How to choose a general partner

The definitive guide to infrastructure fundraising

Christian Seymour, Head of Infrastructure - Europe

Introduction

The universe of infrastructure managers has expanded significantly over the last decade or two and is currently experiencing a wide spectrum of transformational changes. Despite the current economic climate, there is even more activity to come. A recent study suggests that nearly 80 closed-end infrastructure funds are currently in or coming to market and seeking over $90 billion in additional commitments.[1] And despite the ongoing debate concerning where the asset class fits between private equity, real estate and bonds, a greater number of institutional investors have established investment programmes and devoted resources and capital to their infrastructure allocations.

The key to success in this space – as in any asset class – relies on access to appropriate investment opportunities. Some infrastructure programmes include direct investments while others choose to select fund managers to outsource operating and deal-creating activities. The right choice of general partner (GP) will determine how strong and sustainable access to the market is and will ultimately contribute to a successful investment strategy.

Investment strategy: Which strategy is right for your portfolio?

- Risk-return profile of the GP
- Sector focus
- Geographic focus

When allocating funds towards a GP, thorough due diligence on the team, track record and structure is paramount, but this should only be initiated once the right investment strategy has been established.

Risk-return profile and focus of the GP

Historically, risk-return profiles of infrastructure projects were determined by the stage of development, with an increasing risk perception from brownfield through rehabilitated brownfield/'yellowfield' to greenfield projects.

Brownfield investments refer to existing and operating businesses which generate cash flows and were perceived as low-risk assets. Comparisons in the market were made between long-term bonds and, for example, operating toll roads, showing a strong cash yield over decades of operation.

Sector focus

Rehabilitated brownfield, also know as yellowfield, investments, are characterised by operating and cash-generating infrastructure projects combined with the ability or requirement to expand or repair the existing asset. In some cases, the development of a new project, partly funded by an established and soon-to-be-dismantled operating asset, also falls into this category. Greenfield investments require a period of planning and construction where no cash flows are generated before the project enters into its operating phase.

Given the design and build risk inherent in greenfield projects, the quality of the project developer and contractual risk-mitigation provisions are fundamental. Not surprisingly, return expectations for these projects have historically ranked highest among investors.

Depending on the sub-sector and country, returns in the market have been as low as five to 12 percent for brownfield investments, increasing to 12 to 18 percent

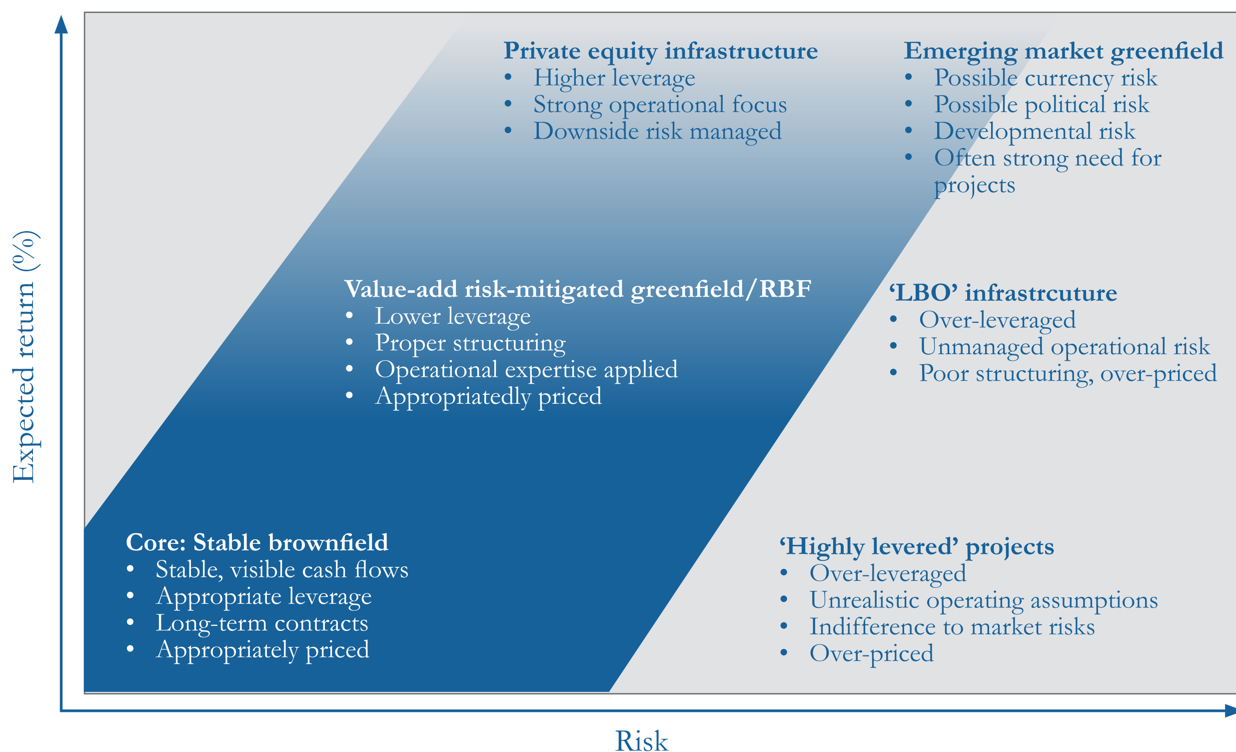
for yellowfield assets and potentially 15 to 20 percent for greenfield projects depending on the level of demand risk taken.

