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ASIAN LPS AND INFRASTRUCTURE: ROUSING THE GIANTS

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Infrastructure is shedding its reputation for being a sleepy sector as Asian investors join a global surge of interest in the asset class. Strategic angling for the best deals will now require a more nimble approach. Justin Niessner, staff writer at *Inframation* sister title *Asian Venture Capital Journal*, reports.

EMEA

Sector: Power
Transport
Country: USA
United Kingdom
Saudi Arabia
Singapore
China
Japan
France
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Infrastructure is not a sector for subtlety. The projects are physically colossal, the timeframes generational, and the financial implications often incomputable in scope. As a result, those involved can be surprisingly blasé about the launch of a USD 40bn fund.

That's the amount The Blackstone Group aims to raise for what is being hailed as the largest private infrastructure vehicle in history. By comparison, infrastructure funds raised recently by Brookfield Asset Management and Global Infrastructure Partners (GIP) amounted to USD 14bn and USD 15.8bn, respectively. KKR's latest infrastructure fund closed in 2015 at USD 3.1bn.

Last month, Saudi Arabia's Public Investment Fund (PIF) firmed up a pledge to anchor the Blackstone fund with a USD 20bn commitment. PIF is also reportedly planning to invest another USD 20bn into a separate infrastructure fund by the New York-listed private equity firm. Both vehicles would target the US market.

Expectations around the ultimate ramifications of these ambitions, however, have been subdued as murmurs about a delayed deployment schedule reverberate in the context of a dwindling opportunity set for making large, quality acquisitions. At the same time, relatively new interest in the asset class from

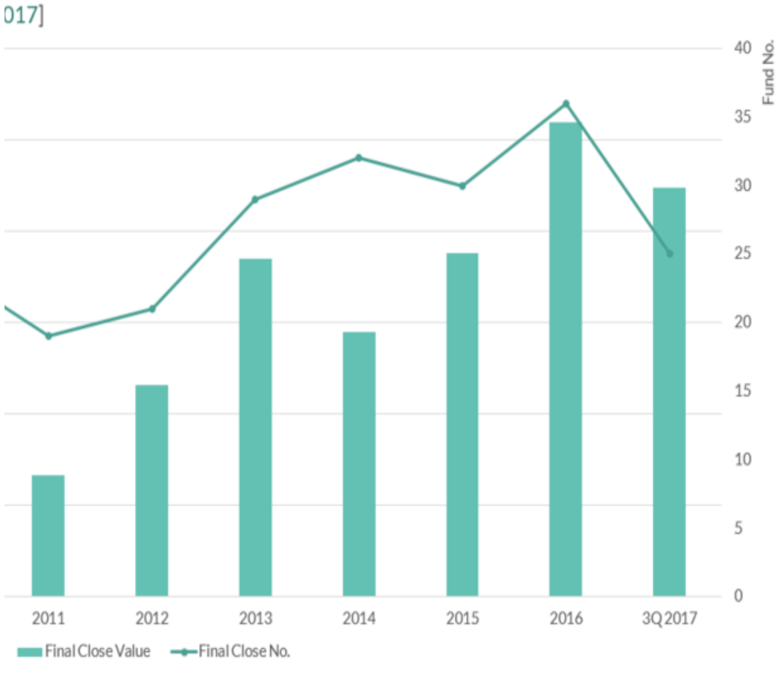
Asia has highlighted a shifting climate that may prove difficult to navigate for an unwieldy mega-fund targeting listed assets.

"Asian investors are increasingly looking at infrastructure to diversify their portfolios because of the low correlation with traditional asset classes," says Raj Agrawal, global co-head of infrastructure at KKR. "While listed infrastructure tends to fluctuate in line with broader market trends, long-term investors tend to see unlisted infrastructure as beneficial to ensuring proper diversification."

Perhaps the most striking aspect of the Blackstone fund may be its massive anchoring in petrodollars. Middle Eastern LPs tend to play more conservatively in a low oil price environment, especially in sectors where deal supply can be choppy. This counterintuitive confidence reflects statistical suggestions that the global infrastructure market, although growing aggressively, is neither easy to enter nor excessively competitive.

