Limited partners

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With stockmarkets and the credit and commodities markets in disarray, and with the leveraged buyout market stalled, the pension fund and institutional investor flight to infrastructure continues to grow as fund managers seek portfolio diversification and long-term investments with cashflow certainty.

A number of large infrastructure funds have attracted new capital over the past six months, despite the worsening global economy, and more are on the way from entities such as Citigroup, Goldman Sachs and Macquarie. New York based private equity firm Kohlberg Kravis Roberts is building up its infrastructure team ahead of the upcoming launch of a $4 billion fund. Barclays Private Equity has also raised around Eu450 million for its Eu1 billion ($1.3 billion) Barclays Integrated Infrastructure Fund (BIIF). And in November 2008 private equity-style closed-end fund M&G Investment Management (part of Prudential Group) closed the eighteen month ramp up of its Infracapital Partners fund at £910 million ($1.3 billion), £160 million more than its initial target.

"It is a tougher environment all round, but there are opportunities, since asset prices should be more realistic, and there still seems to be solid demand from investors globally for infrastructure assets," says Rob Treich, principal at Mercer. "But the loan syndication market is effectively closed, so you have to work very hard to pull together your banking group on a club basis. And debt structures are less aggressive in terms of leverage and the covenants and security packages."

"There is good potential for secondary market activity where existing asset owners, banks and corporates or perhaps also infrastructure funds, are under pressure to raise cash by selling assets," Treich adds. "Buyers need to have good skills in terms of appraising an asset, but just as important is what they do with the asset once they have acquired it. The operational abilities of the manager are under increased scrutiny."

"There is masses of equity out there, but the challenge is getting leverage to get the returns," adds a London-based project lender. "If you look at the volume of transactions required in the UK there simply isn't enough bank debt out there to fund them. Capital will be in short supply and banks will be selective about what they go for."

"There is clearly no appetite for underwriting at the moment, so we are seeing club deals," he notes. "Ideally, you would want a deal with two or three banks, but when you grow to 10 or 20 it becomes extremely difficult to get everybody in line. The problems grow exponentially, and there is no easy answer to any of that."

New market dynamic

This introduces an interesting dynamic into the market. Where a couple of years back infrastructure funds or private equity houses had banks falling over themselves to come in as mandated lead arrangers, in today's market the advantage looks to be swinging towards funds with strong connections to a lending institution, whether as a subsidiary or affiliate.

Some very large infrastructure funds have been raised over the past twelve months, but those sponsored by pure investment banks or private equity houses may suffer compared to those linked to commercial/retail banks, which can come in as lender. That web of relationships is going to be more critical than ever during 2009.

"The big LBO funds are trying to diversify, and are trying to recycle their staff, but they have yet to demonstrate that they have good infrastructure management skills," a banker comments. "Another problem that they face is that bank lenders will tend to aggregate their exposure to one firm, so they will look at new infrastructure loans as adding to this exposure. And the traditional private equity people do not have good contacts with project bankers, since they are in different departments to the bankers who lent on LBOs."

Thus some of the biggest infrastructure funds, which generally prefer very large deal sizes simply because of the amount of money they have under management, are going to face a tough time getting a club of banks to agree on pricing and covenants. Where multi-billion Euro mega-auctions were the focus during the buoyant years of 2005 and 2006, good contacts and industry relationships, and a more flexible approach to smaller deals, are likely to be a winning formula over the next year.
Funds with smaller single-deal sizes will also be able to take advantage of distressed sales, such as hedge funds offloading relatively small project debt portfolios. And that list of contacts will be helpful where banks with infrastructure assets are looking for a quick private sale rather than a long drawn out auction process.

For example, at 3i Infrastructure plc, new investment activity in the six months to 30 September 2008 related mainly to the purchase of a portfolio of junior debt instruments, taking advantage of the dislocation in the credit markets. The debt portfolio comprises facilities issued by Viridian (£28.9 million), Thames Water (£14.5 million), NGW/Arqiva (£32.4 million) and Telediffusion de France (£10.9 million). Each of the assets, says 3i, were purchased at pricing levels which provide a yield to maturity above the company's return objectives.

There is also growing diversification in the way funds are structured. For example Paris-based Antin Infrastructure Partners represents a move away from the fund model that dominated up to 2007, where infrastructure funds were set up as subsidiaries of major investment banks and commercial banks, such as Citi Infrastructure Investors and Goldman Sachs Infrastructure Partners.

Antin is 40% owned by BNP Paribas Investment Partners, and the managing partners own the other 60%, meaning that investment decisions and remuneration are independently managed. "In the coming years governance is going to become a critical issue when it comes to infrastructure funds, and just as most large LBO funds that ten years ago would have been owned by banks are now independent, so we may start to see more independently managed infrastructure funds," says Alain Rauscher, chief executive of Antin Infrastructure Partners. "Limited partners are increasingly looking for more clarification on governance, and a clearer set of rules about how investment decisions are made."

"BNP Paribas is very active in infrastructure advisory and lending, and the way Antin is structured eliminates conflicts of interest," he says. "BNP Paribas has a 40% stake in the management company, and has no representation on the investment committee."

