

InfrastructureInvestor



Lessons from the big crunch

Four European infra specialists on what went wrong during the credit boom

Fund structures: the open vs. closed debate continues

India: the trouble with land acquisition

Asset class: what pensions should hope to find in infrastructure

Funds in market: our latest update on who's raising what

Plus: North America Special

Florida's I-595: the deal that nearly never was

Build America Bonds: a threat to PPP?



After the shakeout

A year after the collapse of Lehman Brothers, the credit crisis is still casting a long shadow over the financial world, and infrastructure is no exception. However, according to the four European investment specialists who came to *Infrastructure Investor's* inaugural fund manager roundtable in September, the brutal change that has occurred is fundamentally a good thing: the crunch was the crisis the industry needed, and the survivors now have the chance to make investments that are better thought through, better aligned and better financed. To find out what it will take to deliver on this opportunity, **Philip Borel** and **Chris Josselyn** sat in on the discussion.

FROM THE TOP floor of London's iconic "Gherkin" skyscraper on a rainy early-September morning, four seasoned managers of infrastructure funds are looking across the overcast British capital, wondering for how much longer the dark clouds over the world economy are going to linger. Many commentators are now expressing optimism that the worst of the global financial crisis is behind us. Are they right? And if so, what does that mean for investors in infrastructure?

Thierry Déau of Meridian Infrastructure, Danny Latham of First State Investments, AMP Capital Investors' Richard Shields and Stephen Vineburg of CVC Capital Partners have come here to talk about the mega-trends shaping the post-crash world in which they now operate. Between them they



From left to right: Déau, Latham, Vineburg, Shields

have several decades of experience in the infrastructure business. But none of them have ever seen what is happening at the moment: the emergence of their industry from the wreckage of the greatest market dislocation in living memory. Other asset classes may have been hit harder by the bust, but there has been pain in infrastructure, too. Those who survived have had ample opportunity to ponder what went wrong and what the lessons for the future might be. Not everyone has been so lucky.

Three of the four men in the room are Australian, which is hardly surprising if you consider that Australia is the cradle of the infrastructure business as it we know it today. Latham, Shields and Vineburg all moved to the UK after doing pioneering infrastructure investment work during the radical privatisation programmes that were implemented in Australia in the 1990s. All three have spent time working for AMP, one of the oldest asset managers in the country, which made its first investment in infrastructure in the late 1980s. Vineburg once worked for First State Investments, the investment arm of Commonwealth Bank of Australia, where Latham is employed today.

“It is disappointing that some people have squandered opportunities to deliver infrastructure’s natural return by paying too much.”

The only non-Aussie at the table is Déau, a Frenchman whose infrastructure credentials are just as impeccable as those of his colleagues from Down Under. “Thierry’s an honorary Australian!”, quips Latham at one point, as if to underline the fact that all four managers in the room know each other, and their industry, extremely well.

As they reflect on the events leading up to the crumbling of global finance two years ago, the men make no bones about the fact that much of what went on in their industry during the boom was over-exuberant and badly thought through. In essence, managers with ready access to seemingly unlimited amounts of cheap capital did deals they shouldn’t have done - and suffered the consequences when the markets turned. “Sometimes when people have too much money, they start doing silly things,” is Déau’s laconic assessment of what happened.

HUNGER VERSUS GREED

Vineburg, along with Latham the most loquacious person at the table, insists that regardless of how much pressure to invest some



The honorary Australian speaks

managers may have been under at the time, the mistakes they made are difficult to excuse: “Your number one job as an infrastructure manager is to grab the natural return that derives from infrastructure assets by virtue of their monopolistic or regulatory position and carry that across to the end investor. Frankly, some people have squandered the opportunity to deliver that natural return by paying too much, adopting overly aggressive business cases, or loading in too much debt.”

Not that it was just the equity investors who became too excited when the market heated up: lenders got carried away also. As Déau recalls: “Before the crisis, bankers were throwing money at people. Even on small PPPs, where you’d normally want some robustness in the capital structure, I saw people going into 95:5 debt to equity structures. Then banks came to me saying ‘we can do 98:2’, and I said ‘no - go away!’

