LPs tell us what they want from the asset class.
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Expert points of view on infrastructure investing

February 2020 • Perspectives 1
Seven LP perspectives that matter

Here are the charts from our survey that reveal what investors think about today’s major talking points

Investors’ appetite for infrastructure continues unabated. Although the final close for Brookfield Asset Management slipped over into 2020, thus denying 2019 a new fundraising record, the momentum building behind the asset class shows no signs of slowing, writes Amy Carroll.

These are challenging times, nonetheless. As global markets adopt the brace position in advance of a potential downturn, investors see infrastructure as a safe haven and commitments to it are climbing. But they undoubtedly have concerns about the prospect of rising interest rates, market turbulence and regulation. Investors are also watching closely to see if deals are being structured appropriately to weather a change in the macroeconomic environment.

With the LP Perspectives Survey 2020 – one of the most comprehensive gauges of sentiment among investors in alternative assets – we find out what it is about investors’ infrastructure exposure that keeps them awake at night and how they see the industry evolving.

**CLIMBING COMMITMENTS**

More than a third of investors expect to commit more to infrastructure funds in 2020 than they did in 2019, as institutions continue to build exposure to this burgeoning asset class.

Infrastructure’s low correlation to equities, its limited volatility and inflation-linked protections mean investors see it as offering shelter from a potential storm.

A further 34 percent of investors expect to keep their allocations steady. However, almost a quarter of investors continue to commit to the asset class on an opportunistic basis only.

How much capital do you plan to invest in infrastructure in the next 12 months compared to the previous 12 months?

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invest more capital</td>
<td>36%</td>
</tr>
<tr>
<td>Invest opportunistically (no set allocation)</td>
<td>24%</td>
</tr>
<tr>
<td>Invest less capital</td>
<td>7%</td>
</tr>
<tr>
<td>Keep investment amount the same</td>
<td>34%</td>
</tr>
</tbody>
</table>
UNDERALLOCATION

More than a third of LPs – 35 percent – say they are underallocated to infrastructure. This places the asset class second only to private debt (36% of respondents say they were underallocated to that asset class) in terms of under-allocation and may point to a healthy period of fundraising to come.

A further 29 percent describe themselves as having their optimum target exposure, while just 3 percent are looking to cut back.

However, 22 percent are not currently investing in the asset class at all. This compares with the 18 percent of surveyed investors that have no exposure to private real estate and 11 percent that are not actively engaged with private equity.

Please indicate your current allocation position for infrastructure

- Do not invest: 22%
- Overallocated: 3%
- At target allocation: 29%
- Invest opportunistically (no set allocation): 11%
- Underallocated: 35%

PERFORMANCE MEASURES

A healthy 54 percent describe their portfolios as meeting or exceeding their benchmarks in 2019. This compares with the 78 percent of investors in private equity funds, the 56 percent of investors in private real estate and the 55 percent of investors in private debt that are satisfied or more than satisfied with the results they are seeing. Only 9 percent say they have been disappointed by their portfolios' performance.

How have the following asset classes performed against their benchmark over the past 12 months? (%)

- Infrastructure
- Private equity
- Venture capital
- Private real estate
- Private debt

Exceeded benchmark
Met benchmark
Fell below benchmark
Not applicable
OPEN-MINDEDNESS

It appears that investors are keeping an open mind on structures. Although 41 percent favour closed-ended funds and only 20 percent prefer open-ended vehicles, 39 percent have no clear preference at all.

Indeed, there remains an awareness that different types of assets are suited to different fund structures. Open-ended funds are often deemed most appropriate for core infrastructure, with its steady cashflows and long-term investment horizons. Closed-end vehicles are seen to work better for more intense asset management strategies in the value-add space.

When it comes to infrastructure fund life, do you prefer either:

- Unlisted, closed-ended funds (41%)
- Unlisted, open-ended funds (20%)
- Equal preference to closed- and open-ended funds (39%)
- No, we do not plan to invest in the future (40%)
- No, but we plan to invest in the future (20%)
- Yes, we invest opportunistically (20%)
- Yes, we have a defined allocation (10%)

Figures may not add up to 100% due to rounding.
Global Experts

FIRSTavenue is a leading global advisory and capital placement business focused on the private markets across the key alternative asset classes.

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91 - Successful funds
100% - Privately owned

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**RISK LEVELS**

The core-plus and value-add segments of infrastructure appear to be attracting the most attention, with 22 percent and 21 percent of investors planning to increase their allocations to those strategies respectively. There is a strong trend towards maintaining current levels of exposure across the risk categories. However, a significant proportion of investors have yet to proactively manage portfolio construction from a risk perspective, instead favouring an opportunistic approach.

And although infrastructure debt continues to gain traction among investors, more than half are only investing opportunistically. Just 14 percent are actively planning to increase their exposure to infrastructure debt in 2020.

**BIGGEST CONCERNS**

Thirty-six percent of respondents cite regulatory risk as their top concern when asked directly about what worries them most about the performance of their infrastructure investments. This is perhaps hardly surprising, considering the regulatory flashpoints across the world. Whether it’s UK regulator Ofwat’s decision to move forward with record cuts to permitted returns, or uncertainty surrounding Australia’s chaotic energy policy, regulation is clearly keeping investors up at night.

Frothy markets are also cited as a significant worry, with EBITDA multiples in some sectors reaching eye-watering levels. Political instability and rising interest rates, meanwhile, round off investors’ list of concerns.

Source for all data: Infrastructure Investor
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Editor’s letter

Infra’s star is rising

What better way to kick off another year of *Infrastructure Investor* than with an exercise to gauge how investors might behave in 2020. How will they allocate capital in the months ahead? Are they content with GP relationships or might they shake things up a bit by forming new partnerships or investing in first-time funds? What issues are most likely to present pain points in the current climate? Are investors satisfied with the fees GPs charge? If you’re a manager, I’ll cut right to the chase – ESG and diversity.

The *LP Perspectives 2020* study is packed-full of findings that go some way to answering these questions. As this report lands on desks, we’ll already be midway through Q1. And although it’s clear from the content within that those much-discussed headwinds – regulation, slowing economic growth, potential superpower trade wars and the possible impact of rising interest rates – are weighing heavily on investors’ minds, the appeal of infrastructure as a home for private capital nevertheless looks set to grow.

Thirty-six percent of investor respondents intend to invest more capital in infrastructure in 2020 (when the same question was asked last year, only 27 percent expressed a desire to increase allocations to the asset class). Just 7 percent intend to decrease allocations. And many respondents – 35 percent – feel underallocated to infrastructure going into 2020, compared with 26 percent at the same time in 2019.

As one commentator in this report muses, these results are a validation of the asset class’s growing popularity with investors, and perhaps an indication that it is seen as a safer and more stable home for money in increasingly uncertain times.

The year ahead looks set to be a positive one for infrastructure, and we look forward to monitoring how it plays out.

Enjoy the report.

Helen Lewer
Special projects editor

“*The appeal of infrastructure as a home for private capital looks set to grow*”

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Qualifying and quantifying the impact of external risk factors, and strategies for mitigating them

Developed and edited by industry veteran Jeffrey Altman of Finadvice AG, this book offers:

- Thought leadership and practical advice for managing regulatory, political, social and technological risks facing the sector.
- A comprehensive overview and analysis of key regulations impacting the sector by region, including the US, Asia, Africa and Latin America.
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A growing number of investors are looking to complete co-investments alongside their infrastructure managers, says Jessica Kennedy, director of investor relations at Northleaf Capital Partners.

