Investing in Infrastructure – The Opportunities, Challenges and Rewards

How experienced are unlisted infrastructure fund managers? Are investors' negotiations on fund terms and conditions changing the typical fee structure? Elliot Bradbrook looks at the challenges and opportunities for investors in the current infrastructure market.

The growing institutional investor demand for exposure to infrastructure assets has led to a rapid increase in the number of unlisted infrastructure funds launched over recent years. The current infrastructure fund market features a wide range of available opportunities, more than ever before, spanning different fund strategies, geographies and industries. Recognizing these disctinctions is important for investors looking to source the most appropriate opportunities for their portfolio.

Preqin Investor Network is a free online resource, available exclusively to accredited investors and qualified purchasers. The service draws on Preqin's fundraising and performance data in order to help accredited investors navigate the range of opportunities available in the infrastructure fund market. Infrastructure remains a somewhat new and emerging asset class and most investors are relatively new to the space. Preqin Investor Network is a valuable tool for helping investors keep on top of the latest market trends.

So what are the opportunities available in the infrastructure fund market? What are the challenges that investors face when committing to infrastructure funds? Based on the intelligence available through Preqin Investor Network and the wider Preqin Infrastructure Online service, this feature article explores the various facets of the current infrastructure fund market to guide investors through what is open to investment.

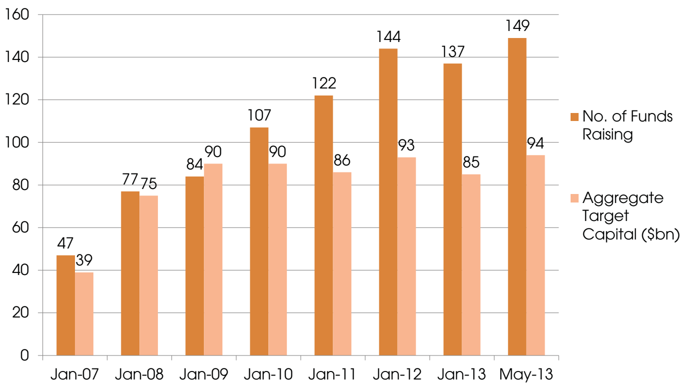
Opportunities

As of May 2013, there are 149 unlisted infrastructure funds on the road targeting an aggregate $94bn. As shown in Fig. 1, this represents a record number of fund opportunities available, with the aggregate target capital also slightly higher than the $93bn being sought by funds on the road at the beginning of 2012. The average infrastructure fund is currently targeting $630mn, although in reality most funds (54%) are looking to raise less than $500mn. Twenty-six percent, however, have a target of $1bn or more. The largest unlisted infrastructure fund in market is Brookfield Infrastructure Fund II, which is seeking to raise $5bn.

The majority of funds in market are primary vehicles investing equity in infrastructure projects and related companies. As shown in Fig. 2, a significant 82% of infrastructure funds on the road are primary equity vehicles. However, the market is evolving and other fund strategies are growing in prominence. The fastest growing strategy is infrastructure debt, with 12% of funds in market following a debt/mezzanine strategy. Eight percent of funds will invest in the form of both debt and equity, while a further 4% maintain a pure debt strategy. The number of investors looking to directly buy and/or sell existing fund interests on the secondary market is growing; however, there are still very few funds focused on this area, with only 1% of infrastructure funds in market targeting secondary market investments.

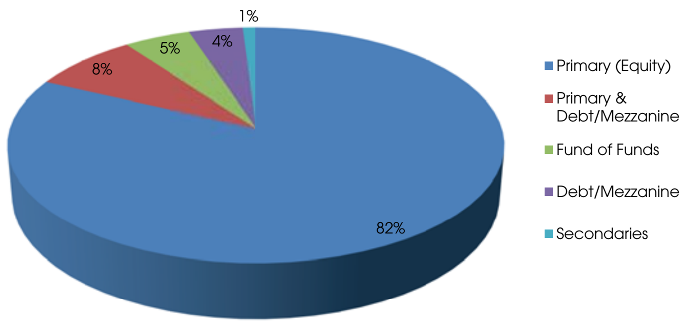
In terms of regional focus, there are 57 funds open for investment focusing on Europe-based assets and projects, targeting an aggregate $33bn. The largest European infrastructure fund on the road is Terra Firma Infrastructure Fund for Global Renewable Energy, seeking $3bn. Funds targeting opportunities in North America are less in number but higher in terms of aggregate capital targeted, with 37 funds looking to raise $36bn. Seven of these vehicles are targeting over $2bn. Interest in Asia and other parts of the world is growing, with 22 Asia-focused funds in market and 33 funds targeting opportunities outside of Europe, North America and Asia, seeking $11bn and $14bn respectively.

