Keynote Address

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What do you see as the most important changes taking place in the infrastructure market today?

2015 was marked with opportunities in the infrastructure sector for the next decade, most of which are supported with strong backing by governments. The most noticeable events that took place during 2015 include:

- Australia, one of the favourite destinations for infrastructure investors, delivered its first top-down audit of nationally significant infrastructure earlier this year. The audit confirms existing and emerging gaps and the government is already in the process of producing the 'Australian Infrastructure Plan', which will create a priority list of nationally significant proposals for consideration by all levels of government, as well as opportunities for the private sector.

- The emergence of The Asian Infrastructure Investment Bank (AIIB): a multilateral development bank, that will focus on the development of infrastructure and other productive sectors in Asia, including energy and power, transportation and telecommunications, rural infrastructure and logistics. The AIIB is expected to begin its operations by the end of 2015.

- From an investor's perspective, pension plans, especially the Canadians, have shown impressive growth in investment capabilities and scale to invest and manage infrastructure assets. This is supported by their proven track record, with the top 10 Canadian pension plans tripling their total assets under management between 2003 and 2014, with 80% of the increase in value derived from investment returns.

Do you see more investors looking at infrastructure? Are there any specific types of institution that are showing particular interest at present?

Investors are showing continued interest in increasing their allocation to the asset class. Many institutions, including some of the large insurance companies, have expressed their intentions to revise their target infrastructure allocations to 3-8% of total assets under management over the next decade, up from around 1-3% at present. There has also been an influx of new entrants to this asset class. According to Preqin, the number of institutional investors actively investing in infrastructure has more than doubled since 2011. We have seen a number of investors emerging from Asia, namely Japan and Korea, who are extremely active in their infrastructure investing. The vast majority of these investors are still accessing infrastructure through unlisted vehicles.

Are you seeing changes to the way institutional investors structure their infrastructure portfolios, such as more direct investments or co-investments?

Investors are increasingly seeking alternative structures to traditional pooled funds. The route via which investors invest in infrastructure has undergone considerable change over the past several years, with a greater number of them now seeking to invest directly in infrastructure assets. According to a survey by Preqin, the number of investors with appetite for direct infrastructure investments has almost doubled since 2012. Large sophisticated investors are looking for ways to do club investment and increase their investment power. The benefits of the 'club investment platform' means better alignment of interest – eliminating blind pool risks – participation on a transaction-by-transaction basis, favourable fees and carried interest, local knowledge and influences. An example of such a club investment platform is the recently announced partnership led by the California State Teachers' Retirement System (CalSTRS), which plans to develop a multibillion-dollar global syndicate for infrastructure investing.

To what extent are investors focused on brownfield assets in developed markets? Is there interest in development opportunities or emerging markets?

The majority of infrastructure investors will focus on brownfield/operating assets as they become increasingly familiar with the individual markets and sectors. Investors with a long track record of investing in the asset class and a program that allows them to diversify and increase their risk profile are in a better position to take up more risk, which allows them to benefit from attractive developer premiums in many asset classes within infrastructure.

The demand for infrastructure investment in developing markets is substantial; however, the risk profile is different to investments in OECD markets, which are more focused on replacing and refurbishing the existing infrastructure stock. The greenfield nature of infrastructure investment in emerging markets normally results in a higher risk profile, particularly related to construction risk and forecasting demand/utilization. There is expected to be an active role for private capital in Asian infrastructure, with the Asian Development Bank forecasting an estimated $8tn in infrastructure investment in Asia by 2020 (data from 2010).

One of the biggest challenges in emerging markets, especially in Asia, is the relatively short history of the asset class and the managers' track record. In addition, transactions in emerging markets are often smaller in comparison with opportunities in OECD markets, which results in smaller fund sizes in the region. Hence, many fund managers remain niche and specialized on certain sub-sectors within infrastructure (i.e. energy). As track record is limited with many of these fund managers in emerging markets, evaluating a team and its prospects for success can be very challenging.

What are investors' biggest concerns in the market at present? How can they mitigate these?

The number of viable investment opportunities will be a key issue in the current infrastructure market. With the increasing capital competing for deals in the asset class, investors are concerned with pricing and whether there are enough attractive opportunities available at present.

Capital is flowing from the world's pension plans and institutional investors (i.e. insurance companies) into infrastructure assets across the globe at an extraordinary rate. The competition is driving a higher than ever premium on the long-term stable cash flow asset class. This results in reduced returns which may not adequately compensate investors for the risks involved over a long period of time. In fact, we have seen managers reducing their target returns from double digits to high single digits for core infrastructure asset investments.

