# Transportation & Logistics

## Infrastructure Funds: Filling the Valuation Gap

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To shareholders of stable, low-risk businesses: there's a new private equity buyer in town – one that may more appropriately value your business. While the private equity asset class has been in existence for decades, a new class of investment capital has emerged to fill a valuation gap resulting from traditional investor return requirements. These new investors, infrastructure funds, which have existed in very small numbers since the 1990s, have raised fresh capital from pension funds, governments, large corporations, institutional investors, and the public markets to invest in businesses whose cashflows are more stable and less risky than those typically attractive to standard private equity funds. With a bounty of available investment dollars, these new infrastructure funds are targeting more protected and predictable investments than their traditional private equity brethren and are pricing these lower risk investments more aggressively than their traditional private equity peers, who are targeting higher returns.

The recent and staggering allocation of investment dollars into infrastructure funds is a result of some stunning facts on the required near-term investment in infrastructure. Domestically, the American Society of Civil Engineers predicts that the U.S. must invest more than $1.5 trillion by 2012 to bring the nation's infrastructure up to satisfactory standards. Internationally, for example, the Indian Department of Economic Affairs estimates that $450 billion needs to be invested in Indian infrastructure by 2012. Additionally, the recent abundance of Public-Private Partnerships, or PPPs, which enable private pools of capital to invest in public infrastructure projects, has furthered the available supply of infrastructure investments. Investment dollars are chasing these infrastructure opportunities through several large and growing pools of capital - the average size of infrastructure funds has grown from about $160 million in 2003 to $3.3 billion in 2008 and over 70 additional funds are currently looking to raise over $90 billion[1].

Most major banks, former project finance professionals, opportunistic private equity veterans, and others are setting up infrastructure funds to manage the demand from LPs to invest in worldwide infrastructure development. Joining the small handful of infrastructure fund families launched in the early 1990s, over 100 new funds have been raised around the world in the last 24 months, eager to put their capital to work in businesses that deliver a highly predictable stream of cash flows, operate in a monopoly-like environment, maintain long-standing relationships with very credit-worthy customers, and exhibit low management and execution risk. Funds such as Alinda Capital, Global Infrastructure Partners, Carlyle Infrastructure, and CVC are relatively new names in infrastructure investing, yet they combine the investment experience of professionals who have been in and around the space for years.

Infrastructure funds, in addition to investing in the most basic and stable Greenfield and Brownfield infrastructure projects and assets, will invest in established cash-flow producing businesses that formerly only drew the interest of traditional private equity funds who typically target levered returns of over 20%. In the absence of infrastructure funds, these lower risk businesses have been forced to fit the 20%+ return model, despite

[1] The 2008 Prequin Infrastructure Review, An Examination of the Unlisted Infrastructure Fund Market.

exhibiting risk characteristics that should enable lower return requirements (and higher prices). Infrastructure Funds are now filling this gap.

***Sector Focus***

By most accounts, Infrastructure Funds are targeting the acquisition of businesses in four primary industries: transportation and logistics, energy & power, water and utilities, and social infrastructure. The chart below highlights the various types of businesses that fall into these industry buckets.

| Industry | Examples |
|---|---|
| Transportation & Logistics | Toll roads, bridges, tunnels, airports, FBOs, and aviation services, seaports, railways and rail assets, ferries, traffic and parking management, and other related services. |
| Energy & Power | Oil and gas pipelines, terminals, petroleum storage and distribution, power (wind, solar, renewable, coal, etc.) generation, and other related energy services. |
| Water & Utilities | Water and wastewater treatment, waste management and hauling, environmental services, fixed-line and mobile telephony, and broad utility services. |
| Social Infrastructure | Education facilities, healthcare facilities, courthouses, prisons, other municipal buildings, and consumer and business-focused municipal services. |

