Investment opportunities in infrastructure debt

Why infrastructure is popular with investors

Infrastructure funds can create a ‘Catch-22’

Global deal value could exceed USD500 billion
In this issue...

03 Why infrastructure investing is proving popular with investors
By James Williams

06 Global deal value could exceed $500bn
Interview with Michael McCabe, MUFG Investor Services

10 Infrastructure funds can sometimes create a ‘Catch-22’
Interview with Craig Cordle, Ogier
Why infrastructure investing is proving popular with investors

By James Williams

Infrastructure has become a key area of focus for institutional investors as they look to diversify their fixed income portfolios to access longer term, resilient credit opportunities for income-like returns. Within this asset class, infrastructure debt is on the rise as investment managers look to construct new debt vehicles: either to provide direct lending to infrastructure operators, to access well-established municipal bond markets, or to structure their own private lending programmes by issuing tranches of unlisted bonds.

Last September, Schroders established a new infrastructure finance capability designed specifically to help institutional investors access the asset class.

Commenting on infrastructure finance as an asset class, Philippe Lespinard, Co-Head of Fixed Income at Schroders, said he believed it was set for future growth: "We believe it is currently benefitting from increasing demand from long-term institutional investors due to the increasing supply of projects, partly attributable to macro-economic factors and changing regulations."

**Listed or unlisted?**

From a structuring perspective, typically an infrastructure fund will look to enter into some kind of loan arrangement rather than making a direct equity investment.

With respect to a listed fund, what investors tend to find difficult to understand is that there’s a re-characterisation, in terms of what the fund does with the debt that it is buying and selling and turning it into an equity instrument, which can then be bought...
and sold as shares on an exchange. More popular is the private, unlisted fund.

“A private infrastructure fund will often be structured as a limited partnership. If investors wanted to hold equity you could use a limited company in place of a partnership or put a limited company on top of a limited partnership to enable some investors to hold equity and some a partnership interest – there really are multiple possibilities for bespoke structures depending on investor needs,” explains Craig Cordle, investment funds Group Partner at Ogier in Guernsey.

Those thinking of structuring infrastructure funds will need to consider where the assets will be located, as well as the target investors, before determining where best to domicile the vehicle. The investment manager’s location will also be an important factor.

“The manager will have to consider the position under AIFMD and how the fund may be marketed. Are any EU investors likely to be targeted? Could they take advantage of National Private Placement Regimes, which we see frequently utilised successfully by funds domiciled in Guernsey, as the Channel Islands are not part of the EU, or does the manager require full passporting rights?"

“Also, think about what advisers will need to be appointed and how exactly investments will be made. Will this require other entities as part of the overall structure? If seed investments have been identified, this will impact the disclosures which will need to be made to investors and the level of verification of that information required,” explains Cordle.

A USD4.6 trillion hole

Doubtless there will be plenty of infrastructure opportunities in Europe but right now, it is the US infrastructure market that appears particularly ripe for investment.

The municipal market supplies 80 per cent of the capital for US infrastructure projects, which could grow substantially if Congress approves President Trump’s USD1 trillion spending plan. As FTSE Global Markets reported on 21st April 2017, an estimated minimum USD4.6 trillion of public spending on US infrastructure is needed by 2025.

“In general, President Trump has indicated that he is in favour of projects such as the Alaska Pipeline and LNG Project. He wants US-built pipelines using US suppliers, US steel, etc. Previously, there was demonstrable opposition to pipelines but under Trump it is a much friendlier environment in terms of trying to push these projects through,” remarks Michael McCabe, Sales Director, MUFG Investor Services.

“The energy infrastructure sector seems particularly deal rich. Our clients are buying into existing pipelines, they are building wind farms. We see interest both in brownfield sites and greenfield investments, depending on the risk appetite of the end investor.”

