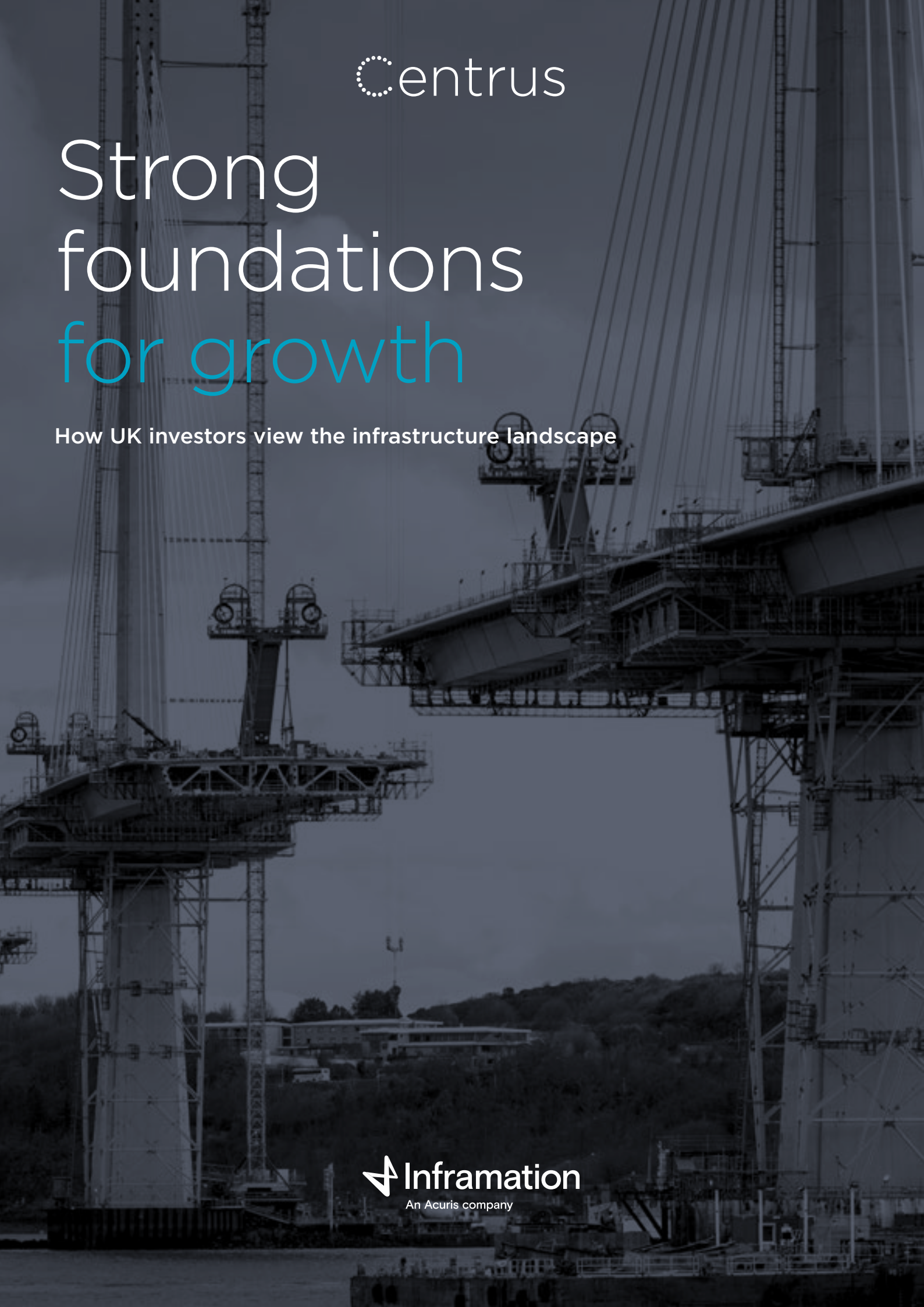
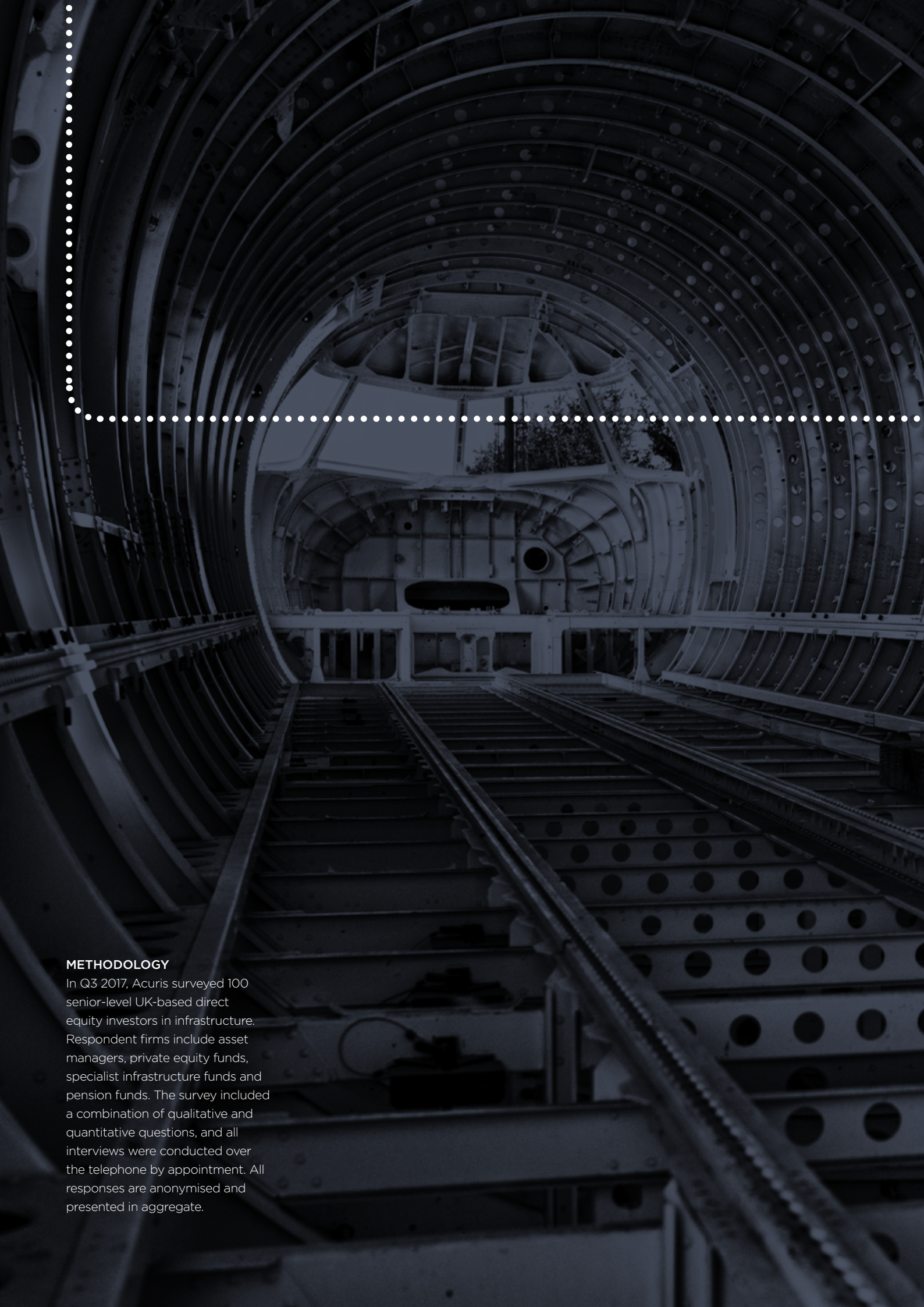
Centrus

# Strong foundations for growth

## How UK investors view the infrastructure landscape



Inframation
An Acuris company



**METHODOLOGY**

In Q3 2017, Acuris surveyed 100 senior-level UK-based direct equity investors in infrastructure. Respondent firms include asset managers, private equity funds, specialist infrastructure funds and pension funds. The survey included a combination of qualitative and quantitative questions, and all interviews were conducted over the telephone by appointment. All responses are anonymised and presented in aggregate.

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# Foreword

Private investment in infrastructure assets has seen enormous growth in recent years. Since 2010, some £1.2 trillion has been invested in infrastructure assets globally, according to Inframation data. Whereas in 2010, total investment in infrastructure amounted to £101bn worldwide – by 2016, global infrastructure investment hit a record high of £239.5bn and competition for assets was frequently fierce.

Globally, infrastructure has suffered from decades of underinvestment and much of it is now long overdue for overhaul or replacement – and with governments facing budgetary constraints, opportunities for private sector involvement in financing infrastructure are growing.

The long-term, stable returns that are generated by infrastructure are currently far more attractive than those offered by government or corporate debt. And this has enticed new investors into the infrastructure arena.

There are also wider factors in play. In emerging economies, population growth and urbanisation are spurring the need for new transport and utility infrastructure. Meanwhile, in developed economies, there is a growing need not only to build new infrastructure, but also to upgrade existing road, rail and power networks to boost their capacity and meet modern performance standards.

Running in parallel with this is the decarbonisation of the world's energy system. The shift from fossil fuels to renewables is creating huge opportunities for private investors. Windfarms and solar are the best-known examples of this trend, but they're only part of the picture. Electrification of the vehicle fleet is creating huge opportunities for vehicle charging, as well as upgrades of grids and power distribution networks.

In addition, revenues produced by infrastructure are typically linked to inflation and, in many cases, revenue increases are mandated in contracts and concession agreements. Infrastructure assets also often benefit from monopoly or near-monopoly market positions and are, therefore, well insulated from competitive shocks.

But against these benefits, there are risks. Increasing competition for brownfield assets, for example, is pushing valuations higher and returns lower. Meanwhile, investors in greenfield projects need patience, strong nerves and deep pockets because new-build investments may take years to generate returns and can be plagued by construction risks.

With these opportunities and challenges in mind, Centrus, in association with Acuris, has surveyed 100 UK infrastructure investors to discover the strategies they'll adopt; the challenges they face; and the drivers for investment. The findings show an asset class in rude health with investors upbeat but realistic about the future. They understand the benefits but acknowledge that, in the current uncertain climate, they need to expect and accept the unexpected.

# Executive summary

Our survey shows that investors are seizing the opportunities on offer in the infrastructure asset class with appetite for risk growing. However, competition, regulation and political risk could yet stifle investment. Here are just five of the key findings from the survey:

**Brownfield is leaping ahead.** Investment in brownfield assets by UK-based equity investors in the first half of 2017 exceeded the total value of brownfield deals made throughout the whole of the previous year. Among the factors behind brownfield's rapid growth are a shortage of investible greenfield targets and declining bond yields.

**Greenfield is sliding back.** 2016 saw UK-based equity investors participate in a total of 94 greenfield deals worth £17.2bn. However, performance in the first half of 2017 has been lacklustre by comparison, with just 26 deals and a total value of £3.9bn. The major factor behind the low level of greenfield investment is the limited project pipeline.

**Investors are seizing opportunities in the power sub-sector.** Power assets are already held by most respondents (85%), more than any other asset sub-sector. Looking ahead, nearly two-thirds of investors say that they intend to increase their activity in the power sub-sector over the next one to two years. "Many people see the opportunity in taking part in the next phase of the modernisation of existing power networks and, at the same time, participating in new forms of energy," says George Karalis, Managing Director, Centrus.

**Risk appetite is growing.** The survey shows that 43% of respondents plan to increase value-added investments and 37% intend to increase opportunistic investments over the next one to two years. "Investors are taking on more risk and there's greater diversification into newer markets," says Geoff Knight, Managing Director, Centrus.

**Regulatory and political risks are top concerns.** More than half the investors interviewed see these as a major challenge to their funds. On the regulatory front, respondents cite concerns about tougher environmental rules. Meanwhile, on the political front, investors worry about factors such as Brexit and the effect of policy shifts on their PPP-based investments.