"As far as debt is concerned, we are very keen to work with BNP, but it is done at arms length and we have no obligation to use their services," says Rauscher. "Clearly, in the current difficult environment, when we are talking to potential consortium partners it is a huge plus to have BNP as a sponsor."

Thus far Antin has done three deals, investing in UK rail leasing company Porterbrook, the Bina Istra motorway in Croatia, and buying a stake in Europort from BBI Euroports.

Rauscher is sceptical of large asset auctions – for example Antin will not participate in Ferrovial's upcoming auction of Gatwick Airport in the UK. This is both because high-profile auctions like Gatwick tend to attract the very large multi-billion infrastructure and LBO funds that bid aggressively against one another and push up the asset price. In addition, for a fund like Antin, committing Eu100-200 million would only get it a junior position in a consortium, and Antin prefers to be much more involved in the management of the asset, as is the case with Porterbrook, which it owns together with Deutsche Bank and LloydsTSB.

Borrowing from the seller to buy

The Porterbrook deal underscores another trend that will likely be seen during 2009 – potential buyers asking the seller to lend them money to help get the deal done.

In the case of Porterbrook the seller was Santander Group via its subsidiary Abbey National, which provided £412.8 million of the total £1.5 billion debt facilities. These included three-, five-, and seven-year loans as well as a capex loan and a revolving credit facility. Pricing was around the 210bp level at the five year tenor. RBS provided similar support for its sale of Angel Trains to a Babcock & Brown-led consortium.

"Going forward, if you have got a stronger balance sheet, providing financing to the buyer is going to feature increasingly in the market," comments a lawyer familiar with the Porterbrook deal. "And if one wants to remove some of the risk from the balance sheet you may have to stay partially in with a project – you may not be able to get a total exit."

The sale price of Porterbrook has not been divulged, and since the loans are a mixture of acquisition facilities and a refinancing of debt put in place for future requirements it is hard to deduce the price from the debt raised. However suggestions are that the sale price was roughly the same as the £1.4 billion Abbey paid for the company in 2000.

In addition to Abbey, seven other banks came in: Barclays Capital, BNP Paribas, Calyon, Commonwealth Bank of Australia, Dexia, Lloyds TSB, and SMBC who each took up £188 million. As is the norm in the current market, participating banks are coming in on a take and hold basis, and little in the way of syndication is expected.

With underwriting appetite largely absent, buyers have little alternative to lining up debt on a club basis, which inevitably becomes more difficult as deals get larger and break through the Eu1 billion level.

"We have moved into a new world and people are getting their heads around that," comments a lender. "We are still in the project lending business, but capital is in short supply and we have to look at whether to do long-term project lending versus other business." says a banker. That will mean a challenging year for equity providers, even though many infrastructure assets, especially those providing essential services, are generally still favourably viewed by lending institutions.

The change in lending appetite and falling asset prices has spawned a few fund casualties, not least Babcock & Brown, which has been hit hard by the credit crunch, and has been looking to sell various assets in order to strengthen its balance sheet. In January trading in its shares was suspended on the Australian Securities Exchange as B&B negotiated a restructuring with a group of lending banks.

B&B has several infrastructure funds, including European, Asian, North American vehicles and events at B&B will be closely watched by other infrastructure funds should more assets come onto the market.

There will also be the normal sale of assets by infrastructure sponsors, such as Hochtief and Bouygues, who periodically sell down stakes or entire holdings as part of their efforts to recycle capital. It was Bouygues that the sold Bina Istra toll road in Croatia to Antin.

Gatwick sale

The immediate focus of many funds is the sale of Gatwick Airport, which is expected to set asset pricing and financing benchmarks for the difficult economic climate ahead.

BAA/Ferrovial received six indicative bids. Gatwick is the second-largest airport in the UK measured by passenger numbers and is the most intensively used single-runway airport in the world handling 34.2 million passengers in the latest 12 months. However, passenger numbers at Gatwick plunged by 13.8% year-on-year in December, the worst performance of any of BAA's seven UK airports.

The sale comes with the option of an 18-month £1.1 billion stapled financing being led by financial advisers RBS and HSBC. The short tenor on the stapled debt has already drawn criticism from some bidders, and at least one bidder, believed to be Hochtief Airport, has been dropped by Ferrovial for pitching too low. Ferrovial is looking for around £2 billion.

The remaining five bidding groups include: Ontario Teachers with Canada Pension Plan and 3i Infrastructure, which is being advised by Macquarie and Rothschild; Credit Suisse and GE's Global Infrastructure Partners, advised by Credit

Suisse and JP Morgan; Gatwick Future Partnership, led by Babcock & Brown European Infrastructure Fund and RREEF, and advised by Deloitte, Cameron McKenna and Arup; Lysander Gatwick Investment, a consortium comprising Citi Infrastructure Investors, Vancouver Airport Services and John Hancock Life Insurance, advised by Santander; and Manchester Airport with Borealis and advice from Dresdner Kleinwort.