According to *Inframation* data, the aggregate value of infrastructure deal flow has escalated steadily since the 2011 sovereign debt crisis to USD 413bn last year. Meanwhile, unlisted infrastructure fundraising has seen similar momentum, reaching USD 52bn in 2016 compared to USD 38bn in 2015 and about USD 13.3bn in 2011.

This five-year period caps a broader trend of geographically proliferating interest in developed market infrastructure assets. Australia and Canada were early movers in the 1990s and early 2000s, joined around the beginning of the current decade by a stronger showing from the US and Europe. Most recently, Asian investors have started to play a prominent role, with institutional players from the region now said to be participating in almost every Europe-facing M&A infrastructure consortium.



So far, Asian activity in Europe and the US has been split between heavyweights such as GIC Private and smaller, less experienced investors – often represented by a field of eager Japanese life insurance companies. Both ends of this spectrum exploit fund-level partnerships with Western GPs to get access to the market, while the larger players are also beginning to amplify significant co-investment strategies.

Over the last five years, industry participants including KKR have tracked several large Asian pension funds and sovereign wealth funds (SWF) as they create in-house teams to acquire infrastructure assets.

“There is a huge amount of capital chasing investable assets, but the pipeline is thin, and everyone’s looking at the same assets,” says Sarah Tame, an associate director at EDHEC Infrastructure Institute, which builds benchmarks for infrastructure investors, in London. “The traditional asset managers are now having to operate in what they call the value-add space, where the asset might be brownfield but it has a greenfield element. This influx of Asian capital has changed the dynamics of the market.”

Rising project valuations are usually considered the most dramatic indicator of this trend. As a case in point, GIP acquired Edinburgh Airport in the UK for GBP 807m (USD 1bn) in 2012 and sold its 75% interest in London City Airport last year to a Canadian-led consortium for GBP 2bn. The pricing discrepancy is especially notable given that Edinburgh handles almost three times as many passengers as London City and its traffic is said to be expanding twice as fast.

The boom in global appetite for these sorts of assets is most broadly supported by the search for steadier yields and portfolio diversification in a depressed interest rate environment. However, Asia features especially potent drivers, including the use of infrastructure as a means of diversifying foreign exchange rate strategies and the emergence of new players in the sector.

As the largest asset owner in the world, Japan’s Government Pension Investment Fund (GPIF) is the best example of this movement. After a few years of non-committal discussions, GPIF formalised an infrastructure plan in April that will see it focus on core brownfield projects in developed markets. At the other end of the spectrum, a host of small Asian life insurance companies are beginning to approach the sector as a way of branching out of traditionally liability-driven strategies.

“Fifteen years ago at life insurance companies in Asia, there was little emphasis on managing assets as a function of liabilities,” says Frederic Blanc-Brude, a director at EDHEC in Singapore. “As they have become more sophisticated, but also as their ‘duration gap’ has widened, Asian insurers have increasingly been looking for long-term assets – but these can be hard to come by in the region and there still is a significant mismatch, forcing them to invest in risky assets rather than the long-term bonds they would prefer to hold. This is why infrastructure debt is so appealing in principle.”

Another Asia-specific driver can be seen in China’s sprawling One Belt One Road initiative. Although the plan represents a riskier-style infrastructure play than many regional LPs are willing to embrace, its support for the asset class in broad terms appears to be resonating.

Kerry Ching, Asia managing director at AMP Capital, notes that most investors start with core infrastructure in developed countries with global funds, then branch off to regional funds in Europe or the US. Some of these have in turn started to move up the risk curve to funds that invest in slightly more GDP-correlated assets. “For Asian investors, the push of One Belt One Road has definitely raised the awareness of infrastructure and has accelerated the growth of the asset class further,” says Ching. “SWFs usually lead the pack, followed by pension funds and insurance companies.”

Despite the enthusiasm around these motivators, first-time approaches by Asian investors have been logically conservative, favouring partnership with funds of at least USD 1bn in size and investments independent of GDP growth such as water and power utilities. Airports have also been popular due to their potential for building on retail capacity.