Approximately USD150 billion in dry powder was ready to invest in US infrastructure at the end of last year and another USD50 billion or more was raised in Q1 2017. From a supply/demand perspective, infrastructure managers are scrambling to keep up with investors and put their capital to work. It is a nice problem to have.

“Unless the global economy collapses, then I do believe there will be continued demand to invest in these assets, not just in renewable energy but core infrastructure assets: roads, bridges, ports, tunnels. A lot of these were built more than 50 years ago in the US and need upgrading,” says McCabe.

Grande Prairie Wind project

Some asset managers are investing directly into global infrastructure on behalf of their clients by issuing unlisted bonds, as opposed to locking investors into quasi-PE fund structures.

“This was evidenced recently by Allianz Global Investors, which made an investment of over USD400 million into the Grande
MUFG Investor Services

MUFG Investor Services, the global asset servicing arm of Mitsubishi UFJ Financial Group, deliver distinctive, tailored solutions in every major market. We are continually looking to serve our clients more effectively – with unwavering commitment, incisive thinking and a proactive, client-centric approach.

From fund administration and custody, to FX, trustee, depositary, securities lending, banking services and a broad range of regulatory solutions - we provide clients with global asset servicing solutions tailored to their specific needs from a partner they can trust.

Please visit us at
www.mufg-investorservices.com
The demand for infrastructure funds remains evidently strong. Last year, these vehicles raised USD62.9 billion in aggregate based on figures provided by Preqin*. In Q1 2017, that number had already reached USD29.5 billion; nearly twice the amount raised in Q1 2016 (USD16 billion).

“We’ve seen increasing interest in infrastructure deals, both listed and unlisted,” states Michael McCabe, Head of US Sales, MUFG Investor Services, the global asset servicing arm of Mitsubishi UFJ Financial Group. “The number of deals in Q1 2017 for the US totalled USD50 billion and was fairly concentrated in the energy sector; natural resources, utilities, power plants. This year we should see north of USD500 billion committed to infrastructure deals, globally.”

Asia recorded the highest level of financings, globally, in 2016. Some 552 deals were completed for a record USD131 billion. Europe recorded the highest number of deals (555), worth USD97 billion, while North America attracted USD96 billion.

“Australia is one of the key infrastructure markets. There has been an increase of pan-Asia deals in that country along with an increased presence of Chinese development banks. Between the China Development Bank and the Export-Import Bank of China, they are becoming major investors in this space,” observes McCabe.

Then there is the Asian Infrastructure Investment Bank (AIIB), a regional investment bank proposed as an initiative by the Chinese government that can lend up to USD250 billion for infrastructure. Doubtless that figure will rise over time, especially if one considers that China has USD900 billion of infrastructure projects lined up to connect Asia with Europe.

The US infrastructure market grew 14.4 per cent from 2015 to 2016, says McCabe. With the administration trying to get a USD1 trillion spending package through Congress, there is reason for optimism.

“There are thousands of failing bridges, roads and railways that need to be repaired so even without the spending package, infrastructure spending was still a necessity. The question is, where does the money come from? Will it be fully government financed? Will the taxation regime be reappraised to help attract more private infrastructure funds to enter into public private partnerships? And if so, what are the risks associated with that?”

“There are lots of questions that require answering to address America’s infrastructure needs,” says McCabe.

One clear trend that has emerged in this asset class is infrastructure debt. USD11.5 billion in infrastructure debt was raised in 2015, compared to USD4.5 billion in 2014. In 2016, the unlisted infrastructure debt market sought $25 billion in target investor capital for a record 43 unlisted infrastructure debt funds, mainly in North America and Europe.

Such is the level of growth in infrastructure that one of the main considerations for investors is determining the level of risk. Do they commit longer term to greenfield sites with no immediate revenue streams, or invest in existing assets? Projects such as the Fort Mojave Solar Project and the Alaska Pipeline are operational assets while the Chicago Union Station Redevelopment, for example, currently has no revenue stream.

