

## INFRASTRUCTURE

### Infrastructure Investing in Europe



**Stephen Vineburg,**  
Global Head of Infrastructure,  
Colonial First State

**How has investing in infrastructure evolved since the beginning of this century?**

Private investment in infrastructure has become increasingly accepted by Western democracies as they grapple with the demands of ageing infrastructure and increased fiscal constraints. At the same time, pension funds and other large institutional investors have been attracted to the robust income streams generated by these types of assets. This trend has transformed the infrastructure investment market.

We are seeing specialist infrastructure funds, pension funds, Middle-Eastern investment trusts and insurance companies all seeking exposure to this sector. Consequently, government agencies and investors have become more sophisticated in their dealings and approach to valuation, service delivery and risk allocation.

**Why is there renewed investor interest in this asset class?**

Investors such as pension funds are searching for real assets that generate long-term returns to match their long-tailed liabilities. Pension funds are well suited to be the long-term providers of capital for infrastructure assets.

This interest is growing as investors seek relatively predictable and stable underlying cash flows, as the opportunity set widens and infrastructure markets deepen. Investors are also increasingly aware of the diversification benefits offered by infrastructure when included in an investment portfolio.

**What sectors do you categorise under infrastructure?**

A key feature of infrastructure investment is the relatively stable demand for the good or service produced by the operating business. In this context, essential services such as the provision of water, gas and electricity as well as transport services such as highways, rail, ports and airports, fit this category. Often, these assets have regulatory frameworks which govern the pricing of services and the rate of return that can be generated. Investors are attracted to the stability provided by these regimes.

Apart from these "economic" projects, there is a range of "social" infrastructure projects such as schools and hospitals that are often included in this category. Increasingly we are seeing investors make allocations to non-traditional sectors which display characteristics of infrastructure such as car-parks and university housing projects.

**Why are you focusing on harnessing its potential in Europe? Why not North America, or Africa and Asia?**

We are focused on Europe because of the relatively stable and transparent regulatory regimes, the need for private funding and deregulated capital markets. Our long track record in the Australian market has braced us with skills and experience which can be leveraged successfully in Europe, particularly the UK. We have an established presence in London, allowing our team to take advantage of investment opportunities in this market.

The US market offers substantial opportunity for infrastructure investment because of its sheer size and legacy of government under-investment. It is inevitable that private investment will play an increasing role in developing new assets and providing investment for existing facilities. Currently, there are a number of legislative, tax and regulatory obstacles to significant levels of private investment. We anticipate that the commercial logic of private investment will eventually overcome these obstacles.

There is no doubt about the infrastructure needs of

Asian economies, particularly the fast growing China and India. These markets offer opportunities that are typically of a different risk and return profile to the available opportunities in Europe. At this stage, investors are generally more attracted to the core infrastructure returns available in Europe.

**What are the different investment instruments available to an investor, interested in investing in infrastructure today?**

One of the features of the increasing sophistication of the infrastructure market is the range of options for investors. This includes the listed market, private unlisted funds, and direct exposure to assets, which is increasingly prevalent among pension fund investors.

**What is/are your instruments of choice? Why?**

With the complex nature of these assets, we believe investors are best served by investing in a professionally managed pooled fund. We have established an open-ended core-plus style of fund, which is aligned with the nature of the underlying assets and the investment objectives of investors. At the same time, larger more sophisticated investors may require exposure on a direct basis.

**What are the risks and do the rewards compensate them?**

There are specific risks associated with infrastructure investment that need to be managed to deliver forecast investment returns. Of particular importance to infrastructure investments is the identification and management of demand risk, financial risk, construction risk, operational risk and regulatory risk. These risks can be mitigated by appropriate risk allocation and management over the project's life cycle. Specialist skills and experience are critical for the identification and management of these risks.

Infrastructure investment offers an "inefficiency" premium because of the more specialised nature of the investment, the complexity of the businesses and the difficulty of gaining access. There is the opportunity to derive attractive risk-adjusted returns from the application of risk management at the asset and portfolio level.

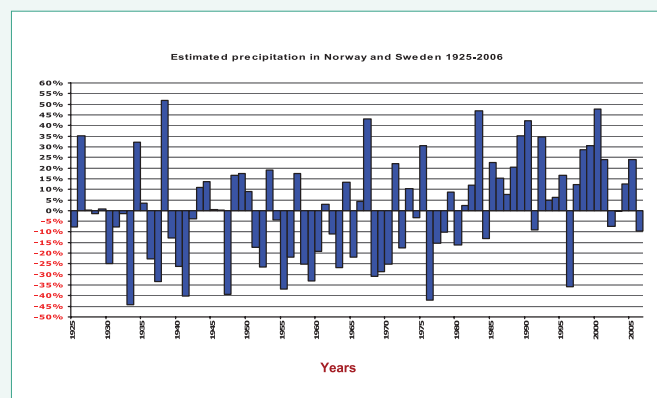
**What is your outlook on this space and the challenges that lie ahead?**

The role of infrastructure investment in the long-term asset allocation framework of pension funds and other long-term institutional investors is here to stay. At the same time, the involvement of private investment in the provision of infrastructure services is becoming increasingly accepted across the political spectrum. However, the mechanism for bringing the capital and the opportunities together is still evolving. We believe the development of long-term, diversified portfolios with specialist managers is a logical part of this evolution.