**Seeing an increase in leverage.** A result of this is due to the existing interest rate trend and credit spread environment as well as elevated acquisition prices. Investors are considering increasing leverage both with medium and long-term funding structures.

Chapter 1

# UK infrastructure investment trends 2017

IN SHORT

**Infrastructure on a high**

Demand for infrastructure investment is burgeoning. In 2016, global investment in greenfield and brownfield assets totalled £239.5bn – a year-on-year increase of 23%.

**Brownfield on the rise**
H1 2017 saw 70 deals with UK equity investor involvement worth £14.3bn. This has already exceeded the value of brownfield deals for the whole of 2016.

**Greenfield blues**
Greenfield deals accounted for only 22% of the total value committed by UK investors in H1 2017 compared to 59% for all of 2016.

**Greenfield projects took a back seat in the first half of 2017 with volumes and values dropping on the back of a shortage of investment opportunities. However, brownfield projects are taking over with H1 values in 2017 already exceeding the total transaction value for the whole of the previous year**

Global infrastructure investment hit a new high in 2016 as demand for physical assets – from roads to renewable energy – continued to rise. In 2016, according to Inframation data, global investment in greenfield and brownfield assets totalled £239.5bn – a year-on-year increase of 23%. A similar trend is revealed in the volume of deals, which rose 16% year on year to 1,203 transactions. Among the factors driving investor interest are the potential for long-term inflation-protected returns, and the declining yields from government and corporate debt.

For UK-based equity investors, the picture is complicated by political uncertainty around Brexit and continuing foreign exchange volatility. This is taking place against a background of declining yields from investments in UK assets. Consequently, UK investors are having to look further afield in search of returns.

## GREENFIELD FALLS

Overall, in the first half of 2017, there were 96 infrastructure transactions with UK equity investor participation worth £18.3bn. Over the course of 2016, there were 214 such transactions with an aggregate value of £29bn.

The volume and value of greenfield transactions by UK-based investors slowed in the first half of 2017. During this period, there were 26 deals worth £3.9bn, compared to 94 deals worth £17.2bn over the course of 2016, reflecting a limited pipeline of such projects.

Greenfield schemes – which attract investors with a higher risk appetite than brownfield projects – accounted for only 22% of the total value committed by UK investors in H1 2017 compared to 59% for the whole of 2016.

One explanation for the lower levels of investment in greenfield is the fact that shovel-ready schemes are failing to materialise. Political inertia is one of the reasons behind this, according to Geoff Knight, Managing Director of Centrus: "Greenfield depends on government or other sponsor initiative," he says. "I would argue that given what's gone on around the globe politically in the last couple of years, there have been very few genuine initiatives actually carried out."

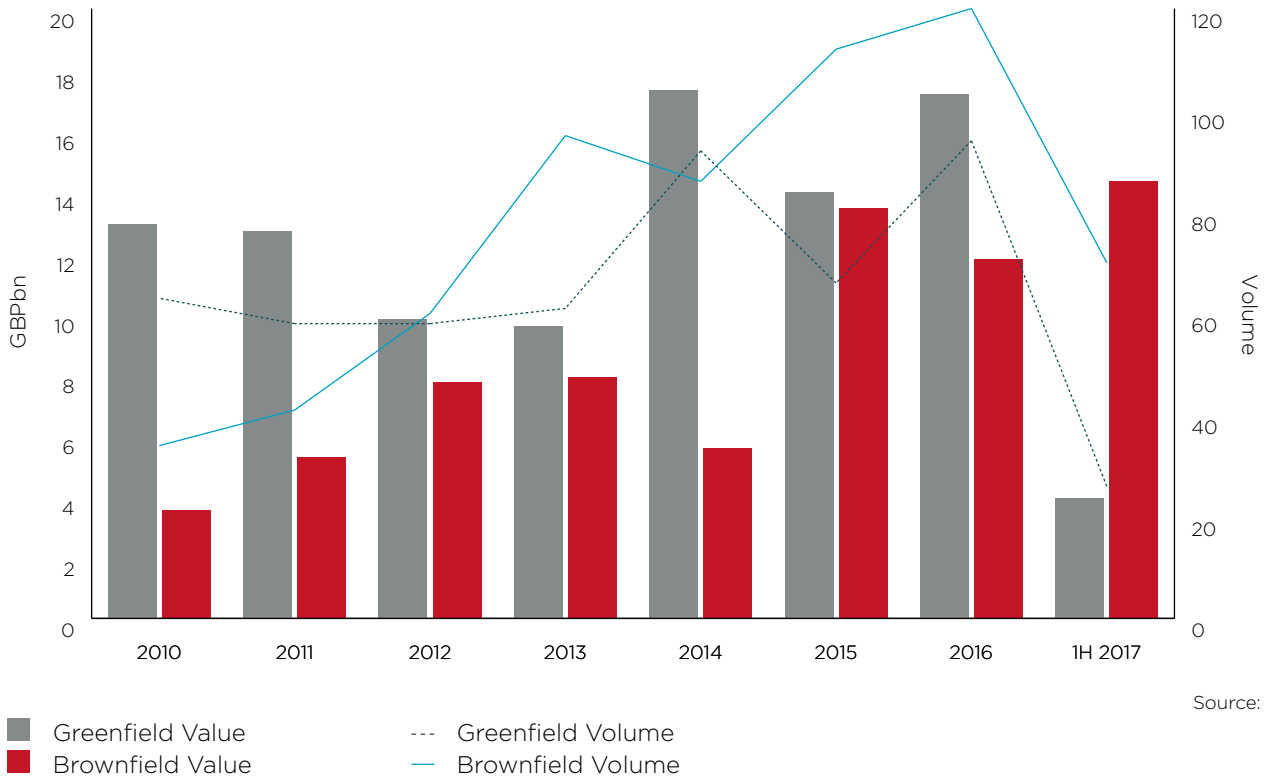
So, is this a temporary slowdown or is it indicative of a wider trend? "It's cyclical – it will inevitably change once the political imperative to invest returns," says Knight.

## BROWNFIELD FLOURISHES

While greenfield is languishing, brownfield has seen far higher levels of investment in comparison with previous years. The first half of 2017 saw 70 deals worth £14.3bn. This has already exceeded the £11.8bn aggregate value of brownfield deals seen over the whole of 2016. Even with the distorting effect of the National Grid and EP Infrastructure megadeals (valued at £5.4bn and £1.3bn respectively), value in H1 2017 still exceeds that of previous years when considered on a pro-rata basis.

The attractions of investing in brownfield projects include the opportunity to access established revenue streams and the absence of construction risk and delays. "We prefer to invest in assets which are already developed," says the managing director of a UK asset manager. "With brownfield investments, the waiting period to generate returns is shorter than it is with greenfield assets. Faster returns mean we can focus on other assets which will help us to expand further."

Global greenfield & brownfield with UK equity investor participation by value and volume




Source: Inframation

The current dearth of greenfield projects is also helping to spur investor interest in brownfield, with sellers commanding top prices for prime assets. "To an extent, it's a reaction to the lack of greenfield opportunities – there are funds out there that need to be invested and that's driving existing owners to sell," says Knight. "There's definitely a link between the two."

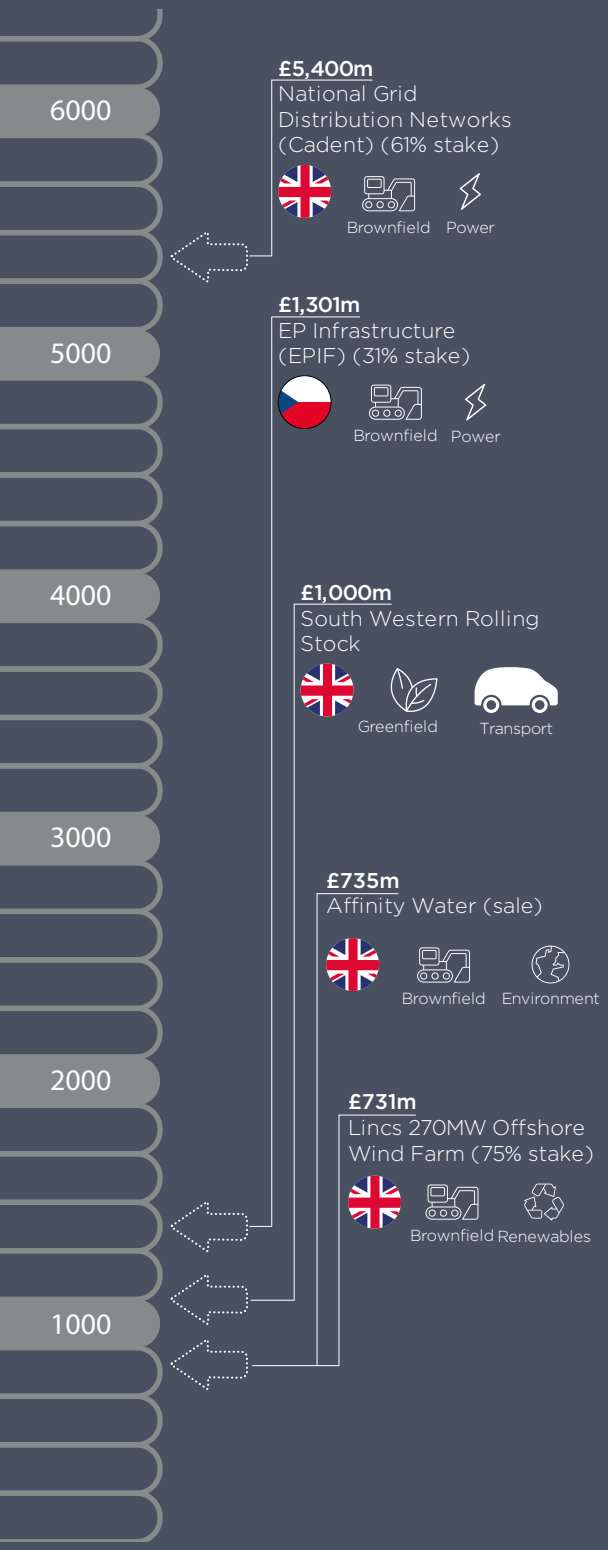
## ENERGY UP

The top two deals in which UK investors were involved – with a combined value of £6.7bn – took place in the power sector.

UK investors had a clear preference for the energy sector in H1 2017, participating in deals worth £7.7bn, 42% of the total deal value involving UK investors in the period. This has already outstripped the £5.2bn deal value for the whole of 2016.

"There are a number of attractions in the sector for investors," says George Karalis, Managing Director, Centrus. "There is significant interest in renewables, and at the same time, there's a need to modernise electricity and gas networks in the

The top five deals in H1 2017 with UK equity investor participation

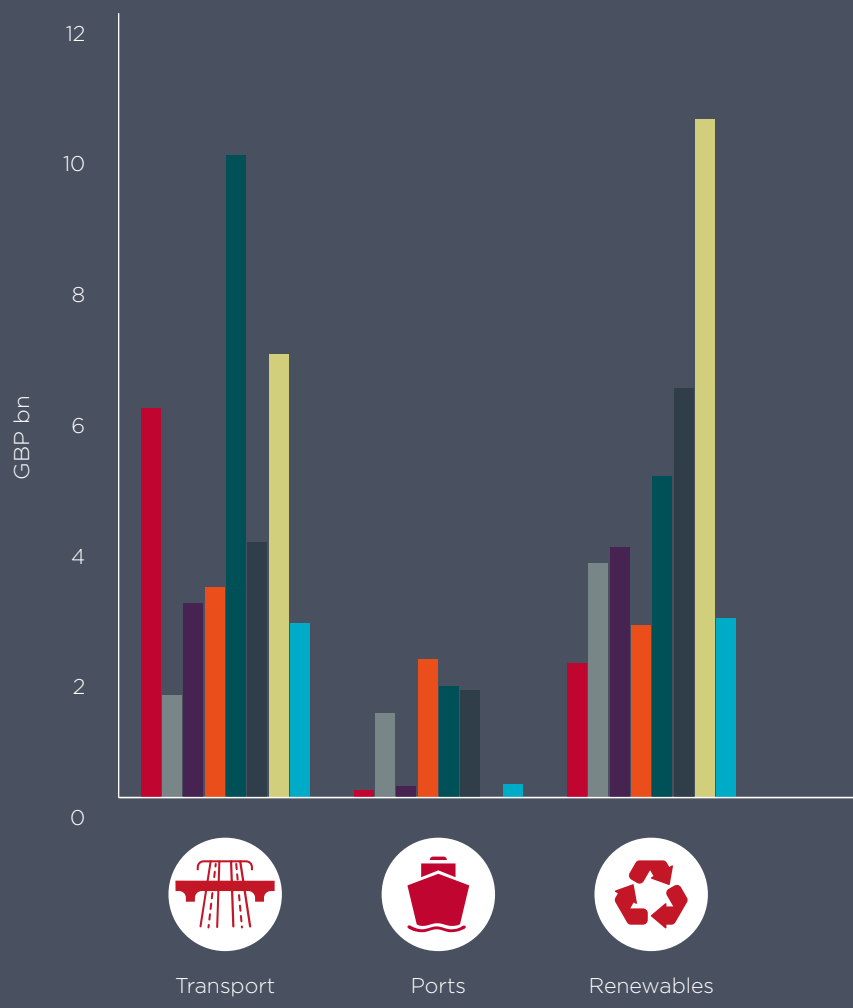



UK, Europe and the US – many people see this as an opportunity to participate."

