EUROPEAN INFRASTRUCTURE: THE STORY THE NUMBERS DON'T TELL

IN BRIEF

- **Infrastructure investment is still falling across Europe.**
- **There is now a deep pool of private money available for infrastructure projects.**
- **This has brought intense competition to buy popular assets which has inflated prices.**
- **Higher prices could bring a revival in M&A as companies and some cash-strapped governments are tempted to sell.**
- **Governments are reluctant to launch projects in a time of austerity and to privatise assets in a political climate increasingly hostile towards private ownership.**
- **Investors are being forced to stretch their risk appetite in order to secure higher returns.**

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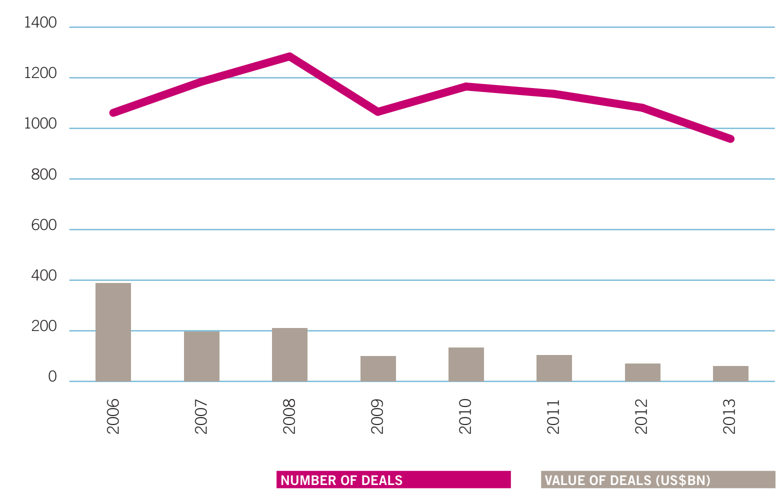
linklaters.com/infrastructure-revival

SMALLER FRY

Fig. 2.1 Infrastructure M&A deals by value and volume, EU28

SOURCE: THOMSON REUTERS



On the surface, the numbers for private investment into European infrastructure do not look encouraging. Public-private partnerships (PPPs), designed to funnel private cash into building public infrastructure, have nearly dried up as governments mired in austerity fail to launch projects. In the first half of 2013, the number of PPP deals reaching financial closure almost halved to 24 across Europe, compared to the same period in 2012. M&A activity among EU infrastructure companies fell by 15% in 2013, on top of an already significant decline of more than 80% between 2006 and 2012. Europe's share of global infrastructure purchasers has crashed from more than half in 2006 to just a quarter in 2013. (See figure 2.1 *Smaller fry.*)

Behind the gloomy numbers, there has been a significant shift. As infrastructure becomes more established as a dedicated investment class and investors look for higher, long-term returns in today's very low interest rate environment, a pool of private investment money is building. The source? Institutional investors such as insurers, pension funds and sovereign wealth funds.

Our research estimates that global institutional investors have funds of up to US$1trn at their disposal to invest in European infrastructure over the next 10 years. That is a big contrast to the years immediately after the financial crisis, when a dearth of bank lending made private infrastructure investment difficult.

This new cash pool has already driven prices for some assets, such as airports, back to pre-crisis levels. This is likely to tempt companies to sell their newly valuable European subsidiaries, as they try to reduce debt levels. It will also entice cash-strapped governments in southern Europe to sell assets as they try to slash public debt. "European assets in a diversified portfolio remain attractive at the right price for a long-term investor," says Ross Israel, Head of Global Infrastructure at QIC, the third largest institutional investment manager in Australia.

"There is now too much money chasing too few deals," says Georg Inderst, a consultant who wrote a study on private infrastructure spending for the European Investment Bank (EIB) in 2013. This is fuelling complaints from within the investment industry that prices for some assets are being driven too high. Many investors admit that they have been priced out of investment opportunities in northern Europe, from PPPs in Germany and France to UK utility companies, as financial investors bid high for what are perceived to be safe assets.

