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Key Markets: South America

Paul Bishop looks at the latest developments in the unlisted infrastructure market in South America, including recent fundraising stats, a look at the deals data for the region, and investor appetite for South America-focused investments.

The South American Investment Environment

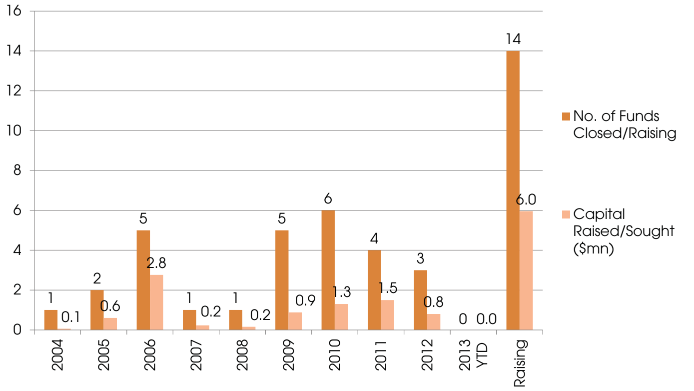
South America has become a region of considerable interest to infrastructure investors worldwide. With the region's existing infrastructure in need of serious investment to meet the challenges of this rapidly emerging economic hub, significant opportunities are to be found within South America. A region encompassing major developing nations, including Brazil, the IMF predicts South American real GDP growth of 4.5% in 2013, and 4.3% in 2014. Brazil alone is expected to experience real GDP growth of 3% in 2013 and 4% in 2014. Due to the high number of developing and emerging economies within the region, there is a strong need for upgrades to ailing infrastructure and development of new economic and social infrastructure to support economic growth.

In addition to the developmental drivers behind the requirements for investment in infrastructure, there are also several non-economic, unique factors that combine to heighten the requirements of certain countries within South America. For example, the Chilean earthquake in 2010 seriously damaged a large amount of national infrastructure in the country, meaning that investment in improvements and repairs are desperately needed.

Perhaps one of the largest non-economic factors is the hosting of large-scale global events in Brazil over the coming four years. Brazil will be playing host to the Olympic Games in 2016 and will also be hosting the FIFA World Cup in 2014. As a result, the country has embarked on a vast infrastructure investment program to meet the challenging demands of these events. Brazil launched the Growth Acceleration Program (PAC-1) in 2007 under the administration of Lula da Silva, with a budget of BRL 503.9bn ($237.6bn). The original program included a set of economic policies, regulatory reform, and investment projects designed to accelerate economic growth through infrastructure investment.

As a result of these factors, South America presents investors in infrastructure with attractive opportunities. In this feature article, we provide a top-down examination of the infrastructure universe as it currently stands in South America.

Fig. 1: Annual South America-Focused Infrastructure Fundraising, 2004 - 2013 YTD (As at 7 June 2013)



Source: Preqin Infrastructure Online

Fund Managers Active in the Region

There are currently 50 fund managers which actively target South American infrastructure investments. Historically, 33 South America-focused funds have held a final close, raising $10.0bn in investor capital. Twenty-eight of these funds have closed since 2004, raising a total of $8.4bn. As shown in Fig. 1, there are also 14 unlisted infrastructure funds currently in market looking to capitalize on the infrastructure investment opportunities in South America. These 14 unlisted funds are seeking an aggregate $6bn in investor capital.

It is important to note that in order to support growth in the region, the Inter-American Development Bank estimates that investment in infrastructure needs to double from 2.5% of GDP to 5%. With plans for half the increase in capital to be sourced from the private sector, the IADB estimates this equates to roughly $100bn of private investment per year. This suggests that, based on the capital sought by infrastructure funds shown in Fig. 1, the unlisted infrastructure fund universe is only potentially providing approximately 6% of the capital the IADB estimates is required from private sources to meet

Fig. 2: Top Five South America-Focused Unlisted Infrastructure Funds by Final Close Size

Fund	Fund Manager	Final Close Size (mn)	Fund Manager Location	Year of Final Close
Transelec Transmission	Brookfield Asset Management	USD 1,368	Canada	2006
P2Brasil	Pátria Investimentos	USD 1,155	Brazil	2011
PineBridge-GE Capital Latin American Infrastructure Partners	PineBridge Investments - Infrastructure	USD 1,013	US	1997
FIP Brasil Energia	BTG Pactual	BRL 1,200	Brazil	2005
InfraBrasil Fundo de Investimento em Participações	Mantiq Investimentos	BRL 1,000	Brazil	2006