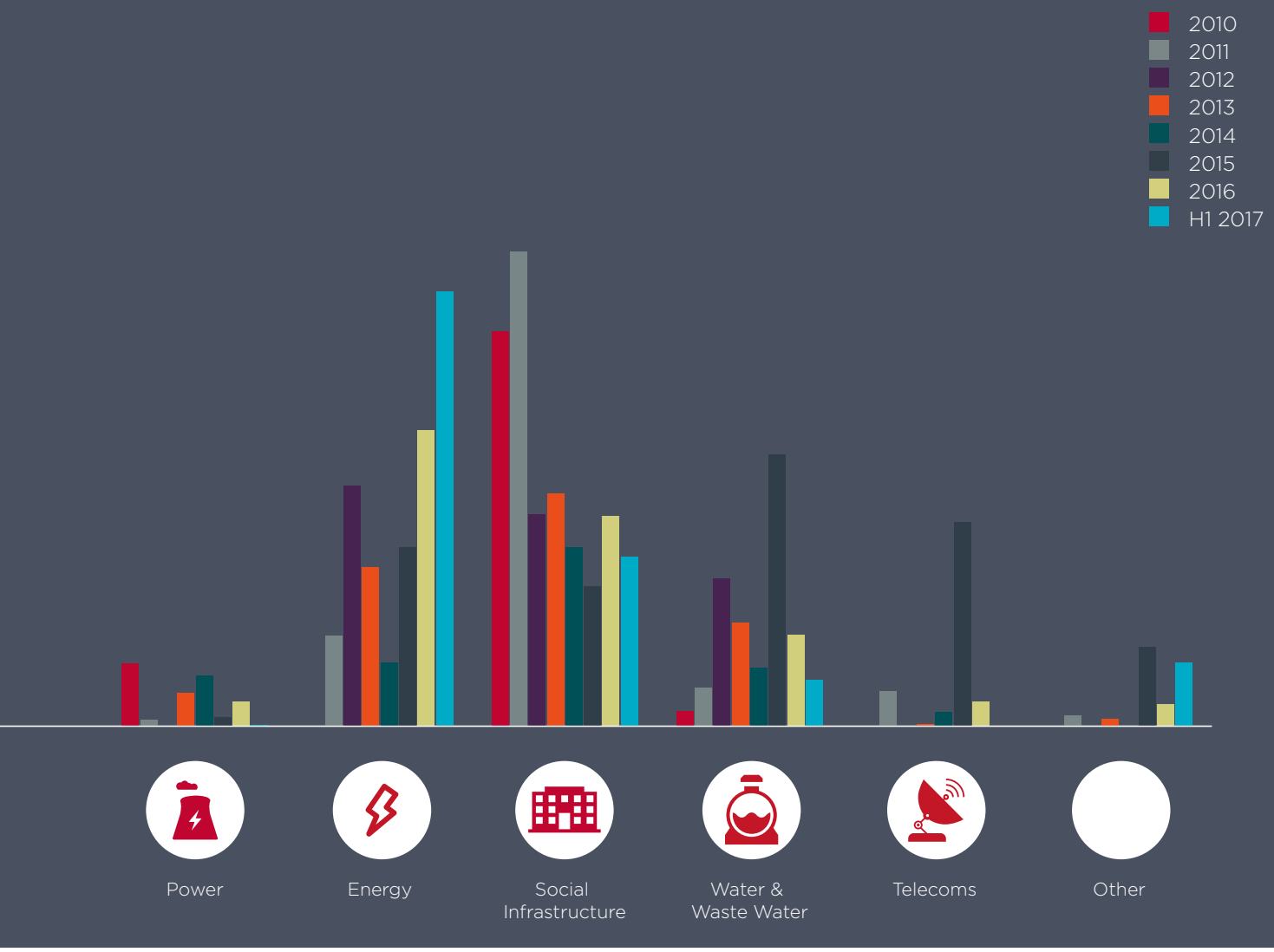
Energy networks are seen as a safe long-term bet: the increasing need for network modernisation means governments are unlikely to rock the regulatory boat. "I think we saw that with the National Grid sale at a premium that no one had envisioned on the regulated market," says Karalis. "Investors appreciate that it's a structurally safe investment in energy."

Social infrastructure was the sector with the second largest total value in H1 2017 for deals with UK investor participation – £3bn – 16% of the total value in the period.

Global transaction value with UK equity investor participation by sector



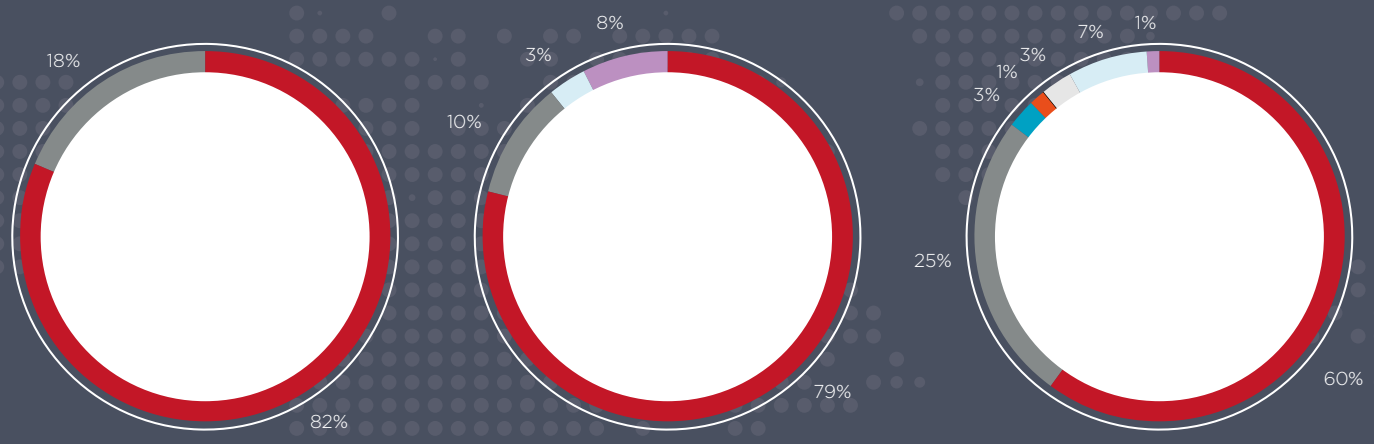
> "We prefer to invest in assets which are already developed. With brownfield investments, the waiting period to generate returns is shorter than it is with greenfield assets. Faster returns mean we can focus on other assets which will help us to expand further."
>
> Managing director, UK asset manager



Chapter 2

# Regional breakdown by UK equity investor type

Global




- Infrastructure Fund Commitment
- Corporate Commitment
- Public Pension Fund Commitment
- Private Pension Fund Commitment
- Insurance Company Commitment
- Government Agency Commitment
- Investment Firm Commitment
- Other Commitment

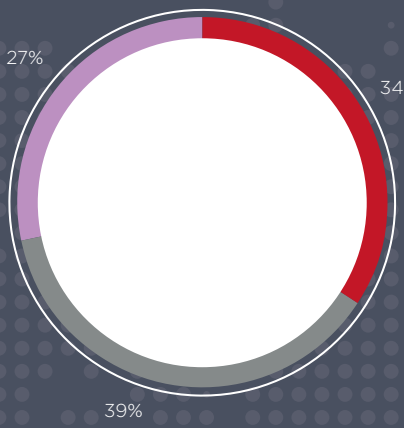
## The top three drivers of infrastructure investment

1. Expansion of infrastructure landscape
2. Increased appetite for private infrastructure
3. Increased number of potential investment partners

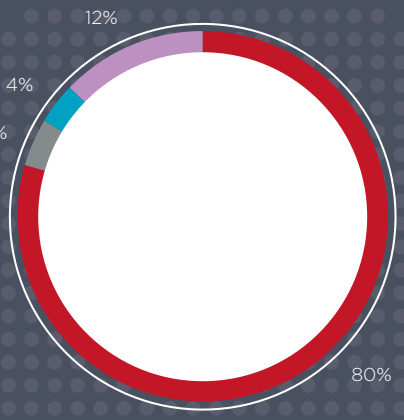
## Top three challenges to infrastructure investment

1. Regulatory changes/political risk
2. Increased competition for assets
3. The number of new projects


Middle East & Africa




Asia-Pacific




## Infrastructure investment in numbers

**£1.2tr**

The amount that has been invested in infrastructure assets globally since 2010

**£239.5bn**

The record high global infrastructure investment in 2016

**£7.7bn**

The value of UK investment in the energy sector in H1 2017 – already outstripping the whole of 2016.

## Chapter 3

# Areas and assets

IN SHORT

**Euro visionaries**
52% plan to raise investment in Europe, 31% and 30% respectively plan to increase activity in Asia Pacific and North America over the next one to two years.

**Hungry for power**
63% will increase activity in power, 55% will increase activity in transport and 35% will increase activity in social infrastructure in the next 12 to 24 months.

**Risk appetite**
43% plan to increase value-added investments and 37% say they will increase opportunistic investments over the next one to two years.

**Public private preferences**
37% say they prefer public-private partnership (PPP) assets, 22% prefer non-PPP assets and 41% have no preference.

## In this chapter, we reveal the strategies which investors will adopt in the near future, including regional and sectoral allocation and the level of risk appetite

Europe remains the dominant geography for UK-based funds – almost all survey respondents have assets on the continent (99%). As the head of investment at one pension fund said, "The European infra sector, and especially the UK market, is giving strong returns and we look forward to increasing our investments there."

North American assets are found in 42% of funds, while Asia-Pacific appears in 29%. Assets in the Middle East and Africa figure less prominently in portfolios (19%), while Central and South American assets are found in just 10% of respondents' funds.

When asked about the proportion of their funds' assets located in each region, Europe emerges as the dominant geography – on average, 78% of respondents' assets are European ones. North America trails behind with 11%, followed by Asia-Pacific (6%) and Middle East and Africa (4%). Just 1% of assets are in Central and South America.

### DIRECTION OF TRAVEL

In terms of future investment plans, Europe emerges as the region with the highest level of churn: more than half of respondents (52%) say they plan to increase their activity in the next 12-24 months. At the same time, only 17% say they plan to decrease their activity in Europe.

"We have invested mostly in the UK, but are looking for assets abroad in Europe which are less affected by the turmoil which has impacted growth in our market," says the investment director of a pension fund.

