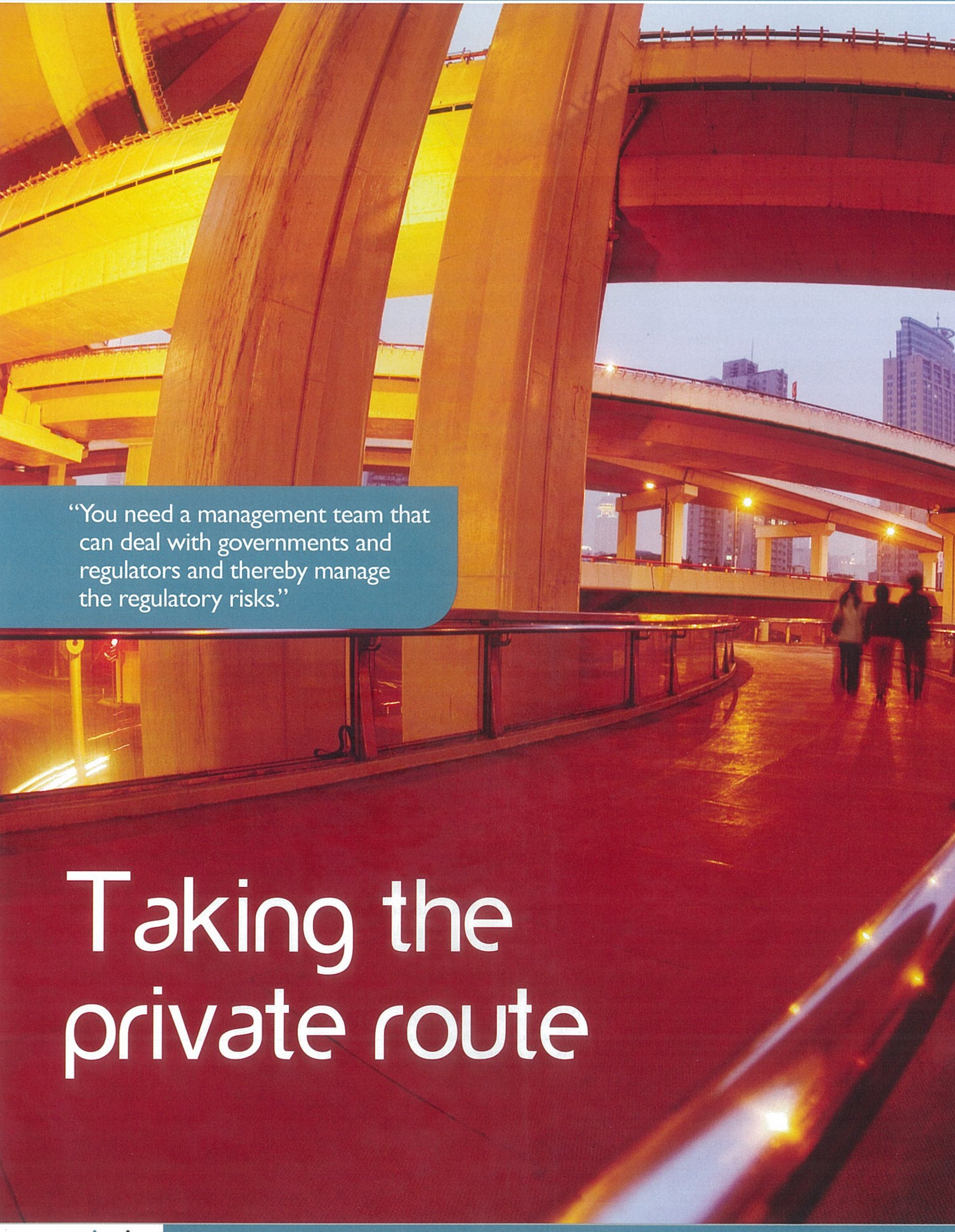


"You need a management team that can deal with governments and regulators and thereby manage the regulatory risks."

Taking the private route

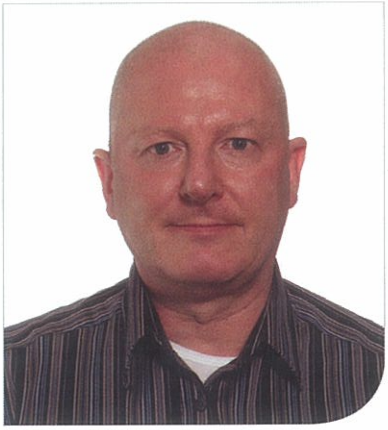
Infrastructure-related plays are big news in Asian private equity. But to what extent can private equity firms get involved in this sprawling asset class? Siddharth Poddar investigates.

