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Targeting Investor Capital:
How Can GPs Address Investor Concerns?

Although a significant proportion of infrastructure investors are planning to make new commitments in the coming year, fund managers face a number of challenges when it comes to securing capital. Elliot Bradbrook explores investors' key concerns and how GPs can target and address these when bringing their funds to market.

Earlier this month, Global Infrastructure Partners II reached an historic $8.25bn final close, becoming the largest unlisted infrastructure fund raised since the asset class's inception. Following the closure, Meridiam Infrastructure reached a $1.05bn final close on its Meridiam North American Infrastructure Fund, taking the total capital raised by unlisted infrastructure funds in 2012 YTD to $19.6bn. These closures have completely changed the profile of the 2012 fundraising market, with the total capital raised by infrastructure fund managers this year almost doubling within the first few weeks of Q4 2012.

This shows what can be achieved by fund managers able to illustrate strong past performance and offer investors attractive terms and conditions. Although very positive, the general infrastructure fundraising outlook remains unchanged. The market is still highly congested, with 141 funds currently on the road targeting an aggregate $86.4bn. Investor interest in the infrastructure space is growing, but issues such as high fund manager fees, liquidity, and a lack of manager experience continue to impact investor appetite for infrastructure funds. Many institutions still have reservations about either entering or increasing their exposure to the asset class.

In Preqin's most recent survey of infrastructure investors published in the 2012 Preqin Infrastructure Review, institutions were asked about the key issues preventing the flow of investor capital into the infrastructure asset class. In this feature article we explore these issues further in order to highlight how fund managers can address key investor concerns when looking to secure fresh capital commitments.

What are Investors Looking for?

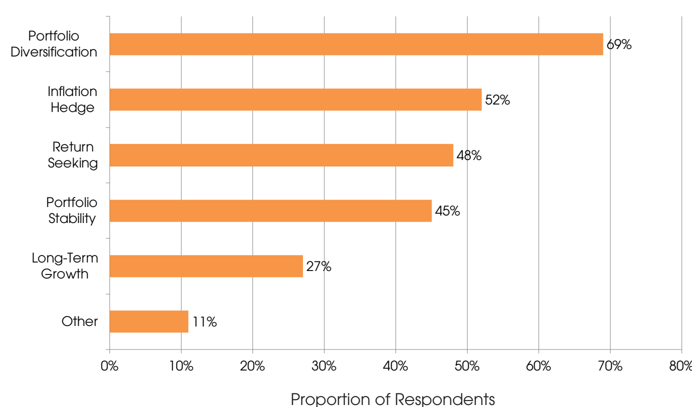
Fig. 1 shows that institutional investors target infrastructure assets for a number of different reasons. Fund managers should consider paying close attention to these requirements in order to improve the chance of fundraising success, particularly in such a challenging and crowded marketplace. A significant 69% of respondents to our investor study look to infrastructure to provide portfolio diversification, while 52% use infrastructure as an inflation hedge and 45% invest in the asset class for portfolio stability. A further 48% consider infrastructure to be a return seeking investment, while 27% invest in infrastructure for its long-term growth potential.

Depending on the type of infrastructure fund being raised, fund managers may consider structuring their funds with these concepts in mind in order to attract investor commitments. Institutional investors are now considerably more cautious when committing capital to unlisted infrastructure funds and will only invest with those managers able to clearly illustrate an understanding of their investor base.

Key Investor Concerns

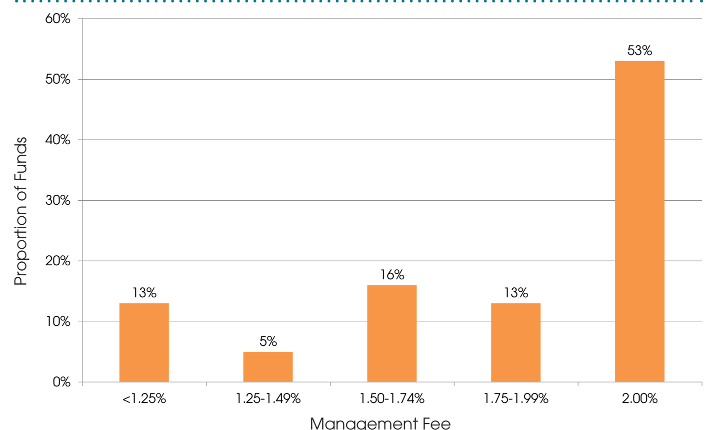
Many institutional investors continue to struggle with the discrepancy between the risk/return profile of infrastructure assets and the level of management fees charged by fund managers utilizing the private equity fund model. One investor summarized: "There are very few core fund offerings with reasonable fees. The private equity model is too expensive given the return characteristics of

