of choice for most infrastructure fund managers across Europe.

On one side, the proponents of evergreen (or perpetual) funds will point out that, in theory, investments in their fund structures will ensure a better match of long-term assets with the long-term liabilities of their pension fund and insurance company LPs. Conversely, one of the main attractions of closed-end fund structures or shorter life funds is that LPs have a decent idea who will be managing the fund throughout its life when they initially invest, and that the management team will be incentivised to maximise returns in the invested assets over the whole fund life. In contrast, investors in an evergreen fund will know there has to be turnover within the fund manager's team over the life of their investment, which introduces uncertainty and makes incentive structures for the key individuals at the fund manager harder to align with LP's long-term interests.

While this poses something of a dilemma for managers launching a fund, to date there seems to be appetite for both models from LPs. It is probably healthy for the sector as a whole that we continue to see a mixture in terms of the duration of the lives of funds coming to market to raise capital.

Maturity of funds surveyed



Direct investors changing views on how they should invest in infrastructure assets have seen a number invest directly as well as collectively forcing fund managers to make their fee structures more efficient.

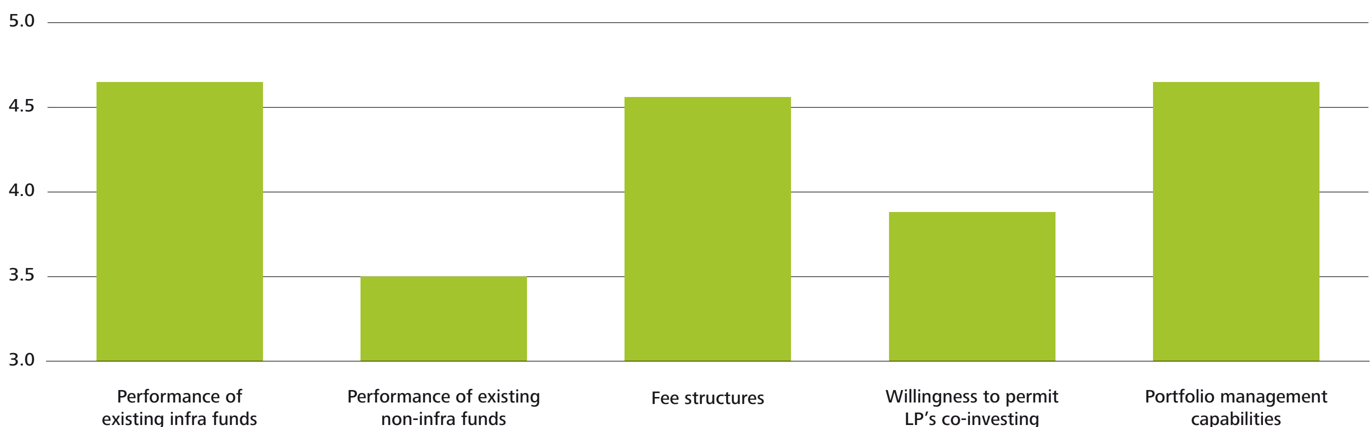
One issue which is going to have a wider significance for all fund managers, regardless of the durations of their own funds, is how the shorter-life, first generation funds intend to exit. Quite rightly, in our view, the majority of funds do not have a clearly defined strategy at this point because the first meaningful wave of forced exits is still two-to-three years away. The choice of IPO, trade sale, secondary sale to another fund or direct investor, or a rollover of the fund, will depend on the outlook of the public and private markets nearer the time. However, we do think it is critical to investor appetite for the sector as a whole that whatever the chosen exit route(s), the proceeds realised validate the fund valuations which are currently driving the IRRs that both investors and fund managers are expecting.

Turning to the other factors that differentiate fund managers on the fundraising trail; the fund managers noted the performance of their existing infrastructure funds, and their overall portfolio management capabilities, as the most important factors for any LP looking to invest in their new fund.

