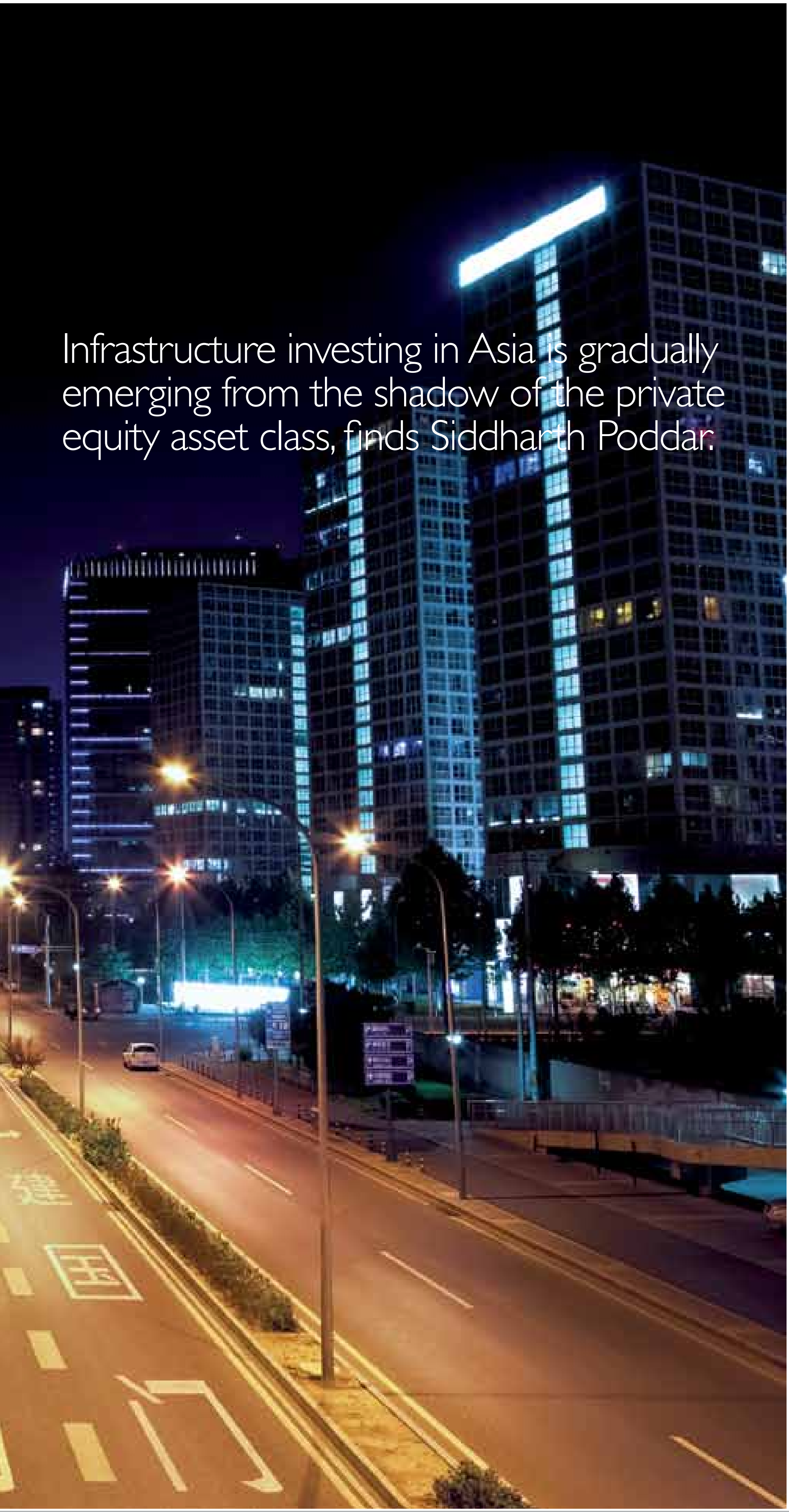
A class of its own

Infrastructure investing in Asia is gradually emerging from the shadow of the private equity asset class, finds Siddharth Poddar.



In the last few years, much attention has focused on the rapid development of the private equity industry in Asia and the long-term prospects it holds for institutional investors. Infrastructure, and related sectors, has frequently been flagged as part of that opportunity set, and indeed has been increasingly drawing the interest of various investor types, including global private equity and infrastructure fund managers, infrastructure companies, Western pension funds, sovereign wealth funds and increasingly, Asian national pension funds.

The high level of interest is linked not just to the region's lack of adequate infrastructure and growing populations but to the fact that most Asian governments are constrained for capital and cannot finance their vast infrastructure needs, paving the way for increased participation of the private sector.