Fig. 1: Breakdown of Infrastructure Investors by Reason for Investing in Infrastructure



Source: 2012 Preqin Infrastructure Review - August 2012 Preqin Investor Study

Fig. 2: Management Fee Charged During the Investment Period for Funds Raising and Vintage 2010-2012 Funds Closed



Source: Preqin Infrastructure Online

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Fig. 3: Infrastructure vs. Other Private Equity Strategies - Median Net IRR by Vintage Year

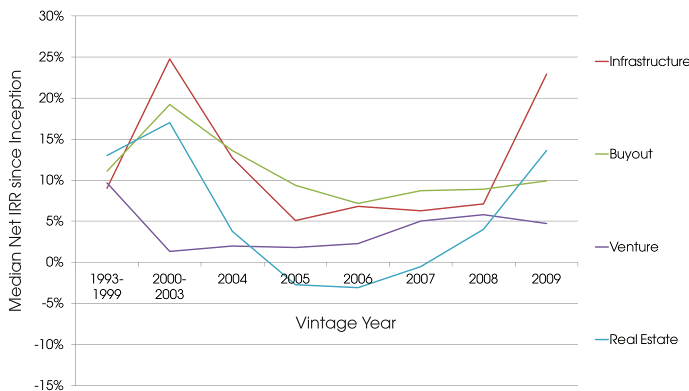

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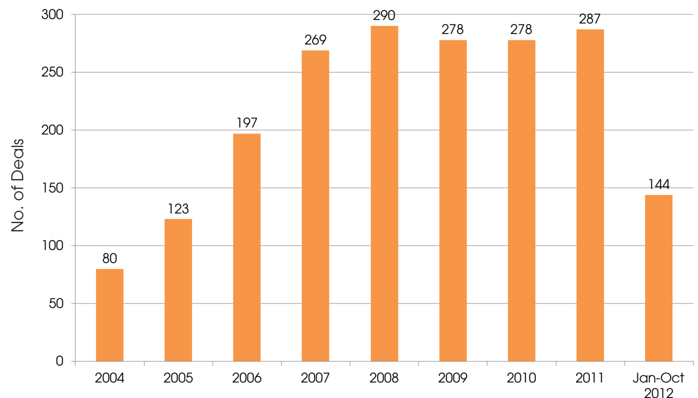
Fig. 4: Number of Deals Completed by Unlisted Infrastructure Fund Managers, 2004 - October 2012



Source: Preqin Infrastructure Online

the underlying asset." Investors are now largely unwilling to pay high fees, particularly to managers without a proven track record or those targeting assets likely to generate a lower rate of return. However, many GPs continue to operate under the traditional 2/20 private equity structure.

Fig. 2 shows the management fee charged during the investment period by funds currently raising capital and vintage 2010-2012 funds closed. Fifty-three percent of these funds have a management fee of 2%, showing that despite increased investor pressure, over half of fund managers continue to apply the private equity model to infrastructure funds. However, a significant 47% of fund managers are charging a fee lower than 2%, with 13% charging lower than 1.25% during the investment period. Many GPs also have structures in place to reduce the management fee charged in different circumstances, such as in return for a higher level of investor commitment.

A fair proportion of managers are therefore beginning to consider investor demand when it comes to setting management fees. Higher fees may be warranted for funds targeting higher risk developmental infrastructure projects, which are more closely aligned with the private equity structure, but not for those funds targeting lower risk brownfield and secondary stage assets. Investors recognize and are largely comfortable with the fact that infrastructure funds may generate lower returns than private equity or real estate vehicles, but expect management fees to reflect this.

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Another factor that contributes to the debate over the level of management fees charged by infrastructure fund managers is the lack of clear performance benchmarks for the infrastructure industry as a whole. One investor summarized: "A core challenge for us is benchmarking the industry given the lack of matured funds." The majority of unlisted infrastructure funds were launched post-2004, meaning there is only limited performance data available for these vehicles. Unfortunately, until these infrastructure funds mature, benchmarking will continue to be a problem for both fund managers and investors operating in the asset class.

