Second chances

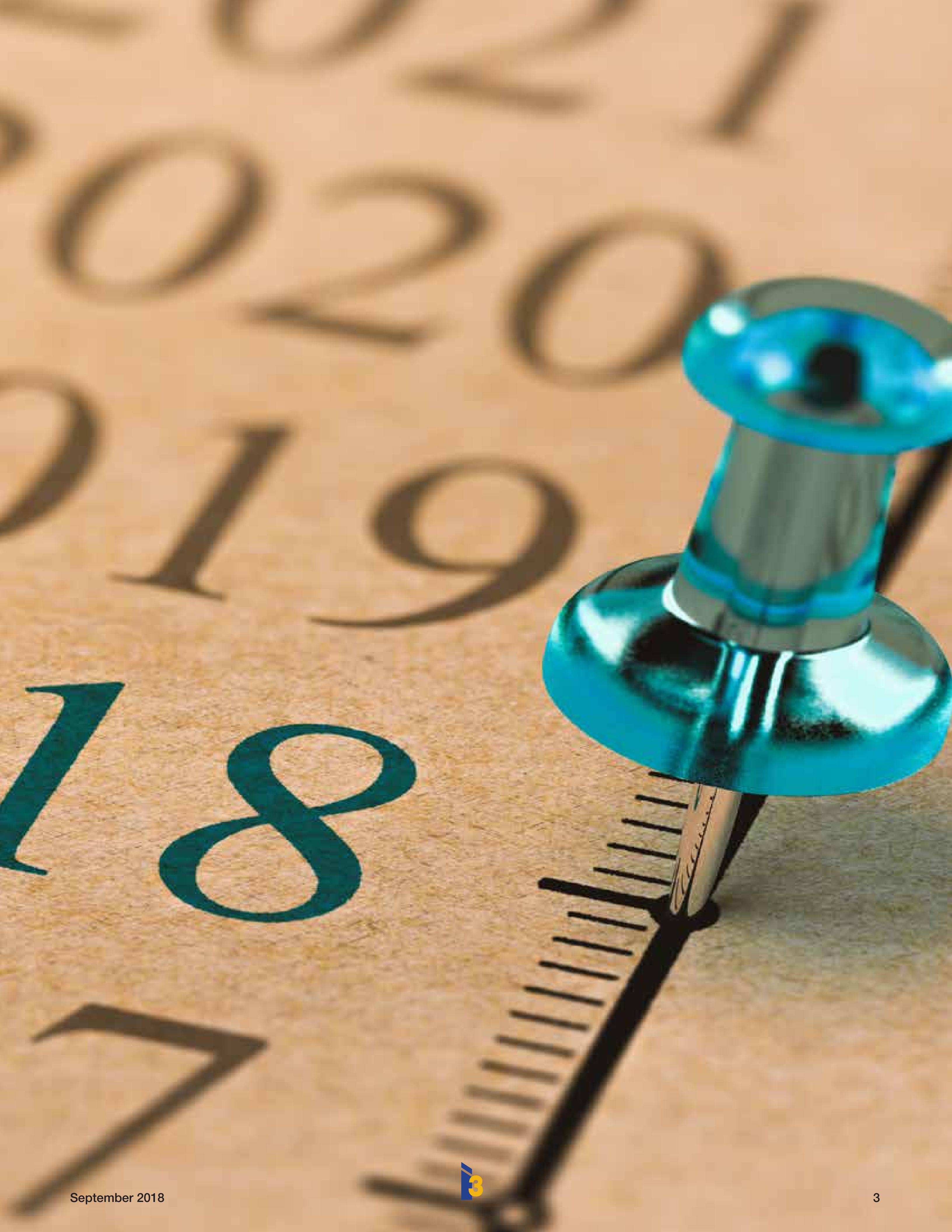
by Drew Campbell

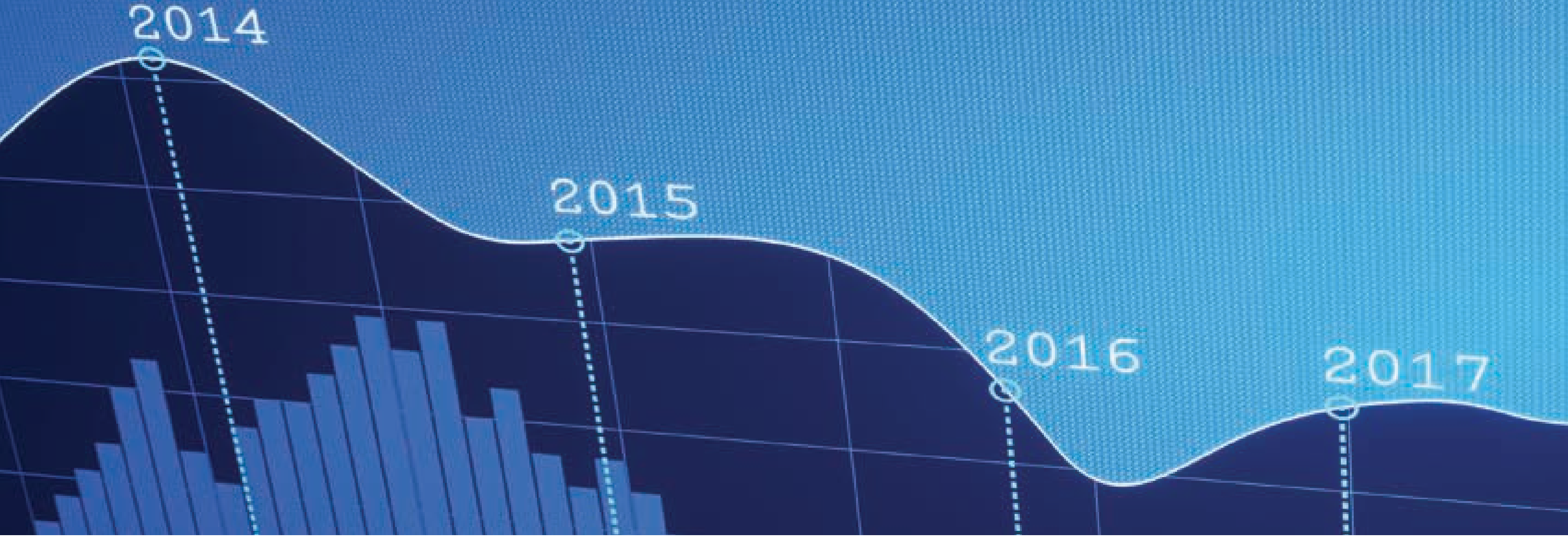
Infrastructure secondary funds and transactions can link investors with long-lived assets

In many ways, today's infrastructure investment market is similar to the market of 2005 to 2007. A lot of capital is being raised by closed-end funds, and the asset class is attracting interest from investors who are new to the market. But one aspect of today's market that was missing 10 years ago is there are more clear paths not only to exit investments but also extend those investments in order to continue to benefit from a yielding portfolio of mature assets.

Today, in addition to the traditional exit at the typical 10- to 12-year life of a closed-end fund, investors are better able to sell their interest in a fund to another limited partner investor in the secondary market, or even participate in a secondary transaction to extend the life of a fund.

"We are witnessing an increasing trend toward active portfolio management across all private markets, and the secondary market is simply a tool that investors can utilize to implement these strategic changes in allocation," says Michael Bane, head of U.S. investor relations with Ardian. "Infrastructure assets have longer holding periods than private equity and a 15-year or 20-year term is more the norm rather than the exception. A lot can change during that timeframe; therefore, the infrastructure asset class needs a functioning secondary market to service changing investor needs and preferences over time."





It used to be that secondary investments were more typically one-off events, but now dedicated secondary funds are raising capital and offering more liquidity to investors in this market. Blackstone, Pantheon, Ardian and HarbourVest are a few of the investment managers currently active in the market. Other firms such as Partners Group allocate to secondary investments out of multi-strategy private infrastructure funds.