Nobody was thinking, nobody was negotiating, nobody was reading documents.”

As a consequence, Déau continues, doing sensible deals was nigh on impossible. “We thought we’d never get to invest in anything. During the boom we had a poster in our office to remind everyone that, as the saying goes, *the hungry pigs get fed, the greedy pigs get slaughtered*. When the crisis came we took it down – we felt we didn’t need it any more. The crisis was actually a saving grace.”

Latham agrees emphatically: “It was the crisis the industry needed.”

REMEMBER THERE'S RISK?

Shields argues there was nothing wrong *per se* with fund managers taking advantage of the abundant liquidity conditions before

AT THE TABLE



Thierry Déau, Meridiam Infrastructure

Déau is President at Meridiam, which manages a €600 million, 25-year infrastructure fund focused exclusively on PPP investments in Europe and North America. Investments to date include health care facilities in the UK, a tunnel in Ireland, as well as motorways in Austria, Germany, Poland and Slovakia. Before joining Meridiam in 2004, Déau spent 10 years working in project finance in Europe and Asia.



Danny Latham, First State Investments

Latham leads the European infrastructure business of First State Investment, the investment arm of Commonwealth Bank of Australia. Previous roles include stints at Deutsche Bank’s RREEF Infrastructure in London and AMP Group in Australia. Latham has sat on the boards of a wide range of infrastructure businesses and along with his colleagues invests primarily but not exclusively in utilities, toll roads and airports.

the crisis by raising large equity funds – provided they then kept their cool and didn't invest their capital in overpriced or imprudently financed assets: "The issue was, did you have the discipline? And if you did, were you able to hold it through the 2006-07 period? If you don't like the price, the prospective return, the forecasts or whatever, you have got to hold your discipline and say, 'well, I'm not doing it'. I don't think a lot of people did that. Weight of money and maintaining discipline often do not go hand in hand."

Others let themselves down in the area of risk management, for instance by way of acceptance of overoptimistic forecasts, or overweighting their funds to assets exposed to economic activity and patronage risk: "In 2006 and 2007, it was all very well managers buying assets that were linked to economic activity. Ports are an obvious example. So you've successfully acquired assets – but have you thought about what might happen when the good times stop?", asks Shields.

Too often the answer to this question was 'no', continues Latham. "The forecasts only ever went one way, in straight lines without any aberrations, and so capital structures were put in place based on those lines, not accounting for the fact that there will be issues with the assets from time to time."



"I saw people going into 95:5 debt to equity structures. Then banks came to me saying 'we can do 98:2', and I said 'no – go away!'"

Vineburg has seen this as well: "We're dealing with risk, but a lot of the modeling is fairly deterministic – there are usually a set of fixed base, low and high cases, but rarely do people look at the likely variability of the returns, and whether there may be remote events, which can impact the range of outcomes. With airports you can almost guarantee that over a 20-year period there will be a number of shocks – for example, a September 11, a Gulf War, or a SARS type problem. Even if you can't pin down what will cause these shocks, it is probably wise to load their impact into the sensitivities of the model. During the boom period, that didn't happen enough."

BUY – BUT DONT FORGET

Not that it is necessarily a boom-time phenomenon for infrastructure investors to get their activity forecasts wrong – it is something practitioners always struggled with. Look at the assumptions people make when they go into building a toll road, Shields suggests: "I'm sure there are exceptions, but all around the world people have consistently accepted traffic assumptions that were too optimistic. It makes you think they want the asset so desperately that they are happy to pay up."

Sometimes, as Vineburg points out, forecasters also get it wrong the



Richard Shields, AMP Capital Investors

With over A\$100 billion under management, AMP Group is one of Australia's largest investment managers. It is also a pioneer in infrastructure, with its first investment (Sydney Harbour Tunnel) dating back to 1988. Shields is in charge of AMP Capital Investors' UK and Continental European operations and overseeing teams dedicated to infrastructure, real estate and private debt. Since 2005, the group has deployed over €700 million in European infrastructure assets.