In line with our finding that infrastructure has carved its niche as a distinctive alternative asset investment class, fund managers believe that it is their individual competence and performance as an infrastructure fund manager – and not the general capability of their sponsoring institution, or their track record of investing in other asset classes – which holds the key to fundraising success. As a result, any new entrants to the infrastructure fund sector will have to think carefully about their approach and assemble a team with the right amount of experience to maximise their chance of success.

Fee structures also ranked highly on the issues that were perceived to be on the minds of LP's. However, the comments of many fund managers suggest that the challenge they have is to demonstrate that the fee structures are designed to incentivise performance and provide value to LP's, rather than it being solely an issue of the quantum of fees that will be paid over the life of the fund.

Please indicate the importance of the following characteristics in the fundraising process (5 being very high and 1 being very low)



In our view, the fundraising environment is continuing to evolve and we have noticed some perceptible shifts since our initial discussions with the funds. The main driver for this is the changing attitudes of pension funds and insurance companies (the staple LPs for the first generation of infrastructure funds). Pension funds and insurance companies are increasingly seeing infrastructure as an attractive asset class for direct investment. They perceive these assets as stable, secure businesses that do not necessarily require specialist asset management skills. However, we foresee possible bumps in the road for investors that follow this direct path. Regulatory re-pricings, asset obsolescence and bypass risk, new technologies (particularly in the renewables sector), and the failure of or suboptimal refinancing resulting in yield lock-up or future recapitalisations, all pose significant challenges which need specialist evaluation and management. In our view, the most experienced and well resourced fund managers have an essential role as intermediaries and they will emerge as the winners as the fundraising environment settles down.

One outlook on this could result in a merry-go-round for investment professionals as they move from fund managers to direct investors. Inevitably, we will see some of this as more direct investors allocate resource to oversee their infrastructure allocations, undertake direct investments and manage these newly acquired assets. However, we think the likely medium-term equilibrium is for a concentration of investment expertise in a smaller number of active fund managers, as opposed to the 40 plus fund managers operating in Europe today. Part of the problem for direct investors is that while infrastructure assets share some common characteristics, there is a wealth of difference between, for example, a UK airport and a German gas distribution business, and again between buying and managing assets. The larger fund managers will have personnel with experience in both deal execution and asset management for the different classes of asset, and will play to those strengths. For a direct investor that may look at only one deal in a particular sector or geography it is hard to see how they can efficiently resource an investment team. Unless they intend to either restrict themselves to a very narrow class of assets or are prepared to commit to a direct investment programme that is comparable in size to the fund's managed by the largest infrastructure fund managers.

We think a far better approach for the sector is for investors to look to both a pool of large, well resourced fund managers with the capabilities to take informed investment decisions across the whole spectrum of infrastructure assets, and to smaller, more specialised funds. An example of the latter is in the renewables sector where fund managers have smaller teams, but with very deep expertise in their chosen area.

The debate for LPs and fund managers then becomes one of how LPs access that expertise and how much they should pay for doing so. This is not just about the pricing of infrastructure funds; it is also about the extent to which LPs want co-investment rights and to be able to join consortia led by their favoured fund managers on larger deals.

In addition, where infrastructure assets come to market in a state requiring active management to correct embedded inefficiencies, or to optimise returns via a consolidation play, we believe it will be fund managers who will make an operational success of these transactions and earn an appropriate return for so doing. In some cases, it may be that after fund managers have done the hard work they can sell some or all of their interests to direct investors in a 'cleaned-up' asset. In these situations we may see fund managers and pension funds on opposite sides of deals, rather than competing for assets as has happened over the last few months.

Infrastructure investing is a long-term game and the future of the sector will be shaped by the fund managers with whom LPs choose to develop their long-term relationships. These fund managers will be the winners and will manage large pools of capital; probably, in many cases, significantly larger than the funds they run today. We think that this will place a floor on the downward pressure that LPs have been exerting on fees over the last few years. As the saying goes, 'you get what you pay for'; skilled and knowledgeable dealmakers and asset managers who deliver real value for their investors in the form of efficient, yielding infrastructure assets will expect to be well compensated.