The European appetite for renewable energy, particularly among the Nordic nations, is a major attraction for investors. The industrialisation of smart energy technologies – which range from grid battery storage systems to virtual power plants – continues to present investors with opportunities as Europe reinvents its energy system.

"European countries are pumping up their resources and finances for a cleaner energy and low-carbon future," notes a partner at a leading private equity firm. "We are seeing massive projects being announced by governments across Europe and this is the prime reason for us to step up the fund allocation."

A significant proportion of respondents (31%) plan to increase their activity in Asia-Pacific. "Emerging and developing markets in Asia-Pacific have shown momentum over the past 12 months and we are looking to increase allocations to

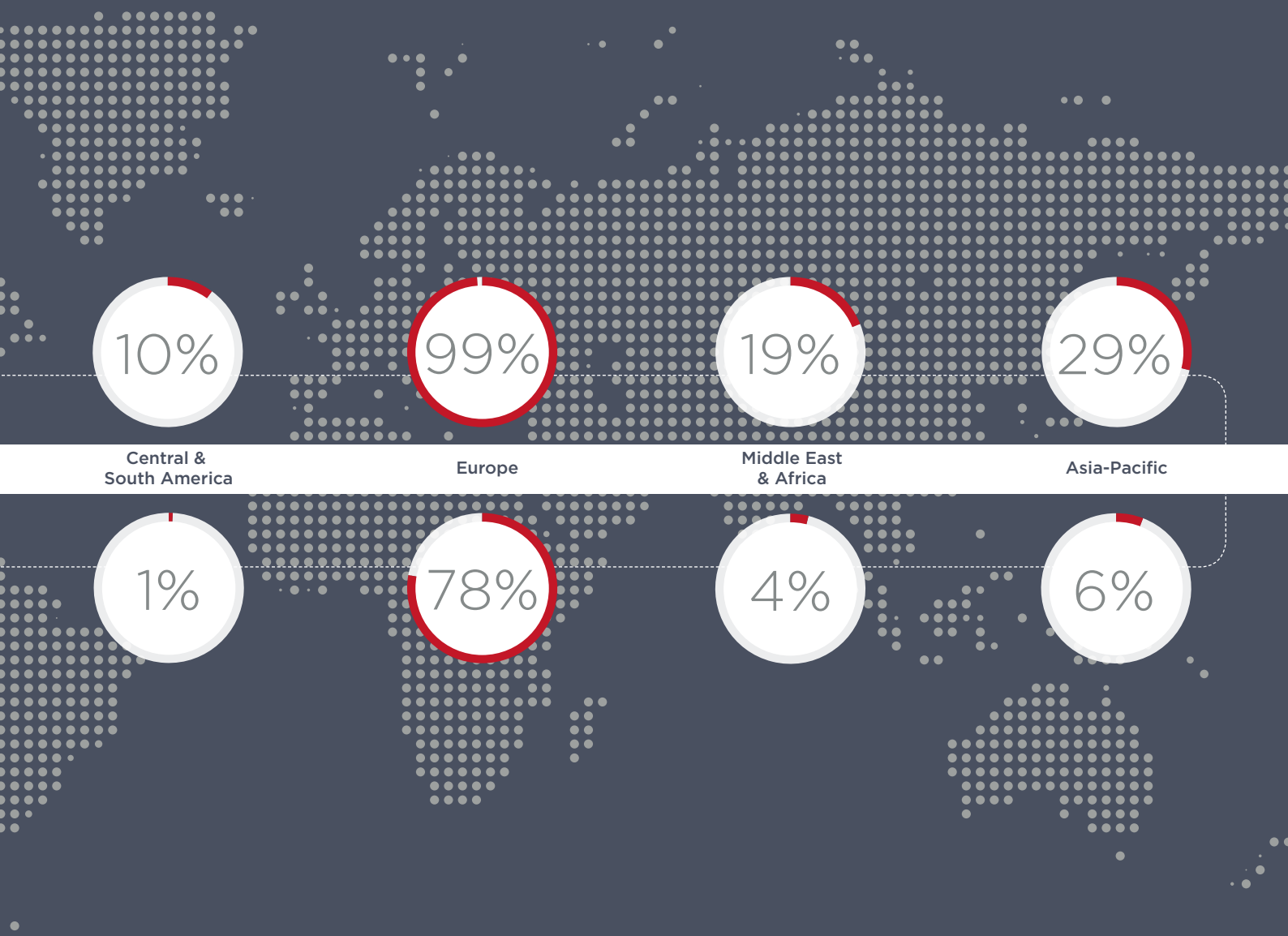
In which regions does your fund currently have assets? (Select all that apply)

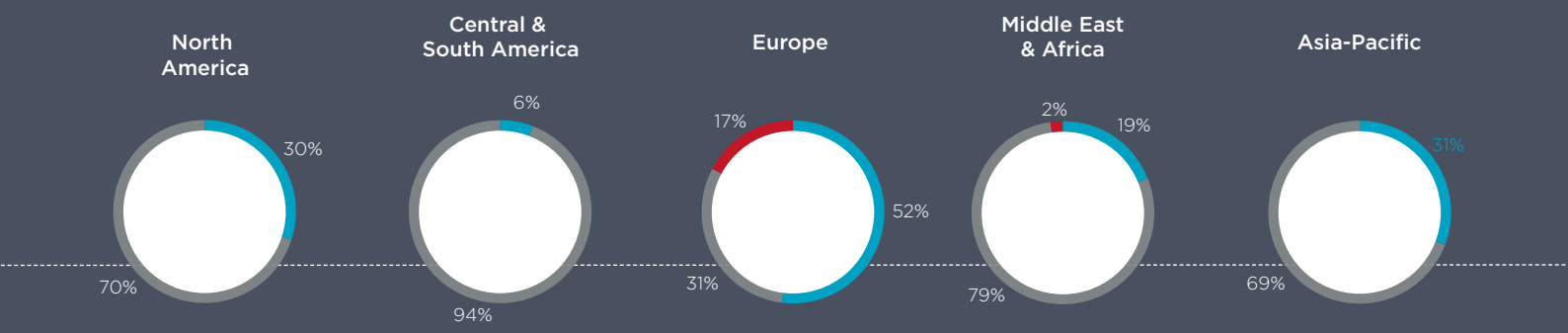

North America

What proportion of your fund's assets are located in the following regions? (Mean shown)


Does your fund plan to increase or decrease its activity in the following regions over the next 12-24 months?

- Increase
- Remain the same
- Decrease


10%
99%
19%
29%
Central & South America
Europe
Middle East & Africa
Asia-Pacific
1%
78%
4%
6%


North America
30%
70%
Central & South America
6%
94%
Europe
17%
52%
31%
Middle East & Africa
2%
19%
79%
Asia-Pacific
31%
69%

a few public and private infrastructure assets," says a PE partner based in London.

## ASSET WATCH

When asked the sub-sectors that they are currently holding, power assets (utilities, power generation and storage) come out top – 85% of respondents have them in their funds. Transport assets (79%) are also popular.

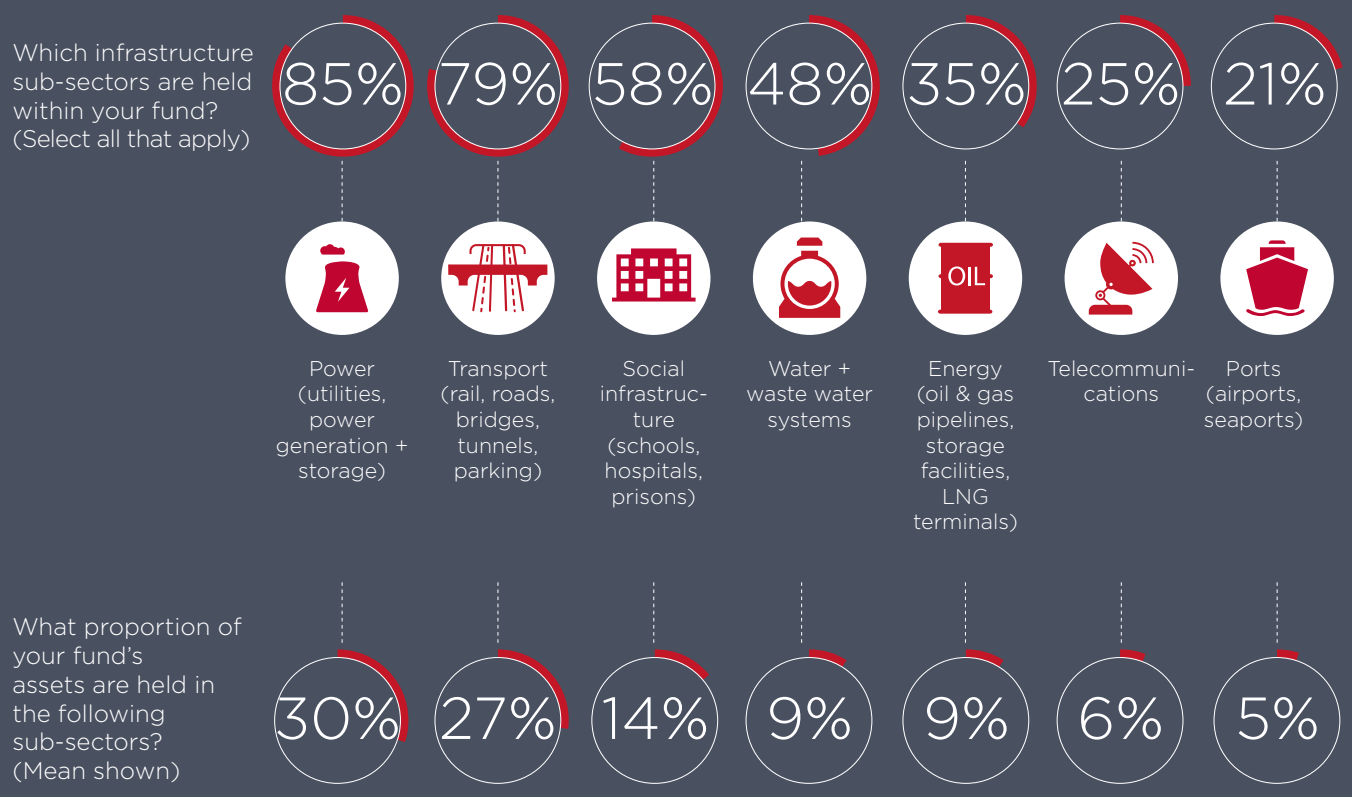
'Traditional' energy infrastructure – such as oil & gas pipelines, storage facilities and LNG terminals – are held by 35%, followed by telecoms (25%) and ports, including airports (21%).

When looking at respondents' holdings in each sub-sector as a proportion of their total assets, the breakdown is the same, with power once more taking the top spot with an average of 30%, followed by transport (27%) and social infrastructure (14%).

## GROWTH STRATEGIES

And when respondents were asked about their plans for future investment – the pattern repeated itself. Nearly two-thirds of respondents (63%) say they will increase their activity in the power sub-sector in the next 12-24 months. This compares with only 1% who plan to decrease their activity.

Growth drivers include changing regulations, the need to renew life-expired energy infrastructure, demand for new generation capacity, attractive tariffs and the shift to low-carbon 'clean' energy. "We want to grow our portfolio for our utility and renewable projects from the current fund allocation. Energy prices and tariff rates are showing a positive trajectory which is attracting investment," says the investment director of an infrastructure fund.



The emerging tilt towards 'clean' energy is apparent in the UK government's announcement that the share of electricity generation attributable to renewables hit record levels in Q2 2017, accounting for 29.8% of overall electricity generation – an increase of 4.4 percentage points compared with the same period in 2016.