“Built assets appear to be more favoured right now but as a consequence this is pushing up valuations. That means there are risks to infrastructure managers potentially buying frothy assets,” says McCabe.

“Pipelines, wind farms, oil storage facilities. Those are areas our clients are involved in right now, raising funds with USD10 billion or more in assets.”

*The 2017 projections and deal volumes / projects were from Preqin’s Quarterly Update: Infrastructure Q1 2017 published in April 2017. The infrastructure debt – listed and unlisted – stats were from a September 2016 Preqin spotlight on that asset class.
OVERVIEW

Prairie Wind Project; a 400-megawatt wind farm in Holt County, Nebraska – the largest wind energy project in the state’s history.

The financing consisted of unlisted bonds with a 20-year term that were privately placed with US and European investors via AllianzGI’s established infrastructure debt platform. The operator in this instance is BHE Renewables, a subsidiary of Berkshire Hathaway Energy, which owns one of the largest renewable energy portfolios in the US. The subsidiary was specifically created to support BHE’s expansion into the unregulated renewables market, including wind, solar, hydro and geothermal projects.

Jorge Camiña is Director, Infrastructure Debt, Allianz Global Investors. He confirms that after first establishing an infrastructure debt team in Europe in 2012 (first investment took place in 2013), where it initially focused on P3 and transportation assets, AllianzGI expanded its reach by targeting the US infrastructure space in 2015.

“Our first US transaction was the Indiana Toll Road. We made a USD700 million long-term investment and that quickly put us on the map in the US,” says Camiña.

“Since then, we have had a good run in transportation and have made three transactions in total: the Indiana Toll Road, Chicago Skyway, and most recently (Q4 2016) the Pocahontas Parkway in Virginia.”

He says that from a deal flow perspective, a large number of P3 and transportation assets are covered by tax-exempt financing, which means the actual number of transportation deals is quite limited.

“We realised that most of the infrastructure investing opportunity in the US lay in the power and energy space. That’s where we’ve been increasing our focus over the last 12 to 18 months.”

Jorge Camiña, Allianz Global Investors

“We realised that most of the infrastructure investing opportunity in the US lay in the power and energy space. That’s where we’ve been increasing our focus over the last 12 to 18 months.”

Jorge Camiña, Allianz Global Investors

capacity and that facilitates the access to institutional investors to such deals. “They monetised the tax incentives and that helped to create a straightforward debt structure,” confirms Camiña.

“The second transaction we recently closed in February was also in the wind space: the Balko Wind Project based in Beaver County, Oklahoma. We are confident we’ll be able to close a few more deals in our pipeline by the end of the year. That said, tax reforms could possibly push back on the timing of some of these transactions, when there is more clarity on what those tax reforms look like.”

Affiliates of DE Shaw Renewable Investments LLC (DESRI) own Balko Wind. The way the deal was structured, AllianzGI agreed to provide the necessary funding to refinance Balko Wind’s existing bank financing. The transaction was executed as a “back-leverage” loan in order to tailor the solution to the structure that DESRI had in place.

Both of these investments differ slightly in composition. With respect to Grand Prairie, this was becoming operational close to the same time that AllianzGI was making the investment. BHE financed the transaction with its own internal resources and then opened it up to institutional financing, close to completion.

“Balko is slightly different. Several banks were providing the trade finance and we stepped in to take over the refinancing of that debt. Balko has been operational for a little over a year now,” says Camiña.

The credit profile of these renewable energy deals is the operational asset itself. These projects usually have a highly rated creditworthy counterparty (typically a utility) that buys the power and green energy certificates from the project under a long-term
contract (PPA – Power Purchase Agreement).

"Since the Borrower is a special purpose vehicle that actually owns the Project, the credit profile of these transactions is typically ring fenced from the Sponsor. We finance specific assets so it’s just project risk that we are taking. Our financing is specifically tailored to the capacity of the cash flows of a particular project," adds Camiña.