Infrastructure has become a significant part of the private equity investment agenda across Asia over the last two years. In fact, in certain regions, such as India – where it seems almost every deal that is completed can be tied back to infrastructure in some way – it has become almost become a requisite.

This is in no small part due to the economic downturn: while companies focused on the retail or export space, for example, have seen demand tail off, financial turmoil does not remove the need for roads, basic infrastructure improvements, or even healthcare and education.

If anything, more capital has been directed to the infrastructure sector in the past year in the form of the economic stimulus packages put together by some Asian governments to boost domestic consumption and create jobs.

In November 2008, for instance, China's government announced a stimulus package worth RMB4 trillion ($586 billion), to be spent mainly on upgrading infrastructure, raising rural incomes and social welfare projects. Other countries in Southeast Asia have announced packages over the last year as well: the Malaysian government unveiled two stimulus packages in November 2008 and March 2009 totaling $18.5 billion; Thailand has



McGregor: Private equity firms offer more than just capital

The road ahead for private investors

In many Asian countries, private investors are now playing an important role in the development of infrastructure. Private equity funds of all types are investing in the sector, there are private equity-styled infrastructure funds in the market, and increasingly, a number of regional conglomerates are investing in the asset class as well.

And while the region has seen a number of domestic private equity firms and other domestic private investors come to the fore, foreign participation in infrastructure projects in Asian countries remains limited.

It is still very difficult for foreign investors to successfully complete infrastructure deals in the region. The importance of an understanding of local sensitivities, strong networks an understanding of the regions they are investing in and a thorough understanding of the regulatory frameworks is vital, and foreign managers often don't possess all these attributes.

Vijay S Pattabhiraman, managing director of the Asia Infrastructure Group at JPMorgan Asset Management, said recently at an infrastructure and private equity conference organized by INSEAD in Singapore, that a major difference between India and China, for instance, is that the firm would feel comfortable making minority infrastructure investments in India, where the legal framework is seen to be robust, but not in China, where corporate governance and legal recourses are less developed.

Raymond Fung, head of infrastructure investment at China Ping An Trust & Investment, says there are restrictive capital structuring limitations in place in China which put foreign investors at a disadvantage. Furthermore, he says: "Many foreigners come into China not able to operate within the culture. As such, many of them act much more like unsympathetic financial investors in a project as opposed to working partners."

Foreign investors in Asia often do not have the personal networks to source deals, which domestic private enterprises have. In Fung's view, offshore players need to think through their investment approach and investment strategy for China in order to make China a rewarding market for them.

These issues, however, are not specific to China, but to the Asian region at large.

"A lot of the operators here don't have very deep expertise in operating assets in Asia."

announced plans to spend THB1.4 trillion ($39.5 billion) in infrastructure sectors such as education, transportation and public heath; and Singapore's government has said it will invest between S$15 billion ($10.8 billion) and S$17 million annually in infrastructure projects in both 2010 and 2011.

Despite the money being channeled into infrastructure, need continues to far outstrip government funding capability in most – if not all – Asian countries, leaving the sector wide open for private investment. Snappy statements like the one that came out of a September report by US bank Goldman Sachs stating 'India requires $1.7 trillion for infrastructure over the next decade' are eye-catching endorsements for an asset class that is seemingly recession-proof.

But this macro view of Asia's infrastructure asset class belies its complexity. And in the time since *PEI Asia* last wrote about the asset class – in July/August 2008 – it seems the industry is still some way away from finding a definitively successful approach to private equity investment in this area.

The problems start with the term 'infrastructure' itself. Infrastructure is an incredibly broad term that is often used to encompass all stages of investment from land acquisition, to project finance for the construction and management of a toll road for example, to investment in companies that manufacture and supply tools, machinery and specialist engineering equipment to the infrastructure industry – the so-called 'infrastructure enablers'.

Bastin: Greenfield investments pose significant development risks

Not all hats fit for private equity

Within this broad playing field, private equity has tended to focus on investment in companies across all infrastructure-related sectors, rather than in projects and land acquisition. This is because it is harder to get the level of liquidity that private equity investors expect from their investments when you go all the way downstream.

Raja Parthasarathy, a managing director at IDFC Private Equity, which is currently investing from the $700 million fund IDFC Private Equity Fund III, explains: "Investing at the project level where the projects are backed by long-term concessions and much of the value creation takes place in the latter half of the project's concession life means that it is difficult to generate liquidity and value for LPs since we are typically structured as 10-year limited life funds."

But there are some who venture outside this more private equity-friendly part of the industry. In fact, one of the key debates surrounding private equity investments in Asian infrastructure is the extent of the role private equity investors are able to play in the sector.

