Infrastructure funds – time for a change?

DOMINIC HELMSLEY OF SL CAPITAL PARTNERS EXAMINES THE OUTCOME FROM A FIRST WAVE OF INFRASTRUCTURE FUNDS TO SEE WHAT LESSONS INVESTORS IN THE ASSET CLASS CAN LEARN FROM PAST PERFORMANCE

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Infrastructure remains a much talked about asset class. It promises long-term stable cash flows delivering reliable returns from 8% up to as high as 15%, including an attractive yield component. But have these target returns been delivered to investors from funds? How should potential investors in the asset class evaluate past performance? As the first generation of infrastructure funds reach the end of their life, investors have an opportunity to assess the overall performance in real terms, and reflect on the learning points from this investment experience and the performance of infrastructure through the Global Financial Crisis (GFC).

Background

The first generation of infrastructure funds were launched around 2002-2003, and until the GFC took hold in late 2008, a steady stream of funds was launched, backed by financial institutions such as banks or insurers. The first investments for these funds took advantage of the cheap and available leverage and significantly increased gearing, with proceeds used to pay dividends to investors.

All this changed over the course of the GFC, following which a new generation of managers spun out from the banks. This new generation had to meet new regulatory requirements and were keen to be seen as independent of conflict. In addition, a new wave of direct investors emerged, led by larger Canadian and Australian pension funds, now joined by larger schemes in Europe and many global sovereign wealth funds.

With the emergence of these direct investors building successful infrastructure portfolios, many commentators have started to question whether traditional infrastructure funds are the best way to access the asset class. In particular, whether the private equity-style fund structure (i.e. closed end with relatively short hold periods, fees payable on commitments and carried interest) is appropriate for the core infrastructure asset class.

Fee structures and returns

Management fees on commitments

It is now evident that fees on commitments can have a significant drag, both on overall returns and on yield payments to LPs in the early years, particularly for larger funds with long investment periods. A much fairer and better aligned structure is to base fees on net asset values. Therefore, investors only incur fees once the money is at work and the quantum of the fee is directly related to the value of the investment.

Hold period

Core infrastructure assets are by definition long-term in nature, therefore it is not best practice to hold the assets for a relatively short period. For example, most 10-year closed end funds end up holding assets for between five and seven years, which given the long-term nature of the assets, can lead to potentially damaging short-term investment decisions for the underlying businesses.

Carried interest

Carried interest is a concept directly lifted from the private equity sector where expected returns are significantly higher and more volatile, and where managers are motivated to drive absolute returns to the maximum over the short term. In core infrastructure, the underlying assets performance is expected to be much steadier and the hold horizon should be longer. Therefore, a carry structure is not the right motivation for a successful core infrastructure manager.

Overall returns

It is now also clear that some funds have suffered due to the impact of the GFC and from poor investment decisions. However, even those funds that deliver

their target gross IRR will still see that the impact of fees on commitments and carried interest payments will be a significant drag on net returns to investors. Calculations suggest that a typical 10-year fund, with fees of 1.5% on commitments and a 20% over 8% carry structure that delivers an 11% gross IRR to the fund will achieve a net return of 7% to investors.

New asset purchases
The historic fee structures discussed above create a drag on performance which has meant that new asset purchases need to satisfy a higher return hurdle. As asset prices have increased due to greater investor interest, many funds have been priced out of the core market and have had to look to either higher risk opportunities or higher risk geographies.

Other key lessons

Leverage
Appropriate leverage is key, and stable assets should be appropriately geared. This was clearly not the case pre-GFC and led to significant volatility being introduced to investment performance.

Asset management
It is also now clear that business, governance and asset management skills are particularly useful for these long-term cash-generating assets, particularly the ability to provide board-level leadership and strategic direction. This will ensure the right management team is in place and motivated to deliver sustainable performance over the long term. In the past, many funds were not resourced to provide oversight, and focused solely on the origination and execution of transactions.

Definition of infrastructure
As asset prices rose, some funds sought to stretch the definition of infrastructure to cover investments such as ferries, car park meters and other non-core activities. In most cases this has proved costly for investors as the assets have exhibited far more volatility than expected.

Time for change?

As we look back over the experiences learned from this first generation of infrastructure funds, it is clear to see that it is time for a change. The asset class has experienced a wave of transformation following the GFC, and in order to give investors the returns they seek, managers of infrastructure funds need to rework many aspects of their strategy.

Most importantly, they should re-evaluate the lifecycle of the fund itself. We have learned that the shorter-term funds of five to seven years can lead to potentially damaging short-term decisions. Due to the nature of this asset class, investors should look for longer-dated funds with at least an initial 12-year hold period, with the added option to extend beyond this to provide even greater flexibility to investors.

Investors should also look for fee structures which are based on net asset value and no carried interest as this is more aligned to the structure of the asset class and will give investors a much fairer return.

Also crucial is the skill of the management team. Infrastructure is a relatively new and niche asset class. Therefore, it is essential that investors look for a highly-experienced team with origination and execution, as well as extensive asset management and previous infrastructure experience.

A diverse and dynamic portfolio is also important. Investors should look for funds which have a good spread across projects such as renewables and utilities; for example hydro electric, gas grids and water projects, as well as transportation projects such as airport and rolling stock.

Also, investors should consider what kinds of deal sizes are being targeted. From what we have learnt it is evident that big ticket deal sizes are not always the way forward. Investors should look to see if there is a diverse deal-size range- as mid-market and smaller, more niche deals can often reap strong returns.

Finally, investors should think carefully about the failings of the first generation of funds, and look for firms offering a more sophisticated and developed approach, who have addressed these initial issues head on, and thus take a much more aligned and cost-effective route to infrastructure investment. With this attitude, investors could expect to reap a much higher net return on their investment.