**Archmore infrastructure debt platform**

In Europe, UBS Asset Management has established the Archmore Infrastructure Debt Platform to cater to institutional demand, specifically targeting private lending opportunities in the mid-market sector.

“This is a part of the market that we identified as lacking the necessary capital,” explains Tommaso Albanese, Global Head of Infrastructure, Real Estate & Private Markets, UBS Asset Management. “We thought there was an opportunity to focus on the private side of the market rather than the public market, to provide debt financing and build investments for our clients with attractive risk return profiles.

"Infrastructure represents the most conservative, but equally a very attractive area of private debt. Investors are looking for alternatives to fixed income investments and infra debt offers them a yield pick-up thanks to the illiquidity premium. These are assets with long-term, stable cash flows, typically secured with a pledge on the underlying physical assets. This is the ‘real asset’ aspect to the asset class and that gives institutions a lot of comfort.”

To date, Albanase says that the team has invested in a ferry and port transportation company in Scandinavia, a solar company in Spain and an energy company in France, to name but a few. He says the plan is to be fully deployed in Archmore by the year-end, "so that we are in position to prepare for the launch of our next fund". The platform has raised USD630 million from 17 institutional investors across Europe and Japan and as Albanese states: “There is plenty of demand and we think it is a trend that is here to stay. Infrastructure companies appreciate the benefits of working with long-term investors and, equally, investors are interested in keeping capital invested over a longer time horizon. So there is a strong alignment of interests.”

“Investors are looking for alternatives to fixed income investments and infra debt offers them a yield pick-up thanks to the illiquidity premium.”

**Tommaso Albanese**, **UBS Asset Management**

Also, infrastructure operators like the idea that they can borrow at a fixed rate, long term, as it gives them certainty of funding costs and avoids having to use swaps.

“Beyond solar and wind, I think there is growing activity in other areas of energy such as biomass and new energy efficiency technologies – smart grids for example. These require more in-depth analysis before structuring deals but they provide an interesting opportunity for future fund investing. I think this more interesting area of energy infrastructure will continue to grow,” suggests Albanese.

**The third way**

As UBS and AllianzGI have demonstrated, investors have the option of investing in dedicated debt fund vehicles such as Archmore, which provide a co-investment-type opportunity, or by taking direct exposure to the operational assets by holding long-term private bonds.

These solutions are not always the most optimal for institutional investors. They might not necessarily want to be in a fund but at the same time they might not have the in-house expertise to source deals directly. Secondly, a number of investors require advice before allocating: the asset class is incredibly complex and offers many different risk/ performance mix to investors that may be difficult to differentiate and assess. Pedagogy should be a cornerstone of infrastructure investment.

“Thirdly, risk monitoring is top of their agenda and they want a close relation with their asset manager to understand how the risks change following the initial investment, and reporting that is as bespoke as possible,” comments Charles Dupont, Head of Infrastructure Finance, Schroders.
Let’s get to the point: we understand funds. Ogier’s specialists have advised on fund set-up, structuring and finance since the inception of the industry, with many actively involved in drafting key legislation that underpins fund structures in our international jurisdictions. We act for banks, financial institutions, funds and sponsors, working with blue chip clients with established track records and the most innovative and entrepreneurial new ventures entering the market. We pride ourselves on providing responsive and practical advice, while our hands-on, partner-led teams ensure a consistent approach.
From a structuring perspective, infrastructure funds are most frequently established as either a limited partnership or a limited company. Partnerships are the familiar vehicle for private funds, whereas companies will be used for listed vehicles.

Obviously there will be nuances, depending on the asset class and the type of investors being targeted. “You can give limited companies characteristics that resemble a limited partnership, particularly in offshore jurisdictions like Guernsey, but generally it will be one of the two options described,” says Craig Cordle, investment funds Group Partner from Ogier in Guernsey.