This trend is perhaps best encapsulated by India, whose government anticipates infrastructure spending in the country to total more than $1 trillion between 2012 and 2017. It expects the private sector to contribute half that amount – providing a fillip to asset managers and their investors.

Emerging independence

Private equity deals backing companies in infrastructure services, for example for companies that provide engineering, procurement and construction services to the sector at large, have become common in India. So have private equity investments in companies that produce materials required for infrastructure development or in companies that own assets rather than the assets themselves. Kohlberg Kravis Roberts, for instance, provided a $141 million loan to the JSW group in June to boost the group's steel-producing capacity; a month earlier, KKR said it was investing up to $166 million in a cement-focused subsidiary of Dalmiya Cement (Bharat).

Private equity fund managers have also been making traditional infrastructure plays. Perhaps the most significant infrastructure deal of the year came by way of a co-investment in March, when a consortium led by Morgan Stanley Infrastructure Partners and including firms such as General Atlantic, Goldman Sachs Investment Management, Norwest Venture Partners and Everstone Capital, invested $425 million in Asian Genco, a Singapore-based holding company with investments in power generation assets and engineering services businesses in India. The deal marked the largest equity investment ever in India's power sector.

With the exception of IDFC Private Equity, which is focused solely on investments in infrastructure companies and projects, these deals have largely been done by generalist fund managers including KKR, The Blackstone Group, Ascent Capital, Argonaut Ventures, Jacob Ballas Capital India and India Equity Partners. However, over the last year or so, a number of funds have been set up in India specifically targeting the infrastructure sector.

Shrivastava: Infrastructure is becoming an independent asset class in India

"The Chinese government will always have to recycle some assets at the right time."

"I think we are seeing the emergence of infrastructure as an independent asset class in India," says Anubha Shrivastava, a managing director and head of the Asian portfolio at UK government-backed fund of funds CDC Group.

"We saw the overlap between infrastructure and private equity initially and it was the nature of the market at the time. But I think competition over the years has intensified," she explains. "A lot more capital has come into infrastructure and the returns have come down as well."

LPs are now beginning to view infrastructure as an independent asset class in India and are willing to get exposure to the sector in India through infrastructure-specific funds. Sunil Mishra, a Singapore-based principal covering Indian opportunities at funds of funds manager Adams Street Partners, says that the firm is looking at infrastructure funds in India "as that is a sector where a sector-focus strategy has shown to be relevant and effective". He adds that such a strategy is not viable for any other sectors in India.

Shrivastava, too, wants to back infrastructure-specific fund managers in the country, and sees opportunities particularly in the power and transport infrastructure sectors. "For us, infrastructure is a big theme in India," she says.

Market participants and observers say the same thing is happening in other parts of emerging Asia as well, not least in Southeast Asia and to a lesser extent in China, where there has already been a divergence.

According to Andrew Yee, joint chief executive officer of Standard Chartered IL&FS Infrastructure Growth Fund, there are a large number of listed and unlisted state owned enterprises (SOEs) active in traditional infrastructure and there is clear separation between these companies and the engineering and construction sectors in China. "Whether it is toll roads or power generators, there are many companies that are either listed in Shanghai or Hong Kong or both."

It is a view backed up by Raymond Fung, head of infrastructure investment at China Ping An Trust & Investment, which has invested $3 billion of equity in infrastructure projects in China. Fung says Ping An has always treated infrastructure in China as a separate asset class, not a sector play within the private equity infrastructure asset class.

"In our opinion, infrastructure is always about core infrastructure with predictable earnings. In China, we have the kind of assets that fit this bill," he says.

> “Competition over the years has intensified in India. A lot more capital has come into infrastructure and the returns have come down as well.”

Distinct expectations

As a result of the relative immaturity of the Asian infrastructure sector vis-a-vis other developed economies, institutional investors tend to have higher return expectations. Johan Bastin, chief executive of CapAsia, which currently manages assets of $460 million across three infrastructure-focused funds investing in non-BRIC emerging Asia, says that the general expectation is that infrastructure funds in Europe return 10 percent to 12 percent net to LPs on a good day, while CapAsia targets a 15 percent to 18 percent net return. Bastin says that from his discussions with LPs, “I sense that the implied premium of 60 percent to 70 percent compared to European funds is seen as adequate compensation for the perceived higher risk”.

Meeting these expectations is possible because, as Yee says, the emerging markets are still much more about growth capital because one is not paying out dividends from very steady state cash flows of mature projects. In his view, in emerging markets, it is about getting some assets into operation and using any surplus cash flows generated to further invest in smaller projects.

“Sure, it has higher risk, but the returns we are seeing are even more significantly higher. You may get double the return, but you’re definitely not taking double the risk,” says Yee.

