Preqin Research Report

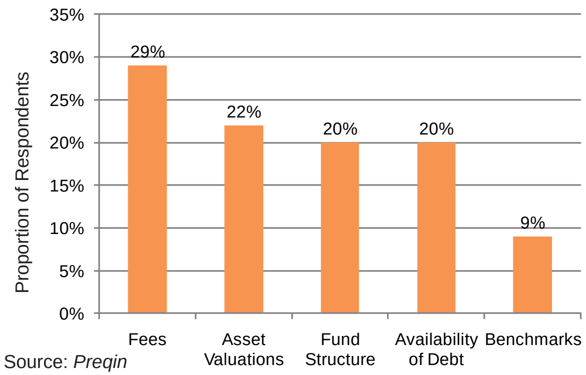
Finding Some Common Ground: Fees, Fund Structure and Leverage (1)

In a recent Preqin survey, 70% of institutional investors stated plans to make further unlisted infrastructure fund commitments in the coming 12 months, up from 40% in October 2009. This increased investor confidence is shown in recent fundraising figures, with 15 infrastructure funds reaching a final close so far in 2010, raising an aggregate $18.7bn. This is already more than double the $7.8bn raised in the whole of 2009.

However, these investors also highlighted several key issues that need to be addressed in order to ensure continued growth within the infrastructure industry. The $18.7bn raised thus far in 2010 is still only just over half the $33.9bn raised in 2008, meaning there is still a long way to go for the industry to reach pre-financial crisis levels. Although this is partly due to lack of available funds for new investments, there are other limiting factors causing investors to hold back from making new commitments.

In order for the asset class to continue to grow, both LPs and GPs need to understand the roadblocks currently limiting investor activity, and then work together to find a resolution. In this month's feature, we examine these issues, and suggest what can be done to overcome them.

Fig. 1: Investor Views on the Key Issues Facing the Infrastructure Industry



Source: *Preqin*

Fees

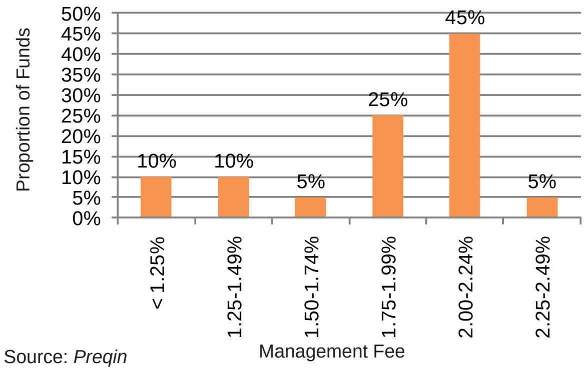
As shown in Fig. 1, management fees and carry structures represent the most pressing issues facing the industry in the eyes of investors questioned by Preqin. Many investors believe infrastructure fees should emulate the risk/return profile of an infrastructure asset, characterized by a lower level of risk rewarded with a lower and more stable level of return. However, in contrast to investor sentiment, many infrastructure fund managers remain reliant on the 2/20 private equity fee structure.

As shown in Fig. 2, 50% of infrastructure funds currently raising capital or those closed with a 2009/2010 vintage charge a 2%+ management fee during the investment period, showing there is a clear discrepancy between what investors expect and what many fund managers are currently willing to accept in terms of fees.

In contrast, 50% of infrastructure fund managers are beginning to address this issue by charging a management fee lower than 2%. This shows that the industry is reacting to LP pressure with prominent private equity firms like KKR and Blackstone publicly lowering their management fee and carry to show their commitment to a mutually acceptable alignment of interests in their infrastructure vehicles.

Preqin's August edition of Infrastructure Spotlight featured an interview with Henri Piganeau, a member of the

Fig. 2: Management Fee Charged During Investment Period, Funds in Market and Vintage 2009/2010 YTD Funds Closed



Source: *Preqin*

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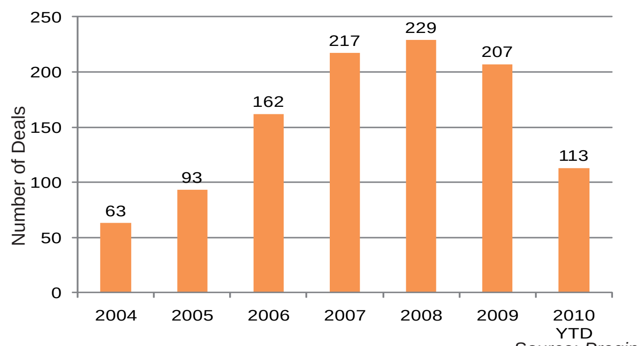
management team of the Cube Infrastructure Fund which recently closed on €1.1bn. Mr. Piganeau highlighted the importance of Cube's management fee structure in attracting investors: "It depends on the size of the ticket of each investor and the recognition that if you manage one investor with a €100mn investment it is easier than managing 50 with €2mn invested each – so it is a reduction by size of ticket."

Going forward fund managers will need to make concessions in order to attract investor commitments. This will include reducing the management fee and/or creating special structures to match investor expectations. As Mr. Piganeau stated, the successful fundraising of the Cube Infrastructure Fund relied on LP and GP cooperation: "There are 22 investors, and they and their lawyers all have different requests. We came to a fair compromise."