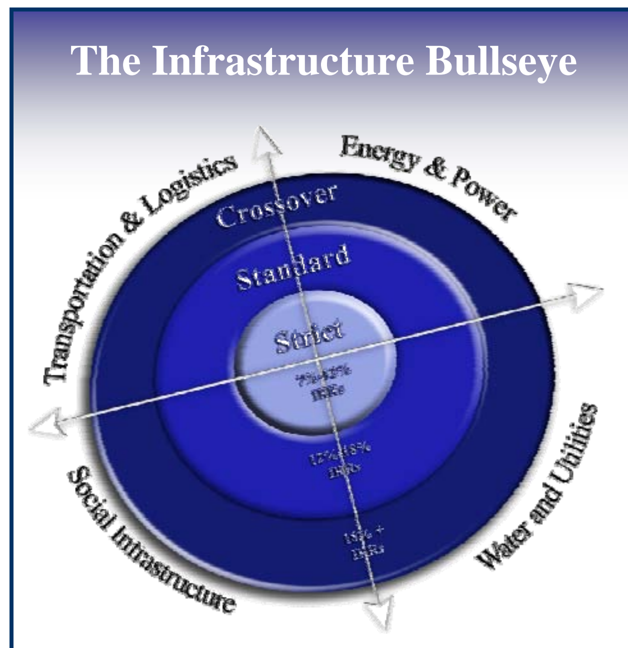
***Key Investment Characteristics***

Over the last several years, infrastructure funds have made investments all around the globe and in all of the sectors highlighted above, but they have remained disciplined in their adherence to several key investment characteristics. Infrastructure Funds look for assets that maintain many, if not all, of the following characteristics: i) long-term customer contracts (i.e., 5-10 years for some and many decades for the most strict infrastructure funds), ii) stable product or service pricing that can be increased periodically or adjusted for inflation, iii) customers that include governments or municipalities or others that maintain a similarly high credit rating, iv) low management and operational risk, v) businesses that do not require periodic shifts in business strategy, and vi) businesses that have monopoly- or duopoly-like competitive characteristics with high barriers to entry. These characteristics fundamentally lead to a more predictable, protected, stable, and lower risk cash flow stream. The reduced risk, in turn, allows lower equity return requirements, facilitates higher leverage levels, and drives correspondingly higher valuations.

***Fund Classifications***

Infrastructure Funds naturally fall into various classifications depending on which end of the desired risk spectrum they fall and, correspondingly, how strictly they adhere to the criteria highlighted above. There exist infrastructure funds that target returns of approximately 8% to 12% ("Strict Infrastructure Funds") for the least risky of infrastructure assets like toll roads, bridges and tunnels with decades-long leases and inflation-adjustable tariff schedules. These funds, very few in number but very large in terms of available capital, stick to a very strict definition of infrastructure often encompassing massive investments in large-scale Greenfield projects or established operating municipal infrastructure assets. There also exist infrastructure funds that target returns of approximately 12% to 18% ("Standard Infrastructure Funds") for assets that broadly fall within the infrastructure asset class but, as compared to toll roads and airports, display some of the risk characteristics of traditional businesses (some management risk, shorter duration contracts, etc.) These funds will selectively invest in businesses that have historically only been considered by traditional private equity investors (e.g., FBOs, environmental remediation services, municipal traffic and parking management, long-term consumer or business equipment rental, or rail services.) Finally, there exist funds or even investment teams within traditional private equity funds that target returns of 18%+ ("Crossover Infrastructure Funds") for assets that are less risky than a traditional leveraged buyout (longer term contracts, contracts with governments and municipalities, etc.), yet are more on the periphery of the typical infrastructure definition. These investments, sometimes called "LBO-Frastructure" investments, cross the line between the two styles of investing and are typically lower risk and more stable than a traditional private equity investment, yet don't demonstrate many of the criteria highlighted above.

The chart to the right highlights the breadth and expanding scope of the infrastructure fund space and the potential valuation differences apparent amongst the various fund types. Business model characteristics will determine where a business fits on the bullseye – the closer to the center, the higher the multiple that is likely to be generated. For example, long term contracts, inflation adjustable tariff schedules, and a monopolistic business environment would position a business closer to the center of the "Infrastructure Bullseye", while greater management risk and pricing instability would position a business closer to the outer boundaries. Each business belongs in a different spot on the Infrastructure Bullseye and, depending on its specific business model dynamics, will generate interest at a different value.



***Summary***

So what does all this mean for owners and shareholders of businesses that may fit one of the infrastructure definitions? It's simple: a well-positioned company that attracts infrastructure investors of any kind should generate higher multiples (prices). Many companies may not have traditionally been characterized as an infrastructure business, but by proper positioning and emphasis on a stable customer base and established and long-term pricing schedules, for example, a Company can begin to attract the interest of infrastructure funds. Over the next few years, there will be a shift in ownership of several types of investments from traditional private equity funds to infrastructure funds, which can understand, appreciate, and appropriately value the lower risk characteristics of these investments. For example, in the last couple of years, a water heater and air conditioner rental business, a stevedoring business, a railcar maintenance business, an agricultural recycling business, and others that may not historically have been considered "Infrastructure Assets" have been purchased by infrastructure funds at higher multiples than would be typical for traditional private equity investors.

Harris Williams & Co. has extensive recent experience in the infrastructure fund sector broadly, has interacted with infrastructure funds as buyers, and has sold several businesses to infrastructure funds. For more information on infrastructure funds or whether your company could be attractive to these funds, please contact Bram Hall, Michael Bor, or Joseph Conner of Harris Williams & Co. at (804) 648-0072.

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