**Q** How would you describe the level of demand you are seeing for co-investment at the moment and has that changed?

Northleaf’s infrastructure programme began almost a decade ago and, over that period, demand for co-investment has increased substantially. We see appetite from institutions across a wide range of different geographies, sizes and types, as investor sophistication grows across the asset class. This is still a relatively new industry, of course, but the evolution of co-investment is mirroring the evolution of the broader infrastructure market.

**Q** What are the key drivers behind this increased demand?

As investors are becoming more sophisticated, they increasingly have specific portfolio construction goals and are using co-investment to help achieve them. We have seen this in private equity and real estate, and infrastructure is following the same path. It could be that an investor is underexposed to a particular geography in its fund portfolio, or perhaps underexposed to a certain sub-sector. That investor will then look to co-investment opportunities to achieve its optimum portfolio construction and to right-size any exposure mismatches. For example, we are seeing some investors looking to increase their exposure to renewable energy investments to achieve certain ESG-related goals, and to be able to report to their board and other stakeholders that they have a direct investment strategy with a positive environmental impact.

Another key reason that investors pursue co-investments is to average down fees. Co-investments are usually offered at a reduced or zero fee rate for those already invested in a manager’s fund programme and can therefore bring average portfolio fees down significantly.

**Q** Which types of institution are typically seeking co-investment opportunities?

The community of investors is somewhat country-dependent. For example, we see significant appetite among mid-sized Canadian institutional investors, following the lead of their larger, direct investing peers.
that have been active in the infrastructure market for years. Generally speaking, though, we see demand for co-investment across most OECD countries, among mid-size institutions and upwards. These are investors that have built an internal team, have already made a number of fund investments and have some co-investment experience under their belt. They trust their managers and are starting to double down on opportunities through a co-investment programme alongside those managers.

We are also seeing certain investors co-investing in particular sub-sectors or regions. It could be a community pension plan supporting local infrastructure projects as part of the organisation’s long-term goals, for example. In addition, we are seeing a lot of activity from sovereign wealth funds, with significant allocations to infrastructure to be invested – a portion of which is for co-investment.

**Q Is a willingness to offer co-investment a significant factor in primary fundraising?**

For some investors, co-investment is a huge factor in approving a primary fund commitment and it can certainly influence an institution’s willingness to commit. Typically, investors will ask to see the history of co-investment opportunities that the manager has offered and ask for insight into which deals in the pipeline are expected to require co-investment capital.

Investors do need to be aware that the types of investments they are targeting might not necessarily be the investments that are offered as co-investments. As a passive investor looking for co-investment opportunities, you are subject to dealflow, which may or may not match the goals that you have.

Equally, a lot of investors will look to test out a new relationship with a co-investment so that they can assess whether a manager is targeting investments that are attractive to them. Then, if they like the way the manager conducts due diligence and runs its investments, they can progress to a fund commitment.

**Q In what types of situation do you typically turn to co-investment?**

At Northleaf, we tend to work with groups looking to invest between $25 million and $75 million per transaction. This aligns with our focus firmly in the mid-market. These types of ticket size can have a significant impact on whether a transaction gets done. We are typically looking to invest $100 million to $200 million of equity per deal, so a co-investor with a $25 million or $50 million ticket can be impactful.

**Q Do you sometimes find, then, that investors are looking to put too much money to work?**

That definitely can be the case. A co-investor looking to invest $300 million per deal would move us into a different market entirely. We would find it difficult to work with those types of investors because they’re in a different size category and we are committed to remaining focused on our OECD mid-market strategy.

**Q How would you describe your appetite for offering co-investment? Has it changed and, if so, why?**

We have offered co-investment since day one. What has changed for us, though, is that the number of investors interested in pursuing co-investment opportunities has increased and we are managing that by creating additional co-investment allocations.

Northleaf acquired Mula Solar Farm in August 2018, during the installation phase, bringing in €69 million of co-investment capital post-close

Mula is a 494MW utility-scale project, situated on 1,000 hectares in the Murcia region of Spain. Its MW capacity was awarded as part of the Spanish government’s third renewables auction and it is currently Europe’s largest solar farm.

Having worked through installation, Mula is now operational and provides enough clean energy to supply a city of more than 400,000 people. In doing so, it is reducing carbon emissions by an estimated 136,000 tonnes per year.

Mula Solar Farm, Spain
For instance, in the past, when co-investment appetite was more limited, we might have brought another financial partner on board to complete a transaction. Now we look to co-investors that have participated in our funds in the first instance.

In working with co-investors rather than an external third party, Northleaf has a better understanding of our partners' objectives and approach and is able to have increased control of an asset. We don’t have to worry about potential mismatches around exit timing, for example. This is optimal for driving an asset’s business plan to create long-term value.

**Q** How are your co-investments typically being structured and how do they work in practice?

Our co-investors typically invest through a limited partnership that sits alongside our fund vehicles. That goes back to the importance of Northleaf being able to control the asset with a view to creating long-term value. Depending on the transaction, there may be one or more investors in that co-investment limited partnership. There may also be multiple limited partnerships in order to satisfy various requirements of different types of investors, from different geographies.

In terms of the transaction process itself, our investors are primarily looking for sell-down opportunities, rather than co-bid situations. So, we have typically agreed a deal, at the very least, and perhaps even closed it, before we look to syndicate part of the exposure to our co-investors, as opposed to bringing the co-investors in at the time when we are negotiating a transaction. Many investors simply can’t take broken-deal costs and need certainty that a deal is going to be completed in order to engage.

Finally, we are also seeing growing interest among investors for discretionary, pooled, co-investment vehicles, where the manager has the ability to deploy capital to top up whichever deals need additional capital. These will not typically be investors looking to increase certain exposures, but rather those that are looking to average down fees and put capital to work in Northleaf’s target markets and strategies more quickly.

**Q** Does post-agreement syndication help investors get around the challenge of tight timelines with co-investment?

Interestingly, timelines can be tight – even in a sell down situation. There is always a learning curve for managers and co-investors that takes place over the first few deals that are completed together. It is important that investors are well equipped and able to move quickly. A co-investment might need to be executed in anywhere between four and 12 weeks, even in a post-deal syndication. Investors therefore need to be nimble and able to manage their approval processes quickly.

That said, there is absolutely more flexibility in a syndication than a co-bid. The other advantage is that the diligence material is already packaged and everything has been done. In a co-bid situation, you are completing due diligence in real time and may be getting advice or reports coming in throughout the process, which can be more challenging for investors that really do need due diligence materials pre-packaged to take to their investment committee.

**Q** What other challenges can co-investment present for both LPs and GPs?

Something that we really value is transparency from our co-investors. It is helpful for co-investors to keep us up-to-date as they work their way through their due diligence and their approval processes. Is the transaction looking good? Do you expect any pushback? Have there been any delays in your timeline? Having open and honest dialogue is absolutely critical.

It can be very difficult for Northleaf if we are working with only one co-investor, for example, and then we find out at the 11th hour that their investment committee has turned the deal down. Were there signs along the way that could have been shared? Is there anything that we could perhaps have done to help them understand and to get the deal over the line? Good communication is essential.