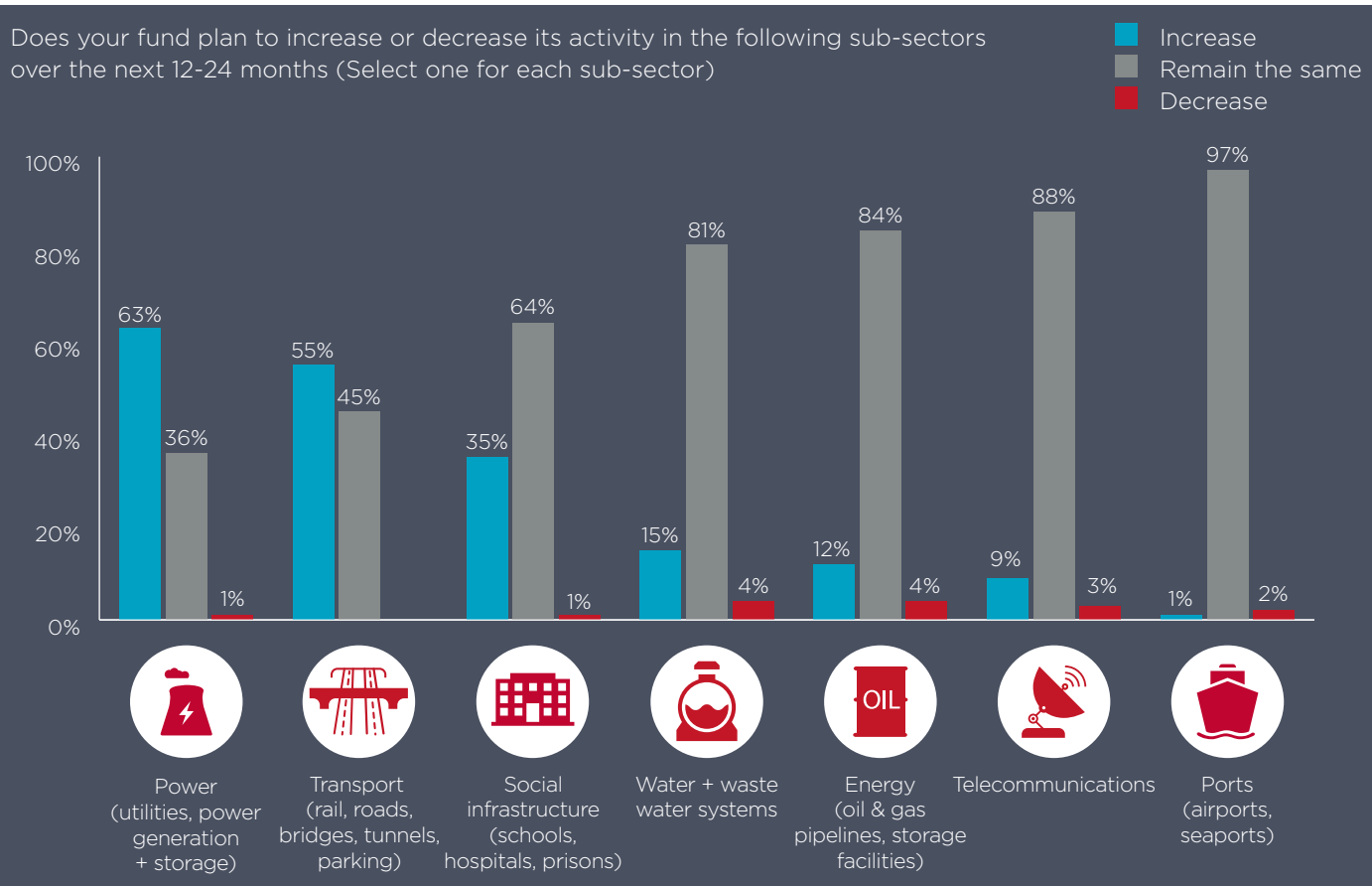
More than half (55%) will increase investment activity in the transport area. The partner of an infrastructure firm says: "We are quite bullish about investments in transportation and utilities projects. Most European governments have announced plans to overhaul and transform major infrastructure set-ups which has made the market upbeat for the short to medium term."

Meanwhile, 35% intend to increase social infrastructure investment activity. Just 1% plan to decrease activity. Some respondents believe that growing populations and a rising middle class means that the demand for social infrastructure will only increase. "Social infrastructure spending is growing rapidly, along with commercial and residential developments," says the chief investment officer of a pension fund.

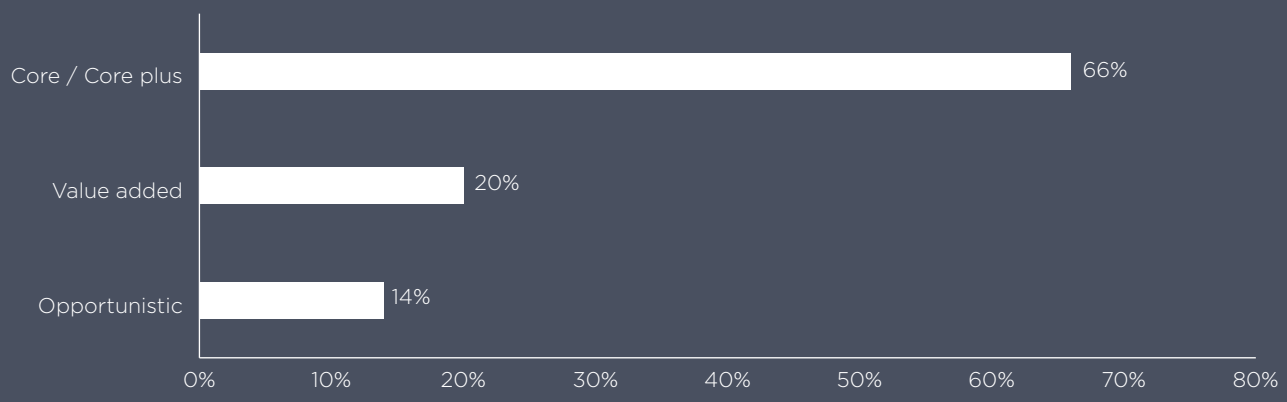
## RISK APPETITE

The survey reveals that a standard fund (based on the average of assets held by all respondents) currently comprises 66% core/core plus assets, 20% value-added and 14% opportunistic assets.

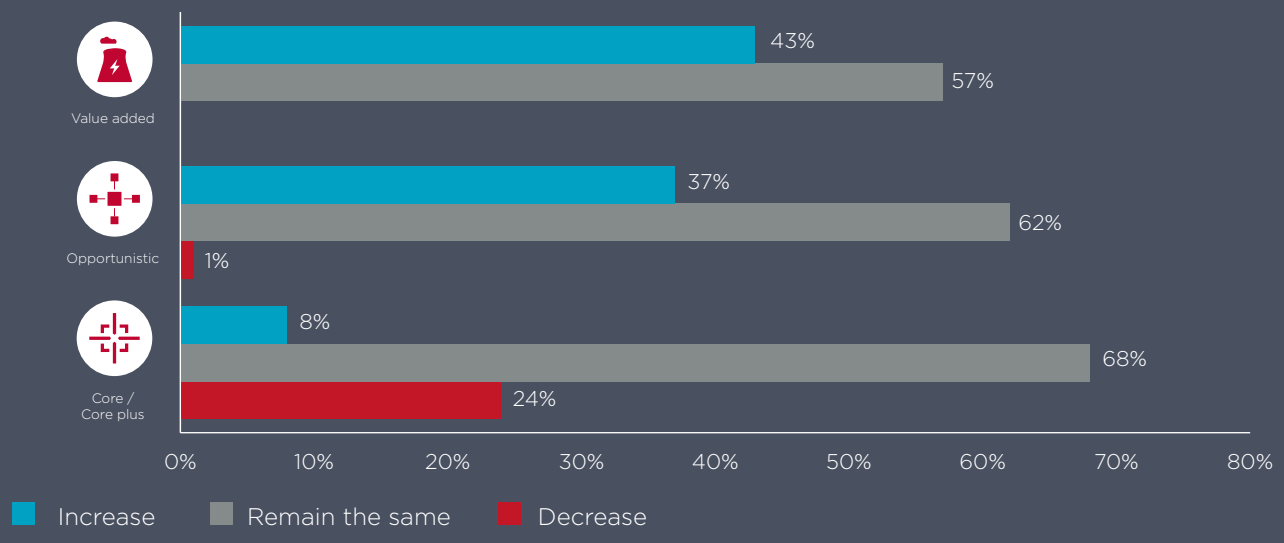
Looking to the future, the survey suggests that investors are willing to take on greater risk. Value-added investments are expected to be the focus of increased activity over the next one to two years by 43% of respondents – none



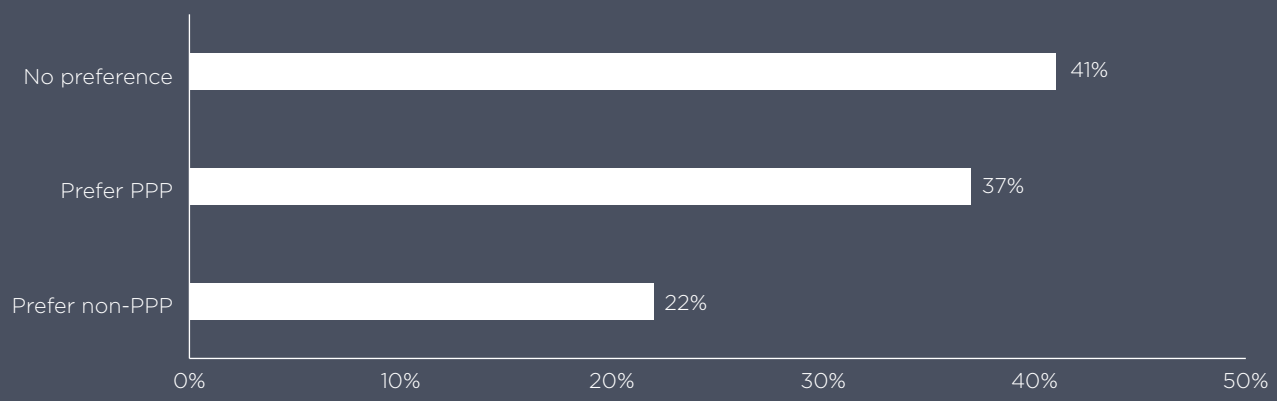
What proportion of the following types of assets are currently held within your fund? (Mean shown)




Does your fund plan to increase or decrease its activity in the following types of investment over the next 12-24 months? (Select one for each category)




Does your fund have a preference towards PPP or non-PPP assets? (Select one)



envisages decreasing activity in this area. Moving even further up the risk scale, 37% of respondents expect their activity in opportunistic investments to increase. Just 1% say activity in this area will be scaled back.

Increasing competition for core assets – along with dwindling returns – are key factors pushing investors towards riskier value-added and opportunistic assets. "It is challenging trying to grow with competition being so high," says the chief investment officer of a pension fund with a focus on brownfield assets. "To compensate for slow growth, we are planning to invest in opportunistic assets where the scope of returns is high."

