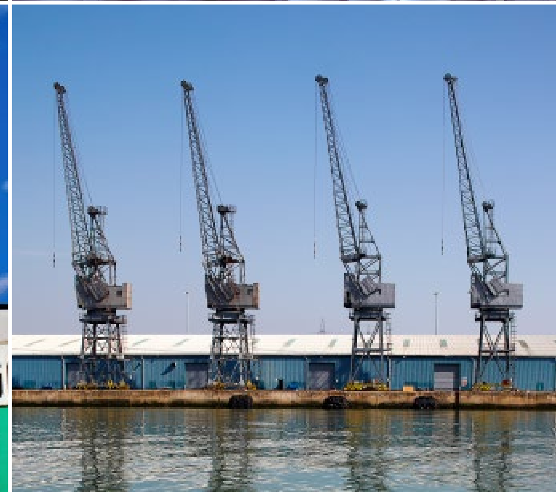
For Investment professionals only

Investing in European brownfield infrastructure

November 2017



A PRUDENTIAL Company

Infracapital

Why invest in brownfield infrastructure?

Pension funds and other long-term investors have embraced infrastructure as a strategic component of their investment portfolios over the course of the past decade. The asset class has attracted significant investment flows, as institutions target the attractive characteristics that infrastructure offers.

Owners of infrastructure assets may capture reliable, secure, typically inflation-linked cashflows over long investment horizons as well as benefiting from capital growth, while helping deliver essential services for the public good. Unlisted infrastructure equity is considered illiquid, and thus carries the associated risks to any capital invested as well as other risks that can adversely affect values. However, it has the potential to offer attractive returns with low correlation to other asset classes, providing an effective portfolio diversifier.

Brownfield infrastructure assets are those that are already in place and operational. We believe investing in brownfield opportunities has the capacity to deliver compelling returns in the current economic environment, by adopting a selective approach and applying the appropriate sourcing and asset management expertise. The popularity of infrastructure investment has resulted in heavily-competed and increasingly commoditised sections of the market where pricing has therefore tightened. However, an experienced and well-resourced manager can still find appealing value in less-competed deals.

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance.

The developing landscape of infrastructure investing

Infrastructure equity remains an attractive asset class for investors worldwide and investment continues to grow steadily. Assets under management in unlisted infrastructure funds globally increased by $60 billion in 2016 alone, taking the total to $388 billion, according to Preqin[1], a research provider. In addition, an August 2017 survey, found that 53% of institutional investors in infrastructure and natural resources intended to commit further capital to the asset class in the next year. Supporting those intentions, more than 90% are at least as confident in the market as they were a year ago.

However, flows into the sector are increasingly concentrated in a small pool of mega funds, which in some cases have raised in excess of $10 billion of capital.

The extensive amounts of fundraising have contributed significantly to the substantial levels of dry powder – investment not yet drawn down and deployed. At the end of 2016, this amounted to $149 billion or 38% of the $388 billion total assets under management[1]. Dry powder on this scale is creating significant competition for assets. However, the largest funds typically focus on big-ticket transactions, those in excess of $1 billion. These deals tend to be high profile, headline-making opportunities, often referred to as trophy assets, such as international airports. Big-ticket, trophy transactions are frequently the most publicised but are limited in number, meaning that high competition for these assets pushes pricing up and, by extension, expected IRRs down, to levels that might only appeal to investors with very low costs of capital.

For instance, when a consortium, which included the Ontario Teachers' Pension Plan and Borealis Infrastructure (investing for another Canadian pension plan), purchased London City Airport in 2016, the reported price paid of around £2 billion was approximately 30 times the airport's 2015 EBITDA (earnings before interest, tax, depreciation and amortization). This may be considered a high level, as multiples would ordinarily be much lower, with 10-15 times EBITDA being commonplace across equity markets.