**Q** How do you expect co-investment to evolve within the infrastructure industry?

We expect to see co-investment, and investment in infrastructure more broadly, continue to grow in size and sophistication. We expect to see an increasing number of investors seeking to access co-investment opportunities and for those investors to continue to refine their due diligence processes to be able to move quickly and efficiently through approvals. Everyone will continue along the co-investment learning curve that has been embarked upon.
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How we conducted our LP survey

The LP Perspectives Survey 2020 is Infrastructure Investor’s study of institutional investors’ approach to alternatives asset classes

The Infrastructure Investor LP Perspectives Survey 2020 aims to provide a granular view of the alternatives market, both current and future, by gathering insight on investors’ asset allocation, propensity to invest and performance predictions.

It is a global study, reflected in the question set and the respondents, which allows for meaningful global views and cross-regional comparisons across alternative asset classes.

The survey questions are reviewed annually, with the objective of reflecting market developments and shifts in sentiment.

For this edition, Infrastructure Investor’s Research & Analytics team surveyed 146 institutional investors. Fieldwork was carried out from August to September 2019. Participation is anonymous, with the findings amalgamated and presented in this supplement.

In which region is your institution headquartered?

North Africa 5%
Asia-Pacific 15%
Western Europe 33%
North America 40%
Other 7%

Figures may not add up to 100% due to rounding

What type of institution are you? (%)

15
10
5
0

Public pension fund Family office or HNWI Insurance company Endowment/ foundation Private pension fund Bank/financial services Fund of funds Corporate Sovereign wealth fund Other

Source for all data: Infrastructure Investor
Some 35 percent of investors currently say they are underallocated to infrastructure, with 29 percent at target and just 3 percent above their optimum allocation.

“We strongly believe that infrastructure is still in the early days of its development as a separate asset class,” says Allard Ruijs, head of investor relations at DIF Capital Partners. “We believe the increasing appetite for infrastructure is driven by the attractive risk-return characteristics, inflation linkage, stability in valuations and limited correlation to other asset classes. In addition, the illiquidity concerns investors may have with closed-end funds have become less of a concern given the development of an active secondary market.”

Just over half of survey respondents report that their infrastructure portfolios had met or exceeded their benchmarks in 2019.

More than a third of limited partners in infrastructure funds expect to increase their exposure to the asset class over the next 12 months, writes Amy Carroll.

Only 9 percent say they were disappointed by their portfolios’ performance.

“The findings validate the increasing popularity of infrastructure as a key addition to a well-balanced private markets portfolio, given its limited correlation and defensive attributes,” says Vittorio Lacagnina, head of business development, private infrastructure, at Partners Group.

**Risk profiles**

However, Sandra Lowe, who focuses on investor relations and fundraising for InfraRed Capital Partners, cautions that the performance of returns on infrastructure investments when compared with benchmarks tells only half the story. “Equally important is the investment strategy, and therefore the risks faced by investors to generate the returns,” she says. “This is particularly important in highly competitive markets.”

With regard to risk/return profile, the
core-plus and value-add segments of the infrastructure market are most popular, with 22 percent and 21 percent of investors, respectively, expecting to increase allocations.

"Value-add infrastructure strategies can deliver strong risk-adjusted returns to investors seeking to shift the risk/return balance of their infrastructure portfolios in today’s marketplace,” says George So, managing partner at InstarAGF Asset Management.

"With active management and robust alignment of interests, we believe there is a significant opportunity to de-risk or grow mid-market infrastructure businesses to create long-term value for investors.”

Ruijs, however, emphasises the undue stigma around core infrastructure assets, regarded as overpriced by the market. He says, “Although the aggressive pricing may be valid for large, visible, trophy assets, we find that smaller or off-market transactions still provide attractive risk-adjusted returns.

“Given where we are in the economic cycle, in our view it remains smart to retain sufficient exposure to longer-term, contracted assets in the core segment. We strongly believe such core assets will provide much-needed downside protection within a portfolio in a recession scenario.”

Investors are also viewing risk profiles opportunistically, rather than as a core component of proactive portfolio construction. For the less mature infrastructure debt space in particular, more than half of investors are approaching the market opportunistically.

Céline Terrier, head of infrastructure finance at Ostrum, says this is ready to change as smaller institutions seek to enter
Regarding the performance of your infrastructure investments, which factor concerns you the most? (%)

- Regulatory risks
- Frothy market
- Political instability
- Rising interest rates
- Other

Which of the following emerging market geographies will you consider for investment over the next 12 months? Multiple responses accepted (%)

- Asia-Pacific
- Latin America
- Central/Eastern Europe
- Middle East
- North Africa
- Sub-Saharan Africa

How will your average commitment to infrastructure funds change over the next 12 months?

- Not applicable
- Decrease
- Stay the same
- Increase
the infrastructure debt space in a more deliberate manner. “We will see more and more investors entering,” she says. “Today, it is primarily the large institutions that are involved. It is a relatively new asset class and there is a cost to enter it. However, I think, going forward, smaller investors will also seek to gain exposure through asset managers. That will be the next major evolution.”

Emerging markets continue to garner attention from investors. Global Infrastructure Partners is understood to be on the road with a $5 billion debut emerging markets vehicle. Asia-Pacific is the most favoured emerging market for LPs, followed by Latin America and central and eastern Europe. Interest in the Middle East, North and sub-Saharan Africa is more muted.

**Threats ahead**

Regulatory risk followed by frothy markets are investors’ chief concerns when it comes to the performance of their infrastructure assets. Both are cited by more than a third of respondents. Political stability is seen as the most significant risk by 29 percent, followed by the prospect of rising interest rates for 21 percent. Across private markets more broadly, however, the threat of recession is most concerning for investors.

“We believe these are valid concerns,” says Ruijs. “Therefore, we always conduct recession scenario tests as part of due diligence to ensure an investment can withstand such scenarios and would also, in such a scenario, be expected to generate an appropriate return.”

Lacagnina adds: “In a heavily contested market for quality assets and a late-stage economic cycle, principal protection is a crucial consideration in the underwriting of new investments. Exit assumptions must recognise the risk of a less seller-friendly environment than is the case today.”

Other concerns cited across the private asset classes include the US-China trade war, extreme market volatility, the impact of foreign exchange rates and government policy shifts. As the definition of infrastructure continues to expand, concerns around strategy drift have also come to the fore.

More than two-thirds of investors say they have experienced occasional examples of managers straying outside their core investment parameters over the past 12 months, although 27 percent say managers have remained disciplined in sticking to their investment thesis.
An expert introduction to the fund and asset lifecycles

- Identifies the important dimensions of a very ill-defined and little understood topic - infrastructure investment.
- Details the challenges faced by investors with regards to valuation and risk measurement and proposes a way forward.
- Demonstrates two academically validated asset-pricing models - one for debt, one for private equity - that have been developed with practical and industrial implementation in mind.
- Explains what data should be collected to be able to run these asset-pricing models.

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How have LP attitudes towards risk categorisation in the infrastructure industry evolved?

When I first started out investing in infrastructure back in 2007, there was no distinction made around risk profile. All the funds being raised in infrastructure distinguished themselves more by strategy and geography than by overall level of risk. An investor might have assumed they were de-risking their portfolio, but in some cases were actually taking on more of a private equity risk profile with increased market and volume risk. This was evidenced when the global financial crisis brought with it drops in the global market, commodity prices, as well as utilisation and pressure on leverage. That hit some funds’ performance harder than others. The industry began to ask itself if infrastructure was inherently riskier than previously thought, or whether risk, in fact, stems from strategy – the amount of leverage being employed, for example, or the growth expectations. As a result, infrastructure adopted a profile system similar to the real estate risk classifications of core, valued-add and opportunistic. That has continued to develop with the emergence of further classifications including super core, core-plus and infrastructure services.

