Patient equity

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The large US-based infrastructure funds have not offered their investors an easy ride. By making acquisitions at the top of the cycle at eye-watering valuations and with extreme amounts of leverage, they were left extremely exposed to a drop in bank appetite. Several managers had to choose between appeasing banks, and keeping hold of assets, and walking away. But those that got the measure of their investors tolerance, or did not have to confront such choices, have prospered.

Infrastructure funds are still struggling to add to their assets under management, eighteen months on from the end of the leverage boom. According to research by Probitas Partners, a private equity placement agent, infrastructure funds raised $10.7 billion in 2009, a significant fall from the $24.7 billion raised in 2008, and $34.3 billion raised in 2007.

Sadek Wahba, global head of Morgan Stanley Infrastructure, says that the credit crisis was a sea change for infrastructure fund operations. Before the crisis, there was a plethora of funds raising. There was great demand from institutional investors in this asset class, and credit was being raised with apparent ease. Post-crisis, it is a different story: A number of players have disappeared from the market and limited partners are considering their investments with a more critical eye, he notes.

However, the full effects of the crisis on the infrastructure fund industry may not yet be apparent. We havent seen all of the shake-out yet, says Felicity Gates, partner and co-head of Citi Infrastructure Investors (CII). Although there were casualties, there are still 119 active funds globally, according to Prequin research. Fund managers credit a cautious approach to leverage, the ability to take hits to their equity stakes and strong institutional and investor relationships, but those still standing are re-evaluating their sources of funding, debt and investment choices.

Several hoped-for fund launches never took place. One former executive of a failed fund agrees: When we entered the market, there was a lot of liquidity available, he says. Some of the funds had too much cash that they couldnt put to use. Valuations were high and everyone was over-bidding because they wanted to invest their capital and there werent enough deals to go around. He puts the failure of his fund down to a number of factors; We entered the market a little bit too late, he notes. When it came down to it, funding was soft circle. A lot of funds have the same thing with secondary fundraising and, when investors have right of approval deal-by-deal, they become reluctant to commit in a financial crisis.

Fundraising and survival

The larger funds, especially those with substantial exposure to power, oil and gas assets, are still prospering. Alinda Capital Partners, whose largest investments include NorTex gas storage, SourceGas and the Regency gas pipeline, closed fundraising for its second infrastructure fund in January, with $4 billion in commitments. It is the only fund post-crisis to have reached its fundraising targets.

Global Infrastructure Partners (GIP), buoyed by opportunistic investments in Terra-Gen, the Ruby Pipeline and Chesapeake Midstream, is looking to raise $5 billion to $6 billion for its second fund. It is also looking towards the pension plans, sovereign and insurance plans this time, rather than to investors such as General Electric and Credit Suisse, which both contributed substantially to its first fundraising of $5.64 billion in 2008. GIP is also planning an IPO of the Chesapeake Midstream holding, in an attempt to capitalise on investor interest in midstream gas assets.

Goldman Sachs infrastructure fund, even though it missed its $3 billion fundraising, and JP Morgans open-ended fund, which relies on ongoing approaches to its institutional clients, continues to attract investment.

Macquarie Infrastructure Group (MIG) has had mixed results, and has expanded its advisory offering post-crisis, often advising former competitors on how to deal with commercial bank groups. Their model is opportunistic, says a competitor, but theyre looking to move back into more direct investment once the storm has passed. MIG has excelled at fundraising but also had to divide its roads assets into two classes (good performers and underperformers) and has had, in some cases, to either deleverage or divest assets. Its most spectacular hit has been the Macquarie-managed Atlas funds decision to write of its equity in bankrupt California toll road the South Bay Expressway.

Morgan Stanleys Wahba says that infrastructure funds rely on institutional investors such as insurance companies, large pension plans and sovereign funds for capital, but these investors have become more discerning. Ultimately, post-crisis, investors are seeking to generate longer-term returns and are seeking out proprietary opportunities.

But although some pension funds and larger institutional investors are exploring ways to invest in assets directly, Chris Beale, Alindas managing partner, believes that the two can peacefully coexist, Infrastructure funds and the larger pension funds that make direct investments in infrastructure will join together on some transactions and compete for other transactions.

One investor also suggests that it is difficult for public sector pension funds to manage direct infrastructure investment in-house, because the salaries required to attract executives with the relevant expertise are simply unpalatable to public pension plans, especially those in the US with public sector connections. He believes that investment via infrastructure funds is, and will remain to be, a necessity in the majority of cases.

The asset mismatch

Just as the working relationships between infrastructure fund managers and investors have become more complex, lenders willingness to stretch their practices for fund clients has also decreased. Less established funds in particular struggled with the increased margins on loans, and lenders have also been less forthcoming.

