Infrastructure Funds Update

Nadav C. Klugman [1]

Among private investors, the term "infrastructure" denotes a wide range of physical assets that facilitate a society's principal economic activities — transportation, energy and utility, communications and "social" infrastructure, for example. Historically, funding for these projects has been the domain of governments, multilateral institutions, official lenders, and large commercial banks providing debt alongside such other institutions. However, with an estimated $57 trillion needed to finance infrastructure development around the world through 2030, according to a report from McKinsey & Co., private investors have an unprecedented opportunity to fill some of the gap created by public-funding shortfalls, and the last decade has been witness to a flurry of innovation in private funding methods and structures, with varying degrees of success. As the asset class matures, some infrastructure funds—private equity vehicles that attract capital commitments from investors and deploy that capital to invest in these assets—will need to explore new ways to create and demonstrate value in order to capture some of that capital.

Fewer unlisted infrastructure funds reached final close in 2014 than in 2013, and the level of institutional investor capital secured by those funds fell by almost 16% when compared to 2013; however, the aggregate $37bn raised by unlisted infrastructure fund managers was still 23% higher than the $30bn raised in 2012, and the amounts raised by funds reaching interim close increased for the twelve-month period ending January 2015. An increasing proportion of that capital is concentrated among a few large players, and the market remains crowded, with 144 unlisted infrastructure funds in market as of January 2015, targeting aggregate capital commitments of $93bn. And while the average fundraising lifecycle shortened to 19 months in 2014, as of January 2015 40% of funds in market had been fundraising for over two years.[2]

Although fund managers face increased competition, investor appetite for infrastructure remains strong, with investors continuing to indicate an interest in expanding their allocations to this asset class. Many have increased their target infrastructure allocations to 3-8% of total assets under management over the next decade, up from around 1% today. There has also been an influx of new entrants. Preqin now tracks more than 2,400 institutional investors actively investing in infrastructure, more than double the figure from 2011 when it began tracking the asset class.[3] While the main route to market for investors, especially new entrants, is through unlisted vehicles,[4] some larger investors are opting for direct investments. According to a survey conducted in the second quarter for Aquila Capital Concepts GmbH, about 57% of institutional investors said direct ownership is the best way to invest in real assets, including infrastructure.[5] While the avoidance of expensive management fees is certainly an incentive, the driving force behind direct

investments seems to be control over the portfolio. In addition to concerns over time horizon and liquidity, the use of leverage can be an issue of contention, especially after the recent financial crisis. Investors disappointed in the performance of infrastructure assets during the financial crisis pointed to high leverage and lack of transparency in financing arrangements as reasons for their disappointment.[6]

In addition to adding infrastructure teams to their staffs in order to make unilateral direct investments, large investors are also looking at new and more sophisticated ways to club together and increase investment power. Theoretically, the benefits from club investing relative to those of investing through a conventional fund manager include improved alignment of interest with other, similarly situated investors, including with respect to investment horizon and fees, larger average commitments and local knowledge, and the spread of risk relative to unilateral direct investment.[7] Consequently, club investment platforms and research groups have started to emerge. Examples include The Long Term Investors Club (Global), Pension Infrastructure Platform (UK), Global Strategic Investment Alliance (Canada HQ), and the Fiduciary Infrastructure Initiative (USA).[8] The most recent example is the California State Teachers' Retirement System (CalSTRS), which announced plans to develop a multibillion-dollar global syndicate for infrastructure investing. The syndicate is intended to be comprised of public pension funds and to invest in North American infrastructure, similar to the IFM (Investors) model, which invests on behalf of institutional investors and is owned by 30 major Australian superannuation funds.[9] With total funds under management of A$23bn and control of 44 board seats across 29 infrastructure investments with operations on four continents, IFM is one of the largest infrastructure investors in the world.

