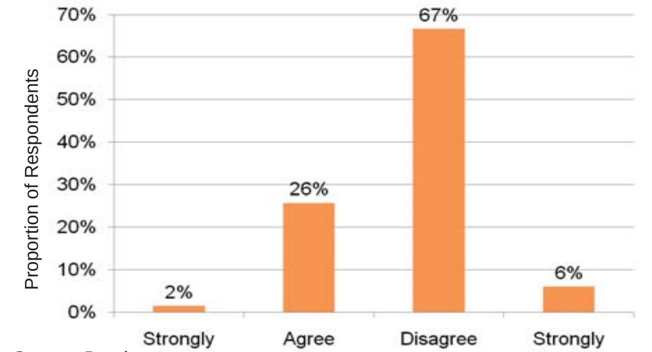
Preqin Research Report
Infrastructure: Lost in Transition? (1)

The unlisted infrastructure market is in a period of transition. Therefore, in June 2010, Preqin surveyed institutional infrastructure investors from around the world to find out more about investor sentiment towards the key issues facing the asset class. Respondents were asked about their views on the alignment of investor and fund manager interests, specific issues such as management fees and carry structures, the future of the private equity fund model in infrastructure, and their future plans for infrastructure investment.

Alignment of LP and GP Interests

As shown in Fig. 1, almost 75% of investors surveyed disagree or strongly disagree that the interests of investors and fund managers are properly aligned. Many investors highlighted the discrepancy between the risk/return profile of infrastructure assets and the level of management fees charged by fund managers utilizing the private equity fund model. Others suggested that there is a fundamental difference between the reasons why investors look to gain exposure to infrastructure assets (such as for long-term, stable yield) and the profit-orientated aims of fund managers when raising an infrastructure fund.
One investor stated: "There is too much reliance on the private equity fund model, essentially the 2 and 20 structure," while another claimed: "I believe [interests] are trending in the right direction, but most are still trying to apply the private equity model, which may not work for core and core-plus type infrastructure investments."

Fig. 1: Extent to Which LPs Believe that LP and GP Interests Are Properly Aligned



Source: *Preqin*

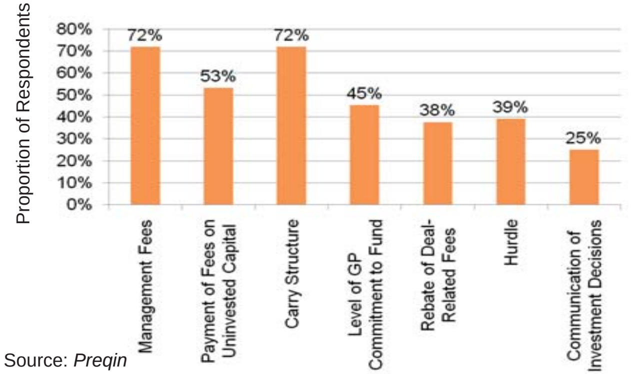
Infrastructure projects are characterized by a lower level of risk and a longer holding period than private equity assets, meaning investors are concerned about the reliance on a relatively short-term fund model for long-term infrastructure assets. One respondent reflected this concern saying: "There is tension between the long-lived nature of infrastructure assets and the shorter-term focus of private equity funds, which call for shorter holding periods, realizations and distributions of capital, profits and carry."

However, just over a quarter of those investors questioned believe interests are aligned. One respondent commented: "In Australia they are. The market mainly consists of fund managers running open-ended infrastructure funds rather than closed-ended private equity-style funds." This statement reflects the notion that other fund structures, such as open-ended or evergreen funds, may be better suited to infrastructure investment than the private equity fund model.

Areas of Improvement

Specific areas in which investors believe interests need improving are shown in Fig. 2. The level of management fee charged and carry structures were the most prevelant areas perceived to be in need of improvement, with 72% of investors citing each issue as a problem. One investor stated: "The fee structure is set up for an asset class capable of returning 20%, but expected [infrastructure] returns are much lower than that."

Fig. 2: Areas in Which LPs Believe that Alignments of Interest Can Be Improved



Source: *Preqin*

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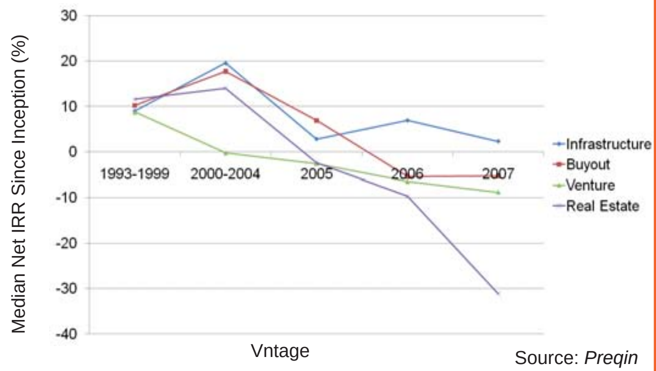
According to Preqin data, the majority of unlisted infrastructure funds (76%) target a net IRR of between 10% and 20%. This is lower than the level of returns traditionally sought by fund managers operating private equity or real estate funds. Also the potential for very high returns is much lower in infrastructure than in these other strategies, with only 2% of infrastructure funds targeting an IRR of over 25%.

As shown in Fig. 3, when compared to other private equity strategies, older infrastructure funds have performed well, with the median net IRR for funds of vintages 1993-2004 at a similar level to both private equity and real estate. However, this is as a result of the limited number of unlisted infrastructure funds in existence prior to 2005 and the abundance of highly profitable opportunities in need of financing during this period. It is still too early to make solid performance predictions about more recent funds, but the likelihood is that future IRRs will be towards the lower end of the 10-20% range. Therefore infrastructure investors are largely unwilling to buy into the traditional 2/20 fee structure, when forecasted infrastructure returns are less than in private equity.