The result of this phenomenon would encourage investors to turn their focus to businesses that demonstrate infrastructure-like returns and cash flows or start investing in assets in much earlier stages of its life cycle (i.e. taking on construction risk).

What should investors be looking at closely when evaluating infrastructure managers?

Many lessons were learned from the mistakes investors made in the past few years. Investing in infrastructure is more than pure financial play; in-depth sector knowledge and the ability to operate the assets have proven to be the key to success. Limited partners must get comfortable with all these critical points through due diligence before making a commitment. A prudent infrastructure fund investor must be aware of the distinct characteristics of the asset class and know the right questions to ask during the diligence process. There are several key aspects of fund diligence in the infrastructure space:

- **Identifying the right manager:** An essential but challenging task, particularly in a rapidly developing asset class. Rigorous qualitative analysis of a team's skills and dynamic is critical, especially with regard to emerging managers. A successful team should demonstrate a mix of both financial and technical expertise, together with the operational and regional/country knowledge and networks necessary to allow them to successfully execute their strategy.

- **Deal sourcing capabilities:** Especially true within infrastructure where deal flow may be limited and participation may be restricted. Investors should review the manager's ability to attract proprietary deal flow, pricing discipline in an auction process and ability to discern value, as well as the manager's relationship with key stakeholders (i.e. promoters, banks, regulators).
- **Fund structure and fees:** Does the proposed fund structure match the target strategy? Investors should also consider its own objectives and liquidity positions, and determine whether the proposed fund structure is a good fit to their portfolio. For example: does the manager provide investors with liquidity options at an evaluation point?

How competitive is the fundraising market at present?

The current infrastructure fundraising market is defined by the large number of funds on the road seeking unprecedented levels of capital, with at least two funds each seeking over $10bn in commitments from LPs. The consequence of this is an increasingly congested fundraising market, with success achieved by fund managers with the most attractive offerings only. We also expect managers with strong brand names to close with relative ease. While some of the largest and most sophisticated institutions are moving away from fund investments and operate direct infrastructure investment programs instead, the unlisted fund model will continue to play a vital role in private investments in the asset class. In order to successfully raise capital, fund managers will need to be able to effectively communicate how they can find and create value in the current market in order to successfully secure investor commitments.

Are the fees charged by infrastructure funds evolving?

Generally speaking, across all asset classes there is mounting pressure on both management fees and carried interest level, with the infrastructure asset class experiencing the most pressure given the relatively modest return expectation. However, investors also recognize that an adequate level of profit sharing is required to fairly compensate the manager's skill and expertise. According to data compiled by Preqin, among private infrastructure funds currently raising or those with a 2014/2015 vintage, 37% charge a management fee of 2%. That figure is down significantly from 2012/2013 vintage funds when 57% charged a management fee of 2% or more.

Alternative fee arrangements are emerging; while it is unclear whether they are just ways for general partners seeking to differentiate themselves or are evidence of a trend, they provide an interesting counterpoint to the traditional private equity structure. Examples of discussions around fees include: 1) should the GPs charge management fees throughout the commitment period or just on invested capital, or charge no management fees at all?; or 2) should the carried interest of a brownfield core infrastructure fund be compensated based on cash yield instead of on the traditional IRR basis? Today, investors are taking a very active role in assessing the most appropriate way to gain exposure without dissipating returns, asking questions such as: "What is an appropriate management fee level?" or "How much carried interest should limited partners pay to fairly compensate the GP's value-add and ensure interests are aligned?" deserve renewed attention and consideration.

What are the key things you look for in the managers you work with?

At MVision, we always take on an investor's mindset. We follow the "five Ps" principal: people, process, performance, philosophy and portfolio. We spend a huge amount of time on each of the Ps before we decide to work with a manager. The manager should be able to demonstrate its dedication in the targeted segment, be supported by a strong track record and have a team of professionals that have worked together in some sort of capacity. The strategy should address a gap in the market or provide unique solutions to existing issues with its differentiated approach. The GP's process should be robust with sound corporate governance.

Is the role of a placement agent/ fundraising advisor changing?

Placement agents acting as a distributor will be left behind. Today, fundraising advisors like MVision are expected to demonstrate extensive knowledge in the asset class, combined with a thorough understanding of the potential issues which investors may encounter. We are solution providers, where creativity is key. The ability to structure, value and provide suggestions on enhancing governance in the partnership will be required.