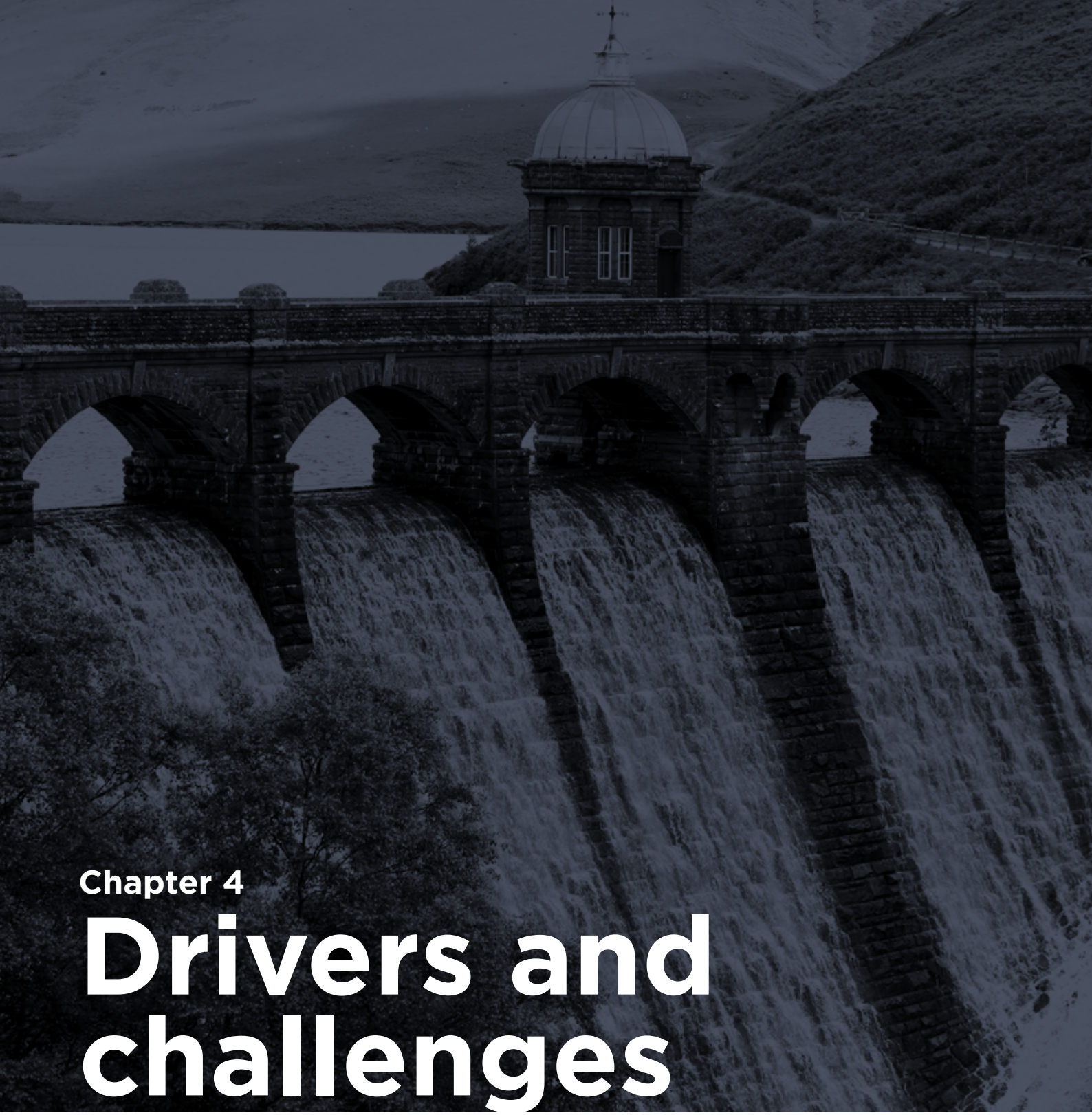
"Returns are being pushed further and further down," says Knight. "I believe they will definitely be moving along the risk spectrum to try and get yield."

Indeed, only 8% of respondents say they plan to increase core investments while 24% plan to decrease. "Our investments for core asset funds are performing as per our planned objectives and targets," says the managing director of an asset management firm. "Core assets need time to mature and we are optimistic about our investments. However, we are seeking to strengthen our portfolio for value-added investments in waste and wastewater management."

## PPP PERSPECTIVE

Public private partnerships (PPPs) provide investors with exposure to social infrastructure (the third most popular sub-sector in our survey) that would otherwise not be available to them. PPPs are the preferred choice of 37% of respondents. "We seek assets with long-term, predictable and inflation-linked cash flows. Most of our investments are PPP," says the chief investment officer of an infrastructure fund.

Meanwhile, 22% prefer non-PPP assets. According to one respondent, the managing director of an asset management firm, this is due to the complications surrounding PPP projects. "PPP assets are governed by a lot of regulations and this creates problems for us when investing in them," he says.



Chapter 4

# Drivers and challenges

IN SHORT

**Aiming higher**
54% of investors say their internal rate of return (IRR) targets have increased by 1% or 2% in the last three years.

**Investment drivers**
Top drivers of investment in infrastructure are the expansion of the infrastructure landscape and increased appetite for private infrastructure funding.

**Emerging threats**
The most significant challenges to investing in infrastructure are seen as regulatory changes/ political risk (54%) and increased competition for assets (53%).

## Here we investigate the motivations behind investor activity and the obstacles that stand in the way of further investment

Abundant targets, access to funding and regulatory certainty are just some of the drivers needed for growth in infrastructure investment. There's nothing new about that. However, what is new is that infrastructure investments are increasingly being targeted as a matter of necessity – rather than choice – as decent returns become tougher to achieve elsewhere in the market.

"Investors have been getting almost nothing from fixed income. So why hold it?" says Knight. "That's why people have been diversifying into infrastructure and I think that's a good thing. But they need to think about the relative liquidity of some of these assets versus more traditional classes of investment."

Alongside the issue of liquidity, there are other challenges for infrastructure investors. Competition for assets is intensifying, valuations are rising and political risks such as Brexit and increased protectionism are a threat to stability.

### RETURN RATES

Evidence from the survey suggests that competition for assets is steering traditionally conservative infrastructure investors towards riskier asset classes and geographies – a trend exacerbated by dwindling returns from assets in established markets.

Target IRR data, for example, shows that respondents have shifted towards higher-risk investment strategies over the last three years. More than half (54%) of all respondents have increased their IRR targets, with 37% saying they have raised them by 1% and 17% reporting they have increased their IRR targets by 2%.

"Our targeted returns have grown with a change in market conditions," says the managing director of an asset management firm. "And because the demand for new technologies and infrastructure has increased, we have been able to take advantage of the growth in the market and have generated strong returns."

IRR target requirements vary according to investors' risk appetite – the more opportunistic the fund, the greater the target IRR. The survey bears this out: 60% of private equity investors have increased their IRR targets over the last three years, while only 4% have reduced them. Pension fund investors, by contrast, have taken a more conservative stance, with just 36% increasing target IRRs and a greater proportion (12%) reducing them.

### SEIZING THE OPPORTUNITY

The biggest driver for infrastructure investment is the expansion of the infrastructure landscape. Well over half (56%) of respondents cite this as one of their top two investment drivers and it reflects the emergence of new investment opportunities in growth areas such as clean energy.

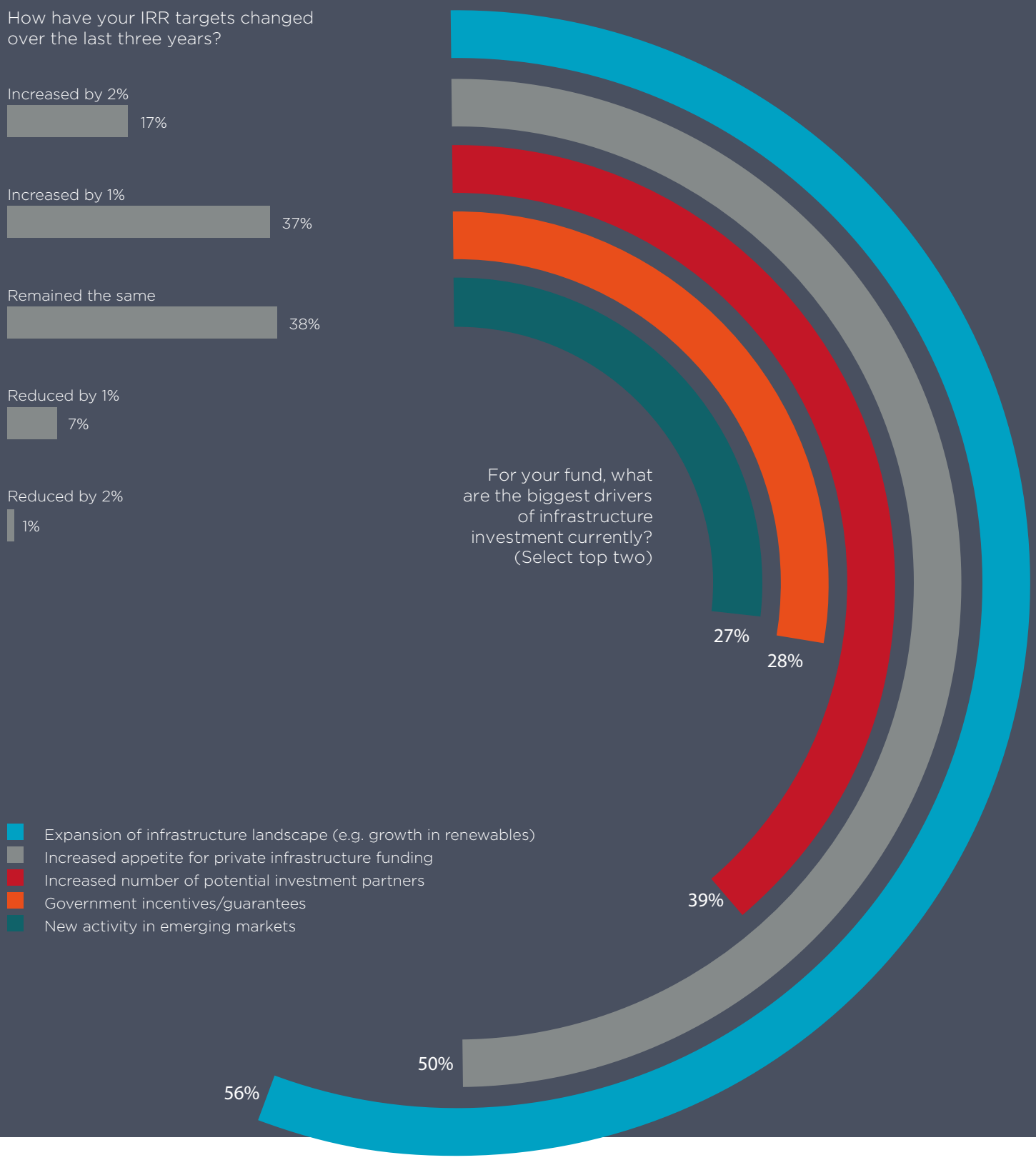
"There is a buzz in the market for renewables," notes the chief investment officer of an infrastructure fund with a strong interest in value-added assets. "People accept the need to build up resources and this is attracting new investors into the market. The asset base is growing steadily as activity in the market drives new investments."

Demographic shifts, a rising population and migration are all fuelling the need for infrastructure developments. And investors point to the increased appetite for private infrastructure funding as being one of the biggest drivers for them (50% selected this as one of their top two). "The landscape for infrastructure investments has certainly expanded – this has attracted a lot of private and institutional funding, thus driving up investment," says the chief investment officer of an asset management firm.

How have your IRR targets changed over the last three years?




For your fund, what are the biggest drivers of infrastructure investment currently? (Select top two)



The increased number of potential investment partners is seen as one of the biggest investment drivers by 39% of respondents. "Large-scale fund diversification has become possible as the number of potential investment partners have gone up," says the managing director of a pension fund.

## INVESTMENT OBSTACLES

The survey shows that political concerns such as Brexit and regulatory changes (particularly environmental laws) weigh heavily on the minds of respondents – more than half (54%) say this is one of the top two challenges confronting their fund.

"Ongoing global geopolitical developments pose a serious risk for investments," says the head of an asset management firm.

In terms of regulatory risk, respondents are concerned about changes in policy and legislation that can quickly turn a thoroughbred investment into an also-ran.

"Stricter environmental regulations have affected the performance of our assets and have reduced growth rates for a number of our investments," says the investment director of a pension fund.