CIIs Felicity Gates notes that there are still challenges in the credit markets, particularly in terms of matching the tenor of debt with the long-term characteristics of the asset class. She says that CIIs recent Kelda water deal in the UK is an example of sensible leveraging and debt maturity for a stable asset. She also says that these kinds of inflation-linked assets are well matched with pension providers needs, because pension funds are seeking returns of a given margin over inflation. Were a 15-year fund, so we recognise that crisis will hit at some point during that time and can prepare for it, she says. Some of the smaller funds have three to five-year cycles. Although short-term funding for long term assets has its upsides, it is terrible in a crisis.

Alinda has used fairly conservative leverage and has tended to issue long-term bonds and lock in interest rates, explains Beale. Therefore, Alinda did not have any hung bridge loans or liquidity issues during the financial crisis. For instance, Alindas NorTex and Regency investments were in large part equity funded. Wahba notes that, despite the extreme fluctuations of the debt markets over the past couple of years, Morgan Stanley Infrastructures appetite for credit has not been significantly altered; Weve always kept our leverage at around 50%.

Capacity is also a continued strain, even as debt markets have again picked up. Before the Pennsylvania Turnpike deal was pulled, the sponsors had commitments for around $7.5 billion in mini-perm bank debt with a view to a bond refinancing after five years or so. According to one lender, Doing that deal in todays market, sponsors would be able to raise $2 billion if they were lucky.

Challenges and risks

One fund manager believes that infrastructure funds reputation with investors has suffered as a result of a small number of high-profile incidents. CIIs withdrawal from Midway was a big black mark for Citis reputation and was a negative for the market as a whole, he notes. It must have severely disappointed some of the larger investors that are big participants in CII. I know at least one of those investors has shied away from investing in infrastructure as a result.

According to a source close to the deal, the commitments were just not there. It was at the worst time possible for investors, who had to sit on their hands while their exposures were being calculated. Midway was by no means the only challenging moment for infrastructure funds during the crisis, and many still believe that the deal will eventually go ahead, but its public dissection makes it an obvious target for criticism. At least one manager at another fund confesses that rather than submit to banks demands he will usually contribute the additional required equity. CIIs return to its limited partners for more equity is more notable for taking place before financial close than for taking place at all.

CIIs troubles may have left some investors smarting and damaged the reputation of infrastructure fund investment, but the angrier investors may be those exposed to the more over-levered assets that changed hands pre-Lehman.

The equity in RREEFs Maher container port terminal deal and Macquaries Atlantic Aviation deal really took a haircut, says one fund executive. Those deals were done at the top of the market. There was a lot of deleveraging after that time, and it killed the equity. Assumptions on volume and use were inflated. The equity in any of those deals that included zero-coupon swaps or accreting swaps will also have been seriously damaged.

Morgan Stanleys Wahba believes that one of the biggest challenges now facing investors is the increased regulatory environment. There is going to be greater government interference and regulatory oversight in industrial markets, he expects. In some cases it is good and necessary, but in other cases its not so good.

The flip side is that opportunities may arise in emerging markets as a result; OECD economies dont have the growth to keep spending on infrastructure. Political will is lacking for PPP and private sector participation. Emerging markets have a greater need for infrastructure investment and are more willing to invite private investment. Despite such opportunities, however, Wahba maintains that Morgan Stanleys interests lie predominantly in industrial economies, 70% of our investments are in the North American markets.

The survivors

Given that so many managers are already looking at power and midstream gas assets, the most exciting opportunities for the large US-headquartered generalist funds will be in renewables. The sector is capital intensive, enjoys consistent support despite government spending retrenchment though competition from specialist fund managers is intense. Alindas Beale thinks that the infrastructure funds main bread-and-butter will remain unchanged: Renewables will be a component of the total market but not the largest component. There are limits to how fast the renewables market can grow.

Beale is also optimistic about the future of institutions that have survived thus far. With some infrastructure fund managers disappearing or cancelling follow-on funds, the successful funds should gain market share.

For the limited partners that have stuck it out in funds where there were write-downs, and equity and returns were thus diluted, there is some residual discomfort at the longer-term implications. Its a consideration for limited partners, says one US fund manager. The recovery of their investments over time, versus the risk of a dilution of their investment.

However, limited partners are in it for the long game in the most part, and for longer life funds, say of more than ten years, a recession is often factored into the calculations of return. Equity investors in infrastructure are reluctant to back away from their assets, and have maintained cordial relations with many of the respective funds throughout the crisis. Im not familiar with any infrastructure deals where LPs have walked away, says the fund manager, despite some significant damage to returns. The only cases I know of where equity has been diluted are where the headline fund investor or manager, or a bank, with its name associated, put in more equity to save its reputation.