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Emperor's new shoes?

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It is a bitter-sweet irony of the booming global infrastructure market that as many pension funds, private equity houses and international banks set up shop in the growing infrastructure fund market, the acknowledged pioneer and world leader in infrastructure fund management, Macquarie Bank, has released disappointing results for one of its headline funds, global toll road operator Macquarie Infrastructure Group (MIG).

MIG net profits before finance costs are down year-on-year to $424.7 million from $772.6 million – according to MIG caused by lower revaluation income (borrowings made against the rising value of assets and paid out as dividends on the expectation of cash to come). The same happened in 2004 when MIG reported a loss of $251 million.

Too much leverage?

The problem for MIG – and potentially for those new infrastructure funds that have set up shop over the past year and plan to copy the Macquarie template – is that it has made very solid long-term assets attractive to investors by borrowing or refinancing with cheaper debt to make short term dividend payments. That is only possible when asset prices are increasing and cheap debt is available. The template is made difficult by rising interest rates, which spawn a host of other variables that do not fit into the equation – and interest rates are rising.

Theoretically, MIG's assets are inflation and interest rate-proof. If interest rates rise to combat inflation MIG can increase its toll prices by inflation or more. But for MIG to continue to grow and pay short-term dividends it needs access to cheap debt and equity financing to fund acquisitions – a potential credit crunch acknowledged by MIG itself. And interest rate rises both increase cost of debt and make traditional funds markets more attractive to the pension funds and retail investors that MIG has tapped to date.

Furthermore, the refinancing opportunities on existing assets will get slimmer as asset prices continue to climb in reaction to the growing competition for long-term quality cashflow assets from other new infrastructure funds – for example Macquarie is currently battling with Deutsche Bank's RREEF investment fund for a stake in UK-based Peel Ports.

Similarly, EPC contractor fees are climbing and pushing up initial project costs – albeit offset to some degree by current cheap bank debt – which means there could soon be less benefit from refinancing greenfield projects post-construction.

Macquarie's growing pains are neither fatal nor symptomatic of a problem with infrastructure investment – merely the result of aggressive financial engineering. And MIG has a very strong long-term asset portfolio. Furthermore, analyst reservations about the sustainability of the MIG structure have been confounded again very recently with MIG successfully refinancing its M6 toll road in the UK in a £1 billion deal where £392 million is released back to MIG as a dividend through the use of an accreting swap mechanism – the first time such a mechanism has been used in the UK PPP market (for more details see box).

Nevertheless, the type of highly leveraged deal synonymous with MIG to date may prove harder for investors to swallow in a changing lending climate. And many of the new bank-managed funds concede that while Macquarie has been very successful, they will not be following the same template. As Bob Parker, vice chairman of Credit Suisse Asset Management, says: "We are going to focus on projects where returns are less sensitive to leverage and more cashflow based."

It seems certain that Macquarie's big fee earning days will slow. If interest rates continue to rise MIG will start tapping the unlisted market to fuel growth, a sector that is dominated by pension funds looking for long-term stability at fixed rates and with little appetite for the kind of high leverage structures MIG favours or the internal fee generating practises the bank has earnt so much from in recent years by selling assets from one of its funds to another: MIG has just sold $762 million of US assets (half its US portfolio) to another US-based Macquarie fund in what is touted as a move to offset growing US angst about key infrastructure sales to foreign companies – the deal will also generate internal fees.

And the rhetoric from MIG's annual report indicates a shift of direction. In the coming year MIG will be focusing on "optimising the performance of existing assets" and around half of the cash generated from the M6 refinancing will be used for a share buy-back to bolster its share price.

Funds and private equity convergence

But if Macquarie's long-term infrastructure fund template needs tweaking, its overall strategy does not. The bank has pioneered a pension fund fuelled alternative investment push into infrastructure that is snowballing.
As John McCarthy, Managing Director, Head of Europe, RREEF Infrastructure, says: "Previously it was largely the banks guiding pension funds into infrastructure. Now we are reacting to demand and more pension fund investment in global infrastructure is almost a self-fulfilling prophecy."

Given the spread and depth of the UK and European PPP markets like Spain, European fund allocation to infrastructure is surprisingly small – estimated at less than 2% on average with portfolios ranging from 1-5% asset allocation.

For institutional investors infrastructure assets provide longer-term, relatively stable returns that are less sensitive to business cycle fluctuations or stock market volatility. Returns are often positively correlated with inflation, another important hedge for the portfolio.

And more funds are looking at the market: France's Eu29 billion state fund, the Fonds de Réserve pour les Retraites, is moving into infrastructure as part of a revision of its strategic asset allocation levels; and the £21.7 billion UK Universities Superannuation Scheme announced in June that it intends to invest up to 25% of its assets in alternatives, including infrastructure. Bankers predict that asset allocation could rise to between 6-10% in five years if European pension funds continue to pick up the pace.