However, the performance of older infrastructure funds gives an indication of what to expect from more recent funds. According to Preqin data, 84% of unlisted infrastructure funds target a net IRR of between 10% and 20%. This is lower than the level of return traditionally sought by private equity or real estate GPs, but older vintage infrastructure funds have performed well in comparison. Fig. 3 shows the median net IRRs achieved by infrastructure, buyout, venture capital and real estate funds of vintages 1993-2009, revealing that despite infrastructure funds traditionally targeting lower returns, the performance actually achieved by vintage 1993-1999 infrastructure vehicles is similar to that of the other fund types shown. Fund managers able to demonstrate a record of good past performance will likely be more successful in the current market, although few firms are realistically able to do so.

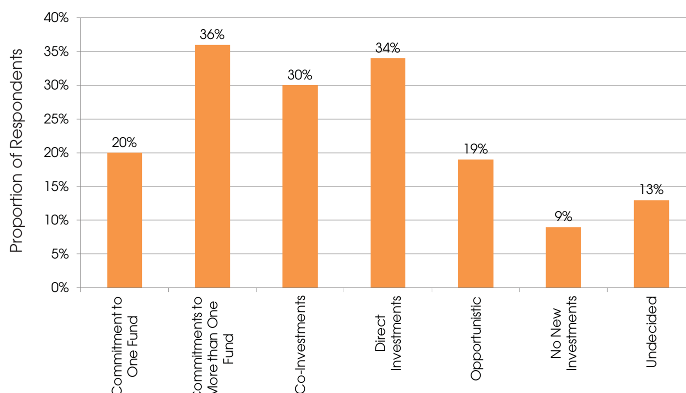
The availability and high cost of debt financing in the current environment is also limiting investor appetite and affecting deal flow. As shown in Fig. 4, the number of deals completed by unlisted infrastructure fund managers grew steadily year-on-year prior to the financial crisis but has plateaued since due to banks becoming less inclined to provide long-term affordable debt financing. A growing number of fund managers have begun to launch debt funds in order to compensate for the shortfall in infrastructure debt financing; however, not all LPs view these vehicles as attractive investment opportunities. One investor highlighted: "The limited availability of debt will restrict deal flow but infrastructure debt funds will close the gap. Unfortunately, infrastructure debt funds will fail to meet our minimum return requirements."

Other notable challenges highlighted include the illiquid nature of the asset class, inappropriate fund structures, high asset valuations and a lack of manager experience. Investors are also concerned that increased competition for assets in the market is driving up the prices of the best infrastructure assets, resulting in the expected level of return becoming unattractive.

Outlook

Growing demand for infrastructure development worldwide has increased private sector interest in the space, with more GPs launching funds and more LPs committing capital to such vehicles. Investor appetite has regained momentum following the financial crisis, although many investors now follow more cautious and conservative investment strategies. As a result, some infrastructure fund managers are now having to make greater concessions to investors in order to secure fresh fund commitments, and are spending more time in market.

Fig. 5: Investor Plans for Infrastructure Investment in the Next 12 Months



Source: 2012 Preqin Infrastructure Review - August 2012 Preqin Investor Study

The amount of fresh capital raised by infrastructure fund managers over the past 18 months shows a healthy investor demand for such exposure. This looks set to continue over the next 12 months, with 78% of surveyed investors stating plans to make some form of infrastructure investment in the next year. As illustrated in Fig. 5, 36% of respondents plan to make multiple unlisted fund commitments in 2012 and 2013 and a further 20% expect to make a single fund commitment. Thirty-four percent plan to pursue direct investments in the next 12 months, while 30% will look to make co-investments. Nineteen percent of interviewed investors will operate an opportunistic investment policy.

This shows that investor interest in the infrastructure asset class remains strong. However, as mentioned, several key issues still constrain the flow of investor capital into unlisted infrastructure funds. Though many fund managers are becoming more attuned to investor concerns, the future growth of the unlisted fundraising market may be dependent on a larger effort to resolve these issues. Managers seeking to raise capital need to be prepared to consider investors' concerns, and address and mitigate them if necessary in order to secure capital commitments. The greater alignment of interest between GPs and LPs that this could produce has the potential to encourage more investors to become active in the asset class.

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