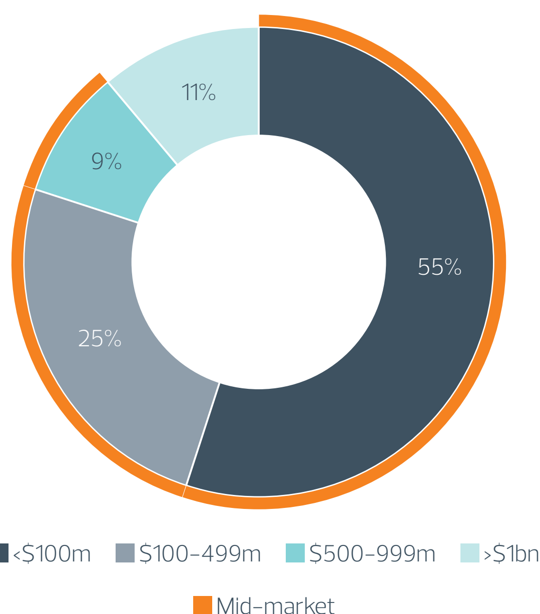
Alongside the growth in investment through funds, larger institutional investors increasingly purchase assets directly, either wholly or as part of a joint venture or consortium. Some early movers in the sector, such as a number of Australian and Canadian public pension schemes have developed globally-diverse platforms of infrastructure assets. However, direct investors frequently lack the necessary asset management capabilities to take controlling investment stakes despite the need for them to undertake sizeable investment transactions. Therefore, they often participate by seeking passive stakes in the biggest deals.

Beyond the mega funds and trophy transactions

The largest funds and direct investors do not typically look to the mid-market – deals smaller than $1 billion – for assets. As a result, competition is reduced for mid-market assets, However, it is in the mid-market where the majority of deal volume is taking place.

Almost 90% of all infrastructure deals in 2016 were for mid-market assets

The mid-market dominates in transactions



Source: Preqin, 2016 M&A activity

1 Preqin 2017 Global Infrastructure Report

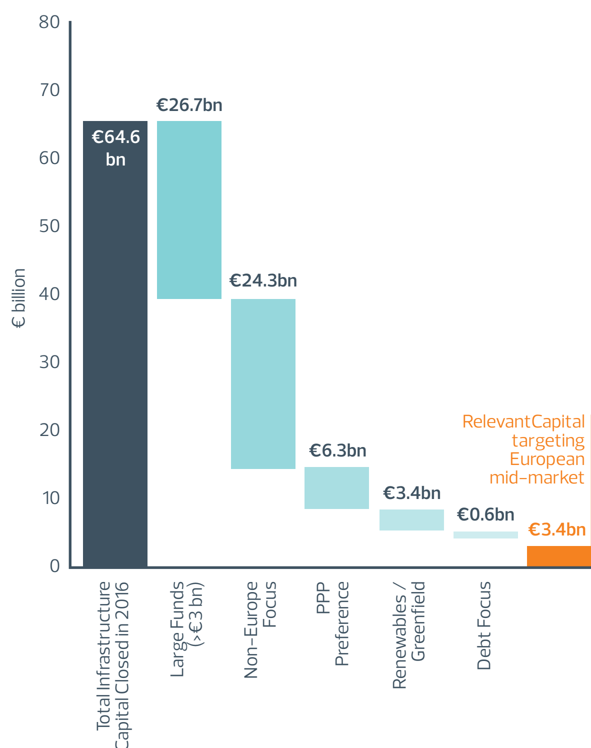
The mid-market — under the radar

Across Europe, we believe that mid-size infrastructure assets benefit from a supply/demand imbalance, providing compelling investment opportunities for selective investors.

There is potential for specialist investment managers to use their experience and extensive relationship networks to target and source opportunities bilaterally or to secure non-price advantages in a more competed process. These may be complex opportunities or where the asset needs to be created (e.g. a business spun out of a larger company) or because a vendor has specific requirements or objectives. In these mid-market circumstances, competition for assets is reduced and pricing more attractive.

Of the nearly €65 billion (approximately $68 billion) capital that was raised in 2016, barely 5% (€3.4 billion) was destined for the European mid-market. Where larger transactions have faced upward pricing pressure from the weight of demand, it is possible to avoid such excessive competition across the broader mid-market sector.