But at the moment, the market for infrastructure investments of all types is competitive, and finding good new investments at a fair valuation is a challenge.

"Infrastructure secondaries was a sub-half-a-billion market in 2009, but by 2017 it had grown to more than $5 billion," says Naoki Ohta, managing director, alternative investments with Barings. "That is significant growth. This is being led by two drivers: first, there are a number of funds that are reaching the end of their lives. GP-led secondary transactions provide an elegant solution for diverse and sometimes contradictory needs of LPs. The other driver is simply the secondaries market is maturing and expanding into real assets and the volume of capital raised for infrastructure investment has grown considerably."

Nearly $400 billion has been raised since 2006, and investors, for whatever reason, elect to sell sometimes. "That has flowed through to the secondary market, Ohta notes.

In this market, with so much capital targeting infrastructure, including infrastructure secondaries, many limited partner investors might view the opportunity to remain invested in yielding assets for an extended period of time as a better option than cashing out and having to reinvest in the current market.

For those investors who aren't ready to exit as a fund reaches maturity, investment managers can offer to extend the life of some of the fund assets using a particular type of transaction commonly known as a "tail-end secondary" or "liquidity solution."

Secondary funds offer the infrastructure market additional liquidity and can help replace those LPs that do choose to exit at the end of the fund's life.

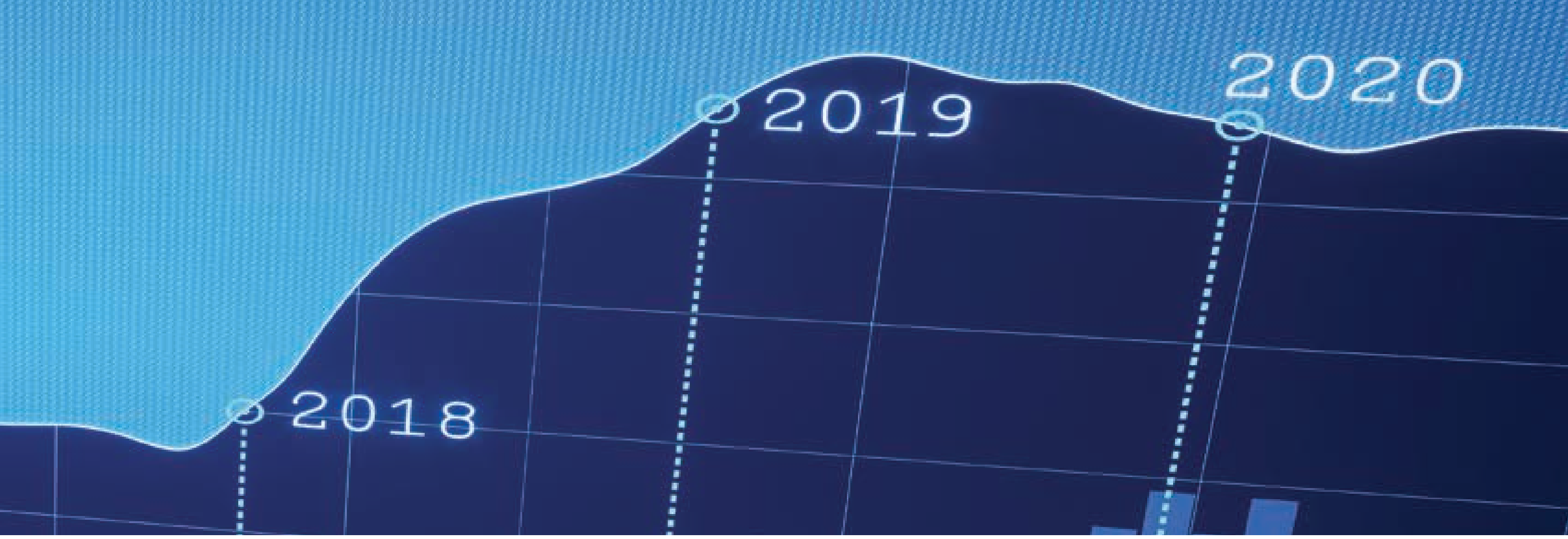
"Tail-end transactions are a big part of the infrastructure secondaries market now — we estimate that 70 to 80 percent of the secondary transaction volume in 2017 was going to liquidity offerings," says Marc Meier, senior vice president, member of the private infrastructure investment committee with Partners Group. "Real estate and private equity markets have had this type of secondary transaction for a long time, but this is new in infrastructure and a sign of a maturing industry."