However, recent market developments and the collapses of a number of GPs indicate that there is more to the risk-return assessment than simply assessing the stage of development. Following a period of easy access to leverage, at potentially historically low cost combined with aggressive bidding in a booming environment, even widely perceived low-risk brownfield investments turned out to face significant financial and operating set-backs. The consequences have included large write-downs in asset valuations and reassessment of risk across the infrastructure market worldwide.

As part of this reassessment of risk, additional factors are now scrutinised in the selection of infrastructure investments and the risk-return profile of GPs. The additional factors are not particularly innovative or novel but they do seem to have been overlooked, or at least taken too lightly, in the past. They include:

- Leverage: Although brownfield assets usually have the ability to carry more leverage than greenfield projects, overly geared investments lack financial and operational flexibility. This risk amplifies in economic downturns and can lead to severe difficulties for management, boards and fund managers of over-leveraged assets.
- Elasticity of demand: Depending on the contractual or regulated structures of projects, there might also be demand risk inherent which needs to be addressed properly. For example, transport infrastructure assets, such as toll roads, airports, and to a certain extent seaports, were favoured for their 'bond-like' behaviour. However, the recent past has shown that despite long-term contracts and strong relationships, an economic downturn and drop in gross domestic product (GDP) can lead to a very different reality. Companies as well as individuals have to adjust and reduce output, which ultimately leads to lower traffic numbers, shrinking revenue and profit contribution, and a changed risk assessment of economic shocks.
- Political and regulatory risk: Risks identified in this area are changes in legislation, tax rules or economic regulation. This is very much a fundamental market risk and often very country-specific, with emerging markets typically showing higher uncertainties. Institutional investors need to assess to what extent political risk can be borne or in some cases even sought, across their portfolios.

Fund manager models according to risk and return



Source: Probitas Partners

Geographic focus

This also leads to the geographic focus GPs tend to apply. While the majority focus on OECD countries and have high exposure to North America and Europe, a number of smaller niche funds have focused on emerging markets such as India, Latin America and China. The risk appetite and diversification benefit of picking different geographies requires thorough consideration within the strategic asset allocation.

Summary

Considering all risk factors involved in infrastructure assets, investors have come to appreciate that fund managers need to balance pro-forma returns with asset-specific and portfolio risk. This leads to a more diversified universe of GPs categorised by their risk-return profiles, development stages as well as geographic considerations. The above figure[2] illustrates various fund manager models and maps them according to risk and return. For example, as illustrated in the above figure, depending on leverage and operational management, higher risk does not necessarily translate into higher potential returns, unless managed properly.

This more realistic view of infrastructure investments is likely to have a material impact on institutional investors' portfolio construction going forward. A more sophisticated assessment of infrastructure GPs based on the overall structure and strategy can lead to a more successful selection of fund managers.

The team

Direct investment in infrastructure businesses has any similarities with the investment disciplines used in mainstream private equity funds. One of the key considerations in GP selection is therefore, not surprisingly, the fund manager's team.

