

Infrastructure Funds: Trends and Opportunities

The market for infrastructure funds has grown dramatically in recent years, as an abundance of opportunities in both developed and emerging markets has paved the way for increasing numbers of investment vehicles to successfully raise capital. Owing to investor appetite for infrastructure and the increase in opportunities worldwide, the average size of infrastructure funds increased from US\$159 million in 2003 to US\$3.3 billion in 2008.

This commentary examines some of the recent trends among unlisted infrastructure funds and the impact of the credit crisis, including tightened competition in the infrastructure fund market, the shift in focus toward mature, producing assets, and opportunities resulting from escalating equity investment in infrastructure projects and stimulus packages worldwide.

As the cornerstone of economic growth, infrastructure assets have been known for their long-term return stability and resilience to economic cycles. Despite the economic downturn, the infrastructure sector will likely continue to grow, fueled by continued demand and new drivers such as government spending via stimulus packages. The OECD estimates that a massive US\$70 trillion is still required for infrastructure development and improvement worldwide through 2030.

Infrastructure funds invest in projects either directly or indirectly through infrastructure companies, who may participate in such projects as project owners. Unlisted infrastructure funds are more inclined to take ownership in infrastructure assets directly as significant shareholders, and favor project financed deals over all-equity deals. Through limited recourse financing, equity funding enjoys reduced risk exposure, as sponsor returns are optimized through higher gearing levels.

INVESTMENT STRATEGY TRENDS

Infrastructure fund managers generally take prudent approaches in their strategy and execution. Every deal is thoroughly scrutinized and classified according to its scope, geography, and level of maturity, in order to establish a unique risk profile. Some recent trends on how fund managers evaluate investment opportunities include:

Wider investment scope: A recent development is the emergence of funds with relatively wide investment criteria. Infrastructure funds are investing not only in core infrastructure but also in more peripheral assets. For example, some infrastructure funds have invested in logistics and support services companies. These service companies are increasingly exposed to the potential risks of higher competition because of low entry barriers and lack of revenue assurance. Infrastructure funds investing in these companies face higher risks, but in general they can benefit from this diversification.

Multi-region focus: More funds have started to expand their geographical investment focus. At least 32% of investment vehicles currently in the market focus on multi-region investment, compared with the 22% of funds closed between 2003 and 2008. Probitas' infrastructure fund list, which lists funds that are currently in the market or that plan to be in the market by October 2009, reports that ten out of the top 20 infrastructure funds intend to maintain a multi-region portfolio. For example, KKR Infrastructure Fund, Citigroup Infrastructure Investors, and Santander Infrastructure II are all open to investment opportunities in infrastructure assets on a global basis.

Targeting mature assets: Due to the credit crunch, most infrastructure funds are adopting a more risk-averse investment strategy and now prefer producing assets or

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projects that have already secured debt financing over unfunded greenfield projects. A higher level of competition is expected among infrastructure fund managers in the search for higher quality, producing assets. That being said, a few infrastructure funds still plan to invest in greenfield projects, such as 3i's India Infrastructure Fund (US\$1.2 billion) and UBS' international fund (US\$1.5 billion).

Partnering with sovereign wealth funds and other state agencies: As funding sources become increasingly scarce, more infrastructure funds are tapping sovereign wealth funds and other state agencies as limited partners to help with co-investment and deal origination. For example, in April 2009, Macquarie and State Bank of India announced the launch of a joint venture, the "India Opportunities Fund", which aims to raise US\$2-3 billion to invest in infrastructure assets in India. Goldman Sachs and GIC (a sovereign wealth fund from Singapore) announced plans in December 2008 to invest €1.7 billion in Sintonia, the Benetton family's vehicle for infrastructure investments focused on the BRIC countries (Brazil, Russia, India, and China). GIC is expected to invest €850 million in this venture.