There are some inherent difficulties with infrastructure funds, given the incubation period for setting up one of these vehicles. Cordle notes that ideally, investors want the fund vehicle to have a seeded portfolio in place or at the very least identified target assets – they will want to be confident that the capital will be deployed and, particularly in the case of listed funds, that their investment will not be subject to extended cash drag.

Not all managers, however, can come to the table with a book of seed assets which are lined up and ready for investment by the new fund vehicle.

This creates a bit of a Catch-22 for many of these funds. How does the investment manager balance investor expectation for capital deployment with the need for a long enough runway to identify the right assets? Time is not always on their side.

“Some have fallen down because of the difficulty of raising a book of capital from investors given that the investment period may potentially be over multiple years,” says Cordle. “Identifying and vetting investments takes time – this is one of the reasons why the largest infrastructure funds tend to launch in the private space.

“There are some notable listed infrastructure funds but it remains easier to raise a private infrastructure fund given the ability to draw down commitments gradually and because of the size of investment which investors would prefer to make.”

Private funds generally raise higher amounts of capital than listed funds. What a private fund provides, in a limited partnership arrangement, is the ability to use capital calls and draw down capital as and when required, whereas a listed fund would need to have all of its shares fully paid up before listing on the London Stock Exchange or elsewhere.

A listed fund could potentially decide to invest in a single or limited number of infrastructure assets, thereby making it easier to put the capital to work, but the difficulty with this is that the fund may not then be considered suitable for listing in the eyes of the listing authority.

“The regulator will expect to see a spread of investment risk for a premium listing on the LSE and that the portfolio will be comprised of a sufficient number of assets. What investors will be looking for is disclosure in the prospectus on the nature of those assets. Fortunately, there are alternatives in the form of the Specialist Fund..."
OGIER

projects in the energy sector will require a lot of diligence by fund managers.

“For private infrastructure funds investing in the energy sector, there will likely be added regulatory complexities that could increase costs for the fund; especially if it requires working with advisers, lawyers and specialist valuation agents in local markets.

“These are specialist investments. Investors will want assurances that their capital is protected and being managed appropriately,” says Cordle.

Cordle says that in terms of structuring a private fund, the most frequently used option is to have a limited partnership where a group of investors band together as limited partners under a partnership agreement.

“The general partner of the partnership then appoints the investment manager. This is the tried and tested model and is generally no different for private equity and real estate funds,” adds Cordle.

In Europe, there are various markets to consider for setting up limited partnerships. There is the English limited partnership and each of the Channel Islands has a partnership regime too. In addition, in recent times, jurisdictions like Luxembourg have updated their legal regime to better support global private equity, real estate and infrastructure managers with the introduction of a Special Limited Partnership (SCSp), which unlike the SCS, has no legal personality and therefore more closely based on the Anglo-Saxon LP model.

“As a limited partnership will not typically have a legal personality, the LPs should be taxed on a look-through basis.

“The team structuring a new vehicle will look to minimise tax leakage within the fund structure, which one of the reasons why we see fund promoters heading to Guernsey. The aim will be for investors to be taxed principally in their home jurisdiction,” says Cordle.

He notes that structuring teams will look to take advantage of jurisdictions with good double taxation networks, as well as those jurisdictions which are familiar to investors.

“The ultimate structure of a fund will depend on a combination of factors – where the assets are located, where the investors are based and how investment will be structured,” concludes Cordle.
While returns are very much deal-specific, the common denominator is that most institutions are looking to get a pick-up (a spread) premium over the price of the equivalent bond of the PPA off-taker; that is, the utility company taking the power being generated. This involves looking at how that utility's bonds are trading in the capital markets and applying a premium for the operational risk and more limited liquidity of the project financing.

“Let’s say that the bond of the utility off-taker for a similar average life as the project is trading at 4% yield. If one then prices in wind risk, operational risk, liquidity premium and so on, this will lead to adding a pick-up premium to that coupon. This pick-up varies a lot depending on the deal and the sponsor.

