



# frontiers in finance supplements

Infrastructure funds: down but far from out  
June 2009

FINANCIAL SERVICES



Tony Rucker

Have infrastructure funds had their day? To judge by the gloomy headlines of the last few months, many commentators seem to think so. I think this is a misconception, and that the sector can look forward to a sound future. There are some challenges to be met, to be sure. But with increased transparency and realism, the recovery should bring clear opportunities for growth.



The financial crisis has seriously dented many investor's confidence in infrastructure funds. Returns have fallen. The sector has been hard hit by the dramatic reduction in liquidity. Over-gear assets and fund mergers have come under severe strain, and one of the most high-profile casualties, Australia's Babcock & Brown, fell into voluntary administration in March of this year.

Macquarie Group, which pioneered the infrastructure fund model in Australia, reported sharply reduced profits from its Macquarie Capital businesses in May including a number of write-offs on the carrying value of its stakes in its listed infrastructure funds. In the UK, the sale of Gatwick Airport is struggling, with bids depressed by the scarcity of debt at reasonable tenors together with the decline in air traffic volumes. No wonder some commentators have been quick to proclaim the death of infrastructure funds. Just last month, *The Economist* published a litany of bad news ranging from falling airport passenger numbers to huge declines in container traffic at ports on the west coast of the United States<sup>1</sup>.

So does all this gloom herald the end of the specialist infrastructure fund? In my opinion, far from it. Once you disentangle the specific impacts of the current crisis from the fundamentals underpinning the sector, I'm sure that infrastructure funds are still a sound investment class which can play a significant contribution in many diversified portfolios with a focus on long-term performance.

### Over-optimism

One of the problems in the past was that the performance potential of these funds was overstated, or at least over-rated. The perception developed – encouraged, it must be said, by some early marketing rhetoric – that they offered equity-type performance with bond-type security. Not surprisingly, these 'recession-proof' assets proved extremely popular. Equally unsurprisingly, the realization that this was an over-optimistic view has caused some disappointment.

But the reality is that infrastructure funds are assets like many others. Listed structures will always be reasonably closely-correlated with the performance of equity markets, and where these have suffered from the current crisis, so have they. Highly-gear fund structures have found it really hard to maintain cash flow and service debt when underlying assets cash flows have been affected. Few deals have been completed, as funding and credit have dried up, just as in other sectors.

A more realistic assessment of the comparative attractions of infrastructure investment shows that they should not have been considered as totally recession-proof in the first place. When economies contract and inflation falls, components of the earnings of long-term infrastructure companies eg; water and power companies inevitably fall with them. When trade declines, ports see lower throughput.

**Once you disentangle the specific impacts of the current crisis from the fundamentals underpinning the sector, I'm sure that infrastructure funds are still a sound investment class which can play a significant contribution in many diversified portfolios with a focus on long-term performance.**

When airlines and rail companies lose money and passenger numbers decline, throughput dependant transport infrastructure yields decline too.

But despite the crisis, and the inevitable problems faced by the more highly-gear funds, virtually all the infrastructure funds developed over the last decade remain in business, with cash to invest in the right opportunities, and with few signs of extreme stress. The sector is still worth close to US\$120 billion<sup>2</sup>. It seems to me that the time is right for a new realism to emerge, in which the underlying risk-reward characteristics of the variety of infrastructure funds can be more fairly understood.

**Virtually all the infrastructure funds developed over the last decade remain in business, with cash to invest in the right opportunities, and with few signs of extreme stress. The sector is still worth close to US\$120 billion.**



### Challenges remain

In a market where debt availability is constrained, funds are finding it difficult to price their equity investments. There is still a mis-match between buyers' and sellers' price expectations. As a better balance returns to the system, this gap should close, but it will take a little time. More fundamentally, there are threats emerging to the basic business model of infrastructure funds, as pension funds in Canada and in the State of California, for example, turn to direct investments in infrastructure. Could more follow suit, and conclude that they don't need the complexity, and cost, of an intermediate fund manager?

I think it's unlikely. Infrastructure assets need active operational management and decision-making, over a sustained period of time. They are not buy-and-leave-alone investments. Infrastructure funds bring expertise and focus to the sector. They also allow investors to gain exposure to significantly diversified portfolios of assets. Infrastructure assets in the main involve large individual investments, which limits the scope for all but the largest pension funds to control risk through diversification. The value of active fund management is well-established in other sectors; in infrastructure, as the underlying assets get larger, the case is stronger still. Many investors will pay a fair premium for its benefits.

### Underpinning confidence

How will the sector develop over the coming months? Based on my regular discussions with the sector, it appears that lack of debt is ceasing to be such a major constraint. As yet, there is a trickle rather than a flood of new and longer tenor money, and price remains high. But many banks, which have until recently been offering facilities of only 18 months or so are now beginning to offer deals of up to three years, enabling funds to accept greater equity risk. Confidence is slowly returning.

Many vendors should still seek to lower their price expectations, but as this happens, purchasers will find it easier to achieve desired returns. Many funds have uninvested cash. Many pension funds are realizing that valuations are holding up, and that cash yields support the present value of future cash flows.

The underlying need for expenditure on infrastructure remains: the OECD estimates that US\$2 trillion per year will need to be invested over the period to 2030<sup>3</sup>. Many governments in the developed world have focused on supporting this as part of their response to the recession. Perhaps one of the most encouraging signs is that new infrastructure funds are being established, and that new capital, including private equity, is flowing into the sector: Carlyle Group, Blackstone, EQT, CVC and KKR have all recently launched new infrastructure funds.

This recovery of confidence should now be underpinned by a new transparency among infrastructure funds themselves. Rebuilding trust will require a more open and realistic discussion of risk and reward. Fund managers have an opportunity to explain more clearly how their investments are likely to perform in relation to the bond-equity spectrum. In the new, more sober, environment following the crisis, solid, well-managed funds which are careful to communicate realistically with their investors are likely to find there is a profitable future ahead.

For more information please contact:

#### **Tony Rocker**

Partner, Global Head of Infrastructure Funds  
KPMG in the UK

Tel: +44 20 73116369

e-Mail: [antony.rocker@kpmg.co.uk](mailto:antony.rocker@kpmg.co.uk)

<sup>1</sup> Ports in a storm, *The Economist*, 7 May 2009

<sup>2</sup> *Financial Times*, 23 November 2008

<sup>3</sup> *Infrastructure to 2030: Main Findings and Policy Recommendations*, OECD 2007

The views and opinions expressed herein are those of the author and do not necessarily represent the views and opinions of KPMG International or KPMG member firms. The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2009 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.

Designed and produced by KPMG LLP (UK)'s Design Services

Publication name: Infrastructure funds: down but far from out

Publication number: RRD-151129

Publication date: June 2009