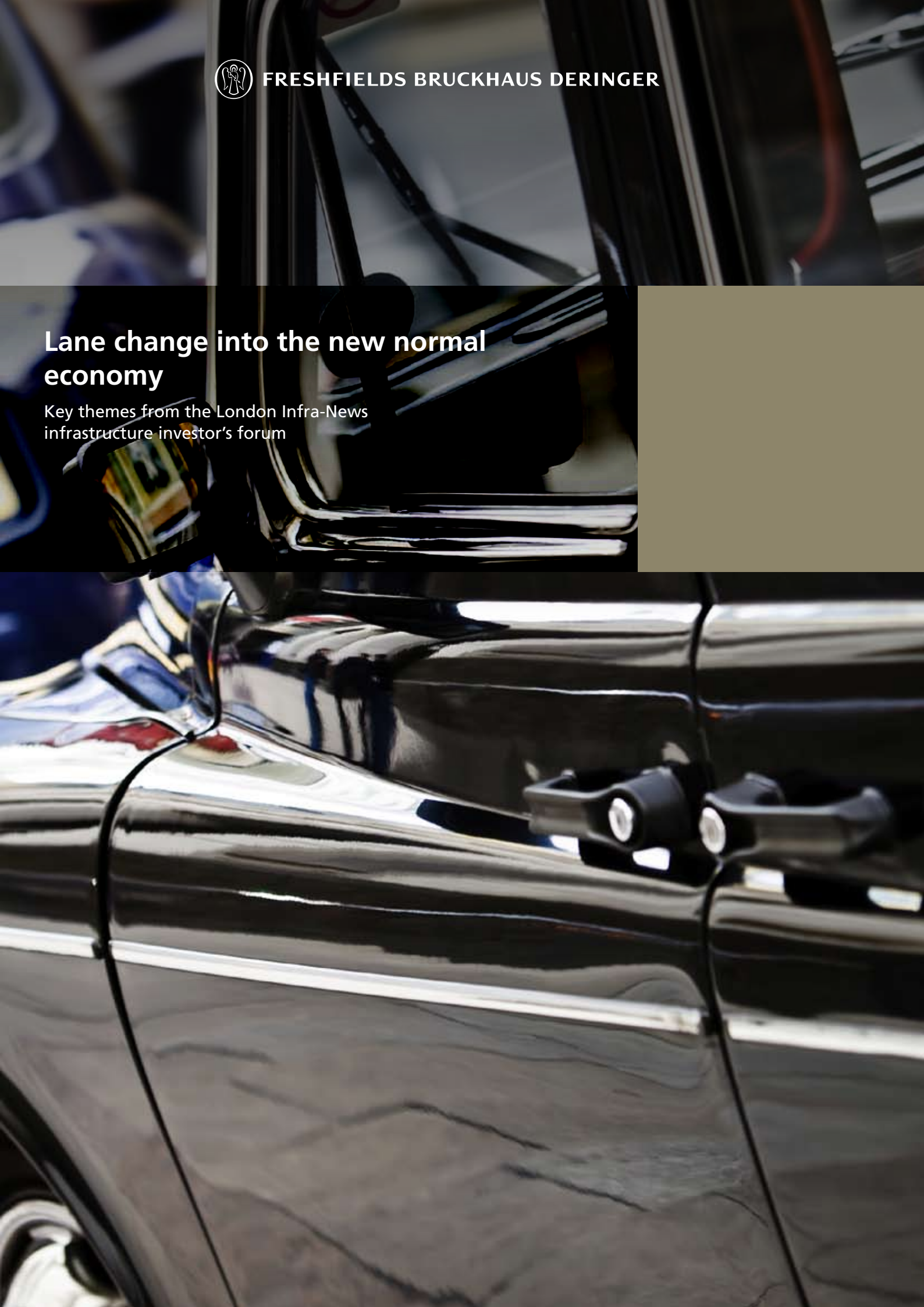




FRESHFIELDS BRUCKHAUS DERINGER

## Lane change into the new normal economy

Key themes from the London Infra-News infrastructure investor's forum





## A rethink of the infrastructure market

Industrial operators and developers, infrastructure funds, strategic investors, advisers and pension funds were among the delegates at the fourth annual Infrastructure Investors Forum Europe in the Freshfields Bruckhaus Deringer London offices on 2 February. In a fascinating session they focused on and discussed new approaches and strategies for the next generation of infrastructure investing in Europe.

