PEI Alternative Insight
INFRASTRUCTURE INVESTOR
www.infrastructureinvestor.com

Beginning to flow

Published: **08 October 2013**
By: **Andy Thomson**

The infrastructure asset class is young – and the infrastructure secondaries market is even younger. But for those involved in this niche area, there is plenty to keep them interested. Andy Thomson reports.

It says a lot about how the infrastructure secondaries market has evolved over the last few years that Brenden Woods of Macquarie Funds Group should not really be running an infrastructure secondaries business at all.

To explain: Woods joined the Funds Group in London in March 2010 having previously held various other roles within Macquarie. The original intention was to put together an infrastructure fund of funds, but ultimately that market was not viewed as big enough. Instead, attention turned to secondaries.

“We identified the secondaries opportunity in mid-2011,” recalls Woods. “We had conversations with a small number of seed investors and we designed a product around what they were looking for and where we saw the market heading.”

Woods and Macquarie are unable to comment on fundraising, but industry sources indicate that the firm has currently raised around €100 million for an infrastructure secondaries fund and may achieve a final close by the end of this year on as much as double that.

Post-Crisis pick-up

Woods concedes that, up until 2011, it would have been difficult to justify a dedicated infrastructure secondaries strategy. However, he says: “Post-Crisis people have been reallocating to infrastructure and it seems that the market has really picked up.”

But why are opportunities to buy secondary limited partner (LP) interests arising? Woods says one reason is that, pre-Crisis, a lot of investors were allocating to infrastructure out of their private equity buckets. Reordering the portfolio so that infrastructure is no longer mixed up with private equity is one reason for sales – a motivation no doubt assisted by the under-performance of certain infrastructure funds pre-Crisis.

There is also the pressure to sell as a result of the stress being faced by many LPs in the harsher, post-Crisis environment as they have sought to repair battered balance sheets – especially in Europe. Woods says this was a factor in the “noticeable uptick in activity in 2011”. He also notes that this activity is growing year-on-year although he describes deal flow as “somewhat lumpy”.

These days, Woods sees more diversity in terms of the kinds of interests coming up for sale. “Initially, the market was driven by larger portfolio sales but now you get single funds, portfolios with between five and eight funds, and private equity portfolios that have one or two infrastructure funds in them.”

Also carefully monitoring the progress of the market has been Ian Charles, a partner at Landmark Partners in the US. Landmark has a long history in secondaries, having entered the private equity space back in 1989 and real estate seven years later in 1996. Charles justifiably describes his firm as a secondaries “pioneer”.

Charles says that Landmark has been buying infrastructure secondary positions over the last four or five years, having seen the primary market in infrastructure grow impressively.

“Over the last 10 years there has been around $450 billion raised in the real assets category, more than half of that by infrastructure funds,” he notes. “That makes infrastructure bigger than energy-focused private equity, and that doesn’t seem to be common knowledge.”

Deciding what worked

The infrastructure secondaries market, he suggests, “is big today and will only grow”. Landmark estimates that between $1.5 billion and $1.7 billion of trading occurred in the space last year. He thinks that, over the next three or four years – “as LPs decide which GP relationships have worked and which haven’t” – the secondary market will reach the 5 to 10 percent proportion of the primary market seen today in private equity and real estate rather than infrastructure’s current level of 2 to 4 percent.

Like Woods, Charles believes that portfolio management will be a driver of activity as some GP relationships are pared back. He thinks that even those LPs that have concluded they are happy with a substantial infrastructure allocation will decide that “certain GPs and strategies do not fit with their overall portfolio strategy”.

Also like Woods (and other observers too), Charles does not believe that post-Crisis regulatory pressures have had much of an impact on the infrastructure secondaries landscape. “Unlike with buyout funds, infrastructure fund exposures didn’t find their way onto banks’ balance sheets in anywhere near the scale of large LBO [leveraged buyout] funds,” he points out.

Woods adds: “As well as natural growth in the secondaries market resulting from increases in the overall scale of the infrastructure funds market, we expect to see an increasing level of activity driven by specific factors such as changes to the regulatory environment facing many investors, which take effect over the next few years. There have been some examples of this to date, but certainly not the flood that many predicted."

However, Francois Marius-Garcin, London-based chief executive officer of investment company Argenthal Group, thinks that regulatory changes in the renewable energy industry will likely drive some secondary activity in the years ahead.

"Changes in regulations…around subsidies will affect total returns," he says. "The price of electricity will eventually float freely…for the green sector and then volatility will force conservative investors out of that market."

Visibility is key

Woods sees a lot of demand for infrastructure secondary positions from the buy side, particularly as, in his view, buyers in the core infrastructure space are generally more confident about valuations than in the private equity space. "Portfolio composition and performance visibility can provide more confidence in infrastructure secondaries than in other unlisted asset classes," he says. "If you have visibility, the underlying valuations of core assets are typically based on long-dated contract terms or regulated revenue streams rather than on growth projections that can often be subjective."

On the topic of valuation confidence he adds: "Whilst core infrastructure assets tend to be fairly narrow and low risk in their operational scope compared with many other businesses, regulatory and sovereign factors, as well as financing structure, can change their risk profile dramatically."

Unsurprisingly, perhaps, Francois Gamblin sees the future of infrastructure secondaries as an online future. After all, Gamblin is chief executive officer of SecondCap, a global online platform for secondaries.

He says 'going online' is the most efficient way to sell a secondary asset. "Sellers recognise they must be careful in their selection of bidders and to go to the usual suspects is not the best way. We tap into a large universe of buyers and we make transactions easy and fast to execute."

Gamblin says that, for SecondCap, traditional business means areas such as buyouts, mezzanine and venture capital. However, the firm has recently closed a couple of infrastructure secondary transactions. As with other market participants canvassed by Infrastructure Investor, he detects "significant demand on the buy side" where discounts of around15 percent are typically being sought.

There's little doubt that significant demand exists for infrastructure secondary assets and portfolios – both from opportunistic buyers as well as those forming more permanent strategies. In terms of the supply side, there's no getting away from the fact that it's currently a small market. Equally, it's also growing and bound to grow much larger - and that guarantees a lot of attention will be paid to it, both now and in the years ahead.