9. Conclusions and predictions

The last three years have been significant in the evolution of infrastructure funds. The sector in Europe was in its infancy at the beginning of the period, and, looking back, one of the effects of the global downturn has been to accelerate its 'growing-up' process. While this has delivered some unpleasant surprises to a few fund managers and some LPs along the way, what has emerged is a sector that is less reliant on complex leverage structures for its returns, and more focused on core infrastructure assets that are best able to produce the stability of yield that should attract the investment of LPs.

The best of the fund managers have weathered the storm of the financial crisis and have emerged wiser for the experience. The infrastructure fund model is here to stay and the volume of institutional money that is invested will grow steadily over the next few years with the pace quickening if and when more countries introduce systems of compulsory pension saving. However, the sector itself will experience some significant changes as it evolves to a form that is best able to manage this flow of money.

The trend which will have the biggest influence in shaping the sector over the next three years:

1. **If, at the beginning of 2008, there was a clear road ahead for infrastructure fund managers we now think there is a fork in the road ahead, where the LPs will direct which path the fund managers must take.**

   - **The best fund managers will lead the growth in investment and head a smaller pool of active fund managers than exists today. These successful managers will invest their own funds and those of co-investors, and lead consortia on deals that include pension funds and insurance companies investing directly. These are the funds whose names will become synonymous with the sector.**

   - **Other fund managers who cannot raise new funds will become specialist asset managers returning cash yield and ultimately proceeds from asset sales to their investors. We expect some consolidation among the managers in this position with some highly regarded asset management operations being created as a result.**

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Some other trends which could manifest themselves over the next three-to-five years:

2. There are a handful of demand-exposed assets where the combination of ongoing poor operational performance and highly leveraged structures will result in some restructuring taking place as debt packages come up for refinancing. In some cases, infrastructure funds may have to make capital calls to facilitate equity recapitalisations, however, the recent return of the high yield market may to some extent mitigate this risk. Generally, we do not see infrastructure portfolios giving rise to many defaults with any that do occur probably arising on tangential infrastructure assets with debt packages negotiated at the height of the market in 2006 and 2007.

3. An increasing number of senior ex-industry executives will join infrastructure funds and bring their deep operational expertise to bear in portfolio company management. Retiring utility CFOs and CEOs will have another alternative to joining the listed non-executive director circuit.

4. Caution amongst funds about investing in certain countries given austerity measures and the risk of sovereign defaults, and other concerns over political and regulatory risks, will continue. Privatisations of core infrastructure assets in the UK have and will continue to attract keen interest; but infrastructure funds are unlikely to be buying assets in countries where significant economic uncertainty remains.

5. Governments will increasingly structure privatisations so they are regarded as core infrastructure assets – in the same way that corporates and private equity woke up to the potential for sales to infrastructure funds in 2007 and 2008. More government-owned assets will follow the example of High Speed 1 and restructure to create a core infrastructure asset prior to coming out of government ownership, which in turn will maximise the proceeds on sale.

6. There will be continued involvement from pension funds as direct investors but, where they act totally independently, with a focus on lower risk and less complex assets. Their role in the medium-term will depend on their success in building up their skill base to execute and manage investments. Failure to do this properly could well lead to poor investment performance and a re-evaluation of the direct investment strategy on a fund-by-fund basis.

7. No change from Western Europe remaining the key geographic area of investment focus in Europe. Areas like Central and Eastern Europe will look for infrastructure fund investment, but will have few takers in the short-term.

8. Debt will remain for quality assets. Terms and pricing will remain relatively tight for the next few years and there will be no significant shift in the current balance between demand for debt from the infrastructure funds and appetite to lend from the banks.

9. We will witness a resurgence in the number of UK deals as fund managers who have filled the Sterling allocation in their current funds close their next generation funds and direct investors begin to take the plunge. At least one of the three remaining listed UK water companies will have been taken private over the next three to five year period.

10. Contact us

If you would like to discuss any issues raised in this report, please do not hesitate to get in touch.

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