Bloody fundays

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Infrastructure funds can be broadly divided into funds focused on assets that are concessions backed by availability payments from governments (social infrastructure) and those focused on demand risk projects, such as ports and airports, that are usually backed by short term acquisition debt facilities (economic infrastructure).

The scale of opportunities in economic infrastructure was mirrored by the waves of commitments to multi-billion dollar infrastructure funds accumulated in 2007 and early 2008. However, in a de-levered world these funds have found opportunities thin and managers that missed the pre-Lehman window have struggled to secure their targeted commitment levels as investor appetite waned.

While the smaller social infrastructure funds have been buffeted by higher debt costs and the threat of deflation (which reduces RPI-linked availability payments), their ability to raise commitments has not been as hard hit because their models do not rely on the use of racy acquisition facilities and high levels of leverage. The universe of potential investments for social infrastructure is a niche compared with economic infrastructure so better suits smaller funds, rather than the large private equity firms and money mangers.

What has affected all infrastructure asset classes globally is the fall in asset values. As a high profile example, BAA got nowhere near its initial valuation of Gatwick airport in the £1.455 billion sale to Global Infrastructure Partners.

"During the past six months I've seen more assets up for sale than in the previous three years," says an investment manager of a large European infrastructure fund. The consequence of a glut of assets is a fall in the prices of those assets, and many listed infrastructure funds – HICL, International Public Partnerships, 3i Infrastructure – have reported falls in the net asset value of their portfolios during 2009 due to increases in discount rates.

Discount rates

The fall in asset values cuts both ways. As well as denting the fair asset value of funds' portfolios it has boosted the internal rate of return of assets bought at the current low market price. But while asset prices have been volatile for social infrastructure, things are beginning to settle down. The discount rate for trading secondary assets is 8% to 9%, and for primary assets around 12-13%. At the height of the boom, due to leverage, asset prices were bid up pushing discount rates for secondary assets down as far as 5%.

The glut of PPP assets is driven by constructors' and some financial investors' need to recycle equity or pare down their leverage to finance their primary activities. PPP sponsor Carillion has long had a strategy of selling two or three assets a year to recycle capital, though there are uncorroborated reports that the firm is looking to offload around £100 million-worth of assets from its £150 million portfolio. John Laing, which was acquired by Henderson at the peak of the market, beating off stiff competition from Allianz, and was a perennial buyer of assets, is in advanced talks with Innisfree about offloading the bulk of a £100 million portfolio. RBS is also looking at divesting its PPP portfolio, thought to be valued at around £250 million.

This asset glut, particularly in the UK, is compounded by the absence of traditionally aggressive buyers. The SMIF vehicle has been muted by its various migrations from Land Securities through Trillium to the £1.3 billion Semperian fund and the Infrastructure Investors vehicle has been saddled with the acquisition debt from the Barclays take-out. Both I2 and SMIF relied on portfolio leverage and canny refinancings to achieve 20+% returns, but as debt pricing has leapt up and refinancing opportunities have vanished, these returns are unlikely to reappear.

Aside from asset disposals constructors have been exploring alternative methods of extracting capital. In November Hochtief confirmed plans for an IPO of its concession business. Hochtief puts a value of Eu1.5 billion ($2.24 billion) on Hochtief Concessions (HC) – some analysts estimate its value at more than Eu2 billion – and is expected to sell down to a 51% stake, thus retaining majority control. In addition to the secondary selling, HC will raise Eu600 million in primary stock.

Infrastructure withdrawal

Given the abundance of relatively cheap assets now should be a prime time to raise commitments and make acquisitions. The reality is very different. The golden period of infrastructure commitment raising was 2007 and 2008 (pre-Lehman).

During 2008 Global Infrastructure Partners, a JV between Credit Suisse and GE Infrastructure, closed a $5.64 billion fund, overshooting its original $3.5 billion target and Morgan Stanley Infrastructure fund similarly exceeded its target, closing with $4 billion in commitments against its target of $2.5 billion. The Danish EQT Infrastructure fund also achieved a Eu1.2 billion close.

According to alternative investment advisory firm, Probitas Partners, commitments to infrastructure funds in the first nine months of 2009 compared with the same period in 2008 fell by over 70% to just over $6 billion, compare with around $21.5 billion being raised in the first nine months of 2008. As the economic climate soured, banks reversed decisions to pursue their plans for infrastructure funds; according to fund researcher Prequin so far in 2009 10 would-be funds have halted fundraising and abandoned their plans.

Probably most high profile among these moribund funds has been the ING abandonment. ING pulled its planned Eu1 billion fund in July, and despite lowering its commitment target to just Eu300 million, still failed to find sufficient commitments. It is now in the process of divesting its seed assets – a 29% stake in Welcome Break, the motorway services group, and a 24.9% stake in Q7, a Dutch offshore wind farm.

In July, RREEF closed its planned $500 million North America Infrastructure Fund because of the difficulty securing commitments. In late 2008 Bank of Ireland pulled its Eu400 million fund, even though about Eu100 million had already been raised. Santander pulled the plug on its second Eu1.5 billion infrastructure fund and is looking to dispose of its stakes in Thames Water and Cory Environmental, and in two Chilean road concessions, Rutas del Pacifico and Autopista Central. And Merril Lynch canned a planned infrastructure fund before its takeover by Bank of America.

The driver behind these withdrawals, as well as the difficulty raising commitments has been banks' wavering commitment to a non-core business such as infrastructure fund management, particularly given banks' need to horde capital when cornerstone equity investments in their own funds is necessary to tempt institutional investors.