This has been an important evolution for investors. After all, a power plant may be a regulated utility or it may be a greenfield merchant project. With the former, you take limited utilisation or pricing risk. With the latter, you take both, and possibly construction risk too. These current infrastructure risk categorisations reflect, fundamentally, where the asset is in the investment lifecycle. But these categorisations can change over time. A value-added asset can move to core and later become opportunistic depending on the life of contracts, regulatory regimes, technological changes and capital expenditure needs.

The challenge for both GPs and LPs, however, is that there is no commonality in these risk distinctions beyond basic return ranges and basic characteristics. Small differences in IRR can involve a large distinction in risk profile and there are very few benchmarks available to help differentiate. This is complicated by the fact that IRRs are time-weighted, so a hold period becomes just as important. As it stands, these risk profiles are primarily qualitative measures...
for risk based on investments’ underlying characteristics.

The issue is that the further you go up the risk curve, the fewer of the foundational infrastructure characteristics are likely to be present in an investment. It’s hard to get a core investment that has a private equity return profile. And again, the challenge is with effective benchmarking. Whether you’re looking to benchmark against an absolute return target – consumer price inflation plus 4 percent, for example – or against a mix of listed infrastructure equity indices or peer-ranking services, none of these make a distinction based on risk profile.

If you’re investing in core and generating a consistent 8-9 percent net return, comparisons with value-added or opportunistic approaches can be misplaced. You’re always going to be behind your benchmark even though your expectations might be met. Additional challenges come when an investment’s return materially exceeds or falls short of these expectations. Did the manager outperform or underperform? Or was the investment miscategorised?

I’m optimistic that accurate benchmarking will help provide more clarity on some of these nuances, but interpretation will still be key because most infrastructure funds in the market might actually be a mix of risk profiles. Because of this, more benchmarking service providers are looking through fund portfolios and are focusing on the underlying assets. This seems to be gaining momentum as more investors are requiring GPs to disclose underlying portfolio information to the service providers on a regular basis. Transparency and industry adoption will be key here.

Q What are your predictions for the infrastructure funds industry?

From being an investor, and now an adviser, it’s been wonderful to see the growth in the infrastructure universe over the past decade. I welcome the proliferation of managers, vehicles and ideas. I like to see differentiated approaches and specialist engagement. I also think investors in infrastructure are becoming more sophisticated. We’re no longer asking ‘why infrastructure?’ The conversation is now more around portfolio construction and allocation.

My hope is the asset class continues to mature and innovate. I can honestly predict that we’ll continue to debate relative valuations, fund structures, benchmarks, optimal portfolio construction and risk/return profiles well into the next decade. The good thing is that infrastructure will continue to be a key component of investors’ overall portfolios.

Q Why do some investors approach risk categorisation opportunistically?

An investor’s approach to risk depends on the reason it is investing in the asset class in the first place. Investors like infrastructure because it involves monopolistic and essential assets, features uncorrelated investments with downside protection in terms of contracts and regulatory environments, has real asset features such as inflation linkage, and offers cash yield opportunities. This all provides a good fit for asset liability matching and means infrastructure can complement or provide a substitute for riskier or more correlated asset classes, as well as for fixed income.

Investors can also customise their approach in infrastructure investing. If an investor wants current income and longer durations, or if it prefers liquidity and higher returns, there are options available. I also believe that investors, when viewing portfolio construction, don’t need to fill one allocation before they move on to the next risk-profile allocation. It makes sense that investors choose the work plan that suits them based on capital deployment, options in the market and overall market conditions.

What I hear most in the market is how investors are looking at and reviewing their strategy as to whether they will reinvest with existing managers versus investing in new opportunities. As more investor portfolios mature and with overall liquidity being low, coupled with a more rapid deployment pace by most managers, these decisions are even more challenging.

Q Is there a danger, therefore, that in this low interest-rate environment, investors are chasing returns without fully appreciating the associated risk?

Investors tend to have allocation policies around their exposures to core and value-add opportunities. Most of the market, in terms of funds in the market, are targeting these types of risk profiles. There are regional differences in terms of return expectations, but I wouldn’t say that investors are chasing returns or increasing their expectations compared with the past few
years. When I talk to US investors, a large majority are looking for somewhere between 10 and 15 percent net returns. That’s going to be difficult to achieve with a core, or even core-plus, strategy. Value-add to opportunistic become the sweet spot based on return expectations. Conversations with investors in other geographies tend to target 8-12 percent returns, with a focus on current income and duration, which can open up the infrastructure opportunity set.

Based on these expectations and allocation preferences, the real question is whether managers – not necessarily investors – will be chasing returns outside their associated risk profiles. I’m sure there are many opinions on this – 2019 was a strong fundraising year, further compounding the issue of dry powder or uncommitted capital in the market. Can this capital be invested in a prudent manner and within a reasonable timeline? Infrastructure equity and debt offer a compelling return opportunity set in this low interest-rate environment, and it is one of the reasons we’ve seen the rise in infrastructure allocations across investors over the past decade.

**Q** Is appetite for core infrastructure waning?

Based on the current fundraising market, I don’t believe so, but access for most investors to this segment is relatively limited. It does feel like 2019 was the year of the super core vehicles. There does seem to be a concern that returns in this segment will continue to compress, but we continue to see meaningful capital flows to the area.

Interestingly, investors targeting core opportunities have been looking at more innovative vehicles and focusing on duration and cash income. Traditional private equity structures are not necessarily the best option for investors. Rather, investors are deploying capital to open-ended funds, SMEs, club deals and co-investments. This can also help manage an investor’s portfolio construction, deployment timing and the overall impact of fees.

**Q** As value-add and opportunistic strategies push the boundaries of what is defined as infrastructure, what does the emergence of new subsectors mean for the risk investors are taking on?

The expansion of infrastructure’s parameters is simply a feature of the asset class’s maturation. In my consulting days, I once used a Venn diagram that categorized sector and subsector overlap across natural resources, real estate and infrastructure. Infrastructure has gradually absorbed certain sectors that would previously have been in other asset classes.

Definitions will continue to evolve. After all, we have seen strategy shift discussions before around data centres, ports, rolling stock and others. I’m sure there will be further lessons learned in the market.

There does seem to be a rise in the number of opportunistic strategies coming to the market in 2020. These tend to involve more of a private equity approach to infrastructure and focus on growth equity strategies or on non-traditional sectors that might share infrastructure characteristics but aren’t necessarily essential or monopolistic assets. I’m not sure this will push any boundaries, but it does show a differentiated approach and options for investors in their portfolio construction.

I’m more excited about the growth and mix of specialists, both by sector and geographic focus, available in the market today versus 10 years ago. Investors have more options and can define in most cases which new sectors they would like exposure to.

“Small differences in IRR currently drive meaningful distinctions in risk profile and there are little to no benchmarks out there to help differentiate actual risk/return profiles”
The Operating Partner in Private Equity - Volume 2

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Asterion Industrial Partners, a firm created by a trio of former KKR executives, raced to a €901 million close for its maiden infrastructure fund in 2019, surpassing its €850 million target in less than a year.

The firm’s debut is understood to be one of the biggest first-time infrastructure vehicles ever raised in Europe, second only to Cube Infrastructure Managers’ €1.08 billion inaugural fund, which closed in 2010.