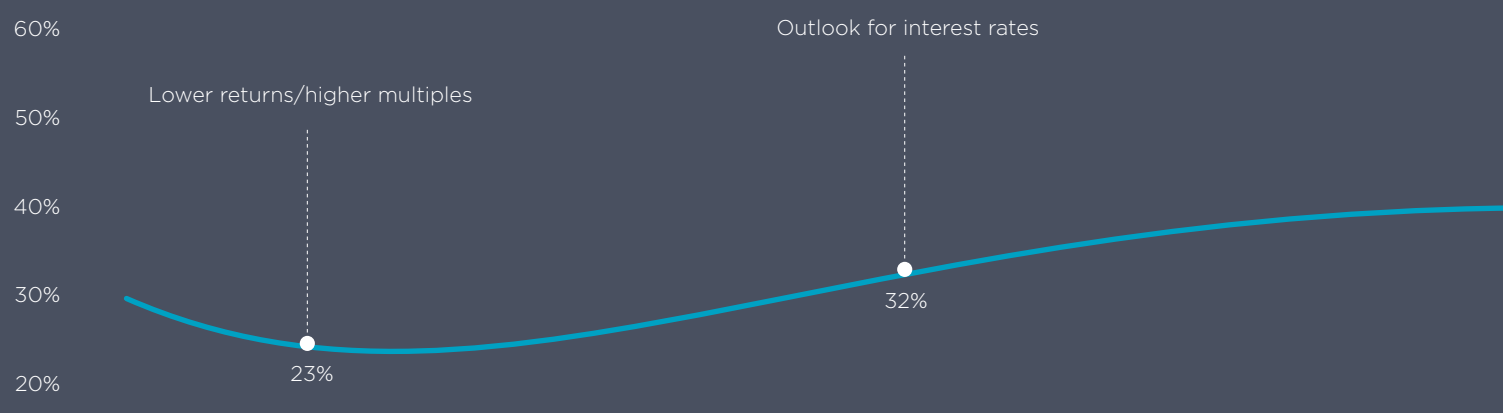
Another risk factor is political uncertainty around PPP investments. PPPs provide private capital with direct exposure to public sector projects and they are therefore susceptible to shifts in the political climate. "We are vulnerable to any changes in the regulatory outlook or policy changes by the government as almost all our funds have exposure to PPP-based investments," says the investment director of a fund with investments in transport, utilities and social infrastructure.

Investors also rank competition for assets as a major challenge, with 53% highlighting this. A related factor – worries about the volume of new projects coming on stream – is mentioned by 38%.

Respondents cite two distinct sets of concerns around asset competition. The first is competition for scarce infrastructure assets, which drives up prices.

The second is around competition in sub-sectors where new assets are proliferating, such as in renewable power generation.

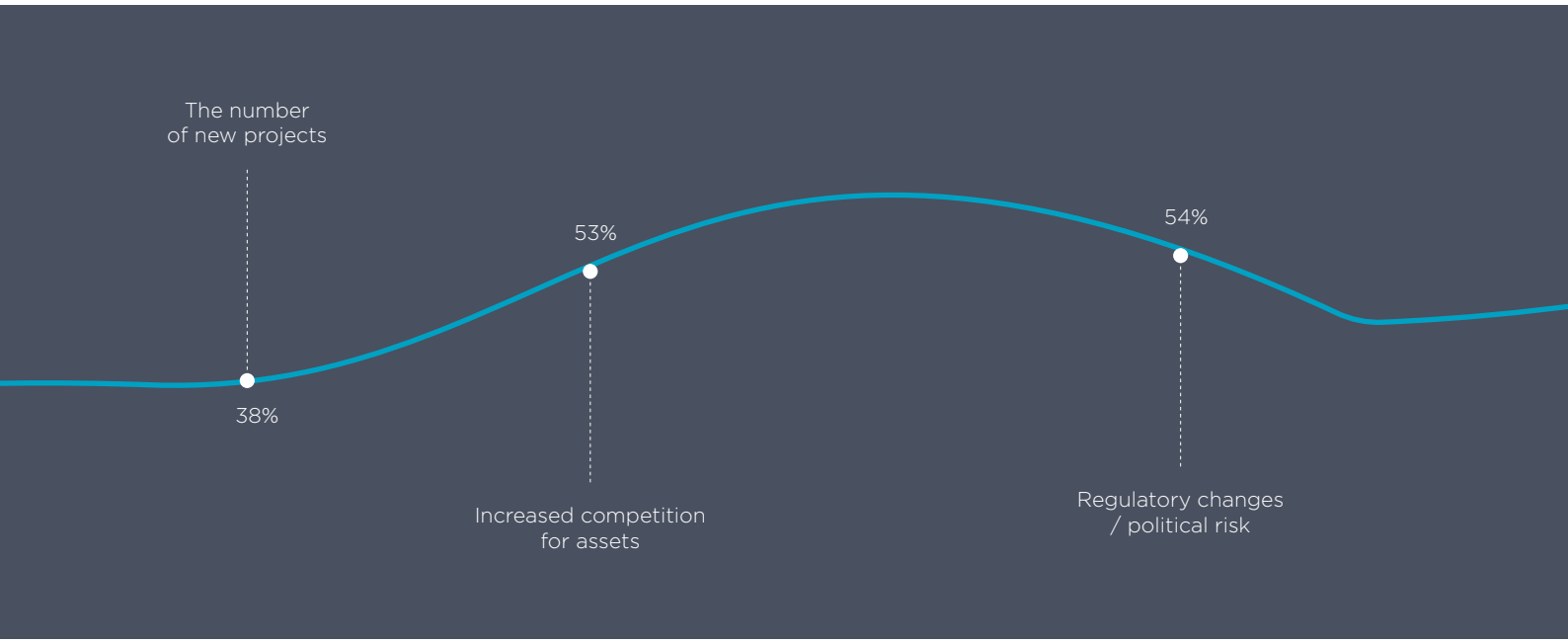
For your fund, what are the biggest challenges to Infrastucture Investment currently? (Select top two)



This can adversely affect the expected performance of existing investments. The partner of a UK infrastructure fund, whose fund includes investments in clean energy, says: "The number of projects that have sprung up in the past few years has affected our position in the market. Competition is growing and we expect the number of assets to keep on rising."

The increasing likelihood of higher interest rates and increased borrowing costs weighs on the minds of nearly a third (32%) of respondents. "Changes in interest rates affect the net IRR values of projects, which in turn dampens investor sentiment," says the investment director of an infrastructure fund.

> "There is a buzz in the market for renewables. People accept the need to build up resources and this is attracting new investors into the market. The asset base is growing steadily as activity in the market drives new investments."
>
> Chief investment officer, UK infrastructure fund



Chapter 5

# Focus on finance

IN SHORT

**Levering up**
57% of respondents intend to lever up in the next 12 months.

**Offsetting risk**
98% hedge interest rate and inflation variability and 65% hedge currency risk.

**Good counsel**
52% of interviewees are using hedging advisors.

**This chapter examines the credit environment and the reasons why most investors plan to lever up in the next 12 months. We will also examine hedging strategies and discuss the role of hedging advisors**

The collision of low interest rates and intense competition for scarce assets means many investors are opting to lever up. The survey shows that most respondents (57%) are planning to increase debt over the next 12 months. Only 3% of investors interviewed say they plan to reduce leverage.

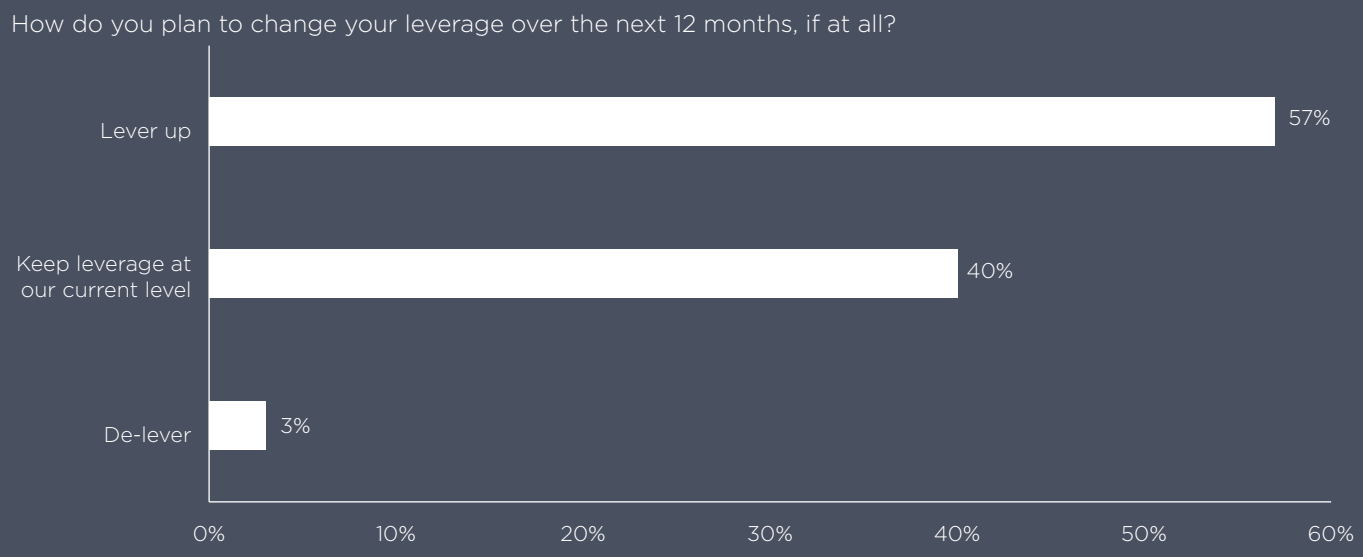
"We will increase leverage because interest rates are low, investors are willing to invest in our company and because the cost of acquiring assets is so high," says the partner at an infrastructure fund which invests in power and water utilities. "We want to steadily expand in the market, but the lack of capital is a problem for us when considering the acquisition of new assets. To accomplish this, we plan on increasing our overall dependency on leverage."

## HEDGING STRATEGIES

Almost all respondents (98%) hedge interest rate and inflation variability. Comments made by respondents point to increasing levels of uncertainty in the market which are being amplified by geopolitical factors, including the implications of Brexit.

"Ongoing political developments demand hedging for interest rates and inflation fluctuations," says the managing director of a pension fund. "Markets have become sensitive to these developments and we need to spread out the risk evenly across our investments."

Hedging inflation risk is often not considered necessary though, because the pricing power of some assets means they effectively hedge themselves. "Inflation-linked assets and inflation-linked revenues naturally lead into inflation-linked liabilities," points out Karalis. "But there are certain funds for which the objective is exposure to inflation, and therefore, they don't want to hedge out of the inflation-linked element of their assets and revenues. By contrast, other types of infrastructure funds require predictability in dividend



distributions and they tend to hedge inflation risk to manage their margins."

Nearly two-thirds (65%) of investors say they hedge against currency risk. "We need to hedge currency risks because our investments are made in different markets," says an asset manager with investments in Europe, Asia-Pacific, the Americas and the Middle East. "Last year wasn't great as currency fluctuations were very high."

Increased foreign exchange volatility in the wake of the Brexit referendum has focused investor attention on the need for currency hedging. "Post-Brexit, the value of the pound fluctuated wildly, affecting our short-term risks and making our investments vulnerable," says the partner of an asset management firm with investments in power, water and social infrastructure. "The best way to deal with this was to hedge the risk we faced."

Currency hedging presents more of a challenge than interest rate hedging, says Knight: "The reality is that most of these assets are levered and investors are aiming to create neutral hedges between foreign currency assets and corresponding foreign currency liabilities. However, there is mismatch during the holding period, created from diversified streams, as well as during the disposal phase. Companies are, therefore, considering operational as well as balance sheet hedging programmes."

## HEDGE HELPERS

The survey shows that just over half of all the investors interviewed (52%) use hedging advisors. "Depending on the asset and the country we are in, we choose different hedging advisors. This allows us to make the right decisions and cut down on risks," says the head of infrastructure fund management at an asset management firm.

The unique complexity of some sub-sectors makes the use of professional hedging advice a necessity, according to a partner for a private equity firm: "Clean energy and renewable investments are very sensitive to market developments and political changes, so we need to use hedging advisors."

Meanwhile, the partner of a private equity firm that is looking to increase its core/core plus investments in transport and water says: "We need hedging advisors who can advise us on our specific needs, as we are looking at certain sub-sector-specific fund allocations for our investments."