Another example, the Global Strategic Investment Alliance (GSIA), was launched by the Ontario Municipal Employees Retirement System (OMERS), one of Canada's largest pension funds with more than C$65bn (US$59.8bn) in net assets. The alliance, a US$12.5bn-plus infrastructure club investment program, has an investment period of five years followed by a holding period of 15 years, and then an exit period of five years,[10] and allows its investors to choose the deals in which they wish to participate on a transaction-by-transaction basis.[11] The investment opportunities are sourced and actively managed by OMERS through its various investment arms—Borealis Infrastructure will originate and manage the investments, and Rosewater Global will provide administrative support services. Marketed at 50 basis points and a carried interest fee for performance at a later date,[12] the platform offered limited partners the opportunity to put their money to work at a rate structure more favorable than what a fund manager would offer. However, collaboration with like-minded investors and size of investment power were touted as the main drivers. By targeting "alpha assets" of $2bn plus, the thought process was that these assets would be out of reach for almost anybody else, and therefore GSIA would be able to get superior returns. While theoretically appealing, there are typically only two or three such assets that are put on the market each year, and with a typical five-year investment period, GSIA will need to close at least one or two deals a year, which could undermine its leverage with sellers. The alliance's maiden transaction was the acquisition from OMERS of a one-third stake in Midland Cogeneration Venture (MCV), a US combined-cycle gas-fired power plant. OMERS retained the remaining two-thirds equity in MCV. This strategy, where OMERS buys the asset first and then syndicates the equity to its GSIA partners, is expected to be repeated.[13]

With increased capital flowing into direct and club investment platforms, and a crowded fundraising market continuing with well-established managers garnering the majority of investor commitments, opportunities for fund managers to create and demonstrate value do exist. However, they may require creativity and a willingness to depart from the traditional closed-end infrastructure fund model with 10- to 15-year "lockup" periods. While providing a known investment period with defined entry and exit dates — which are well-suited to higher-risk investment strategies that don't provide stable, predictable cash flow — this structure is not ideal for all investors or all infrastructure assets. Open-end funds, on the other hand, offer periodic opportunities for acquisition or redemption of shares and the absence of a fixed investment horizon. The in-place income streams associated with traditional infrastructure assets are thus often a better fit for the open-end structure. Though infrastructure fundraising for closed-end funds has increased in recent years, industry observers believe that the lack of open-end funds has kept on the sidelines significant additional capital that would otherwise be committed to infrastructure investments.[14]

In addition to the open-end model, some fund managers are addressing investor liquidity concerns by taking their private equity infrastructure funds public. Not only does this allow investors to liquidate their investments at any time, the funds are also not forced to sell at a time when valuations may be unfavorable. Fortress Investment Group LLC (NYSE: FIG), for example, plans to convert its Fortress Worldwide Transportation and Infrastructure Investors private equity infrastructure fund into a publicly traded vehicle with the prior approval of the fund's limited partners. We expect smaller fund managers to continue to innovate.

In prior years, we have noted the growth of infrastructure funds focused on providing debt rather than equity investments, which arose during a prolonged period of diminished bank liquidity and concerns over the impact of new capital maintenance requirements. Investment opportunities for debt funds, however, have been scarcer than anticipated as a result of increased bank liquidity and shrinking margins. Further, debt funds are not able to offer the same flexibility as banks due to stricter investment parameters, and borrowers have found that their pricing and fees are often higher. New debt fund entrants are trying to complement banks instead of competing with them by entertaining subinvestment grade type transactions and offering longer terms. In addition, many of these funds are buying debt in the secondary market, which is pushing up the price.[15] The impact of new capital maintenance requirements are just beginning to take effect, however, and they are likely to present opportunities for infrastructure debt funds, albeit somewhat later and perhaps less broadly than anticipated. Further, as infrastructure continues to mature as an asset class in the United States, we anticipate that sponsors of infrastructure projects will demand – and be willing to pay for – debt other than the traditional, senior secured structures that continue to be most prevalent, including mezzanine debt, term loan B, and other subordinated loans. Infrastructure debt funds will be particularly well positioned to take advantage of such opportunities.