Some investors now worry that infrastructure prices are a bubble waiting to burst. This was the terminology used by one senior executive that we interviewed, pointing to the inflated prices paid for airports across Europe. He argues that prices have soared too high, making it a question of when, not if, they will crash.

Others take a more pragmatic view, arguing that the high prices reflect a permanent shift in the market, with new types of long-term investors willing to pay higher prices in return for stable, if relatively modest, returns.

The upside to this is that private investment is being driven into new areas, as the obviously attractive deals dry up or become too expensive. Andrew Liau, Managing Director of Ardian's infrastructure team, says that they are currently seeing more attractive investment opportunities in unregulated assets as compared to price regulated assets. "It was not a policy decision," he says. "We are constantly studying regulated assets and remain interested in including these within our investment portfolio. However, we feel that regulatory risks present a real threat towards achieving satisfactory investment returns in the current environment, particularly when compared to the prices presently being paid for these assets."

THERE IS NOW TOO MUCH MONEY CHASING TOO FEW DEALS.
Georg Inderst
European Investment Bank (EIB)

Investors are not only looking at a wider range of assets, but also of countries, as they look for better returns. As the supply of assets in northern Europe remains limited, and asset prices are inflated as a result, investors are looking to countries in southern and emerging Europe for prices that are more palatable.

Investor appetite for risk applies not only to brownfield assets, but greenfield projects too. Though construction risk is still a step too far for some institutional investors, others think that the reward warrants the risk. For example, infrastructure and energy fund Marguerite, Danish pension funds, PKA and IP and Siemens Project Ventures, have invested approximately US$548m of equity in the Butendiek greenfield offshore wind project in the German North Sea. This was one of the first times funds have taken construction risk on an offshore wind farm. "These investors thoroughly examined risks attached to this project and found them to be acceptable. The success of this deal may pave the way for further investments by funds into greenfield projects," says Thomas Schulz, a Linklaters partner in Berlin, who advised on the project.

Who is driving demand?

European investment in home markets has sharply declined. Although buyers from northern and southern Europe still account for close to three-quarters of infrastructure acquisitions on the continent, between 2010 and 2013 they spent approximately 70% less than in 2006-2009. (See figure 2.2: *Rapid change*.)

Despite spending over 60% less than before the crisis, northern European investors have maintained their share of the market, accounting for just over half of all infrastructure investment in Europe.

The real collapse has been with investment from southern Europe, which fell 80% after the crisis, as Spanish investors stopped buying. US buyers eased up on acquisitions too, although the fall was less extreme than among the Europeans, with values down by 40%.

Despite the gloomy statistics, some buyers have increased activity in recent years. China, for example, has increased its acquisition activity 80-fold to a total of US$23bn since 2006, including acquisitions through Hong Kong. There have been some big individual investments, with Chinese companies buying stakes in UK nuclear and water companies, as well as in energy companies privatised by Portugal. However, "as much as they are interested in the European market, given the cautiousness of the Chinese and their mode of investment, Chinese investment alone is unlikely to be big enough in the aggregate to have a major impact on satisfying Europe's infrastructure needs," says Tom Ng, a Linklaters partner in Beijing.

Canada too offers Europe a source of private investment through its pension funds, who in the last three years have invested over US$13bn into Europe's infrastructure, often leading consortiums on the most high profile deals (see page 13 *Canadian pension funds: game-changers?*).