**98%**
hedge interest rate and inflation variability

**65%**
hedge currency risk

**52%**
use hedging advisors

Chapter 6

# Ins and outs: deal sourcing and exit strategies

IN SHORT

**Relationship building**
More than three-quarters (77%) of respondents actively build relationships between deals.

**Off the books**
A third of investors plan to dispose of between 26% and 50% of their assets in the next 12-24 months.

**Biding their time**
41% have a five to seven-year timeline for exits of infrastructure assets and 49% have an eight to ten-year horizon. Only 10% say they hold assets for 11 to 13 years on average.

## In this final chapter, we demonstrate how effective partnerships and clear exit strategies are key ingredients in creating successful infrastructure investments

Partnerships hold the key to deal sourcing but there are a variety of ways to forge these relationships. The survey shows that more than three-quarters of respondents (77%) actively build partnerships between one deal and the next, while 74% approach partners after an opportunity has been identified.

"We seek to build trust and confidence in our partners and look for long-term growth prospects," says the investment director of an infrastructure fund. "We vet every opportunity and project carefully, and then look for partners who fit those objectives."

As noted above, many respondents prefer to approach partners after an opportunity has been identified. However, increasing competition and shrinking deal horizons mean that this is not always possible. "It is advisable to seek a partner after you have identified an opportunity, but time is of the essence these days," says the partner of an infrastructure fund. "Markets are changing fast and we need to adapt accordingly."

### EXIT STRATEGIES

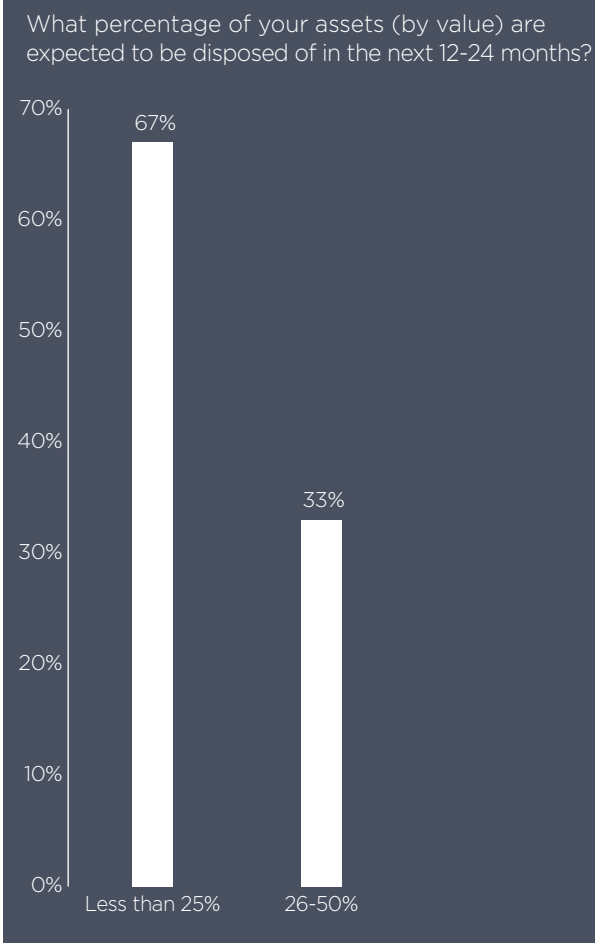
When it comes to exiting assets, the majority (67%) say they expect to dispose of less than 25% (by value) in the next 12 to 24 months. And when they do, there should be no shortage of buyers. "Current market conditions are ideal for sales," says the investment director of an infrastructure fund.

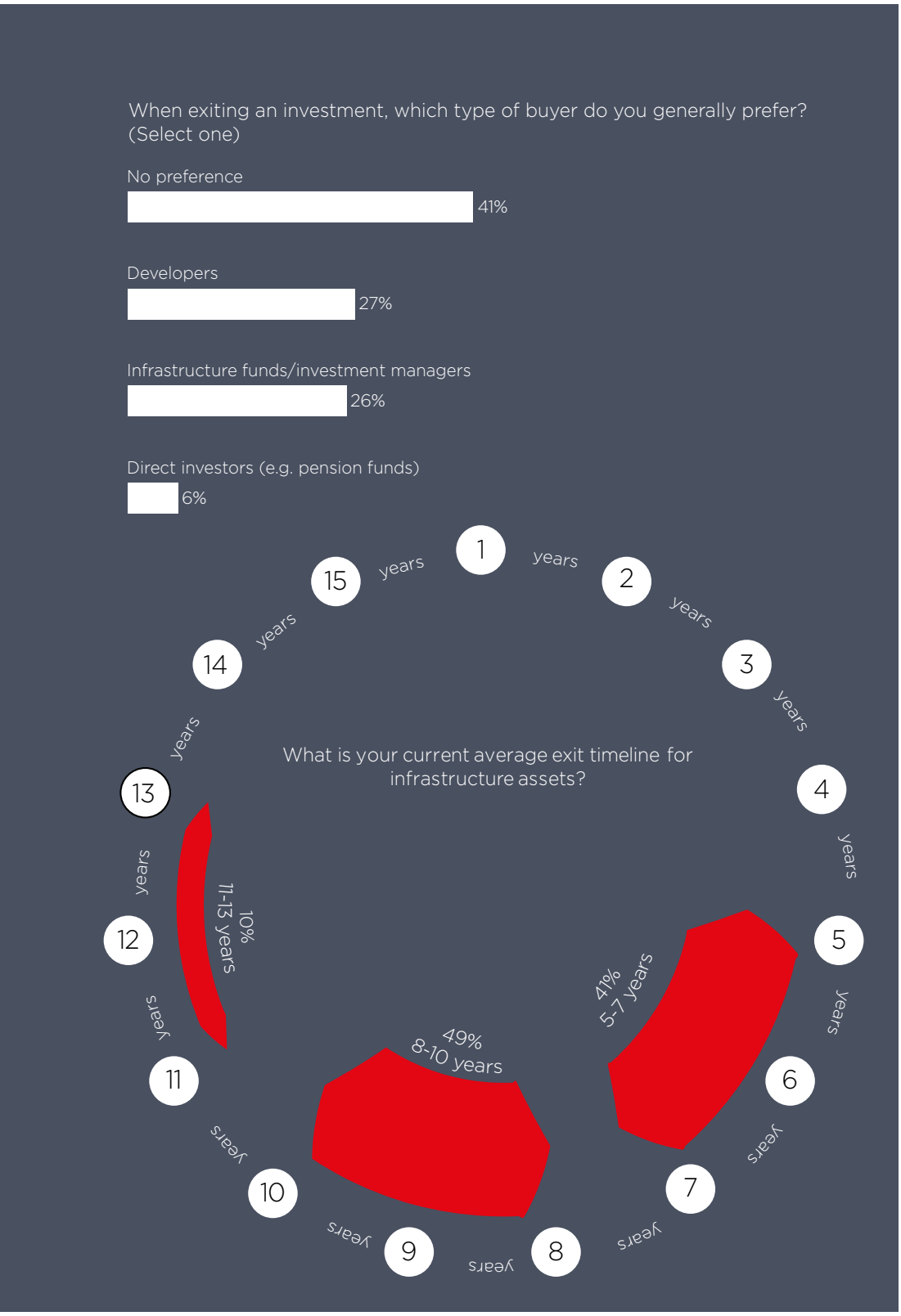
Exits can have a number of drivers, depending on the strategy of the investor. One is to release capital to tap into new opportunities, improve portfolios or pay-off investors. Another is simply to get poorly performing assets off the books.

Exits are also driven by the fact that some funds have set lives. "The problem with having a set life is you don't want to sell all your assets at the same time, because it may not actually suit the cycle of the company's development," says Knight. "By contrast, the advantage of having a fund that's more flexible on timing is you're able to come out of the investment at the time that is best for having maximised the value for that period."

### FINAL COUNTDOWN

In terms of the average exit timeline for infrastructure assets, well over half of respondents plan to hold onto assets for more than eight years (49% state that they would hold on for eight to ten years, while a further 10% say they hold assets for 11 to 13 years on average).




"We believe in in remaining invested for a long time," says the partner of an asset management firm. "These investments in infrastructure projects are long-term, predictable and often inflation-protected cash flows."

And for the majority, these exit periods have been justified. Half of the respondents say they have no plans to extend the term of their current fund. "We have remained invested long enough already and need to get back capital, pay-off investors and turn to new opportunities to expand," says the investment director of an asset management firm.

## BUYER PREFERENCES

The largest number of respondents (41%) says they have no preference when it comes to buyers. However, 27% prefer developers and 26% prefer infrastructure funds/investment managers. "If the buyer fulfils our objectives, we usually consider it irrespective of the classification. We have a select portfolio of buyers we work with based on historical investments and strategic growth objectives," says the investment director of an infrastructure fund.

Those who expressed a preference for a specific type of buyer marginally favour developers.

# Conclusion
# Staying ahead of the pack

**Downward pressure on government spending and the need for new infrastructure across all sub-sectors are likely to continue as fundamental drivers for private investment in infrastructure. And while greenfield growth remains slack, plans for asset recycling by the present US administration are likely to lead to an uptick in both greenfield and brownfield projects in the medium term.**

In the meantime, UK-based investors need to consider five key steps to make the most of their infrastructure opportunities:

### SPREAD THE NET

The survey shows that investors are increasingly turning their attention to new geographies in search of returns. Looking beyond Europe, 31% of respondents are looking to increase their activity in the Asia-Pacific region and 30% are planning to boost investments in North America. Meanwhile, 19% intend to increase activity in the Middle East and Africa. "You wouldn't have seen many people wanting to go to Asia-Pacific or the Middle East five years ago," says Knight. "It comes down to investors' required returns – they're moving along the risk spectrum to try and get yield."

### BROADEN THE AGENDA

As well as moving into new geographies, investors are sizing up opportunities in sub-sectors with high growth potential. Nearly two-thirds plan to increase their activity in the power sub-sector, which continues to experience significant growth as governments race to de-carbonise their energy systems. Meanwhile, more than half of respondents plan to increase investment activity in the transport sub-sector and more than a third are looking to opportunities in social infrastructure – both of which are benefiting from increased government sponsorship, particularly in Europe.

### FOREIGN EXCHANGE FACTORS

Currency fluctuations are a clear and present danger for some investors, so it pays to have a strategy to deal with these, says Knight: "I think there's a reasonable chance that we will end up having quite a lot more volatility in the major currencies' exchange rates, which will have an impact on the performance of certain funds – irrespective of the underlying performance of the assets they bought, which is still important to their end investors."

## TAKE ACCOUNT OF INFLATION RISKS

High inflation is generally good news for infrastructure investors. However, deflation can spell trouble in sub-sectors where pricing power is limited, such as ports and rail operations. “I think infrastructure investors are potentially underestimating the impact of low inflation or deflation because they have assumptions of around 2.8 to 3% inflation in their cash flows,” says Karalis. “A period of prolonged low inflation would impact valuations significantly.”

## AVOID ANIMAL SPIRITS

Finally, infrastructure investors should look to the long term and avoid getting swept up by deal fever, warns Knight. “Stick to your investment principles. If you’re tempted to buy things that you haven’t set out to buy, or you buy them at the wrong price, you’ll be an awful long time regretting it.”

# About Centrus

Centrus is a leading corporate finance business in the UK and Ireland with a primary focus on essential services sectors including Housing, Education, Energy & Utilities, Infrastructure and Transportation. Our team of experienced professionals offers innovative solutions and market insights across:

- Bank Finance
- Institutional Finance
- Asset Finance
- Risk Management
- Mergers & Acquisitions
- Financing Strategies

The company's Centrus Analytics division offers market leading risk management, treasury system and derivatives valuation services to a range of blue-chip companies.

As a leading corporate finance advisor to the Infrastructure sector, we are playing a key role in shaping its future. This survey is intended to provide further insight into the plans and aspirations of participants and sponsors and we plan to repeat this survey annually, providing a barometer for sentiment and trends in the Infrastructure sector.

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