Source: Preqin Infrastructure Online

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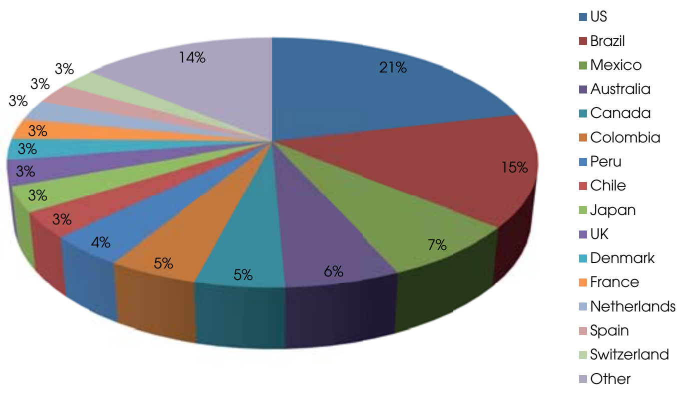
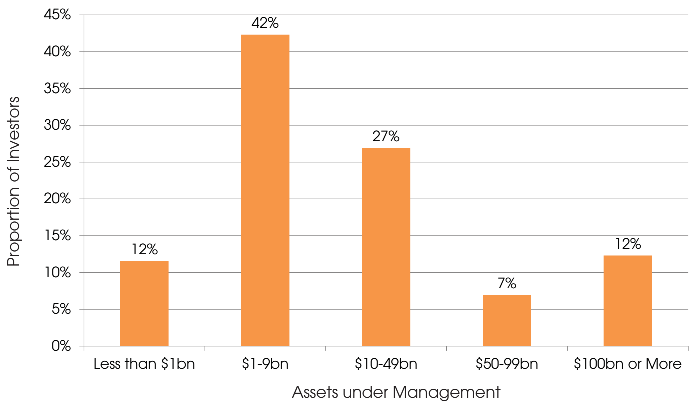
Fig. 3: Breakdown of Infrastructure Investors with a Preference for South America-Focused Investments by Country Location



Source: Preqin Infrastructure Online

Fig. 4: Breakdown of Infrastructure Investors with a Preference for South America-Focused Investments by Assets under Management



Source: Preqin Infrastructure Online

growing demand for infrastructure investment. This is optimistic for fund managers and points to the incredible potential for growth in the region.

Fig. 2 shows the largest unlisted infrastructure funds that invest in the region. Brookfield Asset Management has closed the largest fund targeting the region, raising $1.4bn for its fund Transelec Transmission. Three of the largest unlisted infrastructure funds to have closed with a focus on South America have been raised by Brazil-based fund managers. Notable local managers include Brazil-based Pátria Investimentos, which raised a $1.16bn fund focusing on energy, natural resources, transportation, logistics, water and waste management. Similarly, Mexico-based Infraestructura Institucional has raised a MXN 2.7bn fund, which seeks exposure to assets in the transportation, energy, water and healthcare sectors.

However, foreign fund managers have also been quick to recognize the potential for investment in South America. Although the majority (60%) of the total number of fund managers active in South America are based on the continent, a significant proportion are located offshore, with foreign fund managers accounting for 40% of all managers active within South America. In terms of capital raised historically, foreign fund managers have raised $5.2bn of the $10bn raised targeting the region historically. Additionally, in terms of funds on the road, funds raised by managers based outside of South America account for 43% of vehicles currently in market, and $2bn of the capital being sought.

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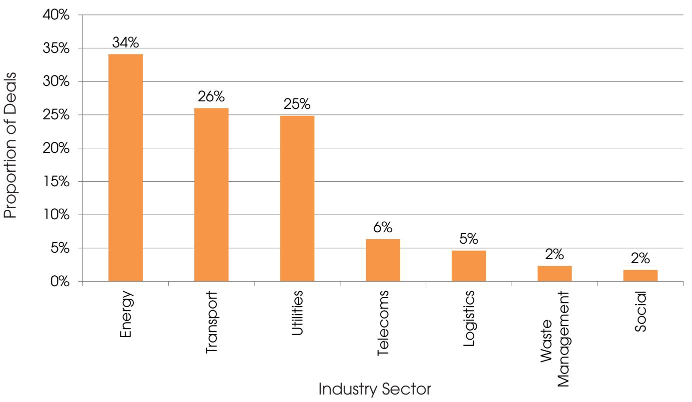
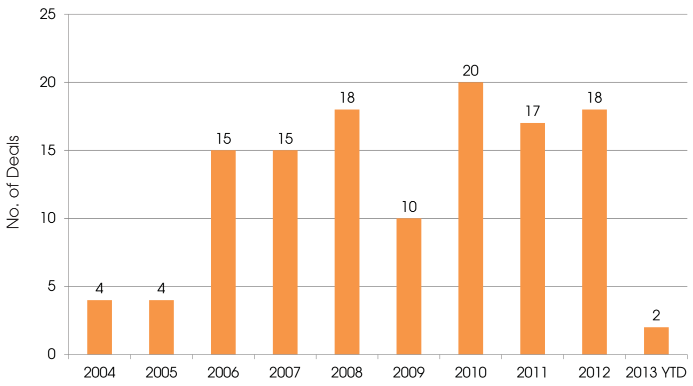
Fig. 5: Breakdown of Infrastructure Deals in South America by Industry Sector, 1994 - 2013 YTD (As at 7 June 2013)