But Asterion, which will invest in mid-cap telecoms, energy and utilities, and mobility opportunities, defied a challenging market for new managers.

Some 40 percent of investors in infrastructure funds are planning to increase their total number of GP relationships over the next 12 months.

GPs’ track records top diligence concerns ...

... while more than half of investors in infrastructure avoid first-time funds, writes Amy Carroll

However, more than half – 54 percent – do not plan to invest in any first-time infrastructure funds. This is significantly higher than the level in more mature asset classes, such as private equity.

There are some in the industry who believe that performance from new entrants has lacked consistency. Not all share that view, as 5 percent of investors do have a defined allocation for first-time infrastructure and 30 percent intend to back first-time managers opportunistically.

“The proliferation of new entrants in the asset class has led to a plethora of hyper-focused regional and sector funds with mixed success stories,” says Vittorio Lacagnina, head of business development, private infrastructure, at Partners Group.

“In some instances, a confirmation bias sets in, leading to a decoupling between asset pricing and return fundamentals.”
Selling a stake

Investors remain unconvinced about the merits of selling a stake to an outside investor – 45 percent believe such a move makes the GP a less attractive proposition, while 43 percent are unsure.

The sale of minority stakes has become increasingly common across the alternative asset classes. The emergence of specialist buyers, including Dyal Capital Partners, Blackstone’s Strategic Capital Holdings, Goldman Sachs’ Petershill fund and AlpInvest, illustrates the trend. These fund of firms groups have raised more than $17 billion since 2012 to pursue the GP stakes opportunity and are currently looking to raise $14 billion more.

Managing generational change has been one of the most significant drivers of GP stake sales. The more mature private equity and hedge fund industries have, therefore, inevitably led the charge. Blackstone’s acquisition of a $500 million stake in BC Partners has been one of the latest transactions to complete. However, infrastructure typically tracks these longer-standing asset classes, and similar deals are likely to be struck in the space.

In addition to providing a solution for succession, the sale of a stake in the general partnership can fund acquisitions or expansion into new territories and subsectors of asset classes. They can also finance recruitment or internal investment in areas such as technology. For the buyer and the underlying investors in these specialist funds, the acquisition of a GP stake provides participation in a firm’s cashflows, not just the returns from an individual fund.

The income stream from management fees and carried interest can be both steady and substantial, particularly as a firm expands its assets under management. It can also result in preferred allocations in a firm’s primary fund, as well as opportunities for co-investment.

Deal breakers

With the exception of performance track record, team size and investment capacity are seen as the most important areas of focus when considering an alternative assets fund investment. Some 88 percent of investors say these two factors play a major part in their due diligence. Terms and fees, a fund structural review and succession are the next three most important features of due diligence. However, only 23 percent of
Analysis

investors in alternative assets say that diversity and inclusion play a major part in due diligence and 22 percent say these factors play no part at all.

Furthermore, only 31 percent say environmental, social and governance credentials are key, and 19 percent do not review ESG policy and practice as part of their investment decision-making.

Almost half of investors in infrastructure funds are confident that their GPs are structuring deals sensibly to withstand a potential downturn. However, 15 percent of investors say they are lacking confidence, with the remainder describing themselves as neutral.

How confident are you that your GPs’ deals have been structured sensibly enough to withstand a downturn?

Not confident 15%
Neutral 38%
Confident 47%

How significant a part do the following play in due diligence? (%)

Forms a major part of the process  Forms a minor part of the process  Not covered in due diligence

GP performance track record

GP team size and investment capacity

Terms and fees benchmark

Fund structural review

Succession planning and retention plans at the GP level

GP balance sheet/financial strength

Evidence and consideration of ESG

Diversity and inclusion

Source for all data: Infrastructure Investor
A strong ESG framework is essential in infrastructure

**ESG best practice mitigates risk and enhances returns, says Whitehelm Capital chief executive Graham Matthews.** What’s more, investors are becoming increasingly sophisticated at spotting the real thing.

**Q Why is environmental, social and governance best practice so important for infrastructure investors, in particular?**

In some asset classes, I can accept the argument that there may be a trade-off between getting ESG right and maximising returns. But that is definitely not the case for infrastructure.

If you think about what it is that we’re actually investing in, these are long-term assets that have a real impact on the local environment and on local communities. That means if you don’t get ESG right, it is going to hit you in the cashflows. It’s not like you are buying a business that is all about brand or short-term dynamics. These are long-lived assets and that means ESG is critical.

**We made our first investment in infrastructure with the Eastern Distributor toll road in Sydney in 1998.** Even then we were looking at these long-term factors. We weren’t calling it ESG, because ESG hadn’t been invented yet. But we were focused on factors that affect the long-term sustainability of the asset. We are far more sophisticated in terms of how we approach these issues now, but it is something that has been important to us right from the very start.

**Q What are the risks associated with not getting ESG right?**

At the most basic level, if you don’t take ESG factors into account, you might end up investing in something that can no longer be used. When the world changes and that business model is no longer viable, there is a real risk of ending up with stranded assets. A good example would be an oil pipeline. In other energy sectors, the energy transition can forge pathways for fossil fuel-based assets to be converted into low-carbon assets over time. But an oil pipeline is always going
to be an oil pipeline. It can’t be anything else and so it has a finite life. When oil stops being used at some point in the future, that asset’s worth is going to be zero.

There are other risks as well. There are regulatory risks, of course. All the assets we invest in operate within some sort of regulatory environment. It doesn’t necessarily have to be an asset that’s subject to direct economic regulation, but every asset is affected by regulation to a greater or lesser extent. Those regulations naturally encompass ESG factors; so if you are not taking those into account, you risk falling foul of regulatory changes.

Then there’s financial risk. There’s risk around the availability of debt and the availability of insurance. And there is risk around operating and capital costs. A good example of taking that risk into account would be what we did with Kvitebjørn Varme, a district heating waste-to-energy asset in Tromsø, the largest Norwegian city inside the Arctic circle. It’s obviously a very cold place, which is a good fundamental for district heating. But we also know that the world is warming. As temperatures increase, we can expect demand for heat energy to fall. Therefore, we engaged an environmental expert to provide us with advice on future heating requirements and their impact on operational and capital costs, and factored that into our analysis of the investment.

There is also a fundamental risk around the social licence to operate. If you are not in tune with ESG factors, and if you don’t take them into account on a day-to-day basis as part of your asset management, ultimately you risk losing that licence to operate, with all the associated financial implications.

Q How do you expect infrastructure’s ESG journey to evolve?

I think it definitely will continue to evolve. I don’t think we have reached the peak. This is not just the flavour of the month. ESG will increasingly be seen by both GPs and LPs as an integral part of the investment toolkit and an essential requirement for anyone positioning themselves as a successful manager.

I also certainly think that ESG assessment will continue to move away from a tick-the-box compliance approach, to an approach that is focused on outcomes. We call that ‘moving beyond the bullshit’. You have to be able to demonstrate how ESG affects your investment decisions, how it is taken into account in your asset management and, importantly, how you measure results.

I think we’ll see a greater use of benchmarking and scoring systems. I also think we’ll see increased calls for transparency, with investors and with the broader world as well. Finally, I think investors will become increasingly sophisticated in their own articulation of what they want from managers, with more stringent requirements built into limited partnership agreements.

Q To what extent has ESG risen up the priority list for investors in infrastructure funds?

