Pessimism has Never Won any Battle –

Some Optimistic Views for Infrastructure Fundraising in 2014

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2013 proved to be a very successful fundraising year for infrastructure funds, especially in Europe and North America, with $38 billion raised globally. Now the question becomes whether this momentum will be sustainable through 2014 and beyond. Many variables will influence the infrastructure fundraising environment of the coming years, including three key factors: (1) the demand for greenfield and brownfield investments in the public infrastructure space; (2) investors' continued search for stable, long-term cash flows with returns above their internal return requirements; and (3) the acceptance of infrastructure as an asset class in its own right.

From a macroeconomic perspective, the global demand for new-build infrastructure and refurbishment projects is still huge and growing. Not only have most developed countries fallen short of making the necessary investments to maintain and update their aging infrastructure in recent decades, but many have failed to adjust their infrastructure in tandem with sprawling urbanization or for implications of the exit from nuclear and fossil-fuel energy, that in turn require tremendous investment in electricity transmission, distribution and storage. At the same time, emerging economies require enormous amounts of capital to build new infrastructure to accommodate the needs of their fast growing populations. Even before the global financial crisis, most economies had been unable to fund their infrastructure investment needs. The crisis has further exacerbated the constraints on governments and public entities around the globe. Most governments have reduced rather than increased infrastructure investments over the last several years. Western economies, for example, have decreased their infrastructure spending from approximately 3% in 2009 to 2% of GDP in the last year. The gap between global infrastructure demand and expenditure, both in developed and

emerging markets, has always been tremendous and is widening by up to $500 billion every year, according to a study conducted by Standard & Poor's. According to the study, the global annual demand for infrastructure spending may add up to more than $3 trillion per year by 2030. In addition, although governments have historically considered infrastructure ownership and operation to be a sovereign duty and were reluctant to allow private ownership of public assets, this view has increasingly softened. Over the last few years, many countries have realized that they must allow for investment by the private sector so that they do not fall behind in terms of their global competitiveness. These dynamics thus suggests a case for private sector funding and ownership of infrastructure going forward.

At the same time, institutional investors are seeking ways to put their money to work at attractive return levels. The low-interest environment of the last few years has made this task even more challenging. While many investors have tried to avoid illiquid investments in the past, the relative unattractiveness of public bonds and the pressure to achieve their internal return targets have made investors rethink this former guiding principle. Furthermore, there seems to be an obvious match between what institutional investors are looking for and what infrastructure investing can deliver. Stable returns over longer tenures at relatively attractive, and in most cases risk-adjusted return levels, are compelling for most institutional investors, especially those with long-term liabilities they are looking to match, such as insurance companies and pension funds.

Lastly, for many years, institutional investors have struggled to classify infrastructure in their broader investment portfolios. Many have considered infrastructure investments as part of their real estate allocation, while others have viewed the sector as part of their private equity allocation. European regulators have further complicated the issue by enacting capital requirements at the same level as private equity. Recently, however, investors have come to view infrastructure as an asset class in its own right and as a result, the number of new investors seriously considering and participating in the infrastructure space is growing quickly. Between capital inflows from new investors to the asset class and growing infrastructure allocations, among existing infrastructure investors who are looking to allocate up to 4-5% of their assets under management to infrastructure, relatively large amounts of capital are flowing into the asset class. While infrastructure is not yet a segment of each and every institutional portfolio, it is well on its way to becoming an established part of the investment mix. All of the aforementioned factors can help explain the fundraising success infrastructure fund managers had in 2013. Large brand-name funds, as well as infrastructure funds with at least one predecessor fund, are attracting capital to back their investment strategies with the most ease. However, high-quality first-time funds, as well as smaller funds targeting specific infrastructure subsectors or regions, are – sometimes after a more protracted effort – ultimately achieving their fundraising targets. Furthermore, given that these drivers of appetite for private infrastructure investment are expected to remain, if not intensify, 2014 will most likely be an even better year for infrastructure funds seeking limited partner capital. The times when infrastructure funds struggled to raise sufficient capital to realize their respective investment strategies seem to belong to the past.

The momentum in the space has led to a more competitive investment environment for managers, as the amount capital flooding into the sector has made it more difficult for managers to source well-priced assets. In this situation, both sets of constituents, the fund managers and their investors can contribute to the success of a fund. Managers must be encouraged to continue employing rigorous investment discipline when acquiring assets to ensure that their portfolios can deliver attractive risk-adjusted returns for their investors. Investors, on the other hand, should contemplate the strategic guidelines they give to the funds they back. Some asset types, such as regulated assets in Western European countries, for example, have been a major focus for many infrastructure investors. These assets have been viewed by investors as "safe haven assets in safe haven jurisdictions." With the increasing demand for such assets, prices have naturally increased, leading to return compression in that segment of the market. While it is still incumbent on the fund manager to analyze and decide whether a given asset presents the opportunity for an adequate return, investors can help enable managers to achieve attractive returns by allowing for flexibility in the fund's mandate (e.g. geographically or by asset type).

Ultimately, the key to success is building a diversified infrastructure investment portfolio across different managers with different strategies. A thoughtful approach to portfolio construction – internally or with the help of an external asset manager – is worth the effort. Such preparation and forethought positions investors to benefit from investment opportunities in certain segments and jurisdictions, without jeopardizing the overall target of achieving stable return levels over longer durations – well beyond a 2014 perspective.