Source: Preqin Infrastructure Online

Fig. 6: Annual Number of Deals Made in South America by Unlisted Infrastructure Fund Managers, 2004 - 2013 YTD (As at 7 June 2013)



Source: Preqin Infrastructure Online

There has been a general increase in domestic managers raising private infrastructure funds targeting the region, with 57% of these funds on the road managed by South America-based firms. This underscores the current uptake of a privately financed infrastructure investment market by domestic investors. It also points towards the efforts that have been undertaken domestically in terms of regulating for private infrastructure investment and ancillary regulatory efforts, such as PPP legislation, which we will examine later.

Investor Sentiment

The economic and non-economic factors in South America explored above provide the potential for significant opportunities within the region for both foreign and domestic infrastructure fund managers. However, this potential relies on appetite among active institutional investors globally for gaining exposure to South American infrastructure. Currently, only 8.5% of all investors actively investing in infrastructure have a preference for investments in South America.

As shown in Fig. 3, the largest proportion (21%) of investors open to South America-focused infrastructure investment are based in the US. Brazil is second, with 15% of the investors with a preference for South America-focused infrastructure funds located within this country; Mexico third with 7% of the total number. While demand among domestic institutional investors for the private equity model for infrastructure investment is still somewhat low, it is worth noting

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that a large proportion of institutional investors within the region have gained some exposure to the asset class through the uptake of project bonds.

The regulation of pension funds investing in infrastructure has had an important impact on South America. However, significant work has been done to allow institutional investors within South America to acquire exposure to infrastructure funds. The majority of South America-based pension funds are subject to a quantified limit on the amount that a pension fund may invest in unlisted equity, as well as limitations on bonds by credit rating. Mexico has made particular strides to unlock institutional pension fund money for investment in unlisted equity, such as infrastructure. The use of CKDs, structured instruments traded on the Mexican stock exchange, has unlocked significant capital from institutional investors such as pension funds, which could be directed towards infrastructure funds.

As shown in Fig. 4, 42% of investors with a preference for investing in South America-focused infrastructure have assets under management between $1bn and $9bn. Twenty-seven percent have assets under management between $10bn and $49bn. Significant amounts of foreign capital can also be accessed, providing that policy makers recognize the current bottlenecks to investment within the region: primarily regulation, investor uncertainty towards the region, and security of investments. Among domestic-based investors investing in the region, the average assets under management is $41bn. With the average target allocation to infrastructure for all active institutional investors globally standing at roughly 6%, if South America-based infrastructure investors can be persuaded to match this level of allocation some, some $2.4bn of capital would be unlocked by each investor. Serious efforts need to be made by policy makers to rectify any potential barriers to foreign and domestic investment, as noted by the Organisation for Economic Co-operation and Development, which placed specific emphasis on this in a 2012 report.

Deals

So where will fund managers find opportunities to invest capital within South America? The current deal climate in the region provides insight into the most active sectors served by unlisted infrastructure funds currently in South America. As shown in Fig. 5, the largest proportion of unlisted infrastructure deals has historically been conducted within the energy sector (34%) in the period 1994 to 2013 YTD. However, sectors such as transportation and utilities are also well served by unlisted fund managers, making up 26% and 25% of infrastructure deals respectively. Sectors such as telecommunications, logistics, waste management, and social infrastructure are underserved historically, which could be due to regulatory hurdles that preclude investments in these sectors.

Specifically with regard to public-private partnerships in infrastructure, regulatory mechanisms to allow these projects to be privately financed are somewhat lacking in various countries within South America. In addition, the price-hikes and unrest caused by the privatization of Bolivia's water industry may cause regional policy makers to think twice before backing more PPP investments in the region. However, despite this it has been widely noted that significant effort is being made by governments to improve the regulatory situation with respect to PPPs. Mexico has recently allowed toll increases after the initial cost of construction and has extended the lease period for certain qualifying private road concessions. Paraguay is also debating a new law to allow for more public-private partnerships in the country and hopes to pass the legislation by April. Serious effort is being made to allow further private investment in assets outside the traditionally core preserves of energy, transport and utilities. However, given the political dispositions of citizens and policy makers within the region, the concept of allowing private investment and ownership of key social infrastructure may prove a step too far for some.

Conclusion

South America represents a significant opportunity for private infrastructure investors, but the region also has several barriers currently inhibiting a large inflow of capital into the region. Despite these barriers, continued effort within the region to increase private investment in infrastructure means that institutional investors and fund managers would do well to keep the region firmly in mind and monitor developments. With the IMF anticipating emerging economies overtaking developed economies in terms of share of global GDP in 2014, the frontier markets of 2013 could realistically be key markets in the coming years. Infrastructure investors that wish to stay ahead of the curve should ensure they keep abreast of these markets.

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