Most private infrastructure investors in Asia are currently investing in operating projects, says Robert McGregor, Singapore-based partner at Actis, which held a final close on its second infrastructure fund on $750 million in October. And this is because

A snapshot of private equity investments in infrastructure in 2009

a) Indian port: In February, global private equity firm 3i invested $161 million for a minority stake in Krishnapatnam Port Company. The company has been awarded a 30-year concession from the government of Andhra Pradesh to develop, manage and maintain the Krishnapatnam port, a natural, deep water, all-weather port in the state.

b) Pakistani power: MENASA-focused Abraaj Capital is investing $361 million over the next three years for a 50 percent stake in KES Power, which owns a 71.5 percent stake in Karachi Electric Supply Company (KESC). KESC is the sole power provider in Karachi, Pakistan's financial hub. The deal was approved in April this year.

c) Chinese hydropower: In July, Hong Kong-headquartered Olympus Capital Holdings Asia led a $57.5 million investment in Zhaoheng Hydropower Holdings, a hydropower generator and supplier in China, for an undisclosed stake. Zhaoheng owns and operates small- and medium-sized hydro assets with an installed generation capacity of 200-megawatts and aims to acquire assets with a total generation capacity of 1000-megawatts over the next five years.

d) Oil and gas in Southeast Asia: In the month of September, energy-focused private equity firm First Reserve Corporation invested $500 million for a 99 percent stake in KrisEnergy, a newly-established oil and gas company headquartered in Singapore. KrisEnergy aims to build a portfolio of exploration, development and production assets across Southeast Asia.

e) Indian wind power: IDFC Private Equity invested approximately $72 million in Green Infra, which is a developer and operator of renewable energy assets in verticals including wind, biomass, small hydro and solar energy, in September. Through Green Infra, the firm acquired BP Energy India, a subsidiary of BP, which manages a 100 MW portfolio of wind energy assets, for an undisclosed sum.

such projects have a contractual structure in place along with debt and equity. "To participate at a very early stage, you need to get your debt in place and in some markets, that's not easy at this time," he says.

Generally speaking, there are some private equity firms that raise funds based on a desire to deliver yield and if they have sold their fund on that basis, then they need to invest in assets that are operating and yielding dividends, managers say.

McGregor says if managers have presented their fund as one that will deliver an exit IRR and an x-times money back multiple, then they can invest at an earlier stage in the project lifecycle. However, he adds that it is highly likely they will still want to invest around the financial close. "This means that although they are still taking the entire risk of the construction period, they are joining a project at the point where it has all of the contracts and financing in place," he adds.

In greenfield assets, there are significant development and construction risks at play which private equity is not well-equipped to take. In general, the development risk is taken by governments, says Johan Bastin, CEO of CIMB-Standard Strategic Asset Advisors, which currently manages assets worth $460million, including the Islamic Infrastructure Fund, which had an initial closing at $262 million and is targeting $500 million. The Islamic Infrastructure Fund is sponsored by the Manila-headquartered Asian Development Bank and Jeddah-headquartered Islamic Development Bank.

If a company has revenue earning assets and it needs equity from financial investors for expansion, including new construction, then it is not a problem, he says. However, to go into a greenfield project is unusual "unless there is no or little development risk, a brief construction period, and a contractual cash flow".

"Investors in our funds and any infrastructure funds are looking for a combination of current yield and capital appreciation," Bastin says.

In China, however, many private equity investors are investing at the greenfield stage, says Raymond Fung, head of infrastructure investment at China Ping An Trust & Investment, which has invested more than $2 billion in infrastructure projects in China. A number of them are investing in infrastructure-related construction and development companies in the hope these companies will generate development profit through bringing on new projects, thereby pushing their returns higher, he says.

However, he adds that it is "very risky" from investors' perspective because development businesses are inherently risky businesses relative to operating assets.

Smooth operator

Another factor private equity firms must bear in mind is the quality of the operators they are working with.

In Asia, the need for infrastructure has been so high that the last few years have seen the proliferation of developers, operators and constructors, all looking to cash in on the boom in infrastructure spending, both at government as well as private sector levels. Many of them have thrived as well, because the demand for their services has been so high.

However, often questions are raised about the lack of operating experience among private sector developers. The lack of operating experience among private sector developers is not a real bottleneck yet, but as deal flow increases, it will be a problem because in certain sectors there is a dearth of operating experience, Bastin says. "If I compare it with Europe, a lot of the operators here don't have very deep expertise in operating assets in Asia," he says. This is particularly evident in the power sector where there are a number of small operators that are inexperienced, he adds. It is also sometimes the case for toll roads and telecom.