Some investors, particularly those from the Nordics and Australia, have been at the forefront of ESG considerations for many years. But it’s been interesting to see how quickly other regions are catching up. The US, in particular, where a lot of investors outside the public funds space were not as concerned about ESG until a few years ago, has seen a real transformation.

And it’s not just the number of investors thinking about ESG which is having an impact; it is their increased sophistication. It is no longer just a box-ticking exercise. There is rigorous analysis taking place and investors are really focused on assessing ESG outcomes and measuring improvement over time.

Q What does that look like in terms of the due diligence process and how are benchmarking tools supporting investors in their decision making?

Some investors are now using third-party experts to review a GP’s ESG approach. We are also seeing investors develop significant internal capabilities. Some have developed their own methodologies and questionnaires. Others are using external ratings agencies such as GRESB. One of
our fund-of-funds investors has a particularly rigorous approach to ESG, even giving an annual ESG award.

Q Do investors buy that good ESG doesn’t come at the expense of returns?
I think investors increasingly accept that this is the case. Up until a few years ago, you would still come across some investors, particularly in the US, that would ask about the cost of ESG in terms of returns. But that is changing. Of course, we need to be hardened investors. As a GP, our responsibility to our investors is absolutely to deliver the best investment returns that we can. But with infrastructure, I feel we have moved beyond the idea of a trade-off.

That said, you do need to be careful about how you implement your ESG strategy. You have to approach it with skill and care, and make sure you are focused on outcomes and that you are tailoring your approach to a specific asset. If you do that, I think you can be absolutely confident that getting ESG right is accretive to returns.

Q How do you, as a GP, incorporate ESG principles into your investment and asset management decision-making?
We have an aspirational ESG policy that applies, at a corporate level, to everything that we do. It articulates what it is that we are trying to achieve as a business, both for ourselves and for our investors. We then have a specific code for implementation of that policy across each business segment. For example, in infrastructure that code specifies various things that we must and must not do. It sets out a blacklist of countries and sectors that we won’t invest in and a ‘white list’ of sectors that we have a preference for investing in. It sets out requirements for us at every step of the process from initial discussions with a potential vendor, through analysis, ownership and then eventually disposal.

We then have a proprietary implementation framework involving 180 different ESG factors. It’s like a credit rating. We strive to achieve AAA-rated assets but recognise that not every asset can start off that way. The framework is also a measurement tool, therefore, as we look to improve the asset over time. We reassess assets every year and those assessments are communicated through our annual sustainability report.

“At the most basic level, if you don’t take ESG factors into account, you might end up investing in something that can no longer be used”

Q As an industry, is the focus still primarily on environmental concerns, or are ESG parameters widening?
When people talk about ESG, the mind naturally goes to the E. The need to focus on carbon emissions and the resilience of assets in the face of climate change is obvious. It is a clear area of endeavour. That said, in our experience, the S and the G are where we spend most of our time. That is not to play down the importance of environmental factors at all, but we find the S and G to be the most challenging components.

To illustrate that, of the 180 factors that we look at across ESG, only 30 are, in fact, environmentally focused. There also tends to be more room for improvement with the S and the G.

The interplay between all three is also very interesting. For example, we turned down a potential investment into an export terminal development in Australia. The proposal was to expand an existing facility, but as part of that expansion, to dredge material from the seabed and dump it in the ocean, adjacent to the Great Barrier Reef.

From an environmental perspective, that wasn’t something we were prepared to be involved in, but it was actually from a governance perspective that we turned down the opportunity. The company had achieved all the necessary environmental approvals, but our concern was that if the board was prepared to take, what seemed to us, like quite an obvious risk, then what other risks was it taking? The environmental concerns were the symptom, but the real problem was an underlying governance issue.

Q How is ESG best resourced within a manager?
It depends on the size of the organisation. We have around 70 in our team, split between London and Australia. For us, what works best is to have ESG as a responsibility for everyone but then also have someone as a dedicated lead.

One of our senior investment directors is our head of asset management and our head of ESG, so we have a very senior person tasked with the responsibility of ensuring everyone in the team is factoring ESG into everything we do. It isn’t his job to do it all himself. Other firms may choose to have a couple of people in charge of everything ESG-related, but we prefer a more integrated approach.
Secondaries are still uncommon in the asset class, but certain fundamentals may drive demand in the future, writes Amy Carroll

Just 15 percent of investors expect to make commitments to infrastructure secondaries funds in the next 12 months. This compares with 33 percent in private equity, and reflects the relative immaturity of the secondaries industry in the asset class.

“Pure secondaries funds are relatively uncommon still in the infrastructure space,” says Bruce Chapman of placement agent Threadmark. “Many of the participants in secondary transactions manage pools of capital that can be deployed into a range of primary, secondary and co-investment situations. The underlying managers of these pools include fund of funds managers as well as pension funds and insurance companies.

“Part of the reason for the lack of specialisation is the relatively small number of typical secondary transactions and the general immaturity of the infrastructure market. Another is that infrastructure is often viewed as a long-term, liability-matching asset class, meaning that there are fewer sellers,” says Chapman.

Indeed, only 2 percent of investors say they expect to sell infrastructure fund stakes over the next 12 months, while 5 percent say they expect to be buyers. More than half, 52 percent, say they will not be active in the secondaries market at all, while a further 35 percent remain unsure.

However, as primary infrastructure fundraising escalates dramatically – 2018 was a record year and 2019 remained strong – the growth of a secondaries market seems inevitable. There are several other fundamental drivers too.

As new investors continue to seek exposure to the asset class, the secondaries market can provide an efficient access point. It can help to mitigate the J-curve effect by enabling investors to buy into portfolios with assets already in the ground. Furthermore, there has proved to be a fundamental mismatch between the longer-holding periods associated with infrastructure and some of the early investors in the asset class.

Given the quality of assets in many portfolios, GPs and investors would often like to extend their hold. Yet that creates a misalignment with investors that want or require liquidity.

**GP-led secondaries**

This is leading to a spate of GP-led secondaries across all alternative asset classes. According to Palico, $22 billion of these types of transaction were completed in 2018, up 30 percent on 2017 and triple the amount seen in 2016.

Once viewed as a last resort for sponsors struggling to get a primary fundraising underway, GP-led secondaries are now an accepted form of portfolio management, providing additional funding, time or improved economics for the manager, while offering liquidity to investors.
Do you plan to commit capital to secondaries funds in infrastructure over the next 12 months?

- Yes: 15%
- No: 57%
- Unsure: 28%

Do you plan on buying or selling fund stakes on the secondaries market in the next 12 months?

- Yes, selling only: 2%
- Yes, both buying and selling: 5%
- Neither buying nor selling: 52%
- Unsure: 35%

*Figures may not add up to 100% due to rounding*

GPs are increasingly instigating restructuring processes on old funds to move assets into a new vehicle. In these circumstances, do you believe:

- They have sufficient information to decide whether to roll over or cash out?* 35%
- They have sufficient time to decide whether to roll over or cash out?* 36%
- The costs of the process were fairly divided between the GP and the fund?* 28%

*Figures may not add up to 100% due to rounding*

Source for all data: Infrastructure Investor

The stigma has faded, and the biggest and most successful managers are increasingly pursuing these deals in order to extend the hold periods on their standout assets. Nonetheless, the growing prevalence of GP-led secondaries has raised difficult questions around best practice.