Team cohesiveness

Most institutional investors prefer backing managers with a track record of successful investing in infrastructure. This places long-established fund managers at an advantage. Not only can these managers demonstrate investment history and performance, but they can present a mature team that has delivered this track record. In such teams, factors such as team dynamics and cohesiveness have had significant time to settle in and a particular work culture has developed. Generally, with the growth of assets under management these teams have seen gradual organic growth resulting in a good balance of transactional, operational, technical and investment banking skills.

Establishing team credentials can be more challenging for newly established managers, even in the case of spin-outs from established firms. Although senior team members can often rely on the track record built up during their time with a previous firm, it remains difficult for a potential investor to assess – during a due diligence exercise – how a new GP team will ultimately work together. If a team is not cohesive, it increases the risk that key personnel may leave or that turnover of junior staff rises. Key-man provisions are meant to mitigate some of these risks, but most institutional investors hope that such provisions are never required.

Integration or segregation

For an infrastructure fund manager to be successful, it is important that its team understands the challenges that underlying infrastructure businesses may face. A good way to accomplish this is to fully involve the transaction team in the ongoing asset management and valuation work after the investment has been made. Only in this way is it possible for the team to identify areas where the investment case differs from the actual results, and for the lessons learned to be applied during the due diligence process for the next investment.

Among larger fund managers there are differing schools of thought on whether transactional and asset management functions should be segregated. The argument for segregation is that it is more efficient as it allows teams to focus on particular roles. The argument against segregation is that it hinders the cross-fertilisation of experience one gets by being involved in all stages of an investment. It also reduces accountability and creates differing incentives for various team members, as some are motivated by closing transactions rather than by long-term investment results. Integration also helps to improve resource utilisation as team members, with multiple skills, can perform both transactional and asset management roles as required.

Alternative fee income

When evaluating a GP with a separate asset management team, it is worthwhile to verify if this team is treated as an integral part of the fund's services or not. Apart from the usual base management fee, certain fund managers charge additional fees to the assets in their portfolio to cover services provided by the asset management team. It may be worthwhile for potential investors to seek clarification about any fee income derived directly from the portfolio companies, as it could be argued that some of these fees cover services that a fund manager is expected to perform as part of the base management fee.

This analogy extends to transactional work as well. A number of infrastructure GPs are owned by investment banks, and have differing policies about the use of

in-house investment banking services to supplement the fund manager's team. A question could be posed as to why a fund manager considers it necessary to supplement its team with additional advisory services. An investor might expect that the GP team is sufficiently experienced to perform the required tasks. The fund manager may also become a captive client of the investment bank. This results in excessive fees and the inability to employ the best qualified adviser, when a financial adviser is required.

Economic incentives

The long-term nature of infrastructure investment does not always lend itself to the standard private equity approach, which tends to determine a performance fee based on exit value. Many well-performing infrastructure assets can be retained for the duration of the fund or, in the case of open-ended funds, may not be subject to any immediate pressure to divest. It may not be practical to link compensation to disposals because of the long investment horizon typical for these assets.

Instead, it can be worthwhile to have regular performance fee arrangements with clawback provisions which allow the GP to incentivise the team for fund performance on a more regular basis whilst retaining the pressure to deliver stable performance over multiple years. Obviously, just as important for team stability is the internal allocation of the performance fee or carried interest. Large differences in the distribution of performancerelated compensation among the senior investment professionals can quickly lead to dissension and turnover.

Attributable track record of successful investing

In general terms, infrastructure assets will typically generate stable and predictable cash flows, with revenues linked to some combination of inflation, population growth and economic activity. Through their total life, infrastructure assets generate a significant amount of current income. Infrastructure assets will be attractive for investors that need cashyield-generating assets with long-term duration that match long-term liabilities.

The GP's ability to analyse and structure an investment is core to being able to deliver maximum returns for the investor. This analysis starts with a review of the fundamental attributes of the business. Is it a regulated business with low demand volatility such as a utility? If so, is there a history of regulatory certainty or are the regulatory reviews driven by political agendas? Is it a business that has certain monopoly characteristics, such as an airport or a toll road, but one that is subject to demand risk? If so, what is the competitive landscape and how sticky will the demand be? For example, in the case of an airport, are there competing airports that airlines could move to and how much pricing power will the airport retain? As with any investment, the risks need to be identified so that the price to be paid reflects the potential uncertainty of delivering the expected return.