Stephen Vineburg, CVC Capital Partners

Vineburg first entered the infrastructure business in 1994 and has invested in range of assets across different sub-segments including Brisbane Airport, Transurban Group and Anglian Water. In 2007, he joined global private equity heavyweight CVC to build the firm's infrastructure operation. Prior to that, Vineburg was global head of infrastructure investment at what is now First State Investments, the investment management arm of Commonwealth Bank of Australia.

other way around and predict too little usage of a new road. He says the early toll road projects in Sydney were “fantastically successful” because expected traffic growth had been too cautious. “With the M5 in Sydney, the original presumption was that once the debt and the construction had been paid off, there would be limited cash available for equity. As it turned out, hundreds of millions of dollars ended up coming out of that project.”

But such happy outliers notwithstanding, the broader point made at the table is that sponsors of infrastructure deals have often failed to pay attention to the risks involved, especially during the boom. What’s more, some also failed to take into consideration that infrastructure assets need to be managed carefully if successful outcomes are to be achieved. Warming to the theme, Latham says: “The perception, if you go back not too long ago, was that infrastructure is almost a buy-and-forget asset class – you’ll never lose money, it will chug along and look after itself. The truth is we’re talking about assets that are very dynamic businesses, and if they go off path it takes a lot to put them back on course.”

Now that the dust has begun to settle and the beginning of a new investment cycle is drawing closes, managers of infrastructure funds will have the opportunity to heed some of the lessons – and do better next time around.

SEGMENTATION, SPECIALISATION

The same is true for institutional investors who want to participate in infrastructure. There is a shared expectation among the panelists that going forward, more institutions will have a better understanding of what infrastructure is, how one should invest in it and what the likely results will be.

Crucially, argues Latham, more investors will appreciate that infrastructure is an asset class made up of many different segments, each with a specific risk/return profile. “Investors used to take the view that infrastructure was just this homogeneous blob. But those who were heavily weighted towards transportation are now seeing that



Vineburg: remember the manager’s number one job

“The developers are keen to invite everybody in these days, but when it gets to doing the work, the institutions will require help.”

structures, holding periods and alignment of interest. To illustrate the trend, Déau points to his own experience with Meridiam: in 2005, when the firm first came to market proposing the 25-year fund it now manages, investors took a lot of convincing about the length of the fund’s life. Now the concept is much better understood amongst LP, he says.

Shields believes some investors will want exposure to particular assets for even longer periods. “Institutions that are focused on liability matching will look at the robust cash flows coming out of many core infrastructure assets and say, we want them, and we want them forever. So the question becomes, what’s the right structure for your asset. We think open-ended funds are the most appropriate and are going to be more common, but there are obviously types of mainly private equity type assets out there where shorter-term structure will be more appropriate.”

Latham predicts that the private equity style, closed-ended 10-year infrastructure funds raised in 2005 and 2006 will be facing an important challenge as they mature. “It’s going to be interesting in six or seven years’ time to see what the realisation strategy of some of those structures is going to be. I think if you talk to some of the managers of those structures, they have no desire to sell their good assets at all. What you’ll find is these managers mulling the possibility of successor funds.”

over the past 12 to 18 months they have underperformed; those that were allocated more to social PPPs or utilities have done better. Now you’re seeing investors doing a lot more work around these kinds of correlation, and what you’re going to get is segmentation, just like you did with other markets as they matured. You’re going to get segmentation by geography, by sector, by risk profile. The balanced fund model that we started out with 15 years ago is going to be less common.”

At the same time, investors will be more discerning about fund

structures, holding periods and alignment of interest. To illustrate the trend, Déau points to his own experience with Meridiam: in 2005, when the firm first came to market proposing the 25-year fund it now manages, investors took a lot of convincing about the length of the fund’s life. Now the concept is much better understood amongst LP, he says.