Whether or not lack of operating experience is a problem for private investing in infrastructure is largely dependent on what private investors themselves bring to the table, says Fung. He says that in developed countries, brownfield assets are generally already being managed by professional management teams, so whether a private investor possesses management capability or not does not matter too much. However, he says, in Asia and in particular in countries such as China, an asset does not necessarily come with a professional management team. As such, there could be significant operational and corporate governance issues if private investors do not have operating experience.

Parthasarathy: Investing at the project level is difficult for a 10-year fund

This is not much of an issue in the more developed Asian countries such as Singapore and Malaysia, but a major issue in places like China, Thailand and the Philippines.

Parthasarathy says that in India, private investors are generally reliant upon the sponsor or entrepreneur to manage much of the regulatory and approval-related risks, as well as the day-to-day operational issues in terms of the assets themselves. "A private equity investor will typically have less hands-on operating experience than an owner," he says, again underlining the importance of having good management at the portfolio level.

It is the same in China, Fung says, where you need a management team that can work within the local regulatory framework: "one that can deal with governments and regulators and thereby manage the regulatory risks". If such a management team is not in place, then lack of operational experience on the part of private investor can be a big hurdle.

Private equity value-add

But if private equity investors are so heavily reliant on the management teams of the projects or companies they invest in, what exactly are they bringing to the table? Are they merely plugging a gap in financing?

"Private equity often plays more than a financial role," says McGregor. He says in many cases, people at private equity firms have years of experience in the sector in which they are investing, including prior experience of raising debt for similar types of projects. They may also have worked and interacted previously with engineering procurement and construction (EPC) contractors or other parties with operational or financing experience.

> "To participate at a very early stage, you need to get your debt in place and in some markets, that's not easy at this time."

"So I don't think it is a case of money alone," McGregor adds.

And Bastin agrees. He says when someone specialises in infrastructure funds, by definition they need to have deep experience and expertise in infrastructure. "Private equity investment in infrastructure is not just about bringing capital to the table, but also experience from investment in similar assets, industry and ownership expertise and international contacts," he says.

Most established private equity investors bring sophisticated and tested financial and operational performance monitoring and operating systems, corporate governance procedures and standards and a framework for business development strategies into any deal, he says.

One factor often ignored when private equity investments in infrastructure are talked about is the networks and contacts that GPs can bring from outside of the market they are investing in. Private equity firms have relationships and past dealings with operators, banks and investors in other parts of the world and they can be introduced to the firm's other portfolio companies. Bastin provides an example – CIMB is using the experience and relationships from an existing toll road investment in Malaysia to benefit a toll road company in Thailand in which it recently made an investment. In September, the firm acquired Babcock & Brown's interest in Babcock & Brown Asia Infrastructure Fund for an undisclosed stake. In doing so, it also acquired a 30 percent stake in the Don Muang Toll road in Bangkok.


Fung: Local expertise is essential

Besides these value-additions and improvement in communication between the management and the owners, private equity investors also help chart overall strategy within the constraints of available capital, Parthasarathy says. They help position a company for eventual monetisation, either through the public or private markets.

He adds that going forward, one of the roles the private equity industry can play is to become a voice for financial sector policy reforms "that can facilitate instead of complicate the provision of private growth capital".

Involvement set to grow

As governments around the region acknowledge that by themselves they cannot meet the costs required to meet infrastructure demand, the role of private investors, and by extension, private equity is steadily increasing.

Private equity investors have begun accessing the public-private partnership (PPP) market through partnerships with local development or construction companies. One example is GMR Infrastructure, a portfolio company of IDFC Private Equity, which entered into the first PPP in the Indian airport infrastructure sector. GMR Infrastructure has a 63 percent stake in Hyderabad's Greenfield Rajiv Gandhi International Airport, Malaysian Airports Holdings has 11 percent, the Airports Authority of India 13 percent and the Government of Andhra Pradesh 13 percent.

The popularity of PPP projects in Asia varies from government to government. Daniel Liew, Hong Kong-based Asia managing partner at law firm SJ Berwin, says that in Singapore, for instance, the government is actively pursuing the PPP model, hence there is more opportunity for the private sector and private equity as well. In Hong Kong, on the other hand, he says, public-private partnerships have not taken off because the government is doing much of the infrastructure development itself. While traditional infrastructure assets in Hong Kong are mainly financed by the government, Singapore is moving away from that model, he says.

As GDP growth in Asia continues, the demand for new infrastructure will only increase as well. And with governments across the region having admitted they cannot meet the infrastructure development needs by themselves, private equity investors will continue to see opportunities in this space.