Operational risk needs to be assessed in terms of the assets' quality and ability to keep operational costs under control. This extends to a review of the business' capital needs, encompassing both maintenance and enhancement expenditure. For example, if the assets are old and require substantial maintenance capital to be spent this must be allowed for. Failure to do so will mean an increase in breakdown maintenance with the associated increase in operating costs. Ideally, the GP should have operational capability in-house and be experienced in this area, so that the risks can be properly analysed prior to an investment decision being made.

An appropriate capital structure must be selected for the business. This means that the amount of debt employed must be at a level that is sustainable. For example, it may be fine for 80 percent debt to be used in a market where debt is cheap and freely available, but

this may turn out to be too much leverage when debt market conditions change. In this event new equity will be required to maintain the solvency of the business. Also, appropriate levels of refinancing fees and debt margins need to be a factored into the business plans.

Tax structuring is important to prevent unnecessary tax leakage so as to optimise investor return. The GP should have an in-house tax analysis capability to ensure that the appropriate investment vehicle is selected, in the right jurisdiction, to address any investor tax concerns. The same can be said for in-house legal capability to structure and negotiate the legal agreements.

Clearly the GP must have a strong financial analysis and modelling capability to ensure that the analysis of cash flows, used to underpin the valuation of an asset, is completed with the utmost accuracy and diligence.

Benchmarking

There is a very small number of GPs that have been investing in infrastructure for any substantial period (that is, over ten years) of time. As such there is very little track record for most infrastructure funds compared to private equity or real estate funds. In addition, the unlisted nature of many of the infrastructure funds means that performance visibility is very limited. Clearly, the investor will need to carefully analyse the GPs' capabilities, particularly where there is limited track record available.

A few experienced investors have set their return benchmarks on an absolute basis, looking for returns of at least 8 to 10 percent in the sector. Other investors prefer benchmarks that are inflation-linked (e.g. 400 basis points over inflation), clearly reflecting the purpose of infrastructure in an investor's portfolios. It should be noted that most of these investors currently tend to focus on investments in developed economies. The risk-return profile – and thus the appropriate benchmark – for funds focused in emerging market countries can be quite different.

Given current investor focus on infrastructure opportunities with long-lived assets that generate some amount of current income, it is likely that absolute or inflation-adjusted benchmarks will become increasingly important. As the market continues to mature and a deeper base of historical results is developed, 'vintage year' analysis of returns for managers will become a more meaningful relative performance measure.

The GP's role in asset performance

- Add value by effecting change
- Providing advice and guidance
- Structuring

The GP is fundamental to driving asset performance. One of the real value drivers of unlisted investing lies in the ability to align management and investor interests more closely. This can only be achieved with the full engagement of the GP, otherwise management is able to orchestrate the same sorts of self-serving behaviours that are rampant within listed companies where executive compensation has little correlation with asset performance.

The key question is whether the GP has the requisite team skills and demonstrable depth of experience in assessing management teams and implementing change.

Of course, the nature of the infrastructure asset will determine the approach required to deliver value. That is, whether the acquired company is a stable, well-managed business, a turnaround situation, or a business unit from a larger organisation that requires a new management structure to be put in place. Regardless of the situation, the GP needs to have the appropriate experience and the time to assess how the

business operates to identify the changes necessary and formulate a strategy for implementation.

The experienced GP will evaluate the team, starting at the top. Should the chairman and CEO remain with a business after acquisition? The GP needs to determine whether the senior management team can deliver on the new owner's plans for the business, and not destabilise the management team in the short run.

While a close working relationship between the chairman and CEO is fundamental, it is important for investors to be able to break into this relationship to challenge practices that may be sub-optimal for business performance. In practice, this usually means the departure of one or both.

Taking such a decision in a turnaround situation may be self-evident but this is not necessarily the case in the acquisition of a well-managed company. In these circumstances it is important for the GP to have selected its partners well as implementing the hard decisions can be problematic where partners are inexperienced or disengaged. Similarly, where partners propose related-party transactions such as advisory mandates (typical for investment bank-sponsored funds) to the company it is important for the GP to have sole blocking rights or to have selected those other partners who will have a similar approach to rejecting mandates where it is inappropriate or uncommercial.

