

The Credit Crisis Provides an Opportunity for Those With Dry Powder to Invest in Infrastructure Asset Class

by Michael Underhill

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Notwithstanding the current credit crisis, infrastructure deals are still getting done and infrastructure funds are still raising money. Because of their long-life cash flow profile, these assets continue to be attractive to investors on several levels. Infrastructure assets have a long history of low volatility along with steady cash flows, which provide a degree of comfort in these unstable times. When investing in infrastructure, one can easily identify the most significant risk factors and control them in a straightforward manner.

Infrastructure deals require less leverage than the typical corporate leveraged buyout deal because they provide investors with both an asset and a cash yield. In addition, regardless of how hard the economic times get, people still need to drink water and turn on their lights; therefore, infrastructure tends to have a higher degree of demand inelasticity, further adding to its attractiveness as an asset class. Since the different risk/return parameters for various infrastructure investments across this broad asset class will vary somewhat, investors need to consider each subsector case by case.

Mature infrastructure investments provide for more stable, low-volatility cash flow profile assets and, thereby, a lower return expectation that exhibits

- Established revenues
- Investment return dominated by yield
- Higher leverage (45-80%)
- Total return expectations of 9-14%.

Value-added infrastructure investments provide for asymmetric return patterns and are characterized by

- Zero-to-low income yield

- Investment return dominated by capital growth
- Moderate leverage (30-75%)
- Total return expectations of 18%+ plus.

Fund-Raising Update

We are seeing fund-raising in the industry slow down as commitments from institutional limited partners (LPs) decrease because of the dreaded *denominator effect* (when devaluation of public equity, fixed-income securities and other pension fund investments precipitously cause institutional investors to become overallocated in areas that have more stability in value, such as private equity/illiquid assets. LPs may be required to scale back investments in those overallocated areas).

However, investors that carved out a standalone allocation to infrastructure before June 2008 are continuing to make commitments. LPs that are allocating to infrastructure out of their private equity allocation or real estate allocation are finding it difficult to meet their stated allocations. The single most common im-

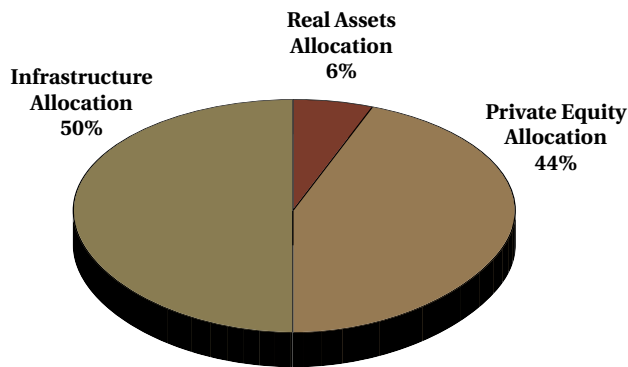
pediment for a pension fund in regard to infrastructure investment is deciding where the infrastructure allocation resides in the overall portfolio.

On average, 44% of the time investors classify infrastructure as a part of their overall private equity allocation; 50% of the time investors are creating a standalone allocation to infrastructure as a separate asset class; and 6% of the time institutional investors view infrastructure as a subset of real assets/real estate.

The United States is poised to be one of the largest emerging economies for infrastructure projects. *Public-private partnerships* (PPPs) are contractual agreements formed between a public agency and a private sector entity that allow for greater private sector participation in the delivery and financing of infrastructure projects (*Source: U.S. Department of Transportation—Federal Highway Administration*). Although as of today PPPs haven't been widely accepted (26 states have passed legislation) the political environment is evolving, with infrastructure initiatives gaining traction.

Paradigm Shift: A recent statement by the U.S. Department of Transportation

Where Does the Allocation Reside in the Pension Fund Portfolio?



Source: Capital Innovations Research 2008.

stated the following: “An increasing number of public transportation owners are transferring their program management responsibilities to private sector firms. This is particularly true with larger and more complex projects and even entire capital programs which benefit from strategic planning. In addition to coordinating environmental studies and approvals, engineering tasks, and construction activities, many of today’s private program management contracts involve financial planning as well.”

It is evident that infrastructure investing will play a vital role in both emerging and developed economies and in improving people’s living standards worldwide. One need only consider all the bridges in disrepair in the United States (for example, the *American Society of Civil Engineers 2005 Report* shows that more than 5,500 Pennsylvania bridges desperately need repairs) and examine the number of deaths related to dirty water on a global level (the Center for Disease Control in 2007 cited unclean water as the single largest cause of deaths worldwide).