Even as the smog of the global financial crisis appears to be lifting, many themes discussed at last year's forum remain prevalent market concerns today. Constraints in securing adequate liquidity for investment and a focus on the management and operation of assets remained key focal points. It was widely recognised that the industry is still wrestling with the implications of the global shock of the last couple of years – as one panel chairman said, 'We are all still learning the language of the current economic environment'.

However, a 'cautious optimism' was the prevailing emotion and the panel discussions and expert presentations also focused on other developing issues including:

- the role played by fund managers in securing funding in this still uncertain yet relatively positive economic environment and the increased skills required by the key market players experiencing an improving deal pipeline;
- the scope of the infrastructure market and the developing sophistication and diversity of infrastructure as an asset class;
- transparency required in fund structures (fees, information etc);
- regulatory risks;
- investment opportunities in renewable energy; and
- developments and trends in the financing of and investment in future infrastructure deals, including the diversification of funding sources, with the increasing importance of the bond markets and direct investment.

The central theme to emerge from the forum was twofold:

- that demand for infrastructure investment will continue to grow; and
- that managers must find ways to secure the necessary funding for infrastructure projects.

The key lies in a more sophisticated understanding of the infrastructure market and improved communication with investors. The onus also falls on regulators and governments to ensure that there is a stable regulatory environment in which infrastructure projects can thrive.

## The need for investment in infrastructure

With a rapidly growing and aging population, the demand for better infrastructure (particularly in transportation and health services) can only increase. Substantial investment in energy projects will also be necessary to meet EU and other governmental targets.

In an age of burgeoning deficits, the demand for infrastructure investment cannot be satisfied by government spending alone, so private sector investment is crucial.

However, during the last 12 months, the increasing need to secure funding has coincided with continued challenging conditions in the capital markets. Sellers have been under less pressure than expected to sell in this difficult market, while purchasers are seeking distressed sales and 'bargain-priced assets'. An asset-pricing 'value gap' remains. Fund managers had difficulty raising funds in 2009, particularly in the primary markets.

## Infrastructure has many faces

Although infrastructure assets are often categorised together as a single class, in reality infrastructure represents a diverse collection of assets with very different risk profiles. Investors increasingly recognise this and are looking at individual risks and assets more closely. Regulated utilities in particular are seen to be better insulated from the effects of gross domestic product movements (as opposed to non-availability payment structure based transport assets) and are considered safer investments in these economically uncertain times.

Fund managers must reflect this when fundraising.

## The scope of the infrastructure market

It was felt that renewable energy projects should be categorised within the infrastructure asset class. They share a similar risk profile and cash flows with other assets traditionally considered to fall within this class.

It is vital to encourage investors to recognise that renewable energy projects share a similar level of risk to traditional infrastructure projects, but due to binding EU targets for renewable energy they arguably have a greater upside.

Investor education is particularly important in relation to these projects, some of which have found it hard to source funding due to the inherent difficulties and expense involved with barriers to entry including:

- accessing grid connections;
- constantly changing government policies; and
- planning restrictions etc.

## 'It might be a boring investment – but it's wonderful!'

One panel member declared that 'infrastructure is a boring, yet wonderful, investment', reflecting a sense that institutional investors remain very attracted to its unique investment qualities. They are increasingly valuing what infrastructure delivers:

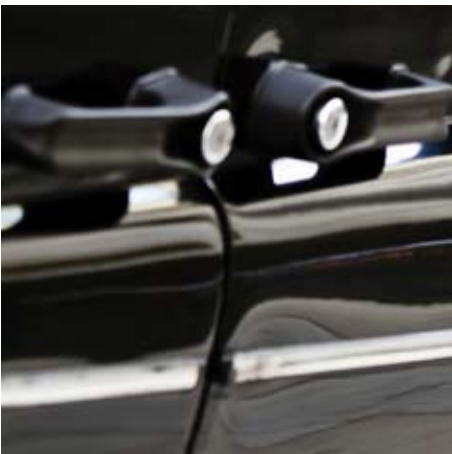
- stable and long-term returns; and
- long-term capital and inflation protection.

They appreciate, however, that the duration, fees and returns on infrastructure will not match the comparatively short-term 20 per cent return and high fee structures of the private equity model.

To a significant extent, the long-term cash flows and associated benefits of infrastructure investment depend on the effectiveness of management performance. Infrastructure investment is increasingly focused on creation of value by operational leverage – or human performance. This was termed 'the people problem' and reflects the importance of the knowledge, skills and long-term management commitment that are required to maximise returns over time.