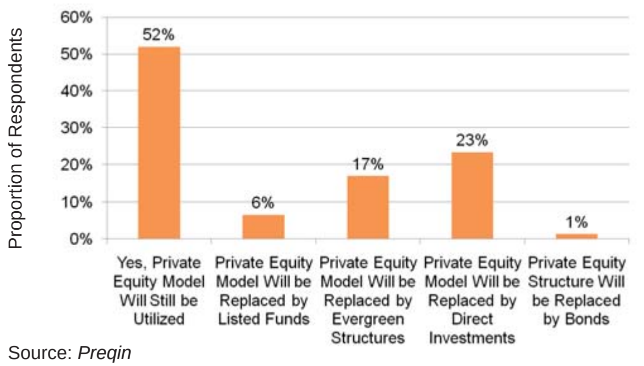
One investor suggested that the fee structure often utilized by core real estate funds is a more appropriate model for infrastructure,

Fig. 3: Infrastructure vs Other Private Equity Strategies - Median Net IRR



Source: *Preqin*

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



Source: *Preqin*

stating: "Management fees should likely resemble what is seen in real estate as you move from core to opportunistic infrastructure. For core investments, the hurdle should be a moving target (i.e. real return or a premium over LIBOR)." This suggests that fees should be based on the risk/return profile of the fund and the types of infrastructure assets being targeted. Another investor commented: "It is simple. Managers should earn significant money (above cost recovery) only when investors earn decent returns."

Aside from management fees and carry, investors also highlighted several other issues that they feel need to be resolved to improve alignment. 53% of investors take issue with having to pay fees on capital that has not yet been invested, while 45% think fund managers need to address their level of commitment to their own funds. 25% of investors surveyed believe there needs to be greater interaction between investors and fund managers when making investment decisions.

The Future of the Private Equity Fund Model in Infrastructure

As previously stated, the use of the traditional private equity fund model in infrastructure investment is a heatedly debated topic. As shown in Fig. 4, over 50% of investors surveyed believe the private equity model will be utilized going forward, although this is dependent on the resolution of key issues already raised such as fund structure and fees. Of those investors that believe the private equity fund model will not be used in the future, almost

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half think it will be replaced by direct investment, although this will limit the level of exposure smaller investors are able to gain to infrastructure assets.

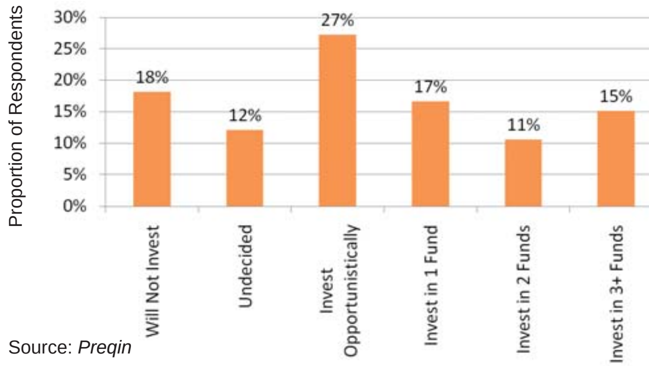
Direct investment is attractive to investors as it removes the cost of third-party fund manager fees. A growing number of large infrastructure investors are beginning to turn to direct project financing to avoid paying fees and maximize returns as they gain more experience in the asset class and become more confident in executing infrastructure deals themselves. However, the resources required to make direct investments means they are an unrealistic option for smaller investors, so a solution to the issues relating to the private equity fund model is essential if these investors are to continue investing in the asset class.
One investor believes that the fund model used will depend on the type of infrastructure fund being raised, stating: "I do [believe the private equity model has a long-term future in the asset class] but core strategies might be best accessed through open-ended funds, while opportunistic infrastructure might be best in a private equity structure. Direct investments are the best way to access the asset class, but are not a viable option for the majority of investors." In this case, an option could be to tailor fund structures based on the type of infrastructure assets being targeted.

Similarly, another investor suggested that fund structures could be tailored to individual investors in the future as well as to certain asset types, saying: "More customized structures for smaller groups of investors may be a likely avenue, including some advanced structures for public private partnerships."

Other investors believe a variety of fund models will continue to be utilized in the infrastructure industry in the future, with the private equity model complementing other structures like open-ended, evergreen and listed funds. One investor suggested: "We believe a combination of closed-end structures, direct investment and cost-efficient core funds will exist in parallel."

On the whole, investors believe that the private equity model will continue to be used in infrastructure investment but must be adapted to fit the needs and demands of both fund managers and investors. Investors make infrastructure investments for a number of reasons, such as diversification, to act as a hedge against inflation and because of the potential for stable long-term returns. Therefore fund managers must relate to these demands when formulating their fund and fee structures.

Fig. 5: Investor Plans for Infrastructure Fund Investment in the Next 12 Months



Source: *Preqin*

Outlook
Investor confidence is beginning to return to the infrastructure market following the financial crisis. As shown in Fig. 5, 70% of investors surveyed plan to make infrastructure fund commitments in the coming 12 months, as opposed to just 40% that stated such an intention in our October 2009 survey. Of these investors, more plan to make multiple commitments than those that plan to make a single investment in the coming year.

However, the survey highlights a number of key issues facing the asset class that need to be overcome to ensure continued growth within the unlisted infrastructure market. Infrastructure fund managers will have to make sure that their fund terms, especially those relating to management fees and the carry structure, satisfy investors if they are to be successful in an increasingly competitive fundraising market. The resolution of these key issues will directly affect investor confidence and therefore impact future fundraising and deal flow.

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