INFRASTRUCTURE: SURGING PIPELINE

Sergio Ronga, Managing Director at **DC Advisory**, spoke to us about the current status of the European infrastructure market.

What were the highlights of the European infrastructure market in 2015 from DC Advisory's perspective?

DC Advisory had a successful 2015 advising on a number of transactions which reached completion, including the acquisition by Antin of Amedes (a leading German healthcare platform), the acquisition by a consortium made up of Infracapital and AMP Capital of Adven (a Finnish energy infrastructure and services business), and the acquisition by First State of the Helsingor-Helsingborg ferry route.

DC Advisory was also involved in the successful refinancings of ESP (which operates gas and electricity distribution networks in the UK and is owned by Eiser) and LBC Tank Terminals (which operates bulk chemical and petroleum storage terminals around the globe and is owned by a consortium of Whitehelm (on behalf of Australian funds), PGGM and APG).

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What are the current trends in the European infrastructure sector and what is driving those trends?
There has been a significant inflow of liquidity into the market (both debt and equity) over the past 24 months, driven by the resilience of European infrastructure assets during recent uncertain global economic conditions and increasing amounts of capital available for deployment in the asset class. As a result, asset prices have risen (dramatically), sellers are obtaining increasingly better terms and buyers have to buy into ambitious management plans – and not simply rely on underlying performance in order to get their acquisition pricing to be competitive.

The increase in asset prices has meant that core infrastructure assets are going to their natural homes (direct pension fund investors, insurance companies and sovereign wealth funds). Closed-end funds seeking 10% IRR (or higher) are being priced out of the core infrastructure auction processes and, consequently, are attracted to the 'hybrid' or 'core-plus' space. District heating, oil and dry bulk storage and pipelines, for example, are becoming increasingly sought after assets for these funds.

Looking forward, there is a wave of secondary assets coming up for sale as a number of closed-end funds (originally invested between 2004 and 2008) look to exit their investments. Interestingly, as infrastructure assets are trading at higher prices and the market becomes ever more competitive with investors looking to deploy capital, a number of the closed-end funds are being extended by their LPs to avoid the requirement to 'flip' what are otherwise scarce core infrastructure assets.

Is the pipeline still strong for 2016?
The pipeline is still very strong with a number of secondary assets expected to come to the market this year, such as the potential sale of Elenia (the Finnish electricity distribution network) owned by 3i and Goldman Sachs Infrastructure Partners. In addition, new assets will also enter the market as part of corporate disposals and government privatizations. Assets expected to enter the market include the privatization of National Grid's gas distribution network, Network Rail's electricity distribution network and certain French regional airports including Nice and Lyon.

With the pursuit of these assets expected to be highly competitive, bidders are already positioning themselves strategically. The infrastructure funds are having to choose which assets they chase and which they pass on, wary of investing time and money on processes that will ultimately be secured by the stronger purchasing power of direct investors such as pension and sovereign wealth funds. This poses a dilemma for the sell-side advisers who are carefully seeking out gaps in the pipeline to attract sufficient and the right type of liquidity to processes and avoiding any overlap that might split the focus of bidders.

Given the competition for assets, what are managers doing to improve investment value?
'Core plus' is where the majority of closed-end funds see value in the current market. In addition, an increasing number of funds are also looking at greenfield opportunities, such as taking construction risk on renewable energy projects, in some cases, as part of a portfolio with other operational renewable assets.

Some managers are also looking at platform deals, utilising existing platforms to do bolt on acquisitions to create further value and improve their competitive positioning.

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We are also seeing managers looking for a blended portfolio risk with some funds bidding on core infrastructure assets as a base (seed asset) for their funds whilst at the same time looking to add 'core plus' assets to the portfolio to achieve higher return expectations and requirements (on a blended basis).

Outside of Western Europe, would you say that the Southern and Eastern European markets remain an attractive region for infrastructure investors?
Most funds are active in Southern Europe as they have OECD mandates, albeit some still require a premium (although that's starting to be eroded) against similar assets in Western Europe.

In Eastern Europe, deals are transacted more on an opportunistic and strategic basis. However, we are seeing increased activity in this region. The potential privatization of three Lithuanian airports, for example, will certainly attract much interest across the investor groups.

On the debt side, are you seeing an erosion of pricing and loan terms for lenders?
We are seeing some, albeit still limited compared to pre-crisis, leverage creep as well as aggressive reductions in margins in most current debt structures. In loan documentation, we have also seen a move towards more sponsor-friendly terms including, more frequent inclusion of change of control (portability) language, more sponsor-friendly equity cures, and an increase in covenant headroom.

How important is alternative funding in the European infrastructure debt market?
Alternative funding is providing a viable alternative to the capital markets as well as competition to the banking product, especially for longer dated maturities. There is, however, still only a limited appetite for involving private placement funds in M&A processes (due to execution risk and inability to run trees), but they are becoming increasingly popular as an alternative to capital market activity in refinancings.

It should be noted that there is a clear distinction, in the private placement market, between those private placement funds looking for fixed rate investment grade lending against those who look to compete against the banking market product by offering, for example, longer tenors for an illiquidity premium.

An important dynamic in refinancing processes is the existing swap position, as those private placement funds that are able to lend on a floating rate basis are able to make their offering more compelling in the refinancing process where the existing swaps need to remain in place.

From the asset/sponsor's perspective, it is important that the lending structure is carefully considered to ensure a long-term platform is put in place to allow for the issue of bank debt, private placement and/or high yield bonds in the future. The security and intercreditor arrangements in this respect will be key.

How is DC Advisory adapting to the changes in the European infrastructure market?
The growing interest from the infrastructure funds in the 'core-plus' and 'hybrid' assets has been significant in the successful track record achieved at DC Advisory to date. Among the emerging 'core-plus' sectors, we are expecting significant interest among infrastructure investors in 2016 in healthcare, bulk storage, smart meters and rolling stock leasing businesses. This is a strong area of focus for DC Advisory and one where we believe we can add significant value to our clients given our strong M&A and debt advisory capabilities.

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