In March 2015, after six months of fierce bidding, the UK government sold its 40% stake in Eurostar, a high-speed rail business, for £585.1 million. Raising almost twice as much as expected, the deal illustrated just how buoyant the market for high-quality infrastructure assets is in Europe. The Eurostar stake was sold to Hermes Infrastructure and Canadian pension fund manager Caisse de dépôt et placement du Québec.

The deal is a clear example of too much capital chasing too few opportunities, according to some industry participants. Infrastructure is seen as an attractive proposition, not only because of its (in some sectors) double-digit returns in a low-yield environment but also because it offers diversification opportunities coupled with reliable earnings and consistent cash flows. Infrastructure can also be used for liability matching and inflation hedging (given that inflation tends to be built into the revenue stream of projects).

Europe leads the global market in providing current opportunities in infrastructure. “Europe dominates the sector because it has willing sellers from the government side,” says Tony Rocker, a partner at KPMG in London. “You also have corporates that desperately need to recycle capital. There’s a phase in Europe for critical development of energy and transport, and governments aren’t interested in more debt. And so you have more infrastructure supply than elsewhere in the world.”

The good performance of the asset class during the financial crisis has boosted its popularity among investors, according to Hamish Mackenzie, head of infrastructure in Europe for Deutsche Asset & Wealth Management. “One of the things we’re seeing is a significant flow of capital into the asset class, either because of investors’ continued search for yield or because infrastructure is increasingly recognised as an asset class that will stand the test of time,” he explains. “A lot of that comes down to the performance of infrastructure during the global financial crisis and the resilience it offers.”

Deutsche Asset & Wealth Management has €27.2 billion of assets under management globally in infrastructure, of which €15.3 billion is in listed infrastructure securities and €11.7 billion is in direct equity infrastructure. Of this latter figure, €8.8 billion (75% of the firm’s direct equity exposure) is in Europe. The reason is simple, according to Mackenzie. Europe offers the most attractive investment proposition compared with other geographic locations.

“One of the attractions of Europe is the scale of opportunity in the regulated utility space,”
says Mackenzie. “The utility market is reasonably fragmented, and there’s a set of opportunities around electricity, gas, and distribution. There’s a need for a lot of capital to be invested into new grids, and there’s the impact of the phase-out of nuclear and coal-fired power and the shift to alternative energy sources.”

SOARING DEMAND

European investors are not the only ones flocking to the sector. According to “Set to Revive: Investing in Europe’s Infrastructure,” a report published by the law firm Linklaters in 2014, global institutional investors have $1 trillion in funds to invest in Europe in the decade 2014–2023. This huge figure is being fueled by interest from investors in Canada, Hong Kong SAR, China, the Gulf Cooperation Council (GCC) region, Japan, and South Korea. Investments from these countries and regions in European infrastructure assets between 2010 and 2013 rose by 465% compared with the four previous years. The findings suggest that the rising investment could give EU member states a further 1.4% improvement in the level of annual GDP from 2014 to 2023.

“Europe is attractive because, in the vast majority of cases, you have a stable regulatory environment and stable governments, and that creates confidence,” explains Andrew Moylan, head of real assets products at Preqin, which provides data and intelligence for the alternative assets industry. He says that there is still a lot of money in the market and “dry powder” yet to be allocated.

“A lot of capital has been raised by infrastructure funds and by institutions both within Europe and outside of it,” he adds. “There are many Asian insurance companies and banks and sovereign wealth funds, as well as European investors, so it’s very competitive, particularly when there’s a public tender process.”

According to Preqin’s 2015 “Global Infrastructure Report,” 15 Europe-focused unlisted infrastructure funds reached a final close in 2014, raising an aggregate $9.8 billion. The 49 unlisted institutional funds on the road are targeting European investments, with aggregated capital commitments of $33 billion. (Figures for North American–focused funds show 32 funds seeking a total of $29 billion of unlisted capital, and in Asia, 20 funds are seeking a target of $12 billion.) The average size of a Europe-focused unlisted infrastructure fund that closed during the year was €622 million, which is 42% higher than the €437 million average for funds that closed in 2013 and considerably more than the €249 million average fund size recorded in 2012.

BUBBLE FEARS

All of this demand has led to increased competition and increasing valuations. Some analysts worry that the market is overheating and believe that investors need to understand the risks they are taking on. Others say the fears are unfounded.

“There’s a lot of talk about a potential bubble, about high prices for infrastructure assets, and that’s kind of counter-intuitive because if it is the case that infrastructure pays regular dividends, come rain or shine, then for an investor with a liability profile, this is a very valuable asset indeed,” argues Frédéric Blanc-Brude, research director at EDHEC-Risk Institute in Singapore.

He believes that, in most market conditions, investors can continue to benefit from the duration opportunities. “More and more investors are discovering these types of assets, and with increasing demand, their prices should go up. These types of owners value the longer duration compared to corporate debt (if you are in the business of matching and hedging your duration).”

RISK MANAGEMENT

But investors and asset managers are being forced to move up the risk curve in pursuit of higher returns. Although they traditionally have stayed invested in core (arguably more stable) assets, they are now venturing further afield.