Ultimately, there are three ways for institutions to invest in long-term resilient credit: sovereign debt, utility bonds, and infra debt. If you want a pick-up over sovereigns you buy utilities, and if you want a pick-up over utilities you buy infra debt, which is where we come in,” explains Camiña.

**RV opportunities**

Within the senior secured debt arena, Dupont points out that there are a number of sub-segments that offer differing relative value opportunities to investors. There are, he says, four different sub-segments: long duration credit, short duration credit, brownfield sites and greenfield sites. Brownfields are existing operational assets, greenfields are new projects with significant construction risk and no proven track record in terms of operational performance.

“Let’s first consider lower RV opportunities in the market. For example, long duration greenfield projects have seen evident...
Sterling, it becomes more difficult for non-UK investors because of the currency risk and the lower price of Sterling, which has fallen significantly since last June. In turn, there is also more political uncertainty. At Schroders, our client base is Euro-denominated and we are recommending them to invest in Sterling-denominated infrastructure at a later stage when the impact of Brexit will become clearer,” explains Dupont.

Strength of partnership
For all of the excitement surrounding infrastructure investing, be it in the US or Europe, investors and managers alike have to take confidence in those servicing the assets. In that respect, fund administrators play a vital role in terms of validating assets and providing a much needed layer of independence to ensure that the fund is doing exactly what it should be doing.

“One of the areas we can support infrastructure managers is by providing finance for subscription lines to minimise capital calls,” says McCabe.

“Investors want the assurance that someone other than the investment manager has looked at the calculations related to the fund, looked at the management fees and that their returns have been verified and calculated by a third party.”

In addition, MUFG Investor Services will do independent reconciliations and from a cash flow and investor perspective, perform all the necessary AML/KYC checks to make sure everything is in order.

“Factor in that there’s also an annual audit and it gives the investor the assurance that fraud risk has been minimised.

“Look through reporting is another key strength of ours. We work with some of the largest pension funds in the US who want to pierce through the fund down to the portfolio company or investment level to understand their exposures in those portfolios. We are a clear market leader in the industry with respect to the accuracy, depth and breadth of reporting available to our clients,” concludes McCabe.

Regardless of how institutions choose to invest in infrastructure, it is clear that the dynamics continue to look favourable. It’ll be interesting to see if total inflows for 2017 break the record books.

Infrastructure risks
There are many risks to investing in infrastructure of which investors will need to be mindful – although these are applicable in varying degrees to any investment. Regulatory risks, political risks, economic risks – these could all potentially play a role in affecting the performance of operational assets and the future cash flows they generate.

By way of example, Cordle says that a risk to the economics of a fund can be introduced if additional infrastructure projects are envisaged. He cites the Dartford Crossing, just outside London, which faces a second tunnel being built under the Thames, reducing the volume of traffic. Infrastructure investors would look to see how their investment is safeguarded in this scenario.

“No infrastructure asset is fully protected. Regulations can change. Economics can change. There’s no guarantee that an electricity producer with a fixed contract for a certain number of years will be able to negotiate a similar deal in the future. That’s part of the cost of setting these funds up - there is often an awful lot of due diligence involved and a critical assessment of the intended investments,” says Cordle.

The UK is arguably Europe’s most important infrastructure having first privatised its airports, water companies and rail line operators 30 years ago.

But last year, a curveball in the form of Brexit occurred, instantly changing the optics of its infrastructure market.

“As these projects are denominated in Sterling, it becomes more difficult for non-UK investors because of the currency risk and the lower price of Sterling, which has fallen significantly since last June. In turn, there is also more political uncertainty. At Schroders, our client base is Euro-denominated and we are recommending them to invest in Sterling-denominated infrastructure at a later stage when the impact of Brexit will become clearer,” explains Dupont.