The rise of 'Frankenstein funds'

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With the next couple of years set to mark the maturity of a number of 10 to 12 year closed-ended funds, LPs face re-investment risk once their capital is returned. However, at least two infrastructure fund managers are working on bespoke fund restructurings to instead retain their portfolios and investors for the long-term.

Like Dr Frankenstein in his lab, these managers are working on a method to reanimate funds after their natural death,

London-based Arcus Infrastructure Partners' Arcus European Infrastructure Fund 1 (AEIF1), was founded in 2007 (at that time called Babcock & Brown European Infrastructure Fund) with over €2 billion ($2.2 billion) of capital raised from over 40 institutions.

With the end of the fund's life nearing, Arcus has almost completed a restructuring to continue the AEIF1 fund, removing the need to sell up the remaining assets in the portfolio and return the LPs their investments. Arcus Infrastructure Partners mandated Campbell Lutyens and Clifford Chance to structure a solution. *IJGlobal* has learned that the process undertaken by Arcus is in advanced stages after a number of months' work.

Another fund manager, Netherlands-based DIF, is in the early stages of also seeking a way to continue the near-maturity DIF Infrastructure II fund. DIF Infrastructure II launched in 2008 and raised €572 million. The fund made 59 investments, and states on the website it has sold off only six PPPs and three onshore wind projects so far.

A past successful example of a GP-led restructuring in infrastructure was Innisfree's in 2003, which took primary investments into a continuation fund. *IJGlobal* understands that other GPs are exploring their own options for continuations, at different stages.

End-of-life options for funds

Asset disposals over the last few years have in part been driven by the nearing maturity of closed-ended funds. A number of these funds launched in the mid-to-late 2000s with 10-12 year life times, and only a few years' extension options. For example the near mature Macquarie European Infrastructure Fund had two two-year extension options.

A fund can sell off its assets one by-one ahead of a wind down, or dispose of an entire portfolio in one transaction. A recent example of the latter is [Ardian's second fund] which was put on the block this month, or the advanced negotiations for 3i Infrastructure to buy out EISER's portfolio.

Continuation options do exist, though they require bespoke structuring for each fund and are hard to pull off.

DIF Infrastructure II's assets are generally 25-year PPP concessions and renewable energy assets. On the other hand, AEIF1 owns core economic infrastructure assets. There tends not to be a time limit to the rights held over those assets, unlike DIF's.

Arcus' solution

IJGlobal understands from a source that AEIF1 was almost, or even fully, unique among the funds at the time of its launch for including in its original documents a provision that is "far more extensive" than typical extension options of just a few years.

Therefore without the need to create a new vehicle, Arcus is undertaking a GP-led restructuring to continue the AEIF1 fund.

Setting up a new vehicle would be possible for others, but more challenging, as it needs to meet the demands of incoming and remaining investors, a source said.

To continue the life of a fund, there must be a "win-win-win situation". Existing investors must find it advantageous, as must the fund manager and there should also be new investors wanting to come in.

IJGlobal understands that the consultants for Arcus sounded out the value at which new investors are willing to buy into the continuation fund, which then by definition represents the market price. Existing investors can chose to sell at that price to entering LPs, or retain their investment. For those staying in, the prospect of long-term income offers a different but appealing incentive to the typical private equity capital gains realisation.

Valuations are a tricky element of the process. Market volatility only adds to this challenge, with the UK voting to leave the European Union last month in particular creating uncertainty.

Advantages of continuation

LPs in general are wondering whether they want their money back or if that will just cause a reinvestment problem, given the risk and cost funds take when bidding for new assets, and also the high premiums being paid at this time.

If a fund's portfolio of assets has been performing well and there is further value to be extracted from the same successful management, they are less likely to want to exit. With 10 years' or so as a stakeholder, LPs are likely to have developed a clear idea of the assets' performance through business cycles.

Another reason to stay might well be that assets in a development-type portfolio, after several years of cap-ex heavy build out phases, have not long been in the operational phase. A sale means missing out to the next buyer on that stable, long-term income generation that infrastructure offers.

Charles Ford, counsel at Hogan Lovells, also pointed out: "An advantage of a GP-led restructuring is that, where the fund structure includes a tax approach which would no longer be available to a newly constituted structure but has the benefit of grandfathering, a GP-led restructuring may give greater opportunity to preserve the ability of investors to continue to benefit from the historic tax position."

Ford explained, "A GP-led restructuring needs careful choreography to be successful... you have to create the right atmosphere to give confidence to both incoming and existing investors."

However, it must be noted that each fund is different, and there are many ways to do it. A source emphasised that really there is no "cookie-cutter" solution.