One of the most peculiar situations we see is that the United States is one of the few developed countries that has not developed its own energy policy. To reduce dependence on foreign oil and create jobs, the United States could capitalize on a tremendous range of opportunities in energy and alternative energy.

The *2007 OECD Infrastructure Report to 2030* provides insight into developed economies that need to replace aging infrastructure, as well as how economic drag due to lack of infrastructure invest-

ment significantly impacts gross domestic product. To help their economies grow, developing economies need to build out critical facilities in transportation, energy, social infrastructure and environmental services. Infrastructure improvements would serve as a foundation or “seed” for future growth.

In the last few years, the infrastructure markets have not been immune to the run-up in asset prices following the excessive liquidity days. Now that the credit markets have imploded, there is less leverage available for deals. This dynamic is driving down the prices of these assets. Assessment of the current infrastructure investment environment now reflects assets with more attractive pricing and target internal rates of return that can be achieved with less leverage and less risk. However, Energy Capital Partners conducted a recent survey where they found that over \$9 billion in debt had been raised in October and November 2008 for the utility sector alone, with more than \$1 billion being raised in the first month of December as well. This illustrates that debt capital remains available for this sector.

Investment professionals are seeing more and more distressed *sellers* (but not distressed assets) in the market. This is creating an attractive supply of assets for investors with money available for infrastructure investing. This phenomenon is unlikely to go away any time soon, so the investment cycle for infrastructure is just entering the first inning of what looks like an extra inning slugfest.

In addition to the increase of private

sellers in the market, many municipalities urgently need to upgrade or repair public assets at the same time revenues are declining and the municipal bond market is nonexistent. Situated between that rock and a hard place, these entities have no viable options other than selling assets to private investors or hoping that their bridges don’t fall into their rivers. (And we all know that hope is not a strategy.)

Finally, since the credit market meltdown, Capital Innovations’ Global Industry Research Department has discovered a large gap between firms’ expectations for exiting assets versus their historical results. This issue has become especially evident in the renewable energy sector.

In a random survey of approximately 40 funds, Capital Innovations found that while two-thirds of renewable energy/clean technology funds preferred initial public offerings (IPOs) as their exit strategy, only 39% of the exits to date in this sector have come via IPOs (*Source: Capital Innovations Research Department, September 2008*). The collapse of the credit market threatens to further exacerbate this problem in the short term, and firms must carefully consider the plausibility of exit strategies when buying or holding assets. Perhaps instead of seeking funds with IPO experience, investors should seek fund managers with workout experience.

Investment Strategies

Infrastructure investments may be utilized in a multitude of ways.

First, they offer pension funds the ability to implement an “immunization structure,” which is an investment program that seeks to defease future pension obligations by acquiring securities (or assets) whose duration equals the timing of an investor’s liabilities. The long-term steady cash flows offered by these investments are well-suited for asset-liability matching structures. In addition to providing this immunization benefit, infrastructure investing may be used to allow pension funds to match long-term liabilities with long-term assets that offer yields above long-term actuarial rates, reducing funding costs.

These tangible assets offering the long-life cash flows provide for a stable, low-volatility investment profile suitable

for long-term institutional investors. Those investors include public pension funds seeking stability, corporate retirement plans that are interested in utilizing liability-driven investment models and nonprofit investors that seek return-generating investments with a low degree of correlation to other assets in their portfolios.

General partners are viewing infrastructure as an attractive asset class when compared to other private equity strategies, which has resulted in a significant focus on getting infrastructure deals done regardless of size and complexity. Brownfield or existing infrastructure assets (telecoms, power, oil and gas, rail, roads, bridges, tunnels, water, ports, airports, petrochemicals, mining, utilities, stadiums, property and tourism development, private and public partnerships) are backed by a long institutional history of strong and steady cash flows. This element diminishes the financing compared with other types of privately held assets.

Capital Innovations' market research finds most market participants appear to be pleased that the leverage in the market has come down. In the recent past, several investment professionals in the market thought that assets were being bid too aggressively and that with the aggressive bids, the only way to reach internal rate-of-return (IRR) targets was to increase the use of leverage. Now, asset managers seem less willing to "play IRR chicken" or "first man to blink" and bid aggressively and use leverage as they had in the past. This phenomenon has created an improved environment for investors. Today, there is an atmosphere of less risk with less leverage, and asset prices have fallen to a point where they are selling at very attractive levels.