Yee: Many Chinese SOEs are active in infrastructure

Although this may not be considered traditional infrastructure investing in the OECD infrastructure fund model which is based on steady and dependable dividend-yields, in Asia the sector is seeing infrastructure investments with high growth. He speaks of a five to 10 year window now where “classic infrastructure can provide excellent returns due to the absolute need for better infrastructure which is being built out at an incredibly fast rate”.

Benjamin Haan, a Sydney-based vice president and member of the private infrastructure investment committee at global alternative investment manager Partners Group, says the firm has made direct investments in select Asian infrastructure projects including a port facility and a telecom tower business, and that the focus on direct investments is expected to increase further over the medium term.

According to Haan, a key attraction to infrastructure investments in Asia is that they typically carry higher return expectations than investments in more mature economies. He adds that often the nature of the projects/ assets themselves are more risky in Asia due to “other factors”, for example they may have more of a green field element or a demand-risk element than projects available in developed countries.

“To the extent a project is truly comparable in terms of the ‘other factors’ we believe an appropriate country risk premium is in the range of 200-400 basis points for key emerging Asian markets to reflect the less mature regulatory framework, legal risks, etc,” he adds.

Furthermore, he adds it is “critical” to include exposure to green field infrastructure projects in the investment remit as many of the most attractive Asian infrastructure investment opportunities lie in the asset-creation space.

Opportunities and competition

Besides traditional giants China and India, the Southeast Asian region in general and Indonesia in particular, are expected to be the source of many infrastructure-related investment opportunities.

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Indonesia is the fourth most populous country in the world and is a classic case of a developing economy whose growth has been severely stunted because of a lack of decent infrastructure. Bastin says that in order to create a market for private firms investing in infrastructure, there first needs to be political will. And while this political will is present in Indonesia, the country has not figured out how to set up a legal, regulatory and administrative framework necessary to create a sustained and sustainable flow of investable projects that will attract foreign private capital. "It's not just about public procurement of private operators and capital, but also the environment you create post-procurement and that gives investors like us longer-term stability, certainty and predictability," he says.

Investors are of the view the country urgently needs an apparatus to provide a sustained flow of private investment opportunities in infrastructure so that investors are comfortable.

Meanwhile, there is increased competition for deals in Asia and deal making is not easy. Yee says finding good assets to enter at a reasonable price is difficult at the moment.

Bastin: Biggest hurdle is competition from strategic buyers

CapAsia's Bastin says the biggest problem his firm faces is the competition – not so much from other private equity infrastructure funds, but from strategic buyers. He says strategics do not seem to have "much ambition" when it comes to returns. A few of them have raised huge amounts of money on the stock markets (as in India) based on a pipeline of deals not on actual, cash flow producing assets. "As a result, some of these are bidding prices for assets here that just do not seem to make economic or financial sense to me," Bastian rues.

Managers also anticipate increased competition in the coming years from Chinese private equity and infrastructure funds. As Chinese infrastructure fund managers accumulate technical knowhow and expertise, at some point, he expects them to start investing in Southeast Asia as the region is of strategic importance to China.

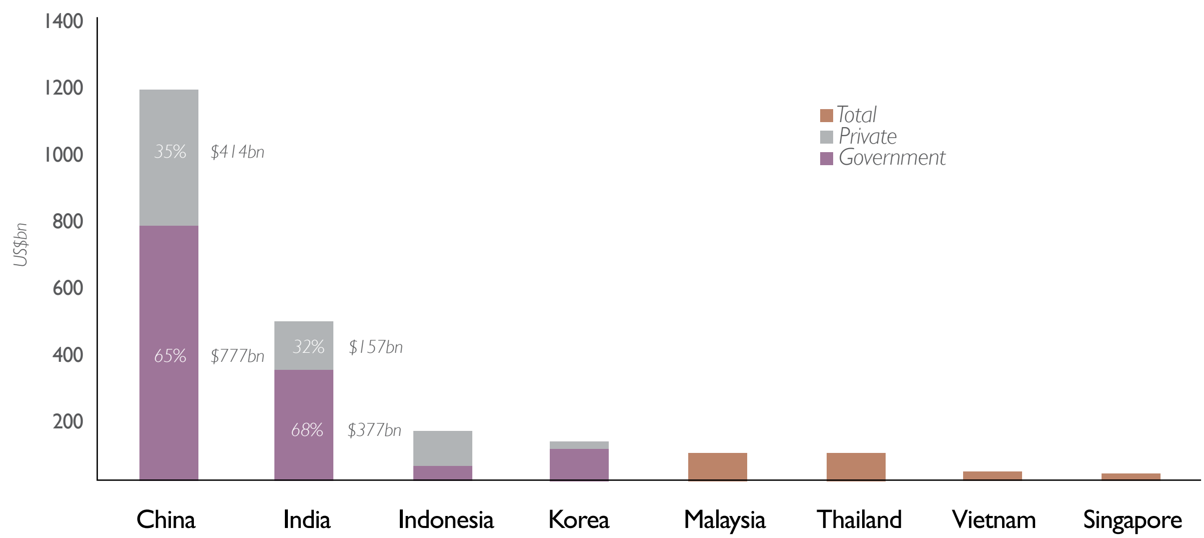
GPs are less worried about exits as there is substantial interest from buyers willing to pay well for assets. For instance, Yee says that SCI Asia has been offered "very attractive" prices for some of its assets. The fund recently exited Meiya Power, which it had acquired along with Standard Chartered Bank and another investor in early 2007. At the time, the company had about 15 power stations in operation, and now it has 22 plants in North Asia. "We've sold the company for just under a 2x to China Guangdong Nuclear, a state-owned enterprise, whom we believe is a very complementary partner with even more capital to fund Meiya's expected growth," he adds.

