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Probing Mezzanine Infrastructure Funds

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Lack of money is the root of all evil - George Bernard Shaw

But it is fertile ground for change and innovation - Me.

The current difficulties in finding available funding for infrastructure highlight the relatively narrow conditions precedent for successful infrastructure finance.

In my last column for Infrastructure Journal, I suggested that project finance CDOs may be a means to intermediate additional capital for infrastructure finance, but by no means did I intend to suggest that this is the only way to do so.

In fact, a more basic and "structural" means would be to utilise traditional corporate finance techniques of increased tranching of related risk and reward and offering investors a more discrete risk/reward choice of investment. For example, in private equity/LBO and real estate financings, it would not be uncommon to see a capital structure include the following:

- Senior secured bank debt (including working capital);
- Senior secured bonds;
- Senior unsecured bonds;
- Subordinated bonds;
- Preferred equity; and
- Common equity.

Accordingly, the absence of mezzanine debt and equity commonly used in other corporate finance from current infrastructure finance markets is striking. I was not able to identify a single mezzanine infrastructure fund targeted for developed countries, although there appear to be a couple for emerging markets infrastructure, often sponsored by bi- or multi-lateral development agencies.

While some infrastructure funds may permit mezzanine investments, the fund's general partner will often be reluctant to make such investments since it will negatively affect the fund's ability to obtain the desired returns for its investors and a mezzanine investment may be perceived as cannibalizing the fund's equity investment opportunity.

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Of course, when debt financing and equity capital are abundant and readily available, there is generally less need for mezzanine financing and, in fact, mezzanine funds are vulnerable to "squeeze" from other parts of the capital structure, especially when available investment opportunities are rare and senior debt or equity funds begin "stretching" for deals and/or market share.

In the current markets, however, the addition of mezzanine financing for infrastructure would likely expand the availability of financing for infrastructure and both (1) provide additional enhancement to the senior lenders as well as (2) increasing the leverage of the related equity investment and so improving the equity return thereon.

The recent withdrawal of the Chicago Parking Meters bond offering may illustrate this point. While the sponsor indicated that there were difficulties in reaching acceptable terms with prospective bond investors (especially regarding a required condition for additional debt to have an initial investment grade rating), the reported amount of total investor interest was less than the amount sought - a funding "gap" that might easily have been "bridged" by a mezzanine investment. In addition, the existence of the mezzanine funding, might have reduced investor pressure for unacceptable terms and permitted the bond financing to proceed as the sponsor had proposed.

While infrastructure fund-raising fell dramatically in 2009 (although has shown recent signs of improvement - at least as evidenced by funds being currently offered), there is apparently still a substantial amount of uncalled capital available for eligible infrastructure investments and, as a practical matter, many fund General Partners (GPs) will feel increasing pressure to invest as they approach the end of the related investment periods for their particular fund. Investment of this uncalled capital, and any additional funds raised, will be more likely if mezzanine capital is available and provides both the increased leverage that the fund's expected equity return requires and also additional "cushion" required for the related senior financing.

In addition, some investors who find the equity infrastructure fund risk/return profile unattractive, might find the lower risk/return profile of a mezzanine infrastructure fund more compelling, especially as a less risky point of entry to infrastructure where a new asset class for them.

Mezzanine Fund Issues

One significant issue that must be addressed in a mezzanine fund is that of conflicts - especially where (as it relatively common) the GP of the fund making a related debt or equity investment is also the GP of (or is an affiliate of the GP for) the mezzanine fund. Other precedents suggest solutions to this conflict, including:

(1) Limits on the number and/or amount of such co-investments that can be made by the mezzanine fund; and

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(2) A requirement that the GP's proposed mezzanine investment also be approved by an independent advisory committee (or similar arrangement to ensure that the mezzanine investment is being made on market and on arms' length terms).

Another issue that will be raised by a mezzanine fund is whether it will only (or the degree to which it may partially) invest in infrastructure transactions sponsored by the GP (or its parent or other affiliate). This may limit the interest of major infrastructure fund sponsors in mezzanine funds, since they are usually relatively reluctant to invest in a deal arranged by another major fund sponsor.

Equally, a major fund sponsor may be similarly reluctant to have a competitor's mezzanine fund invest in its deal due to concerns of having to share proprietary or otherwise commercially- sensitive information. However, this may represent an opportunity for qualified insurance companies or similar asset managers to offer their investment skills to others, including pension and other investors who currently do not find infrastructure debt or equity fund risk/return attractive or are looking for a less risky entry point to infrastructure as a new asset class.

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