FUNDRAISING

Challenge 2014: Find the right assets

Last year was a positive one for infrastructure fundraising but, with the capital having been collected, careful thought now needs to be given to strategy. Matthias Reicherter of Golding Capital Partners expands on this

After a very successful fundraising year for infrastructure funds, especially in Europe and North America, the question becomes whether this momentum will be sustainable through 2014 and beyond.

While many variables influence the answer to that question, there are three key factors shaping the infrastructure fundraising environment of the coming years: 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 macro-economic perspective, the global demand for infrastructure new-build 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 over the last decades, but many have failed to adjust their infrastructure to the fundamental macroeconomic development of urbanisation or to the implications of the exit from nuclear and fossil-fuel energy, which in turn requires tremendous investment in electricity transmission, distribution and storage.

At the same time, emerging economies require enormous amounts of capital to build new infrastructure so they can cater to 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.

Matthias Reicherter

WIDENING GAP

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 percent in 2009 to only 2 percent 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 well add up to more than $3 trillion per year by 2030.

For many years, governments have considered infrastructure ownership and operation as a sovereign duty. This has led to some reluctance when it comes to putting public infrastructure into the hands of private sector companies on a larger scale. Over the last few years, however, many countries have come to realise that there will not be a way around getting the private sector to help if they want to ensure they don't fall behind in terms of their global competitiveness. The aforementioned set of dynamics suggests a clear case for private sector funding and ownership of infrastructure going forward.

At the same time, institutional investors are desperately looking for 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 to achieve. While investors have been trying to steer clear of 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. Today, most institutional investors seem to be prepared to give up some flexibility for the benefit of getting anywhere near the required overall return targets for their portfolios,

recognising that there are acceptable ways to manage a degree of illiquidity in an overall portfolio context.

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 tenors at relatively attractive, and in most cases risk-adjusted, return levels, are attractive for most institutional investors and especially for those with long-term liabilities they are looking to match such as insurance companies and pension funds.

HOW TO ALLOCATE?

For many years institutional investors have struggled with the classification of infrastructure investment in an investment portfolio. Many have considered infrastructure investments as part of their real estate allocation, while others have viewed them as part of their private equity bucket. Many European regulators have not helped the case for building a dedicated infrastructure allocation with regulatory capital requirements at the same level as for private equity.

It has only been a recent development that investors have come to view infrastructure as an asset class in its own right, and, as a result, the number of investors arriving as new entrants to the infrastructure space is growing quickly. While infrastructure has not yet made it to each and every institutional investment portfolio, the asset class is well on its way to becoming an established part of the investment mix.

Between capital inflows from new investors to the asset class and growing infrastructure allocations from existing infrastructure investors who are looking to allocate up to 4 to 5 percent of their assets under management to the segment, relatively large amounts of capital are flowing into the asset class.

All of the aforementioned factors can help explain the fundraising success infrastructure fund managers had in 2013 with $38 billion raised (after $29 billion in 2012). Large brand-name funds, as well as infrastructure funds with at least one predecessor fund, are naturally having the easiest time attracting capital to back their investment strategies. However, high quality first-time funds and smaller funds targeting specific infrastructure sub-sectors or regions are – sometimes after a more protracted effort – very successful in their fundraising.

With all those factors unchanged and additional momentum deriving from the fact that infrastructure investing has moved up the agenda for many investors, 2014 will most likely become an even better year [than 2013] when it comes to investor appetite. The times when infrastructure funds struggled to raise sufficient capital to realise their respective investment strategies seem to belong to the past.

RIGHT ASSETS, RIGHT PRICE

The encouraging developments do come at a price. The focus of fund managers has moved from attracting capital for the purpose of acquiring attractive assets to finding the right assets to realise the fund's strategy. More specifically, it is now even more about finding the right assets at the right price. Sourcing well-priced assets will become the challenge in 2014 in an environment where capital seems to be flooding into the sector.

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 demonstrating rigorous investment discipline when acquiring assets to make sure their portfolios remain in a position to deliver attractive risk-adjusted returns for their investors.

Investors, on the other hand, should rethink what strategic guidelines they are giving to the funds they are backing. Some asset types, such as regulated assets in Western European countries for example, have been the centre of attention for many infrastructure investors. These assets looked like the ideal constellation to fulfil all the requirements a lot of investors had, and were considered safe haven assets in safe haven jurisdictions. With the increasing demand for those assets, prices have naturally increased, leading to return compression in the segment.

While it is still incumbent on the fund manager to analyse and decide whether the return level achievable with respect to a given asset is adequate and beneficial for the fund's overall performance, investors can help managers achieve attractive returns by allowing them to broaden the scope of the fund's investment strategy into essential infrastructure assets, for example in countries that have been less favoured since the global financial crisis.

The key to success is building a diversified infrastructure investment portfolio across different managers with different strategies. Spending time thinking about portfolio construction – internally or with the help of an external asset manager – is clearly worth the effort. It will allow investors to benefit from investment opportunities in certain segments and jurisdictions without jeopardising the overall target of achieving stable return levels over longer durations – well beyond a 2014 perspective. ■

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