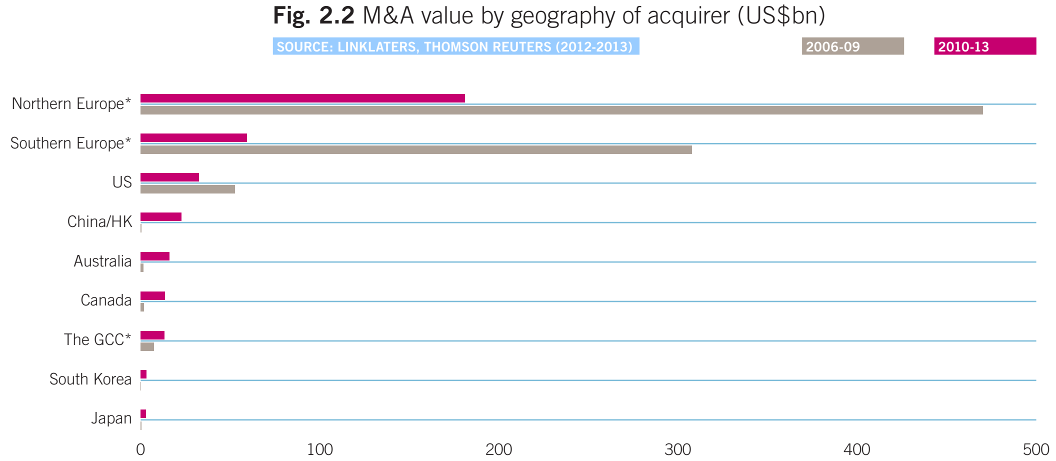
Another category of investor with an increased appetite for European infrastructure investment is sovereign wealth funds and government-related entities. "Outbound investment has largely been targeted at developed markets with new investment opportunities arising as European governments seek foreign investment," says David Martin, a Linklaters partner in Abu Dhabi, singling out the sovereign wealth funds whose 20-30 year time scale for investments is a good match for infrastructure. "They are looking for stable long-term returns and they are increasing their direct investment capability and focus, often in partnership with private equity or specialist funds. Europe offers them lowish but stable returns, in contrast to riskier but higher returns in Asia."

For non-European investors like this, Europe remains an attractive destination, but the sums they spend are small compared to the Europeans themselves. For the time being, Europe must mend itself.

RAPID CHANGE

Fig. 2.2 M&A value by geography of acquirer (US$bn)

SOURCE: LINKLATERS, THOMSON REUTERS (2012-2013)

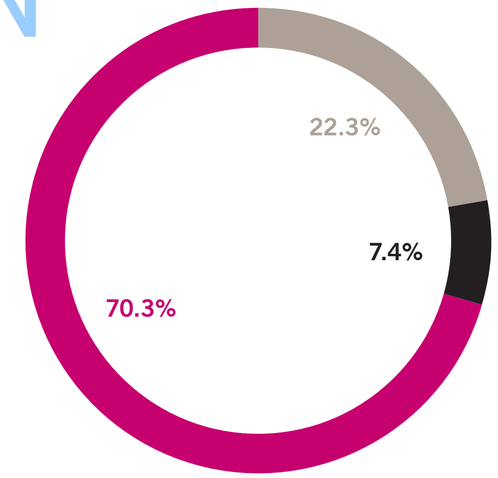


* Northern Europe includes the UK, France, Germany, Benelux, Scandinavia, Ireland and Austria
* Southern Europe includes Italy, Spain, Portgual, Greece, Cyprus
* The GCC includes UAE, Qatar, Kuwait, Saudi Arabia, Oman and Bahrain

THE REFINANCING OPTION

Fig. 2.3
Breakdown of European infrastructure deals by type of investment/ financing (2012-2013)

SOURCE: PREQIN



Changing the mix: leveraging available infrastructure debt

Just two years ago, one of the spectres worrying Europe's financial sector was the wall of debt about to mature before 2016 – US$550bn for leveraged buy-outs alone, according to a Linklaters report from early 2012. With banks cutting back on lending levels to meet tougher regulatory requirements, it was clear they would struggle to meet the demand for refinancing by themselves.

Financial investors, including insurance companies, have become increasingly keen to access infrastructure's secure, long-term, often inflation-linked, cashflows. This has led to a significant amount of affordable debt being made available again, from institutional investors as well as banks. And companies are cashing in.

Private equity investors, heavy buyers of infrastructure assets, refinanced a record amount of their companies' debt in 2013. In the first nine months of the year, Standard & Poor's says that private equity funds refinanced US$31bn of debt, over 50% more than in the whole of 2011 and two-thirds up on 2012.