If the acquisition has been completed with a consortium of investors, as is commonly the case, the board structure and voting rights will have been negotiated and agreed in advance.

In the event that the CEO is retained, staff retention arrangements need to have been negotiated during the acquisition to ensure a successful transition after financial close. This typically includes members of the senior management team deemed critical for the successful continuation of the business under new ownership. Such retention arrangements are typically for at least three years to allow the GP to assume control of the business and be less exposed to key-person departures in the transition phase. Short-term and long-term incentive compensation arrangements will also be negotiated.

Board composition and governance

Other transition planning can include: a focus on health and safety performance and change; accounting and tax structuring; a review of contingent liabilities; and a review of revenue and operating cost drivers.

The GP has a critical role in establishing the governance arrangements for a newly acquired company. The framework for the delegation of authority will typically have commenced well in advance of the acquisition, particularly where partners are involved. The appropriate cascading of delegations from the shareholders, to the board and to management, is important to ensure the necessary controls are in place, while not being so onerous as to jeopardise management's ability to effectively run the company. The GP will have built up the knowledge of appropriate frameworks over a long period of investing in unlisted companies.

It is important for the board to have the necessary skills to guide the business; in many cases this will require the appointment of industry experts to the boards of investee companies.

To an extent, this will depend on the knowledge that the GP holds in-house and may have been built up over a number of years of investing in infrastructure companies.

Boards with too many directors can become unwieldy and stifle the ability to deal effectively with strategic issues facing the company. Sub-committees of the

board such as remuneration and audit are fundamental to ensure appropriate focus on particular issues (e.g. succession planning).

First and foremost, the directors appointed to the board have a fiduciary duty to the company.

Unfortunately, from time to time this obligation seems to be lost on directors appointed by GPs. Decisions taken can appear to serve the GP or even related institutions such as investment banks in the captive fund model. Such potential GP conflicts of interest should be carefully examined by investors before an investment decision is made.

Relationships with management teams

The credibility of the GP is important to developing productive relationships with management teams. Credibility is established through the GP's team skills and collective knowledge and systems. For example, if a regulated utility has been acquired, the GP's knowledge of regulatory systems will be important to give management the comfort that sensible decisions will be taken by the board on such matters. Of similar importance will be the GP's knowledge of engineering maintenance and capital delivery.

As previously discussed, the setting of performance targets and supporting compensation structures is fundamental to aligning the interests of management and the GP. Team harmony is also fundamental and can detract from performance. The GP needs to ensure that the senior management team is appropriate for the task and if not, be prepared to make the necessary changes.

Mistakes and lessons learned

The financial crisis has led to a shake-out among the infrastructure GPs, which was precipitated by the excessive use of leverage at multiple levels of the funding structure. This has included leverage at the fund level or, in the case of listed infrastructure funds, at the listed-company level. Leverage was also employed at the asset-holding-company level and at the operating level. This did not create major problems when the cost of debt was low and refinancing capacity was available, but it became problematic when these costs increased and debt became unavailable. To compound the problem, in recent years many assets were bought at high prices on the basis of very aggressive business-plan assumptions.

For investors holding assets subject to GDP-related reduction in revenue, such as airports and seaports, the effect has been catastrophic and funds have been forced to inject equity or sell assets at drastically reduced prices.

A further problem has been that many of the GPs have been serving more than one master. Those GPs owned by banks, for instance, have an inherent conflict of interest. On the one hand they owe a duty to their investors. However, in many instances this duty has been disregarded in favour of fee generation for the parent bank manifested through lavish management agreements or advisory services to the portfolio companies at off-market rates. Fortunately, many investors are now aware of these tactics and are treating those GPs with a significant degree of caution.

Disciplined investment process

A disciplined investment process is essential to uccessfully identifying and executing transactions. Important differentiating factors between GPs include the ability to generate deal flow and how the investment committee process is structured.

Ability to generate deal flow

Given the number of competing infrastructure funds in the market today, one of the key success factors is access to high-quality deal flow. It will be important to understand from the GP what it anticipates will be the main sources of its deal flow and, for example, the extent to which it will rely on auction processes. Auction processes can be very expensive in terms of bid costs, generally have a low hit rate and feature sub-optimal pricing.