Shields believes some investors will want exposure to particular assets for even longer periods. “Institutions that are focused on liability matching will look at the robust cash flows coming out of many core infrastructure assets and say, we want them, and we want them forever. So the question becomes, what’s the right structure for your asset. We think open-ended

funds are the most appropriate and are going to be more common, but there are obviously types of mainly private equity type assets out there where shorter-term structure will be more appropriate.”

Latham predicts that the private equity style, closed-ended 10-year infrastructure funds raised in 2005 and 2006 will be facing an important challenge as they mature. “It’s going to be interesting in six or seven years’ time to see what the realisation strategy of some of those structures is going to be. I think if you talk to some of the managers of those structures, they have no desire to sell their good assets at all. What you’ll find is these managers mulling the possibility of successor funds.”

INFRASTRUCTURE IN THE ASSET MIX

Vineburg agrees that the asset class will ultimately enable investors to pick and choose from a “kaleidoscope of offerings”, where they decide which



Latham: how will 10-year funds exit?

investment style they like best. Short-term structures won't be popular: "They won't want you to come back after 18 months to tell them, 'I've sold the airport, here's your money back'." But, he warns, permanent ownership at the other end of the spectrum has its shortcomings too: "With a permanent structure you can lose some of the discipline of good asset management. At CVC, we promote a proposition with a geographic focus and a closed end but with greater longevity than a conventional private equity fund."

Is it a concern to the managers that many institutions are currently pondering the possibility of investing in infrastructure directly? Déau says it isn't: "Most teams are fairly lean and won't have the capacity, even when they're familiar with the sector. And even though the developers are quite keen to invite everybody in these days, when it gets to doing the work, the institutions will typically struggle and require help from an experienced GP."

And even if more investors will follow the lead of some of the institutions that are already investing in infrastructure funds directly, such as the Canada Pension Plan Investment Board in Toronto, the possibility of large-scale manager disintermediation in the asset class is remote, because so many institutions have little or no experience infrastructure and are looking to enter the business for the first time. When they do, they are going to need expert help.

Déau, Latham, Shields and Vineburg all agree that institutional thinking about portfolio construction is changing in ways that are overwhelmingly positive for their industry. Vineburg puts it like this: "During the crisis, a lot of people learned that their conventional asset allocation framework didn't serve them very well: the correlation coefficients between asset classes that were supposed to provide diversification never kicked in, and everything went down at the same time. Now investors are now saying, 'look, I can't stand the volatility of the public markets and I can't live on government bond rates, so there must be something out there that has a higher return without the volatility' – that's where infrastructure comes in."



Déau: people got silly

"I think the word 'privatisation' will disappear for the next five years."



Shields: some investors will want to hold forever

TRUST AND GOOD CONTRACTS

If this is right and supply of capital comes on strong, the industry will require the demand for infrastructure assets to be equally buoyant. On this the roundtable is optimistic, too: "Look at governments' ability to finance assets – have they got any better? If anything, they have worsened, and private sector investment will be essential," says Latham.

In other words, the deal flow will be there – albeit with some caveats. For instance, managers should not expect to be able to make straightforward 100 percent purchases of government-owned assets. Says Déau: "After the crisis, governments have even bigger responsibilities than before, and I think the word 'privatisation' will disappear for the next five years. In infrastructure, governments will need to be involved, so you will get partnerships, long-term joint ownership and co-management of assets – based on trust but also written into good contracts."

This means fund investors looking to benefit from the opportunities that will be coming will need to tread carefully to deliver value to, and behave responsibly towards, all stakeholders. And while the roundtable participants agree that the financial markets are beginning to show signs of a recovery, there is also consensus among them that the abundance of cheap funding is well and truly a thing of the past.

Put these two facts together and it becomes clear the key to good performance from here on will be a combination of judgement, alignment of interest and hard work. Vineburg believes it is still possible to generate returns comparable with those of the boom period – but they will necessarily have to be higher-quality returns, derived from good asset management, a more robust business case and with less gearing.

Latham agrees and sums up thus: "There will have to be alignment and a real focus on alpha generation other than through financial engineering. It's almost a back-to-basics world." After the tumult of the recent past, the industry will do well to bear these words in mind. ▣