A Publication of Institutional Real Estate, Inc.
Institutional Investing in Infrastructure

Volume 5, Number 8
ISSN 1941-3831
September 2012

Inside

Dreaming of Direct

The Realities of Direct Investing

by Tyson Freeman

It is tough to blame investors for being disillusioned with fund managers and the business models to date for infrastructure investing. Many funds have been expensive, included risky assets in portfolios intended to be relatively low risk and offered a generally poor alignment of interests. These issues were heightened by an early period of poorly timed acquisitions, the resultant poor returns, and a run of failed P3 deals, which were expected to drive growing investments in the sector. But if previous sentiment was based on high hopes and frustration, today there seems to be a more measured understanding of what it takes to execute a successful infrastructure strategy and a renewed commitment to the asset class.

It's no surprise that many institutions are searching for alternative approaches to investing all of their infrastructure allocation with third-party infrastructure fund managers. What *is* something of a surprise is that the market has begun to adapt its business models, some of which include direct investment opportunities to better match the characteristics of the asset class with the needs of the investor. Many in the industry warn, however, to keep expectations in check: Yes, the gap between what is desired and what is delivered will shrink, but it will take time.

"Investors have been unhappy with many third-party [infrastructure fund] managers, and for good reason," says Ron Lepin, president and CEO of Bastion Funds. "It makes sense that they want alternatives. But accessing the market through direct investments, whether they build in-house teams or somehow outsource that function, can be a lot tougher and more complicated than people realize. There are difficult challenges to overcome."

No one expects the fund approach to disappear, of course, but different business models are being hatched to fulfill many investors' desire for direct investing. Many turn to Canada's in-house direct investment divisions as a possible model. Perhaps that is a valid aspiration, but the message from some of the people who actually built those businesses is: For all the benefits it delivers, going direct is challenging, and it likely will take years of development before there are significant increases in direct investment volume.

Recent data demonstrates the growing interest in alternatives to funds. According to Preqin's August 2012 *Infrastructure Investor Study,* 36 percent of surveyed investors currently invest directly in infrastructure assets, 44 percent plan to invest directly over the long term, and 32 percent of respondents currently make co-investments alongside fund managers, with 45 percent including co-investment in their long-term plans.

Plans to incorporate direct investments, even by U.S. investors, are increasing. The $238 billion California Public Employees' Retirement System (CalPERS) already has invested directly with its minority stake in London's Gatwick airport, and CalPERS plans to make more direct investments with a portion of its infrastructure allocation. The $9.3 billion New Mexico Educational Retirement Board, with the help of Caledon Capital Management, is "expanding its approach to infrastructure" by including co-investment deals in its investment policy. And investment firm Aquila Infrastructure Management in Toronto is investing on behalf of several mid-sized Canadian pension funds as part of a coalition approach to direct investing called the Infrastructure Coalition Program.

SLOW DOWN — GET REAL

Lepin points out that only a handful of Canadian pension plans have direct investing programs in infrastructure. These programs were often established after the pension plan had already gone through a decade or more of increasing sophistication and growing internal management of their funds, including through direct programs in private equity and real estate. It should be noted that while Lepin's current venture, Bastion Funds, will be based on a variation of the third-party fund model, he is intimately familiar with direct investing; he built the direct program at Ontario Teachers Pension Plan (OTPP) from 2001 to 2006 before moving on to Morgan Stanley Infrastructure.

Lepin cautions against high expectations. He says the evolution of direct investing in Canada, for example, was slow and gradual. This evolution required the development of an investment culture that supports the purchase and ongoing management of private companies. To move away from the norm you need to develop the support and confidence of all stakeholders — from the plan constituents and board down through the senior management of the plan. It is not easy to do this in a big bang sort of way.

"The first challenge is that many of the organizations [that try to build internal teams] will never be able to get their mind around the number of staff necessary and to actually staff up to those levels," Lepin says. When he left OTPP, there were 21 people on the in-house staff in the infrastructure program, and he still felt understaffed.

Asif Hussain, a partner at Caledon Capital Management, says there should be at least 10, preferably 15, people for an effective in-house direct investment team in order to manage multiple opportunities at any given time.

Some of the Canadian direct teams have impressive headcounts. The C$166 billion ($168 billion) Canada Pension Plan Investment Board (CPPIB) controls C$9.5 billion ($9.6 billion) in direct investments and has an infrastructure investment team of 31 professionals. Borealis Infrastructure has C$9 billion ($9.1 billion) invested in approximately 20 infrastructure investments and employs 50 professionals.