Capital raised in 2016



Source: Preqin Infrastructure Online, August 2017 and Infracapital

Brownfield — Opportunities in many hues

There is a substantial private infrastructure investment requirement to develop new infrastructure to help support global growth in the decades ahead. However, there remains extensive requirement for expanding, strengthening and reinvigorating the existing infrastructure base, which results in a broad scope of brownfield sector opportunities for investors to participate in. Governments across the developed world face constraints on spending, which means that the private sector is expected to provide significant contributions to the required financing of infrastructure development.

Traditional sectors offer value opportunities for brownfield investment	
Utilities	· Funding the capital expenditure of utilities · Decarbonisation and decentralisation of energy systems
Renewables	· Continuing the switch to renewable energy generation · Looking beyond wind and solar power
Transport	· Diversified opportunities across road, rail, air and sea · Instilling a more customer-focused company culture
Telecoms	· Significant investment in digital infrastructure is required · Rapidly increasing need for high-speed, high-volume data transfer

Astute investment in the brownfield market can generate attractive returns for long-term investors both in terms of income generated and in total returns. Gross IRRs in the low to mid-teens may be achievable over the life of an unlisted fund, which is typically 12 years, particularly where employing a specialist manager, such as Infracapital. However, prospective investors should be aware that investment in infrastructure carries risks common to other illiquid investments as well as risks unique to itself. Having the ability to call upon wide-ranging expertise in securing attractive complex opportunities, usually on a bilateral basis, and supplementing that with a strong asset management capability and track record, may be instrumental in minimising those risks.

Sourcing opportunities and building value

We believe some of the most attractive opportunities in the mid-market can be sourced by reaching bilateral agreements, often for assets that are off-market. They may be most successfully achieved by capitalising on the strengths of a broad existing network of relationships, avoiding the more competitive auction processes, common to such transactions. Securing bilateral agreements for assets can allow investors to enjoy a number of benefits:

- Ability to sidestep overly-competed assets
- Provide more time for comprehensive, focused due diligence
- Potential to develop bespoke transaction structuring, particularly where an investment is complex
- Scope to promote non-price advantages, such as flexibility and deliverability

Vendors may also prefer to work with a familiar partner, avoiding the expense and resource commitments of managing a competitive bid process.

A focus on complex brownfield deals, which require experience, relationships and specialist expertise, can unlock considerable value. For instance, transaction teams may look to separate a non-core unit from a parent company and transform it into a standalone business, providing it with chance to grow independently.

GGE: Origination and value creation through a platform approach

A Slovakian utility company acquired through a bilateral process which allowed for extensive due diligence. The company brought stable cashflows underpinned by its regulated revenues, combined with limited exposure to commodity volatility. GGE also had a well-established platform as an independent energy company at the outset with a strong track record. As at 30 June 2017 the investment had generated a gross IRR of more than 9%.

In seeking to maximise value, we made a number of changes to the company, including:

- Adding Duon Dystrybucja S.A.(a gas distribution network in Poland) as a complementary bolt-on acquisition
- Improvements to governance through procedural changes and the introduction of non-executive Supervisory Board directors
- Operational improvements and increased discipline in the areas of capex and appraising growth opportunities
- Enhancements to risk management practices and local political and regulatory relationships

Calvin Capital: Transformed through a platform approach

A UK-based supplier of smart electricity meters. The business was sourced bilaterally using our relationship network. From an initial investment in 2007, it was grown into a leading national provider. Through active management and follow-on investments Calvin Capital's meter base was tripled under Infracapital's ownership, achieving a 17% compounded annual EBITDA growth.

The asset management team played a key role developing the business, culminating in a strong 2017 sale outcome by:

- Providing assistance in the transition to a standalone business through a hands-on approach
- Maximising market potential, diversifying the customer base and adding new contracts
- Delivering on the growth opportunity by capturing greater market share in a new technology
- Implementing an advantageous capital structure

Sourcing and acquiring assets reflects only part of the process of unlocking value from brownfield infrastructure. We believe having dedicated asset managers with commercial and operational expertise is critical in delivering value to investors. They identify opportunities to improve efficiency and customer service within portfolio companies, seeking to optimise performance, enhance profitability and ultimately, exit value.

