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Article

Infrastructure Funds Primer

By Nadav Klugman[1]

Infrastructure funds are private equity vehicles that invest in a wide range of assets—including assets that could be described as transportation, energy and utility, communications, and "social" infrastructure, and investments that may be specific to a particular asset or in a company that develops such assets or is otherwise involved in their operation. Like other private equity funds, they have limited lifespans, typically five to ten years. They often attract capital commitments from investors with appetites for relatively stable, long-term cash flows, many of which have liabilities stretching over several decades. General partners of infrastructure funds are often able to leverage those commitments during the investment period.

In recent years, institutional investors have felt increased pressure to search for higher returns and diversify from traditional asset categories such as public equities and fixed income instruments. After slumping in 2011, fund-raising by infrastructure funds improved significantly in 2012 and 2013, with capital raised in the first three quarters totaling $19 billion.[2] Despite an increase in the average fundraising lifecycle,[3] not only did capital commitments to infrastructure funds continue to grow, investors indicated that they were looking to expand their infrastructure allocation.

Pension funds are notably increasing their exposure. The Alaska Retirement Board committed $300 million to two infrastructure funds—$200 million to IFM Global Infrastructure Fund and $100 million to J.P. Morgan Infrastructure Investments Fund—and has a long-term infrastructure target allocation of 12.5% within the real assets portfolio, or 2.125% of total plan assets.[4] The Kentucky Teachers' Retirement System committed $100 million to IFM's Global Infrastructure Fund,[5] and the Missouri Education Pension Trust committed $75 million to Alterna Core Capital Assets Fund II.[6] The $420 million Chicago Park Employees' Pension Fund entered the infrastructure space by committing $10 million each to infrastructure funds managed by Ullico Investment Co. and Industry Funds Management.[7] There is, however, considerable room for growth among pension funds. According to a new report from the Organization for Economic Co-Operation and Development (OECD), unlisted equity and debt infrastructure investments for the 69 survey respondents amounted to only 0.9% of total respondent assets.[8]

This growth is being driven by renewed demand for stable, long-term returns in a lower-yield environment, and a variety of "infrastructure" asset classes are filling that demand. With respect to power production, renewables have been popular, and the largest independent power producers were able to take operating assets into the public markets in ways that provide attractive exit opportunities. In 2013, Pattern Renewable Energy and NRG publicly listed "yieldcos," which aggregate the cash equity return from utility-scale power projects that have debt and tax equity financing. Several other renewable energy developers are in the process of evaluating if such a structure would benefit them.

In the transportation space, several states moved forward with initiatives to facilitate private investment in toll roads and other similar assets, and successful project completions in recent years leads some to believe that future formations of such partnerships are likely. Virginia is moving ahead with a series of PPP toll road procurements following the successful completion of its I-495 Express Lanes project, which at $2 billion was delivered on time and on budget. In November 2013, the New Jersey Turnpike Authority put out a request for proposals seeking bids for toll collection services, including management of the electronic tolling system and the toll collectors.[9] MAT Concessionaire, LLC (MAT) received a 35-year concession agreement, which includes 55 months for design and construction, for the Port of Miami tunnel project, one of the first to make use of availability payments. Design and construction costs are currently at $663 million. MAT will be paid $156 million in milestone payments during construction and a $350 million payment upon final acceptance of the construction works. The majority of MAT's equity is being provided by a Meridiam infrastructure fund.

A number of infrastructure funds are also seeking to satisfy the need for debt as an alternative to traditional bank and bond financing at the project level.[10] Of the 1,700+ active investors in the infrastructure asset class tracked by Preqin, as of February 2013, 285 were actively considering debt investment opportunities. Darby Overseas Investments has raised three debt funds totaling $442 million, and Allianz Global Investors is currently working on a £1 billion UK-focused debt fund that will provide debt financing to a wide range of both economic and social infrastructure projects.[11]