David Rogers, a partner at Caledon Capital Management, says addressing long and short-term compensation is critical if U.S. investors want to build in-house teams. "It took a while for this to happen in Canada, and those firms are more removed from the government than in the U.S., which made raising compensation levels to where they need to be somewhat easier," Rogers says.

Senior level professionals at Borealis and CPPIB, for example, can earn upwards of $1 million a year. "For 99 percent of the pension plans out there, that level of staffing and compensation is simply not feasible," says Lepin.

If large pensions can expect challenges in ramping up direct programs, then what about the smaller pensions?

CLUBS AND CO-INVESTMENTS

Smaller investors basically have two choices to invest directly apart from developing an in-house staff: the so-called club approach — a group of like-minded investors pools resources to buy direct, often with a manager or adviser — and co-investment deals made alongside fund managers. Both roads existed before, but there are renewed efforts and business models, and terms are adjusting.

Barbara Weber, founding partner of B Capital Partners, sees fewer investors trying to put together clubs in the United States than in Europe, but says there is clearly interest in the strategy — her firm recently negotiated its first mandate with two large U.S. investors who want to invest directly in Europe.

Weber says her firm has recently undertaken a sizeable 100 percent acquisition of a 35 megawatt portfolio of German, operational on-shore wind parks for a single German insurance group. The firm also is currently in the process of negotiating several club deals in Europe where B Capital Partners will again source, evaluate and present opportunities to groups of investors that have agreed on what types of assets to target, the goal of holding the assets, the distribution policy, desired leverage and geographies amongst other investment details. After the initial acquisitions, she says, if the group wants to buy more assets, they can set up a pool of capital and continue to follow the agreed upon investment strategy. The target sizes of the different clubs, which all have assets lined up for investment, range from €40 million ($50.3 million) to €500 million ($522 million) depending on the strategy and the size of the investors in the club.

"Putting together the group is like putting together a puzzle," Weber says. "The idea is to get the people together that have a similar idea of what they want to do. Some investors are unable

Institutional Investing in Infrastructure

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ISSN 1941-3831

Institutional Real Estate, Inc.

PURPOSE

To provide tax-exempt investors with decision-making tools and information on the people, issues, ideas and events driving the institutionalization and globalization of the infrastructure asset class.

Institutional Investing in Infrastructure (ISSN 1941-2630) is published 11 times a year, with an annual subscription rate of $595 per year, by Institutional Real Estate, Inc., 2274 Camino Ramon, San Ramon, CA 94583. Tel +1 925-244-0500; Fax +1 925-244-0520.

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to pre-agree and they move on. There is [an] incentive not to spoil the deal once everyone makes agreements."

In Canada, Aquila Infrastructure Management is managing C$105 million ($106 million) from a handful of mid-sized pensions including the University of Ottawa and the Teachers' Allowances Retirement Fund of Manitoba under the firm's Infrastructure Coalition Program (ICP). Alina Osorio, CEO of Aquila Infrastructure Management, says the firm also provides clients with the opportunity for more traditional co-investment deals, but it is not Aquila's primary focus.

"Our intention was not necessarily to make wholesale changes to existing models," Osorio says, "but simply to create a customized vehicle that fit the characteristics of the infrastructure asset class and effectively addressed the needs of the investors."

Osorio says some of the differences between this approach and others can appear subtle, but there are a number of factors that make an approach such as the ICP attractive for the investor. "The duration is more appropriate — 20 years — our management compensation is more aligned with the interests of the investors, and the governance reflects more of a partnership approach with a lot of transparency."

Osorio says the ICP is structured to allow for new investors, and it has experienced "a lot of interest from those seeking an alternative to the traditional LP/GP fund approach." She says that Aquila is currently focused on the Canadian LP market, but the firm has plans to broaden that reach to the United Kingdom and the United States, eventually.

People are finding, however, that a club approach — with multiple institutional investors coming to a negotiated agreement on strategy — can be challenging to organize and coordinate.

"Efforts have been made by institutions for years to pool resources and develop dedicated outsourced teams, and the efforts just never came together as hoped," says Lepin, who is building a business based on the fund model. "It is a complex process with a million decisions to be made along the way. Functionally, it is often impractical."

Lepin also points out that if there are 10 investors in the club, either everyone needs to agree on everything — and this can create timing and alignment issues — or discretion will have to be delegated in some fashion, thus losing some of the benefit of direct investing.