Fig. 1: Unlisted Infrastructure Funds in Market, January 2007 - May 2013



Source: Preqin Infrastructure Online

Fig. 2: Breakdown of Unlisted Infrastructure Funds in Market by Fund Strategy, as of May 2013



Source: Preqin Infrastructure Online

Challenges

The private infrastructure fund market is now larger and more diverse than ever, featuring a whole host of different opportunities with varying risk/return potential. Investors must therefore consider where infrastructure should sit within their portfolio structure in order to source the most appropriate opportunities.

Fund manager experience and track record is limited in the infrastructure market, with few GPs able to demonstrate a lengthy history of past performance. As shown in Fig. 3, a significant 54% of fund managers currently marketing a fund are raising their first vehicle, a higher proportion than any other private equity fund type. Furthemore, only 10% of infrastructure fund managers have previously raised four or more funds. With most infrastructure investors seeking the security of an experienced fund manager, there is increased competition among many investors for access to vehicles managed by the small proportion of firms that can demonstrate a strong track record. As a result, the fundraising market is increasingly competitive for first-time infrastructure fund managers competing for investor capital.

Although this competition for commitments provides room for investors to negotiate on the terms linked to funds managed by less experienced managers, Preqin data shows that nearly half of infrastructure GPs still maintain a strict 2/20 fee structure. With many investors turning to infrastructure as a source of lower stable yield over the long term, the application of such a high fee structure to funds generally forecasted to produce lower returns can be contentious.

Fig. 4 provides a breakdown of the management fees charged during the investment period by infrastructure funds currently raising and closed vehicles of vintages 2011-2013. This shows that despite calls for lower fees, investors can still realistically expect to pay a 1.75-2% management fee when investing in many infrastructure funds, with a significant 48% of vehicles still charging a 2% fee. Carried interest and hurdle rates also continue to emulate the private equity industry, with 73% of infrastructure funds maintaining a 20% carry and 71% holding an 8% hurdle rate.

Management fees will undoubtedly remain a contentious issue going forward. However, a greater proportion of fund managers are beginning to more closely link the fee charged with the risk/return potential of the fund. A vehicle focused on greenfield economic assets in India has a completely different investment profile to a UK-focused fund targeting social PPP/PFI projects; however, both are labelled as "infrastructure". This generalization and spread of different characteristics makes the fee debate more contentious as the market features both high and low risk infrastructure funds, and the management fee charged should vary significantly depending on strategy.

Investors also have the consideration of fundraising momentum to take into account. Investors are now considerably more cautious when committing to new funds, and many prefer to wait until a vehicle has held an interim close before making a commitment. As shown in Fig. 5, this has led to funds taking longer to reach a final close, with 36% of those infrastructure funds to reach a final close since May 2011 taking over two years to complete the process. However, of the 149 unlisted infrastructure funds currently on the road, 75 have held at least one interim close securing an aggregate $17bn in investor capital.

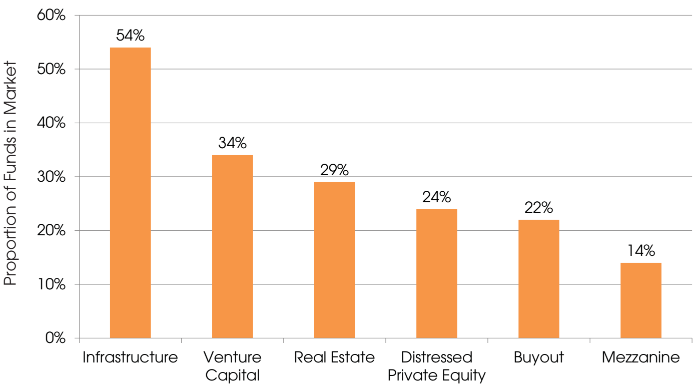
Rewards

Despite these issues, the abundance of opportunities available in the market creates the potential to earn attractive returns from infrastructure funds regardless of selected strategy. When Preqin interviewed infrastructure investors in H2 2012, 45% of respondents stated that they invest in infrastructure to receive a stable annual yield over the long term, while 48% viewed infrastructure as a return seeking investment. This shows that investors in infrastructure funds invest in the asset class for different reasons, demonstrating the variety of opportunities available in the space for investors to consider.

Fig. 6 provides an insight into investor attitudes towards the performance of their infrastructure fund portfolios. A significant 71% of investors interviewed in H2 2012 stated that their infrastructure investments had performed as expected, and a further 10% felt that their infrastructure returns had exceeded expectations. One experienced North America-based investor commented: "As an investor in the asset class since 1998, the sector exceeded our expectations prior to 2007. Since then, returns have been more subdued, and the sector is now meeting expectations."