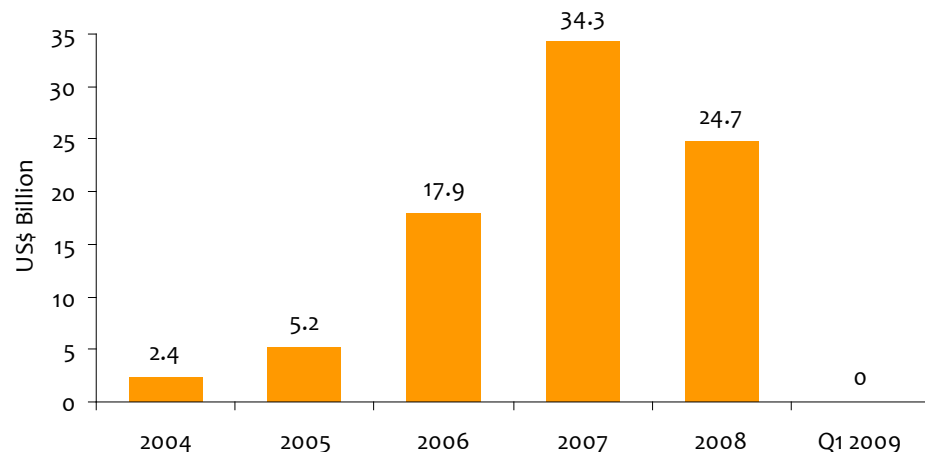
IMPACT OF THE LIQUIDITY CRISIS

The Liquidity Crisis has affected infrastructure fund market in the following ways:

More Competition, More Opportunities

The financial crisis has forced some investors to delay their decisions on making new investments, and fund managers, in turn, are finding it harder to secure funding. As of December 2008, 71 funds were in the market seeking an aggregate US\$90.8 billion, which represents nearly an 80% growth from 2007 when there were only 40 funds in the fund-raising stage. Additional infrastructure fund announcements were made in early 2009, including Blackstone (US\$2 billion), KKR (US\$4 billion), Morgan Stanley (reopening the Global Infrastructure Fund), and another international fund from UBS. There are more funds than ever looking to close and start investing, as asset prices have come down drastically in the past 12 months. A number of quality assets are now seeking new investors at good prices, partially due to the demise of large private equity funds such as Babcock & Brown. Nevertheless, none of the infrastructure funds in the market closed during the first quarter of 2009 (see chart below).

Global Infrastructure Fundraising



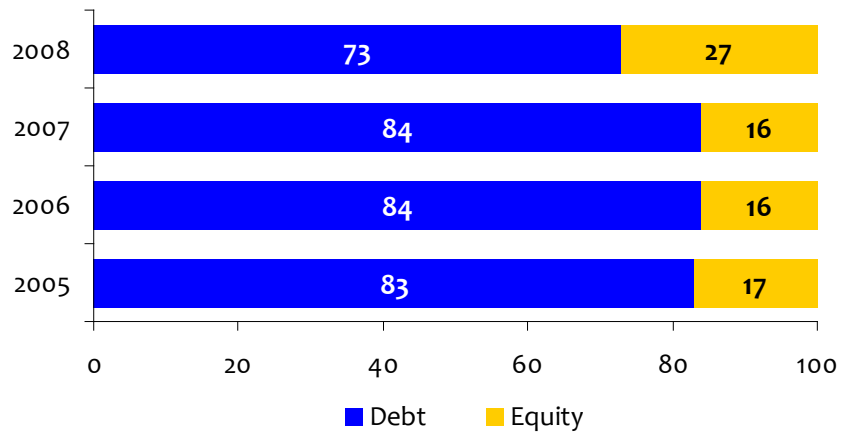
Source: Probitas

"... none of the infrastructure funds in the market closed during the first quarter of 2009... the competition is extremely intense among fund managers for limited funding sources."

However, the frozen debt market offers a unique opportunity for equity investment. Rising credit spreads and lower liquidity have increased both financing and refinancing risks for infrastructure assets. As banks take a more conservative lending approach and no longer offer attractive financial terms, the debt/equity ratio is shifting. In 2008, the amount of equity used in project finance transactions increased by almost 41% compared with the previous year, and the global debt available for infrastructure projects is expected to drop another 20% or more by the end of 2009. The higher percentage of equity required to finance transactions has opened another door for infrastructure fund investment.

The average percentage of equity participation in project finance transactions increased from 16% in 2007 to 27% in 2008.

Debt to Equity Ratio for Project Finance Transactions



Source: Infrastructure Journal

Lower Return Expectations

In terms of returns, the average target internal rate of return (IRR) for private infrastructure funds was approximately 18%-20% in the period 2006-2008, including about 5% average target annual cash yield. Achieved returns and yields were similar to these targets. Due to the credit crisis, investors no longer expect the earlier 18%-20% returns. Returns of 13%-15% are now targeted for infrastructure projects as infrastructure funds can no longer rely on financial engineering to generate the higher returns.