According to Caledon's Hussain, a successful club deal can be especially challenging in a market where there has been very little experience with the approach, but he notes that some Canadian developers have been successful. "New investors to the asset class do not have the relationships yet, so they are not sure if their interests are aligned," he says. "It is challenging, especially when it comes to determining what price to pay, setting the dividend policy and deciding how much money to put into the deal after the initial transaction."

An adviser's business model also comes under a lot of pressure in a club arrangement. Hussain says "pursuit costs" are a significant challenge. "One approach is for advisers to choose a good deal and syndicate the deal down to various investors, but that is a limiting way to invest," he says. "In the end, to serve the investor, you have to be ready to accept those program costs."

Caledon was formed to play the role of an in-house infrastructure investment team for several clients, and Rogers says an effective infrastructure strategy for most investors includes exposure to funds, co-investments and other forms of strategic relationships. How the firm is compensated for the various client advisory roles is unclear as the business model and pricing is proprietary, according to Rogers.

"There is a place for a limited number of closed- and open-end funds," Rogers says. "Especially since that helps drive co-investment activity. One of the keys to getting more direct exposure is the ability to source deals from multiple sources. Doing co-investments with deal leaders is a way to build those important relationships."

This is an important point for investors considering a co-investment program. There is an ecology in the infrastructure space, and third-party funds, developers and a small number of large pension plans are responsible for leading most deals globally.

Hussain says Caledon typically seeks a hybrid position between being a passive and lead investor when it comes to co-investing. Caledon will not have all of the same rights with 5 percent that they will with 25 percent ownership, but the firm still has some shareholder and voter rights and sometimes is able to earn a board seat, albeit with less say in many big decisions such as when to exit.

While co-investments are perceived to be an attractive way to get closer to an investment, Rogers says people should remember they come with real challenges. Transaction timelines can be short, and an investor needs the ability to move quickly. An investor also must be able to bear the costs of due diligence and overhead whether or not a deal goes through.

Weber says co-investment is obviously an option, but there are often limits to the benefits. "Fund managers have recognized that clients are beginning to look for direct investments instead, so they are offering co-investments," she says. "If an investor's goal for direct ownership is to hold assets for a longer period or to not use leverage, for example, it would still be the fund manager who decides upon those issues as well as when to sell the asset, being directed/constrained by its own fund terms regarding IRR target, risk level, duration, etc."

Lepin suggests the real issue the market is working through is not necessarily a major shift toward direct investing, but rather investors becoming more sophisticated about the business models and incentives involved with investing in infrastructure.

"Investors, for the most part, will build portfolios around the third-party fund model," Lepin says. "It is not inherently the case that third-party managers are a bad solution. The real issue, whether we are talking about funds, co-investment or other direct approaches, is to get the business model and incentives right."

Each model will produce a different set of benefits, limitations and risks. A direct model, with the skills and scale required, may not be feasible for most institutions; a third-party fund model, meanwhile, may not result in a perfect match to an investor's particular goals; a co-investment program may lead to less diversification and adverse selection; and a club approach may result in suboptimal or ineffective decision making.

"However an investor decides to balance these issues, they need to appreciate that somewhere in the chain you need to have people who are aligned and who have the requisite skills and experience to properly drive the sourcing, evaluation, execution and management of the investments," says Lepin. "Losing sight of this may result in a Pyrrhic victory."

CONCLUSION

The measured and balanced approach seems to be sinking in. According to Preqin, the fund investment model based on the private equity sector is unlikely to "change drastically in the future, although infrastructure fund/fee structures will continue to be adapted to suit the risk profile of specific assets."

Rogers sees evidence of this. "There is push for better alignment, reduction in management fees, and that non-fee compensation should be based on a combination of yield and capital gains," he says. "Successful managers will be open to models that take into account longer-term holds, yields along the way and even the asset's effectiveness as an inflation hedge."

Weber says it might sound like just another platitude, but as the investment market adjusts it is even more important for investors to really sit down and think through what they want from their infrastructure portfolio and investments: 'How much cash flow do I need, and does it have to be completely steady? What downside risk can I take? Are there certain no-go sectors? Is this part of an inflation hedge? How long do I want to hold the asset?'

"These questions have to be answered," Weber says. "If you have them all figured, then the strategy tends to fall into place. If your universe of options is too narrow, then you can go back and purposefully and consciously take different risks."

In other words, more options and better terms are emerging. But despite the promise of some new approaches that involve direct investing, most have voiced patience. Some of these efforts are more difficult than many believe, and properly finding the resources for these efforts will likely be very challenging. Investors need clear vision and patience as the various business models and the markets continue to develop. ❖

Tyson Freeman is contributing editor to *Institutional Investing in Infrastructure*