We expect to see further competition for these assets, as more investment funds are mobilised. Notwithstanding this competition, infrastructure investment is likely to continue to offer attractive risk-adjusted returns. The Australian experience demonstrates that there is still the opportunity to generate such returns in a sophisticated market.

A key challenge for investors will be maintaining investment discipline in a competitive environment and managing the multiple stakeholder issues that arise from the critical role that these projects play in their communities.

## POWER



The nordic power market: precipitation has a direct influence on spot price  
Source: Plenum Power Fund

## PLENUM POWER FUND

**Focus:** The fund invests and trades in energy-related instruments offered by the Nord Pool ASA (the Nordic Power Exchange)

**Strengths:** Manager expertise, trading experience

**Weaknesses:** In order to optimise the strategies risk/reward potential - better suited to investors with a long term horizon  
• capacity constraints owing to the underlying size of the market traded

**Opportunities:** • The underlying market traded exhibits high volatility - the ability to forecast weather, follow trends, and be positioned to exploit the same, can generate above average returns.

• As Scandinavian weather is the dominant price driver; historically, this market has shown very low correlation with all other asset classes.

**Threats:** Unexpected, sudden, short lived, sharp reversals in trend could pose a challenge.

### Risk Management

□ = low □ = low/moderate □ = moderate □ = moderate to high ■ = high

- Strategies major risk: **price risk (being caught out on the wrong side)**
- Ratio of profitable to unprofitable months: **11:6**
- Leverage used: **normal**
- Liquidity: **typically 1 day to unwind all positions, under normal condition**
- Market risk: □ □ □ □ ■
- Currency risk: □ □ □ □ □
- Key man risk: □ □ □ □ □
- Accuracy in translating weather forecasts into profitable trades: **75 %**
- Effective implementation of stop loss limits: □ □ □ □ ■
- How frequently do these limits get activated? **once a month**

- Mathematical trend following model: **current allocation 20%**

• Inherent /bias - model risk: □ □ □ □ □

• Model fatigue factor: □ □ □ □ □

- Fundamental trend following model: **current allocation 40%**

• Accuracy in defining behaviour patterns upon which signals are triggered: □ □ □ □ □

• Expertise in evaluating fundamentals: □ □ □ □ ■

• Expertise in evaluating positions: □ □ □ □ □

• In defining and adapting filters: □ □ □ □ □

- Strategic model: **40 current allocation%**

• Expertise in evaluating market evolution : □ □ □ □ ■

• Ability to transfer the above analysis into positions: □ □ □ □ □

• Accuracy achieved in implementing positions to optimise risk/reward potential: □ □ □ □ □

### Performance Parameters

■ =insufficient ■ =adequate ■ = satisfactory ■ = good ■ = outstanding

- Positions currently in the portfolio: ■ ■ ■ ■ ■
- Efficiency in putting investor capital to work: ■ ■ ■ ■ ■
- Diversification achieved at portfolio level: ■ ■ ■ ■ ■
- Geography: ■ ■ ■ ■ ■
- Duration: ■ ■ ■ ■ ■
- Scope of trades: ■ ■ ■ ■ ■

- Ability to sustain performance in:

• Rising Falling markets: ■ ■ ■ ■ ■

• Sideway trending: ■ ■ ■ ■ ■

- Since inception, consistency in delivering targeted returns: ■ ■ ■ ■ ■

### Outlook

↑ upside potential ↗ upside to range bound ↔ range bound ↘ range bound to down ↓ downside potential

- Define barriers to entry: **traders - relevant expertise**
- Outlook for investing in power: ↑
- Scope for a fund like Plenum: ↑
- Outlook on the fund being able to deliver targeted returns over the next:
  - 12 months: ↑
  - 1-3 years: ↑

- Presence of competition: **does not dilute performance**

• Max capacity AuM: **EURS 200mn**

• Fund tends to outperform when: **the underlying market exhibits high volatility**

• Fund tends to show relative under perform **when the underlying market exhibits long periods of ranging behaviour**

### Investment Insights

- Fund's current AuM: **EUR121mn**
- The fund is targeted at: **broad based investor base**
- To optimise returns, recommended avg. holding period: **min. 3 years**
- Available to: **Cayman Island Offshore fund structure**

• Fund's base currency **EUR** and other currencies it is available in: **USD**

• Fund's complexity for an investor: **at the fund level simple; however the underlying market traded is complicated**

• Transparency provided to investors: **high**

## MEZZANINE FINANCING

### Glenn Chwatt of Jericho State Fund Consulting LLC on the prospects of mezzanine financing



Glenn Chwatt

Do you believe the US loan market is over heating? How would you gauge the appetite for mezzanine and sub mezzanine loans?