Moreover, there is a lot of appetite for infrastructure assets from strategic and institutional investors in the region. So for the moment, the supply of well-performing assets is relatively limited, whereas there is a surplus demand for such assets.

Indeed, domestic pension funds such as those in Thailand and Malaysia now have considerable inflows that they need to invest in stable, annuity-like assets. There is also an increasing demand from specialist infrastructure investors from Europe, North America, the Middle East and Australia, managers say.

"We expect the level of interest and sophistication to continue strongly as Asia matures," says Yee. In the meantime, with the increasing maturity of the sector in Asia, it would be fair to expect greater specialisation and the emergence of more infrastructure specialists from within the region itself.

Ample private sector investment opportunities in China and India (2008 – 2012)



Source: CLSA, Ramping up – Asia's infrastructure stimulus (March 2008). Government/private splits for Malaysia, Thailand, Vietnam and Singapore unavailable

China: government all the way?

It is often said that private investors have little scope to invest in China's infrastructure sector since the Chinese government and its SOEs have enough capital to fund infrastructure development on their own.

Is this view reasonable? Raymond Fung, head of infrastructure investment at China Ping An Trust & Investment, thinks not. He says Ping An has put $3 billion of equity to work in China since it started its infrastructure investment programme in 2006.

Private investors come into the picture to help recycle the government's capital, he says. "Yes, the government and its SOEs can build everything and fund all its programmes." However, the mandate of the government is to provide ever-improving infrastructure to the public, and therefore, it needs to recycle capital such that it can use it to meet the growing demand for infrastructure.

Fung says: "The government will always have to recycle some assets at the right time." And while they do not have a formal programme to do it, a trusted party with good access can gradually have greater involvement in the sector.

He adds that in China, there has been excess borrowing by local authorities to fund projects that were started during the financial crisis, and the state council has categorically asked these bodies to deleverage. "In fact, for the past six months in particular, the government has been pushing its SOEs, such as the China Rail Investment Corporation, to bring in private capital so that it can recycle capital and lower its gearing."

Andrew Yee, joint chief executive officer of Standard Chartered IL&FS Infrastructure Growth Fund, says that large SOEs are generally focused on larger projects, while infrastructure funds are looking to deploy no more than a few hundred million dollars in China. There are a lot of opportunities in tier II and tier III cities in China and in the central and western provinces, whether it is roads, power, water or renewable energy, Yee adds.

In the years 2008 to 2012, the private sector is expected to invest $414 billion in Chinese infrastructure (see table). This translates into a sum of about $83 billion per year. "Assuming that even two-thirds of this amount is funded by debt, you have opportunities worth about $28 billion annually for the private sector in Chinese infrastructure," Yee says.

Both Yee and Fung stress the importance of knowing the market well. SCI Asia has a local presence of five people in Beijing, so they are not "flying in and flying out", says Yee. Of these, four are mainland China-born and bred infrastructure specialists. "They understand how the country works, how to find deals, how to execute deals and how to relate to the locals," he says.

In Fung's view, Western infrastructure funds do not understand Chinese market and they don't understand the risks, making it difficult for them to invest in the country. Thus far, Ping An has invested in toll roads, wind farms, hydropower stations, high speed rail, nuclear power stations, renewable energy generation and water treatment plants in China. The firm usually buys either from the secondary market or from privatisations and it has been able to find more than sufficient opportunities, Fung says.

And as if to bring the debate to a quick close, Fung says: "At the moment, the amount of investment opportunities we have at hand is way beyond the amount of capital we have, and we have a fairly large investment programme."