Asset Valuations and the Availability of Debt

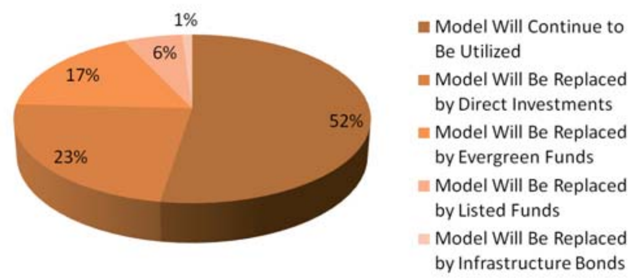
42% of investors surveyed believe both asset valuations and the availability of bank debt are a problem in the current environment. As shown in Fig. 3, 2010 deal flow is significantly down on previous years, which is in part due to the relatively sluggish fundraising market, but

Fig. 3: Number of Deals Completed by Unlisted Infrastructure Fund Managers, 2004 - 2010 YTD



Source: *Preqin*

Fig. 4: Investor Views on the Future of the Private Equity Fund Model in Infrastructure Investment



Source: *Preqin*

also to vendors' unrealistically high asset valuations and the continued reliance on debt to finance infrastructure projects.

Infrastructure investments traditionally require a significant level of debt financing, but the ongoing impact of the financial crisis means banks are now less willing or able to allocate this amount of debt. One surveyed investor commented: "Maximum debt levels should not exceed 35% of total value. It is ridiculous that so many infrastructure deals use such high levels of leverage." In order to combat this, fund managers must be willing to increase the equity-to-debt ratio associated with infrastructure deals and vendors need to address their price aspirations.

Fund manager industry knowledge is also vital to overcoming these issues. Knowledge of a specific infrastructure industry will ensure fund managers are able to source appropriately priced assets and counteract the risks associated with high proportions of leverage.

Fund Structure

Fig. 4 shows that the majority of infrastructure investors (52%) believe the private equity fund model will continue to be utilized in the infrastructure asset class over the long term. However, these investors are concerned that the existing model does not correlate with the long-term

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nature of infrastructure assets and is more suited to the investment life of a private equity company. Building flexibility into fund commitments is one way in which liabilities and investment horizons can be matched – for example giving investors the opportunity to maintain an interest in underlying fund investments after a typical twelve year period.

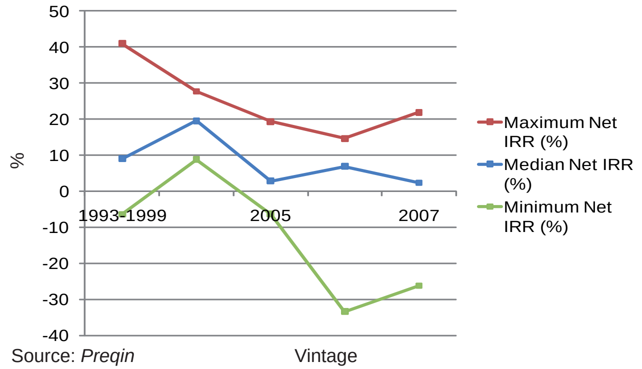
What is clear is that concessions must be made by the fund manager in order to compensate for investor demands. In the short term a reduction in fees would represent the most obvious catalyst to ensure the continued growth of the infrastructure sector via the use of the private equity style fund structure, although other funding models are also an option including direct investment and evergreen funds.

Benchmarks

Infrastructure benchmarking continues to be an issue due to the relative immaturity of the majority of funds in the asset class. Investors are naturally concerned due to the lack of solid data to confirm the level of returns to be expected when making infrastructure fund commitments. However, despite the immaturity of data for the more recent funds, Preqin can begin to analyse the performance of older vehicles for an indication as to what investors can expect from younger funds. In total, we hold performance data for 82 infrastructure vehicles with total capital commitments of over $100bn.

Fig. 5 illustrates the median net IRRs since inception for infrastructure funds of groups of older vintages, as well as the current maximum and minimum net IRRs for more recent vintage years. As expected, median net IRRs for the most recent vintages remain around the 0% mark, but there is evidence that older funds have delivered reasonable returns. Infrastructure funds with a vintage 1993-1999 have yielded a 9% median net IRR, which increases to 19.5% for funds of vintages 2000-2004. This

Fig. 5: Median, Maximum and Minimum Net IRRs for Infrastructure Funds of Vintages 1993-2007



Source: *Preqin*

is in line with what the majority of funds are currently targeting, with 76% of infrastructure vehicles targeting a net IRR of between 10% and 20%. As the industry matures, it will be possible to maintain reliable individual year benchmark figures, which will make it far easier for investors and advisors to objectively assess performance results of various managers and of the overall industry.

Outlook

Both investors and fund managers are certainly agreed on the huge growth potential within the infrastructure sector. Investor confidence is slowly returning following the lows suffered in the immediate aftermath of the financial crisis, there are a record number of funds on the road in which to invest and the need for global infrastructure development has never been greater.

However, although there has been a recent resurgence in the ability of infrastructure managers to raise capital from institutional investors, further development of the asset class is reliant on the resolution of the key issues identified in this article, and this can only be achieved by greater cooperation between fund managers and investors. With investors now wielding significantly more power when negotiating the terms of new vehicles than in previous times, fund managers must ensure that the key issues of fees, structure and debt are carefully considered when assembling PPMs. Although in some cases higher fees and highly leveraged strategies may be justifiable, it will become increasingly necessary to communicate the reasons for this in order to appease investor concerns in what remains to be an extremely challenging fundraising market.

To view further analysis of the infrastructure survey results and the full interview with Henri Piganeau, please visit:

www.preqin.com/docs/newsletters/INF/Preqin_Infra_Spotlight_Aug_2010.pdf