Because funds can sometimes have 100 investors and their interests are not going to be perpetually aligned, secondary funds have become an increasingly popular way for investors to exit primary fund investments.

"In the current secondary market, pricing can be high and certain sellers who may be contemplating selling see the market dynamics as favorable. That is driving volume as well," says Ohta.

What is driving the growth of these specific secondary transactions is the wave of fundraising in 2005 to 2007. These funds are now nearing the end of their life cycles and either have to exit investments or extend the life of the fund.

"Investors have found it difficult to put capital to work in quality assets," says Gerald Cooper, partner with Campbell Lutyens. "Actual investor allocations have lagged target allocations to infrastructure consistently for the past five to seven years. That means investors are underinvested in the space, and we often see them use the secondary market to help supplement their exposure."



In other words, despite the difficulty in finding a good infrastructure investment at an attractive value, limited partner investors continue to target the asset class, and secondary transactions and funds are one beneficiary of this demand. These "liquidity solutions" appeal to new investors to the asset class, as they offer immediate exposure to infrastructure investments, whereas with a primary fund, capital can be tied up as the general partner investment manager searches for new investments.

Secondary funds and transactions are appealing to investors for several reasons, including the opportunity to invest in assets that are known quantities — with a secondary investment there is no lag between the commitment of capital and earning returns because buyers and sellers are entering and exiting positions in mature operational assets. Unlike investments in primary funds, there is no wait to find and win a good investment or to develop an asset over a period of time before it can begin operating and generating cash flows.

Investors in primary funds, on the other hand, commit capital based on a promise of investing in certain types of assets in certain markets, but the specific assets and markets are not known like they are with a secondary fund or transaction.

But Meier warns investors not to get complacent about secondary transactions and investments. As these deals often involve mature, "core-like" operating assets, these positions are being acquired in a highly valued market and in an interest rate environment that is poised to rise.

"We expect the valuation cycle to return to its mean over time," says Meier. "These investments are sensitive to changes in interest rates, and we have not had a market downturn in some while."

He cautions investors to understand not only the assets and structures they are investing in, but also the larger market environment, before committing capital.

TIMING IS EVERYTHING — SECONDARIES COME OF AGE

The age-old adage "buy low, sell high" applies to today's market as prices for investments climb ever higher. Now seems like an opportune time to sell. But, of course, nothing is that simple. Different investors will have different needs at different times, and secondaries can offer them flexibility.

"What has been the real change in the infrastructure secondaries market is GPs using secondaries as a solution mechanism, particularly where there are underlying assets or concessions with natural lives of 25 years or more but where most funds were structured on a 10-year basis," says Ohta.

This asset-duration mismatch can create a need for flexibility for the varied interests of investors, and secondaries can offer this benefit.

"Some sponsors may not think it is the optimal time to sell because there is still more value to be created," Ohta explains. "Or you might have certain investors such as pension plans or insurance companies who want continued exposure to the underlying assets because they are a good match for their liabilities. Other investors may seek liquidity in line with the original investment agreement."

As the infrastructure market has matured over the past decade, so has the infrastructure secondaries market, and investors who used to view exits from infrastructure commitments with skepticism, should welcome the liquidity and flexibility that the secondary market is providing. ❖

Drew Campbell is senior editor of *Institutional Investing in Infrastructure*.

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