Although these transactions should represent a win-win, investors in early deals sometimes felt manipulated. Forced timelines were a particular bone of contention, but lessons have been learned. When asked about restructuring processes on old funds that seek to move assets into new vehicles, more than 60 percent of respondents, surveyed across all private markets asset classes and with experience of such transactions, say they were given enough time to decide whether to roll over or cash out. Inevitably, however, this leaves 40 percent that felt rushed.

“There is a natural tension between keeping the timeline tight to ensure price is maximised in these deals while also providing enough of a window for investors to react to the offer that is being presented to them,” says Gerald Cooper, a partner at Campbell Lutyns. “We do have sympathy for LPs that may be getting multiple election notices at the same time, which becomes extremely difficult to manage. Where possible, we advise our clients to provide a well laid-out timeline so that LPs are not blindsided by the election period and have time to plan.”

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Only a third of investors in private markets say that analysis of a manager’s environmental, social and governance credentials represents a major part of their due diligence process. Surprisingly, 19 percent do not include any examination of ESG practices at all.

Nevertheless, ESG is expected to be a growing consideration. “For European LPs investing in infrastructure, we think ESG will be a significant factor in the due diligence process,” says Darryl Murphy, head of infrastructure debt at Aviva Investors. He adds that there are nonetheless distinct regional differences in terms of approaches to ESG and its perceived importance.

Given the longevity of infrastructure investments and the role the assets play in the environment and society, LPs are increasingly aware that ESG can no longer be a box-ticking exercise. There is also a growing understanding that ESG considerations enhance performance. Viewing dealflow through an ESG lens has unlocked investment opportunities, most notably in sustainable energy generation. In addition, it is increasingly apparent that the number of potential buyers of assets with negative ESG features is steadily decreasing, while a strong ESG rating lowers the exit risk.

**Diversity decisions**

However, analysing ESG compliance is not easy. Covering everything from pollution to workplace equality, it is more nuanced than financial due diligence, and vulnerabilities persist in the tools created for benchmarking ESG performance. This was made clear when Southern Water, which had been given a five-star rating by leading ESG benchmarker GRESB, was fined a record £126 million ($164 million; €148 million) by regulator Ofwat for failing to prevent sewage spillages over seven years and manipulating figures to avoid penalties.

If ESG is still low on some investors’ priority lists, diversity and inclusion receive even less attention. Fewer than a quarter of investors in private markets consider reviews of diversity and inclusion policies and practices to be a major part of their due diligence process. Some 22 percent do not undertake any reviews of diversity and inclusion when making fund commitments.

“The overall view seems to be that infrastructure is no better or worse in this area, and indeed has some way to go,” says Murphy. “This is an important element to improve upon, both at the manager level and through increased demands from LPs.”

Despite a lack of overall focus on diversity policies, 14 percent of LPs say they previously declined an investment opportunity because of a lack of diversity at the fund management
Has your institution ever refused an opportunity based on a lack of diversity and inclusion at the fund manager level?

- Yes: 14%
- No: 73%
- Unsure: 13%

Do you actively engage your fund managers to promote gender diversity and inclusion?

- Yes: 35%
- No: 54%
- Unsure: 11%

Research by HEC Partners and placement agent MVision in the buyout space in 2019 concluded that investment committees with at least one female member performed better, with a lower risk of failure, than all-male teams. Chicago Teachers’ Pension Fund’s initial decision in 2018 to pass on Blackstone Group and Brookfield Asset Management is understood to have been, in part, based on a lack of workplace diversity at the GPs, though it has since committed to Brookfield.

Given the spotlight that has been cast on gender equality, in particular, over the past 12 months, it seems probable that diversity and inclusion will follow in ESG’s footsteps.

What was once an interesting talking point could ultimately become a fundraising deal-breaker. ▲
ESG on the mind

Five institutional investors proffer their thoughts on one of the biggest talking points of the moment across alternatives – environmental, social and governance – and what action they want to see from GPs.

“We look for a documented, rigorous process to evaluate ESG. With a lot of managers, it seems like it’s slide 45 in the pitch deck. I get reports from managers where they’ve got little vignettes each month about what they’re doing on ESG. That is a substitute for having a thorough analytical approach.”

Bill Watson, chief executive of First Super, the Australian superannuation fund, wants to see a more consistent approach from managers toward ESG matters.

“No asset class teams individually are responsible for evaluating all material risk factors as part of their due diligence. The WSIB has not adopted a single position or practice regarding various ESG ratings or metrics systems.”

Chris Phillips, spokesperson for the Washington State Investment Board, says the $139.6 billion pension fund doesn’t rate the formal ESG ratings when evaluating a manager.

“The challenge is that [ESG data are] qualitative and not quantitative, but so long as we keep asking [for data from GPs] and saying it is important, and the regulator keeps saying that it is important, we will keep the ball rolling.”

Maria Sanz Garcia, managing partner of Yielco Investments, is after more data from GPs.

“At some point, we may look at formalising some sort of ESG policy. But today, it’s simply that we review managers’ approach to ESG on their prior investments, just as we’d evaluate their responsible use of leverage or the reasonableness of the valuation decisions they make.”

Marcus Frampton, chief investment officer, Alaska Permanent Fund Corporation, believes evaluating ESG is “qualitative as opposed to formulaic.”

“The most important thing in my mind is for managers to incorporate it into normal due diligence on any infrastructure asset under consideration, and then communicate those ESG efforts consistently and diligently to their investors throughout the year. We also encourage managers to subscribe to ESG principles, as we do believe it demonstrates that a manager realises the importance of ESG in the formation and management of a portfolio.”

Paul Shantic, director of inflation sensitive at California Teachers’ Retirement System, says communicating ESG to investors is key.
World-class fundraising techniques for private equity, debt, real estate and infrastructure funds

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Management fees are the biggest bone of contention for investors across the alternative asset classes. “We see a lot of discussion between LPs and GPs on performance fees and management fee terms for infrastructure funds,” says Rahul Manvatkar, investment funds partner at global law firm Linklaters. “There is wide divergence in the market, driven by how GPs are generating returns and how that is perceived by LPs.”

The second most significant source of conflict is an unsatisfactory key-person clause – or no key-person clause at all. Investors increasingly want to see a wider group of partners fall within the key-person definition, as well as greater clarity over trigger events and remedy periods.

Commitment issues

Other causes for concern among investors include the GP commitment. Investors have always scrutinised the level of skin-in-the-game that a manager has. This has become increasingly challenging for GPs as fund sizes have escalated – 2 percent of a $20 billion infrastructure vehicle is not to be sniffed at.

Investors typically also insist on cash, as opposed to a management fee waiver, to further ensure that interests are aligned. This is also why they favour direct investment into a fund as opposed to a separate co-investment vehicle. Although these co-investment funds are not uncommon, they do represent potential conflicts if the GP is able to vary investment on a deal-by-deal basis.

Equally, some GP co-investment vehicles allow the GP to increase its commitment over time. This means the GP can increase its exposure in a positive market but remain flat in a poor market – a luxury not afforded to investors.

Hurdle rates are cited as another cause of potential disagreement in the due diligence process. These rates hit the headlines in 2018 when Blackstone proposed a 5 percent hurdle on its $40 billion infrastructure fund. This was rebuffed by several of Blackstone’s LPs. The firm nonetheless got the fund with a 6 percent hurdle, making it one of a select group of managers to break the intransigent eight percent norm.