Sources of deal flow include investment banks and other advisers, co-investors and corporates. The key to generating deal flow from these sources effectively is for the team to establish strong relationships and demonstrate that it has the capability to successfully execute transactions. Often team members have developed relationships through their previous roles within the infrastructure sector and therefore it is important to assess this aspect of the team's capability.

Developing relationships with corporates is particularly important for greenfield opportunities and also for access to opportunities where a corporate is looking to divest a minority stake in an asset or is looking for a long-term investment partner.

Another source of deal flow is internal research which can identify potential targets based on criteria that match the GP's investment objectives. In addition, for funds with an existing portfolio of assets, deal flow can be generated from these assets either through buying out co-investors or through opportunities generated through the portfolio companies themselves.

In the period prior to the credit crunch, most vendors believed that they could obtain best value by running an auction process among a large group of potential acquirers. In this environment, although it was generally straightforward to become aware of potential deal opportunities, it was important to be very selective about which auctions to participate in to avoid incurring significant bid costs given the low probability of success.

In the current market environment, although there are still a number of high-profile auctions, vendors are increasingly running limited sales processes or negotiating deals on a bilateral basis. A team with a wide range of deep relationships can access these opportunities which may not be widely known in the market. This is also a market where targeted research can identify potential transactions, such as if an asset owner may have a strong incentive to sell a particular asset to raise capital.

Investment committee process

The investment-committee process is an important indication of the GP's approach to infrastructure investment. Having a clear and efficient process is critical for the GP's ability to successfully execute transactions. In addition to the formal investment committee process, it is also important for the GP to have clear governance processes for the approval and management of bid costs as these can be substantial in the current environment. The investment committee process should equally apply for potential acquisitions as well as potential disposals.

Some of the key aspects of the investment committee process include the time at which the committee is involved in the process, the composition of the committee and the scope of approvals that can be given by the committee (e.g. if there is a bid situation, what flexibility does the GP have to increase the price?). Generally the investment committee will be involved prior to approval being sought for a binding offer. This is important in order to provide more certainty to the deal team that the proposed investment is in line with the fund's objectives. In bid situations, it is important

that the committee be able to give sufficient flexibility to the deal team in order to be able to react to different scenarios or be available to convene at short notice as required.

Ideally, members of the investment committee will have worked together for a number of years and have an established track record of reviewing different types of infrastructure investments. This will give confidence as to the ability of the committee to make the appropriate investment decisions going forward.

Conclusion

Selecting the right GP is critical to achieving expected investment returns. There are a number of factors which should be considered such as the length of experience of the GP in the sector and quality of its team, the GP's investment strategy and approach to asset management, and the structure and fees of the GP's product.

Not every product will suit every investor. For example, some investors may require liquidity and the ability to redeem capital. Some investors may desire a higher-risk/higher expected-return product. Others may be interested in investing in an existing portfolio which can de-risk the investment performance outcome. However, one common thread is the need for the GP to have significant experience and, ideally, not be conflicted in its approach to maximising value for its investors.

Careful diligence of the GP is required to make an informed decision. While past performance may not be indicative of future performance, almost certainly past behaviour is a good indicator of future behaviour and should be carefully assessed before a selection is made.

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[1] Probitas Partners, 2009, Investing in Infrastructure.
[2] Probitas Partners, 2009, Investing in Infrastructure.

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About IFM

IFM is a world leading investment manager with over A$34 billion in funds under management across four asset classes in three of the world's largest pension markets. We manage portfolios across listed equities, private equity, infrastructure and debt via a global team based in Australia, North America and Europe.

www.industryfundsmanagement.com

Christian Seymour
Head of Infrastructure - Europe

Australia
Casselden Place
Level 29, 2 Lonsdale Street
Melbourne VIC 3000
Australia
Tel: +61 (0) 3 8672 5300
Fax: +61 (0) 3 8672 5301

Europe
Tower 42
Level 10, 25 Old Broad Street
London EC2N 1HQ
United Kingdom
Tel: +44 (0) 20 7448 9600
Fax: +44 (0) 20 7448 9640

North America
99 Park Avenue
19th Floor
New York, NY 10016
United States of America
Tel: +1 212 575 1055
Fax: +1 212 575 8738