There are certainly areas of concern which have been well documented including the sub prime market and large private equity transactions but the commercial real estate market has remained quite stable. This is as a result of several factors including: low unemployment, relatively high construction costs resulting in less overbuilding, low interest rates and a conservative stance embraced by traditional commercial lenders owing to bloated residential balance sheets.

Hard money, first mortgages and mezzanine debt for commercial properties have continued to see strong demand. Owing to the negative media attention drawn by the real estate market, banks have been reluctant to enter into real estate transactions in certain markets. This has opened up the market for niche players and has increased the opportunity for them to offer bridge loans. As an example, borrowers who would have traditionally gone to banks for financing have approached Jericho State Fund Consulting LLC - this has enabled us to lend money to a first position at close to rates that we historically have obtained for second position mortgages.

The mezzanine lending environment is extremely competitive, what have been the consequences of this for player like you?

We focus on a niche in the marketplace where we are typically viewed more as an equity alternative than a debt instrument - although our collateral is secured through the recording of a lien on the property and receiving an assignment of all voting rights from the borrowing entity, which is almost always backed by a personal guarantee from the borrower. We also have the infrastructure and are known in the industry for having the capacity to close transactions in as few as three business days. This gives us the ability to dictate terms and conditions without concern for competition. We only consider special properties or situations where our bridge loan (less than 18 months) capabilities allow a borrower to reposition a property or move a development project to a stage, where more traditional lenders would become viable refinance options.

How much is currently being charged by equity providers and how much "cheaper" is it to get a mezzanine loan?

Equity investors provide the financing portion above the debt financing stack - typically providing between 10 and 20% of the equity and in return receive between 30 and 60% of the end profits, often with a preferred dividend return of 10-15% which is senior to the developer's equity. Our hard money, first position and mezzanine (second position) debt is typically a fixed rate of interest between 20 and 25% which results in substantial savings for a borrower that probably does not have to turn to equity investors, or can at least minimize their exposure to equity investors.

What are the different ways in which lenders can and do give mezzanine loans?

Mezzanine means different things to different people. We refer to mezzanine as financing which is subordinate to a first mortgage lien. Our mezzanine real estate financings have a recorded lien as the main component of collateral. We also require an assignment of the stock of the borrowing company, along with personal and corporate guarantees by any owners of 10% or greater of the equity. Furthermore, in order to lower the "loan to value" (LTV) profile of our mezzanine loans, Jericho, unlike traditional lenders, is willing to look beyond the property at issue for its collateral. Jericho is willing to take different properties owned by the borrower to secure a loan, lowering the LTV ratio of our loans with assets most lenders cannot otherwise consider.

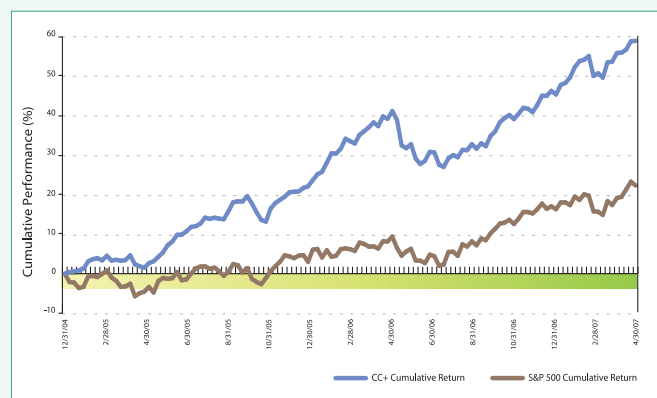
How do mezzanine lenders secure their loans? (Rights to collateral in the waterfall scenario / sharing with primary lenders / collateral split)

Again, we always require an actual lien to be recorded and subsequently require an inter-creditor agreement with any senior lender. Within that inter-creditor agreement we document our right to procure any payments by the borrower in the event of a default. Additionally we arrange, and receive the ability to step into the borrower's shoes and maintain or complete the project, while servicing the senior debt and executing our pre-determined exit strategy which is contemplated at the onset of the underwriting process. We also typically require that the borrower maintains an interest reserve to cover not only our interest payments, but also the interest payments on the first loan for the life of our loan, almost eliminating the risk of a financial default on the first loan.