The banks are reacting to pension fund hunger in a big way. This year new bank-managed infrastructure funds include ABN Amro with a Eu500 million fund, Deutsche Asset Management with its Eu1 billion RREEF Infrastructure fund, Credit Suisse First Boston/GE Infrastructure with a $1 billion fund and Goldman Sachs with a $3 billion fund. Morgan Stanley, Merrill Lynch and JP Morgan are also moving in, as are the major private equity houses – Kohlberg Kravis Roberts and Blackstone for example.

The majority of these high-profile vehicles – all except Deutsche's are global in mandate – are in reality destined for investments in developed markets. Many are a reaction to the vast potential of PPP in the US infrastructure market. Deals like the MIG/Cintra sponsored Chicago Skyway and the Indiana Toll Road have astonished even US banks into action despite initial antipathy to PPP and the rates of return: Although they bid more than double that of the nearest other bidder for the 99 year toll bridge concession, MIG/Cintra are looking at an ROI of between 12%-15% after some clever financial engineering.

Similarly, the growing acquisitions and privatization of infrastructure operators – for example France recently sold off its state-owned toll road companies – is creating convergence between private equity, infrastructure funds, pension funds and even bank debt. In effect, this is the recycling of corporate assets, and funds like it because the investments employ balanced capital structures that are largely unaffected by interest rate cycles.

The size of these acquisitions and the nature of the assets (infrastructure requires specific market expertise) has meant more consortium deals and the birth of large consortia combining private equity and hedge funds with infrastructure funds and pension money. For example, in the bid for BAA earlier in the year the winning bidder Ferrovial was joined by long-term pension fund manager Caisse de depot et placement du Quebec and GIC Special Investments, the private equity arm of the Government of Singapore Investment Corporation.

Emerging markets go local

Such investments, although good for fund managers, are not going to impact the greenfield project market which will continue to be dominated by bank debt – particularly in emerging markets. But although investor demand and the international bank-managed funds appear to be largely focused on developed markets, or at worst undervalued assets in emerging markets, regional equity infra funds are also starting up in a number of developed and developing infrastructure markets.

Most recently, Dubai-based Abraaj Capital has entered into a joint venture with Deutsche Bank and Ithmaar Bank to raise a $2 billion Islamic private equity fund to invest in infrastructure in the Middle East, North Africa and South Asia. And CIMB and Standard Bank have launched the South East Asian Strategic Assets Fund, a private equity fund investing in infrastructure, energy and natural resources deals in South East Asia. The fund's co-sponsor is the Employees Provident Fund of Malaysia.

But the move goes further than equities. In Latin America, for example, the growth of PPP and pensions fund and capital markets reform is creating new sources of home-grown infrastructure funding.

Fund managers of pension and health funds – privatized since the 1990s – are also searching for private issues in local currency. In Chile, for instance, the combination of well-developed capital markets and a pool of large institutional investors has yielded private financing for most of the nation's recent $8 billion investment in new transportation networks and water treatment plants.

Banks project lending to the region have yet to see a competitive threat from capital markets: Bank project lending hit $140 billion in 2005, compared to bond issues of $12.5 billion. But the potential for more attractive terms and lower cost of project capital provided by capital markets issuance sold to local pension funds and other institutional investors, particularly when covered by monoline or multilateral-backed risk mitigation instruments, will become a serious rival in the coming years – not only in Latin America but anywhere with a developing capital market.

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M6: Cheeky but closed

MIG underlined its reputation for innovation and a canny a sales pitch last month when BES, BSCH, Calyon and Dresdner Kleinwort underwrote a £1 billion nine-year bullet with a 30-year accreting swap to refinance the M6 (formerly known as BNRR) toll road in the UK.

The new deal is a significant increase in leverage and many bankers expressed doubts about taking such a large dividend out of a concession so soon into its operational life: Comparisons were made with last year's Bristol International Airport deal when Calyon and SG sweetened the terms of a £515 million refinancing after some banks complained that Macquarie and co-sponsor Ferrovial had over-geared the asset and were taking out too large a dividend – just over £121 million.

The deal refinances £685 billion of 15 year senior debt put in place in 2001 while also enabling sponsor Macquarie Infrastructure Group (MIG) to release £392 million from the project in the form of a dividend generated by an accreting swap mechanism.

The swap fixes the interest rate on the facility at 1% plus the credit margin during the first five years, which then increases by 25bp each year up to 8%. A cash sweep in the first five years reduces the swaps accretion.
The loan is priced at 90bp in year one, 80bp to year five, 95bp to year seven and 110bp to year nine, and features a cash sweep from year six – 40% in year six, 60% in year seven, 80% in year eight and 100% in year nine.

The economics of the project look good until maturity of the bullet loan when banks will have to take a view on the refinancing risk. S&P rated the debt BBB and lenders can take comfort from a 53-year concession period and minimum DSCR of 1.65x. There is a distribution lock-up at 1.4x and S&P believes the project can stand a 15% below traffic low case scenario.