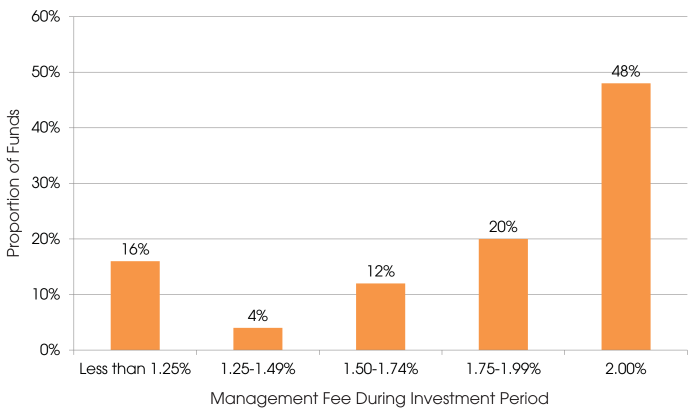
It is important to note that a notable 19% of investors felt their infrastructure investments had not met expectations. Several other institutions commented that although infrastructure had

Fig. 3: Proportion of Managers with a Fund in Market Raising a First-Time Fund by Fund Type, as of May 2013



Source: Preqin Funds in Market

Fig. 4: Management Fee Charged by Infrastructure Funds During the Investment Period (Funds Raising & Vintage 2011-2013 Funds Closed)



Source: Preqin Infrastructure Online

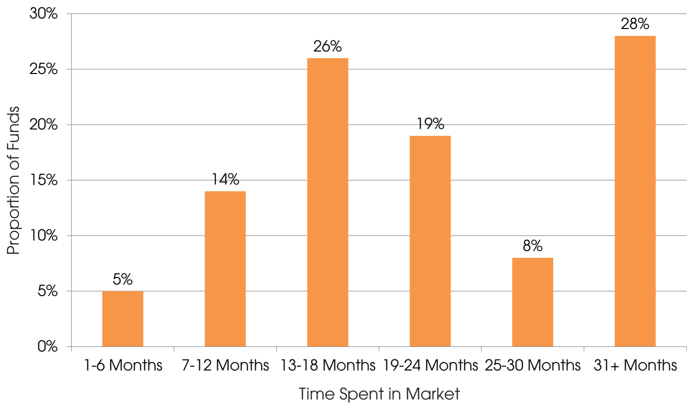
not quite lived up to expectations, it had outperformed equities, which justified its inclusion in their portfolios. The difference in the returns achieved by infrastructure funds pursuing lower and higher risk strategies was also mentioned. Another North America-based investor stated: "The private equity model in infrastructure has been disappointing, but the core/long-term model has delivered according to expectations." This again highlights the range of risk/return profiles available in the infrastructure fund market and the different types of return potential on offer. Nevertheless, Preqin's infrastructure performance benchmarks, available through Preqin Investor Network, indicate that infrastructure funds have provided attractive returns for investors over recent vintages and time horizons.

Outlook

The huge demand for infrastructure development around the world will naturally lead to more funds coming to market. Investors will therefore encounter an increasing number of opportunities when looking to gain exposure to the infrastructure asset class in future. As shown, these opportunities are already spread across a variety of fund types, strategies, geographies and industries, and can have completely different risk/return profiles. This makes the infrastructure sector complicated for investors to navigate; a situation that will only escalate as the sector becomes more established and diversified.

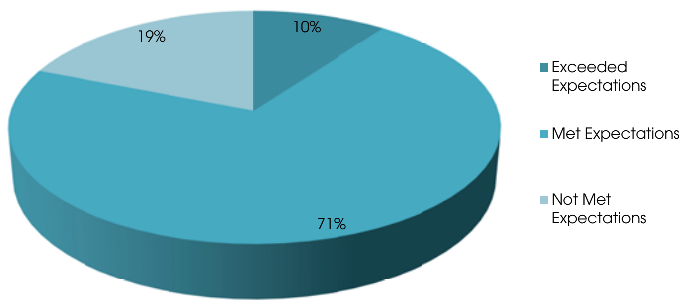
Preqin Investor Network, a free service for accredited investors, seeks to help investors overcome these complications. Subscribers to the platform have full access to profiles of each of the infrastructure funds currently on the road, including details of the fund strategy, investment preferences and any interim closes held. It also includes information on fund manager history and track record, plus terms and conditions benchmarking and fund-level performance where available. Preqin Investor Network is a valuable tool for investors looking to keep ahead of market trends and make informed investment decisions in such an increasingly crowded marketplace.

Fig. 5: Breakdown of Unlisted Infrastructure Funds Closed in the Past 24 Months by Time Spent in Market, as of May 2013



Source: Preqin Infrastructure Online

Fig. 6: Proportion of Investors that Feel Their Infrastructure Investments Have Lived up to Expectations



Source: Preqin Investor Interviews, August 2012