Seventy per cent of all private infrastructure investment since 2012 has focused on refinancing operational infrastructure assets rather than investing in new ones (see figure 2.3: *The refinancing option*). "The projects that were signed in the boom years of 2006-2007, with five-year bank loans, now need refinancing," says Charles Dupont, Head of Infrastructure at AXA Real Estate. He adds that AXA can provide debt for a longer term than banks and usually for a higher amount than the original loans, and has the necessary expertise and resources to analyse more complex credit situations than most institutional investors.

Life insurance and pension investors are looking for long-term returns that are higher than for government debt, and infrastructure debt is a good match. Many institutions have launched infrastructure debt funds in recent years, including Allianz, the German insurer, the UK's Barclays and Australia's Hastings. That is already feeding a flurry of activity over refinancing, as companies take advantage of the flow of available money into the market. With bank lending stretched, refinancing all the European infrastructure companies that took out debt before the crisis will be a major source of business for financial investors over the next few years.

The availability of international funds can also be tapped to raise the money for new investments, and to offer companies a flexible funding source for future investments. (See case study: *Peel Ports: Safeguarding its future.*) ▸

CASE STUDY

PEEL PORTS: SAFEGUARDING ITS FUTURE

In December 2012, Peel Ports, the second largest ports group in the UK, completed the whole business securitisation debt refinancing of its £1.5bn (US$2.5bn) debt package in a club deal involving nine commercial banks. In addition to this, it completed an EIB/ commercial bank project financing of its major new container port, the Liverpool2 deep water container terminal scheme.

"Peel successfully closed one of the most complex refinancings in recent times," says Julian Davies, the Linklaters partner who led the deal, "demonstrating that even in a depressed market there is appetite to provide infrastructure debt both for refinancing and for new projects. In the case of Peel Ports, there were several types of investors, with debt provided by the EIB, commercial banks and US institutional investors."

Less than a year later, Peel Ports raised further funds in the infrastructure debt funds market and was delighted at the response when Westbourne, IFM and AXA agreed to refinance another significant amount of bank debt, further diversifying the investor base and extending the maturity profile of its debt.

Opportunity knocks: who will answer?

Across Europe, there is little government will for new investment, with the focus still on cutting spending and stabilising domestic banks. In addition, political support for private financing of infrastructure is, in general, shaky.

In reality, far from accelerating privatisation to raise cash, several countries are reversing past infrastructure sales in the face of public protest, something true of both French water companies and German municipal energy companies. Elsewhere, there have been political assaults on private infrastructure owners, with UK energy and water companies coming under fierce political and regulatory pressure to cut prices. In fact, southern Europe looks far more likely to yield privatisation deals than the north, as governments from Italy, Spain, Portugal and Greece look to sell companies to reduce public debt, and to cash in on today's high prices. (See section 4: *Southern Europe: rising from the ashes.*)

Rather than privatisation, many investors are looking towards corporate disposals for acquisition opportunities, as higher valuations encourage companies to sell subsidiaries, or stakes in them, often in a bid to reduce debt.

That is the message from RWE's sale of its Czech gas pipeline network, announced in March 2013. Net4Gas, a capital-intensive business operating more than 3,000km of pipeline across the Czech Republic, sold for US$2.2bn to two financial investors, Allianz, the German insurer, and Borealis Infrastructure, the infrastructure investment arm of the Canadian pension fund OMERS.

The German energy giant RWE admitted that the sale of Net4Gas was more to do with reducing debt and capital spending than with energy unbundling: it is refocusing its business to compensate for low gas prices in a weak European economy and took a hit worth billions of dollars on Germany's decision to exit nuclear power.

More deals like this are likely to follow as companies tap into financial investors' appetite for infrastructure assets. Many energy companies are looking to sell, as are Spanish construction groups, who are selling out of their depressed home market to fund international expansion.

With a lot of money chasing only a small number of infrastructure deals, even companies in troubled countries can find buyers if they structure their deals to be attractive to the private investors crying out for stable assets that offer better returns than low-yielding government debt. "The question now is not whether there is private money available for infrastructure investment, but where the new deals will come from," says Iain Wagstaff, Infrastructure Sector Co-leader and Linklaters partner in London.