Lenders need to make loans, as that is their mandate and it remains their main source of operating income. If lenders are going to make loans, they would surely scour the universe for the least risky ones. Less risky loans include those with an asset as collateral; those with a low loan-to-value ratio on an asset; those with an asset that does not display a lot of volatility; and finally, those with an asset that has positive cash flows instead of negative ones (and steady, predictable ones at that). One cannot fathom any asset that is more favorable from a lender's stand-

point in an environment with loan-to-value ratios rising daily.

So, net-net, asset managers exult in taking risk off the table, as do their investors. Moreover, lenders are all too happy to make loans with less risk on assets—loans they had previously seen as among their least risky to begin with.

Looking Ahead for 2009

Infrastructure investing will continue to increase in popularity, similar to the way real estate investment trusts grew from \$40 billion concentrated in the United States in 1990 to a \$700 billion global market in 2006 (*Source: National Association of Real Estate Investment Trust*).

Capital Innovations' global research platform has conducted due diligence on over 300 investment management firms and more than 500 individual infrastructure investment vehicles in the defined universe. The pace of infrastructure fundraising has not abated, with over USD \$14 billion in capital being raised in the first two quarters of 2008. More than 100 funds in the market are presently raising capital for over USD \$100 billion in infrastructure investments (*Source: Capital Innovations Research, September 2008*).

Rebuilding the United States will create jobs for Americans. Capital Innovations believes it is critical for the United States to rebuild its transportation infrastructure, including its highways, bridges, roads, ports, and air and train systems. Investing in national infrastructure bolsters user safety, increases the nation's long-term economic competitiveness and ensures the economy will continue to grow. It is especially important in the fight against international terrorism as well as natural disaster prevention efforts. The bulk of the United States' infrastructure was created in the boom of the 1950s and needs replacement. This fact has been recognized by the American Society of Civil Engineers, who gave the United States' infrastructure a rating of "poor" in 2005 (*Source: ASCE's 2005 Infrastructure Report Card*).

A robust federal infrastructure investment program today will help strengthen the U.S. economy, creating at least one million jobs in the United States, according to Capital Innovations' analysis. This increase in jobs is particularly valuable as

the housing, construction and manufacturing industries slow. The construction industry's workforce has decreased by approximately 400,000 workers, or 5% of its labor force, since the end of 2004 (*Source: Bureau of Labor Statistics*). More disconcerting, the manufacturing industry has been in rapid decline, losing more than four million workers, or almost a quarter of its workforce, since 1998. Transportation manufacturing—the production of motor vehicles, railroad rolling stock, planes and ships—has mirrored the trend of its parent group, losing 24.3% of its labor force, about 500,000 workers, since the end of 2004 (*Source: Bureau of Labor Statistics*).

A report to the National Governors Association 2008, *Economic Recovery: A Federal-State Partnership*, lists infrastructure programs with ready-to-go projects that will create new jobs as being one of the categories of federal-state programs with the greatest potential to assist with economic recovery efforts. The report spells out what billions of dollars in spending on highways, transit, airports and airways, passenger rail, wastewater, drinking water and affordable housing would mean in job creation. For instance, every \$1 billion in transportation infrastructure spending generates approximately 35,000 jobs and \$5.7 billion in additional economic activity. "According to research compiled by the American Association of State Highway and Transportation Officials, more than 3,000 ready-to-go highway projects totaling \$18.9 billion could be under contract within the next 30 to 90 days if additional federal funds, above the 2008 funding levels, are made available," says the report issued in mid-November. Transit agencies have \$3.6 billion in ready-to-go projects that could be implemented early in 2009 with additional federal funding and could initiate as much as \$32.4 billion in projects over the following two years. Add to that \$4 billion for safety, security and capacity infrastructure at airports; \$9 billion for wastewater infrastructure; nearly \$6 billion in drinking water infrastructure; and \$4.8 billion in capital investment to maintain the existing stock of public housing.

All of these factors are likely to make 2009 one of the best vintage years on record for this asset class, which will be good for the market as many new inves-

tors are just now becoming aware of the attractiveness of infrastructure investing.

In a world where the stock market is plummeting, interest rates are low, credit is tight and investors are nervous, where are investors going to find a viable investment that will give them an attractive return and allow them to sleep at night? The answer is hard assets in general and infrastructure in particular. **B&C**



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