Also ranking on investors’ gripe lists were investment restrictions, a lack of clawback provisions, the carried interest distribution waterfall and performance fees. Set-up costs and board representation policy, however, were the least controversial issues.
Transparency and disclosure

Sixty percent of LPs in alternative asset funds called on their GPs to provide greater transparency and disclosure in 2019. This marks the continuation of a trend that has been ongoing for the past few years, bolstered by a widespread crackdown that has seen the US Securities and Exchange Commission take a tougher stance on violations.

GPs have been forced to adapt their limited partnership agreements to provide greater detail on fees and expenses. Transparency around operating partners and directors’ fees, for example, has increased dramatically. However, some other fees that have historically been prevalent, particularly in private equity, such as monitoring fees, have disappeared altogether.

The growing complexity this has brought to LPAs has created a challenge for investors – how to make sure the fees they are paying actually align with the provisions of their agreements.

Several public pension plans, including New Mexico State Investment Council and California State Teachers’ Retirement System, have retained outside help to assist with this process.

The Teachers Retirement System of Oklahoma was the latest to join their ranks after uncovering at least four errors in its recent history of interactions with GPs in 2019. However, our survey shows that the majority of investors continue to handle this matter internally. Almost two thirds report they did not plan to seek external help for fee validation over the next 12 months, and only 13 percent say they did.

Which three LPA terms cause the most disagreement with GPs when conducting funding due diligence (%)

<table>
<thead>
<tr>
<th>Term</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management fees</td>
<td>40%</td>
</tr>
<tr>
<td>Unsatisfactory/ no key-man clause</td>
<td>38%</td>
</tr>
<tr>
<td>GP commitment</td>
<td>37%</td>
</tr>
<tr>
<td>Lack of clawback provision</td>
<td>36%</td>
</tr>
<tr>
<td>Structure of carry distribution waterfall</td>
<td>34%</td>
</tr>
<tr>
<td>Performance fees</td>
<td>33%</td>
</tr>
<tr>
<td>Investment restrictions</td>
<td>32%</td>
</tr>
<tr>
<td>Hurdle rate</td>
<td>31%</td>
</tr>
<tr>
<td>Set up costs</td>
<td>30%</td>
</tr>
<tr>
<td>Board representation policy</td>
<td>29%</td>
</tr>
</tbody>
</table>

Source for all data: Infrastructure Investor
Two out of five investors in infrastructure funds plan to participate in co-investment opportunities in 2020, according to the *Infrastructure Investor Perspectives Study*. A further 35 percent do not intend to co-invest, while 25 percent are unsure. These figures may convey surging appetite for co-investment opportunities, but they are unlikely to be reflected in completed transactions, particularly if non-discretionary vehicles are excluded.

“We would be extremely surprised if the actual figure is close to that,” says Bruce Chapman, a partner at placement agent Threadmark Partners. “Especially if we ignore co-investments executed through a vehicle where investment discretion has been handed to a third party – typically the fund manager of the parallel fund. “Co-investments are typically executed with a limited number of co-investors, up to a maximum of three to four groups, and more typically one to two groups, unless the deal is very large.

“When you consider that there will likely be somewhere between 20 and 100 investors in a fund of $500 million and upward, and a fund might typically complete two to three deals per year, which require co-investment, the numbers just don’t stack up.”

Tavneet Bakshi, a partner at placement agent First Avenue, adds that they too often lean towards discretionary co-invest vehicles. She says this “can help overcome some of the challenges of getting co-invest processes at the LP level to align with the needs of the GP when progressing transactions.”

Appetite vs ability

Appetite for co-investment is clearly increasing. A growing number of investors now have a solid track record in infrastructure fund investment. They have grown their teams internally and built trust in their manager relationships. In short, they feel ready to move to the next stage.

Meanwhile, as their sophistication grows, investors are beginning to create more complex portfolio construction goals; to them, co-investment is a way to meet those targets. Some investors are looking to ramp up exposure to specific sub-sectors – those with strong ESG credentials or a demonstrable societal impact, for example. Others simply consider co-investment as an opportunity to average down fees.

However, execution on co-investment is not always straightforward. The biggest inhibitor for investors, according to the survey, is the speed of execution required. Even post-deal syndications demand an agile due diligence and approval process, which many investors struggle to meet.

Time constraints are followed equally by a lack of internal resources and the level of risk involved in terms of key co-investment challenges. Survey respondents

Co-investment is gaining momentum

*Execution, however, is not always straightforward.*

*By Amy Carroll*
also cite the required ticket size and a lack of available opportunities. Governance models and mandates preclude others from taking part.

“That is absolutely consistent with the feedback that we get from our investors,” says Jessica Kennedy, Northleaf Capital Partners’ director of investor relations. “Reviewing co-investments takes time, agility and experience. Investors that have the ability to move quickly and get investments through their processes to board approval are the ones that are able to transact successfully.”

Chapman says: “The market is clearly bifurcated into those groups that are set up to transact efficiently on co-investments, and those which are not. For the former, the greatest inhibitors tend to be lack of bandwidth and a lack of available capital. “For the latter, it tends to be a single gating item, often a lack of team capacity and skill set but might equally be a lack of familiarity with a specific market, or inefficiency in decision-making.”

Chapman adds, “A pension fund, for example, may be able to move quickly when co-investing into a low-risk asset in its local market but will be much less efficient as it moves further away from home.”

<table>
<thead>
<tr>
<th>Private debt</th>
<th>Speed of transaction and not being staffed up for the opportunity are the factors most likely to hinder co-investment participation (%) (multiple responses allowed)</th>
<th>0</th>
<th>5</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
<th>30</th>
<th>35</th>
<th>40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Speed required to conclude transaction</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not staffed up for it</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk level</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ticket size required</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of available co-investment opportunities</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Governance or mandate does not allow us to participate</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of opportunity to be invited to participate</td>
<td>Yes</td>
<td>No</td>
<td>Unsure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source for all data: Infrastructure Investor
The increasing appetite for infrastructure is driven by the attractive risk-return characteristics, inflation linkage, stability in valuations and limited correlation to other asset classes.

Allard Ruijs, head of investor relations at DIF Capital Partners, explains the asset class’s appeal.

“We expect to see an increasing number of investors seeking to access co-investment opportunities and for those investors to continue to refine their due diligence processes to be able to move quickly and efficiently through approvals.”

Jessica Kennedy, director of investor relations, Northleaf Capital Partners on the growth of co-investment in infrastructure.

“Diversity and inclusion [are] of increasing importance to LPs and … an area which needs to be focused on and improved”

Darryl Murphy, head of infrastructure debt at Aviva Investors, insists diversity at the GP level is on LPs’ radars.

“Part of the reason for the lack of specialisation is the relatively small number of typical secondary transactions and the general immaturity of the infrastructure market”

Bruce Chapman of placement agent Threadmark on why secondaries have yet to take off in infrastructure.

“ESG will increasingly be seen by both GPs and LPs as an integral part of the investment toolkit and an essential requirement for anyone positioning themselves as a successful manager”

Graham Matthews, chief executive of Whitehelm Capital, expects ESG’s relevance to investing to ramp up.

“There does seem to be a rise in the number of opportunistic strategies coming to market in 2020”

Chris Tehranian, head of US project management at FIRSTavenue, perceives an uptick of investors showing appetite for riskier strategies.
Whitehelm Capital is one of the world’s leading independent infrastructure fund managers. With over 22 years’ experience and more than €6.5 billion invested, we offer an outstanding track record and enviable scale. Whitehelm offers infrastructure investment solutions covering direct equity, listed equity and debt.

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