While investor appetite for the various infrastructure asset classes continues to grow, so have fundraising challenges for a variety of reasons, first among them the record number and aggregate target of all funds in market.[12] (A consequence of the crowded fundraising environment is the increasing use of placement agents to assist in the fundraising process, and with reason—over the past two years, infrastructure funds that have used placement agents have been more likely to meet or exceed fundraising targets and to reach financial close.[13]) Investors indicate that the most attractive managers are those with cohesive and concise plans, a focus on high cash yield and defensive and predictable investments, a healthy deal pipeline, and, most importantly, strong past performance.[14] (Globally, the top ten infrastructure fund managers account for 45% of capital raised by infrastructure funds in the last ten years, and the largest firm, Macquarie Infrastructure and Real Assets, raised over six times the amount raised by the tenth largest firm, LS Power Group, but that percentage has dropped in recent years as more firms have entered the asset class.[15]) Current portfolios of infrastructure fund limited partners demonstrate a preference for regional-focused funds, but there is increasing preference for geographic diversification as well.[16]

Further increasing pressure on fund managers is the trend for large, sophisticated institutional investors to bypass infrastructure funds entirely and make direct investments.[17] While the motivations vary—to avoid paying fund management fees and lower carrying costs, increase control over asset disposition decisions, deploy additional capital, and avoid the disposition of assets that could continue to generate steady returns—making direct investments requires significant investments in manpower and the development of a variety of skills. In addition to performing upfront technical, legal, regulatory, and financial diligence, such investors need project management and asset divestiture expertise. While only the largest and most sophisticated investors are able to execute such a direct investment strategy effectively, direct investments and co-investments are increasingly utilized,[18] and investors are conditioning fund commitments on the ability to retain control of key investment decisions, including investment horizons.[19]

In assessing infrastructure investments, investors and fund managers face a variety of concerns that are less relevant in other asset classes. In particular, the stability of the applicable regulatory regime, and the possibility of changes in law that may materially impact investments, are often critically important inquiries. For investments in emerging markets, the risks of adverse action by local governments come to mind fairly readily, but such actions have major impacts in developed markets as well. The renewable sector provides particularly clear examples. Spanish solar tariffs were reduced retroactively, Germany's were cut prospectively, and elections in Ontario, Canada, were in large part a referendum on the province's renewable energy programs. In the United States, key federal tax incentives have repeatedly been renewed and extended only on short-term bases, and there is concern about the deferral of state renewable mandates and the implementation of reliability and market-efficiency mandates by quasi-governmental grid operators. Other infrastructure asset classes present similar concerns. The privatization of government-owned assets generally requires express legislative or municipal authorization, which can be heavily conditioned, and is often subject to intense public scrutiny that may lead to renegotiation, as occurred last summer with respect to the City of Chicago's parking concession.

Infrastructure funds face uncertainties less relevant to funds than investments in other asset classes—for example, the significant risk of statutory and regulatory change affecting existing and target assets, the prevalence of pension and sovereign investors that have strong motivations to bypass the fund structure in favor of direct and co-investments, and the range of expertise needed to diligence and manage such a broad category of assets. Their recent growth, and the momentum of that growth, suggests that that the industry is able to turn such challenges into opportunities. We expect that it will continue to do so, and that the financing structures the industry utilizes will continue to evolve as well.

Endnotes

1 Nadav Klugman is a partner in the Banking & Finance practice in Mayer Brown's Chicago office.

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5 *Infrastructure Investor Research & Analytics: Infrastructure Investor Half Year Fundraising Review* 2013, 1, 7 (Ethan Koh Ke Ling ed., 2013).

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[13] *Infrastructure Fundraising: Future Prospects*, INFRASTRUCTURE SPOTLIGHT (Preqin, New York, N.Y.), Nov. 2012, at 2, 4.

[14] *Infrastructure Fundraising: Future Prospects*, INFRASTRUCTURE SPOTLIGHT (Preqin, New York, N.Y.), Nov. 2012, at 2, 4; Arleen Jacobius, Heydays Past, Infrastructure Firms Feel Heat, Pensions & Investments, Aug. 5, 2013, available at http://www.pionline.com/article/20130805/PRINT/308059979/heydays-past-infrastructure-firms-feel-heat.

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[16] *Infrastructure Investor Research & Analytics: Infrastructure Investor Half Year Fundraising Review 2013*, 1, 7 (Ethan Koh Ke Ling ed., 2013).

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[19] *Infrastructure Investor Research & Analytics: Infrastructure Investor Half Year Fundraising Review 2013*, 11 (Ethan Koh Ke Ling ed., 2013).