“Funds are having to search for higher returns in different places. They are starting to look at broader definitions of infrastructure and to look at different countries and geographies,” states Rocker. He says investors are looking at smaller deals in new regions, such as Serbia, Slovakia, and Poland. “They are also starting to look at things that are not core infrastructure.”

KPMG is currently advising on deals in 17 countries in Europe alone. “Ten years ago, we were looking at five for our clients in one quarter,” points out Rocker.

NEW APPROACHES

Investors are also thinking about new kinds of assets and exposures that can further benefit from infrastructure. For example, Paris-based Antin Infrastructure Partners now owns 88.8% of UK-based Westerleigh Group, which has grown into one of the biggest private operators of crematoriums in the country. In July, it also acquired Amedes Group, one of the leading providers of medical diagnostic services in Germany and Belgium.

Renewables are also a growing sector. In the past, construction risk has been a step too far for some investors, but others think that the rewards might merit the risk. “For example,” states the Linklaters report, “infrastructure and energy fund Marguerite, Danish pension funds PKA and IP, and Siemens Project Ventures have invested approximately $548 million of equity in the Butendiek greenfield offshore wind project in the German North Sea. This was one of the first times that funds have taken on construction risk on an offshore wind farm.”
“A puzzle is matching investments with institutional investors. Larger players are building up their in-house resources, but that is not something that everyone can do,” explains Oldrik Verloop, co-head of hydro investments at Aquila Capital, the alternative investment company, which has approximately €2 billion in renewable assets. Verloop points out that as climate change challenges come to the fore and targets on emissions are introduced, the focus on renewable energy is increasing, making it an interesting investment proposition that can return up to 12% per year.

Others are looking to use infrastructure debt, particularly at the senior end of the market, as a substitute (in effect) for investment-grade credit and a way to diversify fixed-income exposure. In November 2014, for example, the AMP Capital Infrastructure Debt Fund II had a $1.1 billion final close, with 50 investors from eight countries invested.

SECONDARIES

Another area attracting attention is the secondaries market. “The other interesting bit of the market for deal flow is the end of the 2006 and 2007 funds, which were raised in Europe and particularly in the UK. Quite a few of those funds are coming to an end over the next couple of years, and so we’re going to see a lot of secondary transactions of assets and portfolios of assets,” says Duncan Hale, CFA, senior investment consultant and global head of infrastructure research at the consultancy Towers Watson.

Investors are also willing to be more flexible and share in assets. “There is increasing competition in the marketplace, and the competition is for less big assets than in the past,” says Rocker. “Even when there is a big asset coming up in the market, you tend to get all the institutional investors looking at it and, as a result, doing things in consortium. The institutions are being sensible, and rather than slugging it out between them, they are sharing the risk and sharing the cost.”

One example is the UK’s £4.2 billion Thames Tideway Tunnel project, which has been called a “super-sewer” upgrade for London’s sewer network. Amber Infrastructure Group, Dalmore Capital, DIF, International Public Partnerships, Swiss Life Asset Managers, and German insurance group Allianz are all part of a consortium that won the bid for the project.

Although industry participants say interest in infrastructure in Europe will continue, the asset class is not without its challenges. “We will continue to see strong institutional appetite for infrastructure,” says Moylan. “Most investors are below where they want to be in terms of capital. So we see plenty of room for infrastructure to grow as an asset class. But pricing and availability are an issue.”

Maha Khan Phillips is a financial writer based in London and author of the novel Beautiful from This Angle.

Can the Juncker Plan Boost Infrastructure?

In November 2014, Jean-Claude Juncker, the president of the European Commission, announced a new initiative to finance infrastructure projects in Europe using institutional investor money to increase the pipeline of new projects. Under the plan, a €315 billion investment fund would be created and mobilised over the 2015–17 period. The Juncker Plan is still in its infancy, and industry experts are divided over its merits.

If it works, investors will have a much-needed pipeline of investment opportunities. “The Juncker Plan is a wish list of the member states to provide an overview of what infrastructure projects they would like to develop in the coming years,” says Oldrik Verloop, co-head of hydro investments at Aquila Capital. “That is definitely to be welcomed. To see how that can be executed and financed is the second bit.”

Hamish Mackenzie, head of infrastructure in Europe for Deutsche Asset & Wealth Management, worries that the plan’s effect may be the opposite of what was intended. “At the moment,” he says, “the Juncker Plan’s biggest impact is discouraging investment, because people want to know how the plan is going to change the economics of the investment and are saying, ‘Let’s wait and see what the impact will be before doing the project.’ People don’t really understand it, and until it is properly implemented, it might actually discourage investment instead.”

The plan was amended by the European Parliament in April 2015, because the European Commission’s intent to cut back on other budgets to fund it was no longer an option. Experts say the concern is liquidity. The plan includes funding coming from the European Investment Bank (EIB), but critics say that funding was never really the issue and that there won’t be enough opportunities for institutional investors.

But it is too early to see how the scheme will actually work. “It’s hard to say what impact the Juncker Plan will have,” says Andrew Moylan, head of real assets products at Preqin. “Anything that will encourage investment is potentially good for the market, but I haven’t seen any evidence of whether it is working or not.”