Geography also appears to influence investment style. For example, Korean and Singaporean insurance companies are seen as preferring debt over equities or real assets due to domestic risk capital regulations, while less inhibited Taiwanese insurers lean toward funds with higher potential returns. Meanwhile, as Asia Pacific’s most experienced infrastructure market, Australia plays a unique role as a bridge to the West.

“Given the depth and width of the Australian market, there’s an opportunity to get an understanding of the asset class here and potentially take that understanding to other markets,” says Kyle Mangini, global head of infrastructure at IFM Investors. “That can be a positive learning experience, but it’s also worth recognising that infrastructure is going to have some very different characteristics depending on where you are. Every country is different, and in the US, every state is different – sometimes every city.”

IFM’s acquisition of Australian power network operator Ausgrid last year as part of a consortium including AustralianSuper helped illustrate this point. Local sensitivities around foreign ownership of such an asset foiled a number of Chinese bids and left an opening for the all-Australian consortium.

In the US, similar M&A headwinds around primary industrial production and communications infrastructure are expected to crop up across a range of deal sizes as part of a more protectionist political context. Investors are therefore advised to pursue projects governed by US institutions that can facilitate the foreign review process. Likewise, it will likely be best to target partnerships with US groups that can structure deals in ways that mitigate financial implications related to the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA.

“Regulatory risk is always one of the key factors for Asian investors to consider before they evaluate investment opportunities,” says John Walker, executive chairman of infrastructure at Macquarie Capital Asia. “For example, while Chinese investors have shown increased interest in infrastructure investing in the US, it has been challenging for Chinese investors due to national security or political concerns. However, Asian investors are always open and keen to allocate money to developed countries and to look for potential investment opportunities."

Understanding regional stakeholder dynamics, historical geopolitical alignments and applicable national security overlays is crucial to succeeding in such explorations. Although the factors related to this approach can be as fickle as local voter sentiment, Asian investors have traditionally taken a long-term perspective on political and economic issues. Notable evidence includes the strong interest shown by state-owned China Three Gorges in Portuguese energy plays amidst the Eurozone crisis of 2011.

"When considering infrastructure investing, one has to take into account country-by-country differences because local regulations are often a political whim, which actually has a big impact on hard asset investing," says Vincent Ng, a partner at Atlantic-Pacific Capital. "Although infrastructure is a very long-term asset class and short-term political movements shouldn't have a major impact, it does influence conversations with investors and many are keeping an eye on the volatility in the US political climate. The policies in Western Europe have been a little bit more consistent and, to some degree, more investor friendly too."

Resilient demand for sterling exposure and an apparent dismissiveness around Brexit uncertainties have arguably positioned the UK as the most desirable infrastructure jurisdiction among Asian financial institutions. This can be seen in the GBP 5.4bn acquisition last year of National Grid by a group including Macquarie and China Investment Corporation (CIC), the latter of which has also taken a stake in London's Heathrow Airport.

Meanwhile, despite initial government hesitancy around security issues, a China-France consortium received approval to build the country's first nuclear power station at the Hinkley Point project site in Somerset.

Although some sticking points remain such as France's utilities space being notoriously difficult to crack, European openness to foreign infrastructure ownership seems to have fostered a larger pool of local sector-focused funds and managers relative to the US. This environment facilitates the partnering process for investors seeking access to the asset class and has prompted some Asian investors to tilt their global portfolio more toward Europe than North America.

Industry participants note that US-based funds currently tend to emphasise opportunities in mid-stream services and the politically delicate realm of power.

There is a small but growing public-private partnership market in North America, but for more generalist funds, and in particular the more core infrastructure funds, there is a greater propensity to pursue opportunities in Europe.

Andrea Echberg, a partner at Pantheon, observes that although deal activity has stepped up as part of this trend, the increased inflow of capital is still putting pressure on valuations. This is particularly true for larger assets where the most capital can be deployed. With this level of competition, selectivity will be the key to isolating pockets of value.

“Entry valuation and prudent leverage are really the two factors you absolutely have to get right for infrastructure in this environment because there’s very little scope to fix things if you get either of those wrong,” says Echberg. “To truly find value in that kind of market, you have to identify managers that have genuine niche strategies and are able to source attractive deals without necessarily having to be in a cost-of-capital war for assets.”

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