"Securitized mezzanine funds are often a train wreck waiting to happen because if a recession hits we will be likely to have a 10 per cent default spike, which means a further 20-30 per cent of a representative portfolio will be stressed." Comments...

Jericho has been in the business of providing real estate financing for 35 years. It has lived through a variety of economic environments, including tight credit, loose credit, overheated real estate markets, depressions, bull and bear stock markets, and inflationary and deflationary environments. This experience provides Jericho with the knowledge and experience in selecting and structuring loans without being susceptible to macro events. All loans that Jericho negotiates are well collateralised, covering us in the event of a major market drop. They are also short term in nature, making us much less susceptible to market moves as we are the first party the borrower is trying to remove from the picture. In addition, we are very selective with our loans - although we have the opportunity to invest in close to 10 - 20 loans a month, we historically have not invested in more than only a couple each month. We do not believe our portfolio would be greatly affected by a 10 per cent default spike, but in fact may further increase opportunities for us and similar niche lenders, as banks become even more fearful of entering the market.

## CLIMATE CHANGE RELATED INVESTING



Fund's performance (prior to inception is based on back testing calculations)  
Source: NevaFunds ClimateChange+

## CLIMATE CHANGE+

**Focus:** The fund of funds will selectively invest in managers globally, that focus on and invest in climate change related issues - water management (29.1%), clean energy (20.7%), infrastructure (20.1%), sustainable living (20.1%), waste management and recycling (10%)

**Strengths:** Thematic participation in sectors that the fund managers have identified and believe hold promise from an investment perspective over the next 3-5 years; expertise in portfolio management

**Weaknesses:** Owing to the fund's 70% minimum allocation to long only strategies, it exhibits a high correlation to equities (0.63 to the S&P 500) - (managers will contain the portfolio's downside by virtue of their three pronged allocation to: hedge funds; to low beta sectors such as sustainable living; put options)

**Opportunities:** Financial markets have not yet discounted the reallocation of capital that climate change will trigger

**Threats:** Perform could be challenged during a global recession

### Risk Management

□ = low □ = low/moderate □ = moderate □ = moderate to high □ = high

• The fund's major risk:

The portfolio aims to capture long term like equity returns - the manager expects to contain downside risk, but short term set backs can't be ruled out

• Expertise in identifying space specific fund managers

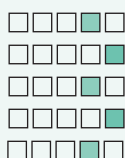
For portfolio

• Ability to actually invest with the above mentioned managers

• Ability to manage downside risk

• Ability to efficiently put to work and manage invested capital

• Ability to consistently deliver targeted returns



• Expertise in constructing a well diversified, robust portfolio

• Expertise in conducting due diligence:

• Currency risk borne (is being hedged)

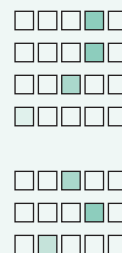
• Liquidity risk

• Leverage risk None

• Event risk:

• Market risk:

• Key man risk:



### Performance Parameters

□ = insufficient □ = adequate □ = satisfactory □ = good □ = outstanding

• No. of underlying managers in the portfolio: currently 20

• The range of correlation between funds themselves is: - 0.2 to + 0.9

• Ability to perform under:

• Rising markets: outstanding

• Falling markets: adequate

• Sideway trending markets: satisfactory

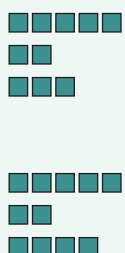
• Diversification:

• Geographic: Europe 45%, US 36 %, Asia 19%

• Sectors:

• Instruments:

• Market capitalisation: (large, mid, small caps)



• Fund outperforms in a bull market

• The fund underperforms in a global recessionary scenario

• Avg annual correlation to:

• Stocks (S&P500): 0.63

• JP Morgan Govt Bond Global Local Index: -0.21

### Outlook

↑ upside potential ↗ upside to range bound ↔ range bound ↘ range bound to down ↓ downside potential

• Barriers to entry: team expertise, industry relationships, infrastructure

• Outlook on investing the climate space:

• Scope for a fund such as ClimateChange+:

• Competition faced by FOF: currently limited

• Ability to consistently deliver targeted returns:

• Over next 12 months (based on manager's current top down view)

• Over the next 1- 3 years (based on manager's current top down view)

• Max. Capacity (AuM): currently non issue



### Investment Insights

• Target audience: institutional investors, pension funds, HNWI

• Level of complexity for an investor: simple

• To optimise returns, avg. recommended holding period: 3-5 years

• Investor access: fund is domiciled in Luxembourg

• Base currency: EUR and other currencies it is available in: USD

• Liquidity provided: monthly

• Transparency provided: high

• Fund's manager is reg. with the FSA

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