Many of the large funds on the road are struggling to find anywhere near the same institutional investor appetite as pre-Lehman. "If you look at the big players, such as KKR and Blackstone, they have struggled to raise money," says a UK-based fund manager. "At the moment the LP market is looking for something more vanilla like straightforward PPP concessions. The American funds have been more hybrid chasing airports and ports with aggressive mini-perm structures – the trouble is these invariably rely on year-on-year Ebitda growth and when that doesn't happen the financing is in trouble."

Top ten fund seekers

Fund	Manager	Size (million)	GP location
GS Infrastructure Partners II	GS Infrastructure Investment Group	7,500 USD	US
Macquarie European Infrastructure Fund III	Macquarie Capital Funds	5,000 EUR	Australia
Alinda Infrastructure Fund II	Alinda Capital Partners	5,000 USD	US
RREEF Pan-European Infrastructure Fund II	RREEF Infrastructure	3,000 EUR	UK
KKR Infrastructure Fund	Kohlberg Kravis Roberts	4,000 USD	US
Macquarie Infrastructure Partners II	Macquarie Capital Funds	4,000 USD	Australia
Energy Capital Partners II	Energy Capital Partners	3,500 USD	US

aAIM Infrastructure Fund	aAIM Infrastructure	2,000 GBP	UK
Blackstone Infrastructure Fund	Blackstone Infrastructure Partners	3,000 USD	US
CVC European Infrastructure Fund	CVC Infrastructure	2,000 EUR	UK

Source: Preqin

While previous MEIF incarnations were overflowing with commitments, Macquarie European Infrastructure Fund III is grinding toward its target. It has so far raised just over Eu1 billion. The jury is still out on whether private equity players can make infrastructure funds work due to their investment time frame and fee culture. KKR halved its fee and carry structure (fee for over performance) for its infra fund to 1% and 10% respectively, which sent ripples around the private equity community. 3i Infrastructure, the £900 million UK-listed fund, as a comparator pays 1.5% per year of the gross investment value of the fund to 3i plc.

Aligning investors' interests with the remuneration of the manager is key to securing commitments; in a recent survey an overwhelming number institutional investors said that they prefer independent fund managers rather than those annexed to a bank or private equity house.

Macquarie has had to re-invent the way it runs its multifarious infrastructure funds, with a rush to de-leverage and sever management contracts. A new model that Macquarie is pursuing is partnering with leading institutions in emerging economies and obtaining cornerstone investment from reputable institutions – this market edge should more than outweigh any reputational issues the fund manager is carrying.

For instance, Macquarie has set up a Russian and CIS infrastructure fund with Russian investment firm Renaissance Group and had its first $530 million close in August. It has cornerstone investments from the EBRD, IFC and Russian development bank Vnesheconombank.

Macquarie has teamed up with the Mexican government to create a fund to invest in the country's infrastructure. By the end of this year, Macquarie and Fonadin, Mexico's national infrastructure fund, will launch a risk-capital fund with $500 million and plan to increase it to $1 billion over six months. Macquarie also has designs on India and China, which are likely to follow the same template.

Small is beautiful

The difficulties of larger funds in raising institutional commitments do not seem to be reflected at the smaller end of the spectrum, where smaller funds can tap bilateral institutional investor relationships and high net worth individuals.

In late October 2009 Natixis' brownfield infrastructure fund announced its second closing, raising around Eu500 million. A third closing is expected before year-end, with firm commitments already made reaching Eu100 million, and several expected to follow.

Michael Ryan, the former managing director of Infrastructure Investor before the Barclays' buyout, is raising a fund – believed to be called Belmore Capital – of around £300 million. The fundraising should be completed by early 2010.

Lloyds Banking Group is also launching a new fund. The fund will be a primary social infrastructure fund, so will contain more risk than its first fund, with a mandate to make investments at bid stage. The fund will have a portfolio value of around $800 million, and will invest in availability-backed projects in the UK and continental Europe. Lloyds will seed the fund with some of the on-balance sheet equity it currently holds and make a cornerstone investment.

Barry Williams, the co-founder of SMIF, has set up Aleltho Energy with Perry Noble, the former co-head of the global finance practices at Freshfields. The fund will invest in renewable projects across Europe and has a cornerstone investment of £75 million, with an aim of raising a further £100 million by the end of 2009. Williams is also a founder and consultant for the new infrastructure mezzanine debt fund Gravis Capital Partners.

One of the biggest obstacles facing economic infrastructure funds is refinancing risk over the next 18 to 24 months. While funds and investors have been busy paring down their debt, at the asset level infrastructure companies have been holding on to cash that would usually have been dispersed to de-lever a future refinancing.

Singapore-listed Macquarie International Infrastructure Fund released a sobering set of results for the nine months ending 30 September 2009, which shows that on a quarter by quarter basis profit has fallen 56% and that its net asset value over the reporting period has fallen by 17.5%. While gyrations in NPV of the portfolio are in part due to falling asset prices, MIIF attributed the fall in the value of its largest investment, its 8.7% stake in communications firm Arqiva, to the probable difficulty of refinancing borrowings at the same terms and levels when it becomes due in 2014. The Arqiva stake had a total acquisition cost of S$434.8 million but its valuation has fallen by nearly a third to S$292.3 million.

However, for those that can make the returns and financing work for assets in the current environment, not only will they pay less for assets but they should benefit from an uplift via refinancing as the lending markets improve.

As the global economy improves, commitments are expected to come flooding back into nascent infrastructure funds but it is a question of time. One fund manager says: "The pick up will be a slow process. Asset prices were overvalued, and the structures became too toxic. Some people got their fingers badly burnt and confidence needs to be restored."