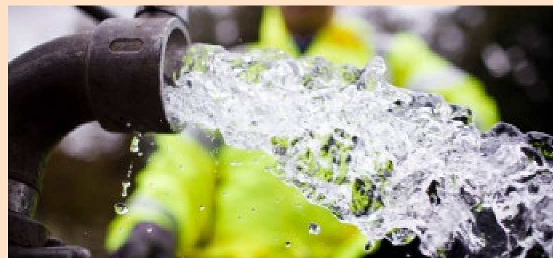
Raising the standards of a business to best practice can be a further source of value. Growth is likely to be most sustainable when an active owner can strengthen ESG standards, enhance health and safety practices and build positive stakeholder relationships.

Experienced asset managers can also oversee complex business turnaround situations and drive growth strategies. Sectors that are fragmented may benefit from a process of consolidation as efficiency gains can add value. One way to achieve that is to adopt a platform approach that gradually builds scale and value over time. A platform approach usually involves developing smaller initial businesses and growing them into larger companies through further tranches of investment that allows for prudent capital deployment, typically at a lower cost.

Asset managers should adopt a practical and pragmatic approach to exiting investments. Managers must consider potential sale routes prior to initial investment and prepare for exit multiple years in advance of sale. Despite being long term investors, infrastructure managers must be aware of changing market conditions which could delay a planned sale or provide incentive to exit early in order to deliver best value to investors.

Assets can achieve an attractive premium value upon exit if managed well and positioned strongly for sale. It can be advantageous to develop individual assets into larger, higher-quality businesses that can generate interest from larger investors and a wider buyer set. These investors may be less sensitive to price in a competitive environment in order to access the cashflows from a proven standalone business with strong operational performance.

Affinity Water: Premium returns from active ownership and asset management



Acquired through an auction process in 2012, Affinity Water was a UK water company supplying over 3.6 million people, serving 1.5 million homes and businesses. It appealed as a core asset with stable and predictable cashflows, accompanied by a long-lived exclusive licence. As a poor performing company in prior regulatory reviews, it offered attractive turnaround potential and was appropriately sized to enable active management. On exit it realised a gross IRR of approximately 15%.

Infracapital delivered significant initiatives in driving better performance including:

- Separating the company from its previous parent, Veolia, into a re-branded standalone business.
- Changing the internal culture to focus on customers helped improve customer service experience
- Utilising management expertise to maximise potential allowed returns following award of 'Enhanced Status' from the regulator
- Implementing governance enhancements including recruiting of a new Chairman
- Developing a stronger interaction with the regulator to facilitate a more accurate anticipatory approach to changing industry conditions

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Infracapital and brownfield

Infracapital, the infrastructure equity investment arm of M&G, is a leading European infrastructure investor with significant experience in infrastructure investments. Since its establishment in 2001, Infracapital has developed a proven capability in capturing the best from opportunities in essential infrastructure assets. The firm has a long and successful track record, having raised and managed over £3 billion to date across a number of funds and strategies.

It draws on the extensive combined experience of its team of 33 infrastructure investment specialists, operating as an aligned boutique within M&G Limited, the asset management arm of Prudential Plc.

Infracapital has gained extensive previous experience in the brownfield sector across three existing funds, Innisfree M&G PPP Fund (IMPPP), Infracapital Partners and Infracapital Partners II. This is complemented by the recent Infracapital Greenfield fund.

Infracapital draws on a long heritage of infrastructure investment at Prudential Group, which extends back to a 1935 investment in the Carsfad hydroelectric dam in Scotland.

Martin Lennon

Head of Infracapital

Martin has been Head of Infracapital since he and Ed Clarke co-founded the company in 2001, overseeing investments in over 40 significant European infrastructure businesses or projects.

He has over 25 years' infrastructure, project finance and investment experience. Martin chairs the Investment Committee of Infracapital and the Investment & Steering Committee of IMPPP. Prior to founding Infracapital, Martin led the Project & Infrastructure Finance business at M&G.

Infracapital

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