Conservative Gulf Investors

Even in the traditionally liquid GCC region, there was not much activity in the first quarter of 2009. The recent leveraged assets bust in the GCC has made Gulf investors extremely fund-averse. According to *Middle East Business Intelligence*, funding sources in GCC countries have dried up and hence prevented these countries from participating in new infrastructure funds. For example, recently established funds such as Bunyah GCC Infrastructure Fund (Bahrain), ADCB Infrastructure Fund (Abu Dhabi), and MENA Infrastructure Fund (Dubai) have a committed investor base, but are wary of making capital calls or new investments in 2009. The withdrawal of GCC investors from the funds market is likely to have a significant impact on infrastructure fund capitalization. Before the start of the recession, GCC investors had committed US\$1.5 trillion for infrastructure investments over the period 2008-2018, which was larger than the amounts committed from the U.S. (US\$1 trillion) and India (US\$500 billion) for comparable investment targets.

“GCC region” refers to six states on the Arabian Peninsula which constitute the Gulf Cooperation Council (GCC), including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

“... the stimulus packages alone will not be enough to satisfy infrastructure investment needs, investments from private funds will be necessary to fill the gap.”

Stimulus Plans: Another Opportunity

Governments around the world have announced economic stimulus plans that promise investment in infrastructure. However, tremendous additional investment is still needed to support planned infrastructure projects. A study by CIBC World Markets earlier this year estimated that governments in Europe, the U.S., and China will have to spend US\$246 billion, US\$123 billion, and US\$165 billion, respectively, on infrastructure every year within the next decade to reach stated targets and developments. In the stimulus packages announced in 2009, the EU allocated US\$6.8 billion, the U.S. US\$80.9 billion, and China US\$220 billion (over the next two years) for infrastructure. As the stimulus packages alone will not be enough to satisfy infrastructure investment needs, investments from private funds will be necessary to fill the gap. A CEO-level executive survey on infrastructure from KPMG and the Economist Intelligence Unit in December 2008 found that 77% of respondents believed that levels of global infrastructure investments were insufficient and that more public private partnerships (PPP) were needed.

The importance of private sector participation in developing infrastructure projects has been recognized worldwide. Private sector partnership programs have been launched in countries including the U.K., France, and Germany, and more and more infrastructure projects have adopted PPP structures. In the U.S., President Obama has proposed US\$5 billion in his budget for fiscal year 2010 to establish a “National Infrastructure Bank” to support the financing of U.S. infrastructure projects. The President further plans to increase funding for infrastructure by up to US\$25 billion over the next 10 years, in order to encourage more private sector participation in infrastructure enhancement endeavors through PPPs. As private sector investment becomes increasingly crucial to meet the infrastructure needs, infrastructure funds will be given more opportunities to invest in infrastructure projects.

CONCLUSION

Despite the credit crisis, there is still plenty of appetite for infrastructure assets, as they are relatively less sensitive to price volatility compared with other assets classes such as real estates, for example. Infrastructure funds have gradually developed broader investment criteria to cover infrastructure-related assets and multiple regions. However, as the liquidity crisis has drained the capital pool, infrastructure funds are striving to close and have had to solicit investment from new investors, such as sovereign wealth funds. Fund managers have also embraced a more conservative approach toward their investments. Mature and cash flow generating assets have become primary investment targets, as opposed to the greenfield investments that were popular prior to the financial crisis.

Competition has soared to historically high level. Infrastructure funds in the market are seeking capital to invest in revenue-certain assets, with even more funds planning to join. Owing to the credit crunch, a new window of opportunity for infrastructure funds has opened. Infrastructure projects are now structured with lower leverage, which allows more equity participation. Infrastructure funds can take advantage of this opportunity by investing directly into infrastructure projects, or indirectly into companies that are project sponsors. The lower expected IRR of 13-15% is now considered compatible with infrastructure fund investments. Finally, economic stimulus packages will likely create more investment opportunities for infrastructure funds, as private sector equity participation will be crucial in supporting infrastructure investment requirements in the coming years.