Even long-term investors value opportunities for liquidity as well as the disciplines that a defined time horizon encourages. The market appears to have space for different investment structures, enabling the accommodation of inevitable differences between investors' priorities. We will continue to see different fund structures, as well as direct and co-investment structures, according to the preferences and capabilities of different types of investor.

'End investors in the infrastructure space are becoming increasingly sophisticated as their understanding of the asset class deepens. The consequence is that fund managers are starting to offer more varied and sophisticated products and infrastructure strategics, such as toll road operators and utilities, are thinking more



deeply about how they can work with pools of institutional capital. Infrastructure is still a young asset class and interest in the sector is strong.’

Peter Allison, *Infra-News*

### **‘The elephants and the mice’**

The appetite of institutional investors for direct investment is clear, partly driven by concern about managers’ fees. However, successful direct investment requires a level of skills and resources that many smaller institutional investors do not possess.

It is the largest institutional players, the well-resourced and knowledgeable investors, who will be most able to realise the benefits (primarily reductions in fees and costs) of the developing trend towards direct investment in infrastructure assets. These entities have the capacity to meet the demands of direct management (transactional and operational), bear the risk of deal success or failure and ultimately access superior returns.

The smaller funds and investors tend not to have the depth of resource and expertise required to make the direct investment approach attractive. These participants continue to rely on knowledge contributed by experienced general partners in a co-investment model or traditional fund structure. Portfolio diversification remains a fund structure benefit, which small investors can access through the infrastructure fund approach to investment. We may also see smaller institutions clubbing together to pool resources.

### **Return to basic principles**

A key overriding theme at the forum, regardless of the mode of investment, was the need for strong management teams.

Successful infrastructure projects and companies require good management. This is where strong fund managers can come into their own – but to compete for scarce funds, they will need to be able to demonstrate that they are managed by teams with strong records, a consistent deal flow, the ability to execute deals efficiently and the relevant asset management skills.

### **The returning appetite for debt**

The general consensus among panellists was that the appetite for debt funding of infrastructure acquisitions has returned, fuelled by the current strength of the capital markets. Although a year ago it was extremely challenging for banks to provide commitments for acquiring infrastructure, banks are now willing and able to underwrite financings on a bridge-to-bond take-out basis.

Appetite for bank debt also continues to improve. Although club deals remain the norm, the bank market was able to absorb several very large financings in 2009, which had seemed unachievable to many market participants at the start of the year.

There were predictions that further improvements in bank debt availability would be driven by continued stability and activity in the capital market. Concerns around post-election fiscal tightening in the UK and more generally in relation to the withdrawal of liquidity and stimulus-funding provided by central governments, resulted in advice to get deals done now – both acquisitions and refinancings – while market conditions are benign.

## Regulatory risk

The panellists also highlighted the role of regulators in providing investors with an acceptable infrastructure climate.

The potential risks and returns of infrastructure projects are affected by the relevant regulatory regimes – regulators have a responsibility to ensure that these are likely to foster private investment.

Regulators, however, are faced with a difficult balancing act between ensuring that the relevant regulatory regime is up to date and relevant to the prevailing economic conditions, while maintaining stability and consistency.

## And the future is...?

We are likely to continue to see a flight to quality, meaning a focus on transactions in developed markets with stable cash flows (the most popular market among the audience was continental Europe). Opportunities to carry out more speculative deals for operators in particular could be seen in Asia and eastern Europe, however. The renewables sector is expected to be active in the US and budget deficits should drive another attempt at public-private partnerships (P3s).

The sectors where the most deal activity is expected include utilities and renewables, with transport assets taking longer to recover. Few airport opportunities were expected in the next 12 months. There is a particular focus on energy companies, as many are looking to divest some of their operations (either as a result of regulatory action or balance sheet repair). Fewer auctions and more negotiated transactions were anticipated.

Management is key to the success of any project and investors should actively look to ensure that the proper management team is in place. However, it is also important to ensure continuity and stability (ie the private equity style of management team replacement is not generally appropriate for infrastructure deals).

There is some concern that once government stimulus measures come to an end, funding may dry up again, meaning that we are currently in a 'mini bubble' stimulated by loose fiscal and mandatory policies. One panellist considered higher interest rates to be his greatest fear.

However, in general, the panellists felt that 2010 will be better than 2009, particularly in terms of raising funds from equity investors and in the debt-capital markets.



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