Despite movement toward open-end funds, direct investments, and club deals, the majority of private equity infrastructure investments continue to be made through closed-end structures. Within such funds, we see room for growth in the subscription-based financing structures that have been so successful in other private equity asset classes, and we likewise anticipate that substantial

opportunities will develop to finance the alternative structures as they continue to develop.

Endnotes

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

[2] *The 2015 Preqin Global Infrastructure Report: 2014 Fundraising Market* (Preqin, New York, N.Y.), at 14-16.

[3] *The 2015 Preqin Global Infrastructure Report: 2014 Fundraising Market* (Preqin, New York, N.Y.), at 37-38.

[4] Evan Barker, *North America-Based Infrastructure Investors – January 2015*, prequin infrastucutre online (Jan. 22, 2015), https://www.preqin.com/blog/101/10616/north-america-infrastructure.

[5] Arleen Jacobius, *Infrastructure OMERS Infrastructure Program Writes New Page in Investing*, PENSIONS & INVESTMENTS, Sept. 1, 2014, available at http://www.pionline.com/article/20140901/PRINT/309019980/omers-infrastructure-program-writes-new-page-in-investing.

[6] Eric Knight & Rajiv Sharma, *Retooling In-House Investment Teams Inside Institutional Investors: Three Perspectives on the Shift Towards Direct Infrastructure Investmen*t, CHARTERED ALTERNATIVE INVESTMENT ANALYST ASS'N: ALTERNATIVE INVESTMENT ANALYST REV. (Q4 2014, Vol. 3, Issue 3), at 15.

[7] *Pooling of Institutional Investors Capital – Selected Case Studies in Unlisted Equity Infrastructure*, 49 (OECD, Apr. 2014).

[8] Eric Knight & Rajiv Sharma, *Retooling In-House Investment Teams Inside Institutional Investors: Three Perspectives on the Shift Towards Direct Infrastructure Investment*, CHARTERED ALTERNATIVE INVESTMENT ANALYST ASS'N: ALTERNATIVE INVESTMENT ANALYST REV. (Q4 2014, Vol. 3, Issue 3), at 15.

[9] Hazel Bradford, CalSTRS *Kicks Off Infrastructure Consortium at White House Summit, Pensions & Investments*, (Sept. 9, 2014, 4:21 PM), http://www.pionline.com/article/20140909/ONLINE/140909873/calstrs-kicks-off-infrastructure-consortium-at-white-house-summit.

[10] Douglas Appell, *Japan's GPIF to Invest $2.7 billion in Infrastructure Alongside OMERS, DBJ, Pensions & Investments* (Feb. 28, 2014, 4:14 PM), http://www.pionline.com/article/20140228/ONLINE/140229855/japans-gpif-to-invest-27-billion-in-infrastructure-alongside-omers-dbj.

[11] WURTS ASSOCIATES, *Infrastructure Manager Search: Fresno County Employees' Retirement Association* (Nov. 2013).

[12] *Pooling of Institutional Investors Capital – Selected Case Studies in Unlisted Equity Infrastructure*, 39 (OECD, Apr. 2014).

[13] Matthieu Favas, *The Gorilla That Wants More Bulk*, INFRASTRUCTURE INVESTOR, May 2014, at 24.

[14] Arleen Jacobius, *Infrastructure Funds Not the Kind Investors Prefer*, PENSIONS & INVESTMENTS, July 7, 2014, available at http://www.pionline.com/article/20140707/PRINT/307079973/infrastructure-funds-not-the-kind-investors-prefer.

[15] Sarah Tame, Crowded In, Then Crowded Out, 351 IJ GLOBAL: INFRASTRUCTURE J. AND PROJECT FIN. MAG. 16 (Oct./Nov. 2014), https://ijglobal.com/Magazine/Download/1.

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our "one-firm" culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience..

Please visit mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Any tax advice expressed above by Mayer Brown LLP was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. federal tax penalties. If such advice was written or used to support the promotion or marketing of the matter addressed above, then each offeree should seek advice from an independent tax advisor.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices") and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies"). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2019 Mayer Brown. All rights reserved.