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CASE STUDY

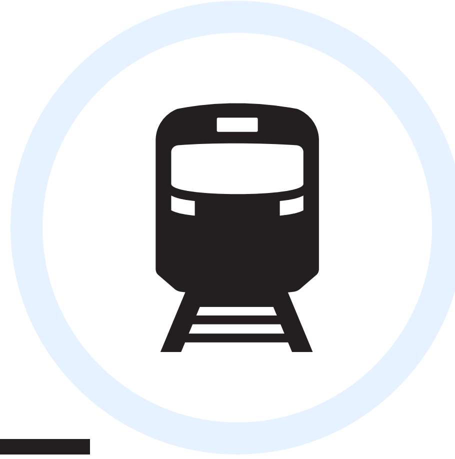
HOCHTIEF: TAKING OFF

Hochtief, the largest German construction group by revenue, had been trying to sell its airports division for three years to reduce debt, and refocus away from capital-intensive businesses.

Their diverse portfolio included holdings in Athens, Budapest, Düsseldorf, Hamburg, Sydney and Tirana airports. Some of these countries were deemed to be high risk, sometimes without a majority stake, which deterred industrial investors such as France's VINCI Concessions and China's HNA from completing the deal in 2011.

However, in May 2013, Hochtief finally announced the sale of its airport division to Canada's Public Sector Pension Investment Board (PSP) for US$1.4bn. The deal certainly shows the risk appetite of the Canadian pension funds and suggests that they are willing to invest in assets in sub-investment grade locations such as Greece. However, these airports were also unusually affordable given that prices for airport assets are generally high at the moment with their proven ability to weather a difficult financial climate.

"There was plenty of interest in buying these assets and especially the 50% stake in two large German airports," says Ian Andrews, Infrastructure Sector Co-leader and Linklaters partner in London who advised PSP on the purchase. "But most bidders were deterred by the complexity of the deal and so it sold for a relatively modest price."



Canadian pension funds: game-changers?

Big Canadian pension funds have invested around US$13bn into the European infrastructure M&A market since 2010.

"In contrast to many European countries, Canadian pension plans are funded arrangements," says Ulrich Wolff, a Linklaters partner in Frankfurt. As the Canadian pension system relies on mandatory personal savings, as opposed to pension payments stemming from taxation, this has resulted in the emergence of some of the biggest pension funds and investors in the world. "With infrastructure as one of their preferred asset classes," says Ulrich, "they have become a significant player in the market."

"CPPIB has billions to invest each year," says Michael Goldberg, a director of the largest fund, the Canada Pension Plan Investment Board (CPPIB). Long-term, steady-yielding infrastructure investments are a good match for pension funds' long-term commitments. "The Chief Actuary of Canada assesses CPPIB over a 75-year time horizon," he says, adding that CPPIB buys infrastructure assets to hold on to, not to sell on for a private-equity-style profit.

That is not to say that they will pay over the odds to build their infrastructure profiles. They will invest for around half of the return of private equity funds but they will not buy at any cost. In order to access assets at more acceptable prices, they may need to look well beyond the standard "safe" bets of north America, northern Europe and Australia. "Making risky investments is acceptable as long as the risks are fully analysed and compensated for in the investment return," Michael says, confirming that CPPIB's appetite is not restricted to investment-grade countries.

Even though they have funded some of the sector's largest deals, for example, Borealis Infrastructure and Ontario Teachers' Pension Plan's US$3.2bn acquisition of HS1 in 2010, Canadian pension funds alone cannot drive the market forward. Their investment of US$13bn in the European infrastructure market since 2010 represents only 4% of the total. For giants such as these, infrastructure is an increasingly useful complement to traditional, safe areas such as government debt, but will not replace it.

BIG CANADIAN PENSION FUNDS HAVE INVESTED AROUND US$13BN INTO THE EUROPEAN INFRASTRUCTURE M&A MARKET SINCE 2010.