FrontLine Research Paper

Infrastructure funds: the upside of low downside

As private markets grow and gain in maturity, fund investors are expanding their investment horizons. This is true both in private equity with niche strategies, in private debt with European direct lending, for example, and it is also the case in private real assets.

Private infrastructure funds can help investors diversify their real asset exposure.

Private real assets have long been dominated by private real estate. This type of investment can be an attractive investment because it usually provides rental income, which can be partially or fully indexed on inflation. Real estate is also a reserve of value which can be insured and generate potential capital gains upon exit. However, many investors are already exposed to this type of asset through listed structures such as real estate investment trusts, or if they directly own residential, industrial, commercial or office space. To diversify their real assets exposure, investors can choose to invest in infrastructure, such as ports, airports, highways, pipelines and other fixed tangible assets. Since these assets are generally large, direct ownership is less frequent.

Listed structures, such as master limited partnerships (MLP), can provide exposure to some infrastructure assets such as oil and gas pipelines but their reach is legally limited. Therefore, investing in private infrastructure funds provides differentiated sources of returns, but the risk associated has also to be assessed.

Thanks to the high quality eFront Insight's cash-flow data, it is possible to explore the characteristics of infrastructure investing, and notably the associated risks.

Funds show long J-curves as a result of long holding periods.

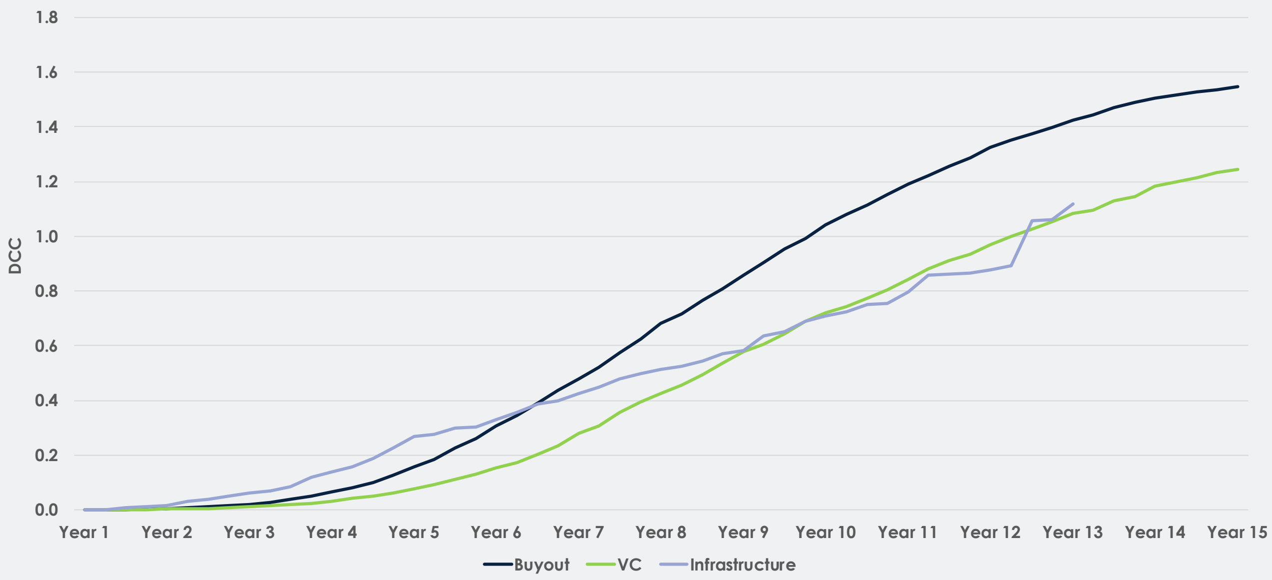
Avoiding risk mirages

In private real estate, the sale of well-maintained infrastructure assets can generate capital gains. Infrastructure investing also benefits from rather predictable long-term streams of income, as infrastructure can often enjoy a local monopoly. This monopoly is a specific risk mitigation factor. The income streams are usually indexed against inflation. Crucially, this income can be generated from the time of investment in the case of existing infrastructure assets. Indeed, as illustrated by Figure 1, distributions start from the first year of activity of private infrastructure funds. On the other hand, the buyout strategy starts with capital distribution in the second year at earliest, while it takes at least three years for VC investments to start to pay-off the returns.

This does not mean that investors can avoid the usual J-curve associated with private markets investing (Fig. 2). In fact, cumulated net cash flows for infrastructure funds reach -51.55% in Year 4 and, on aggregate, private infrastructure funds break even in Year 12.

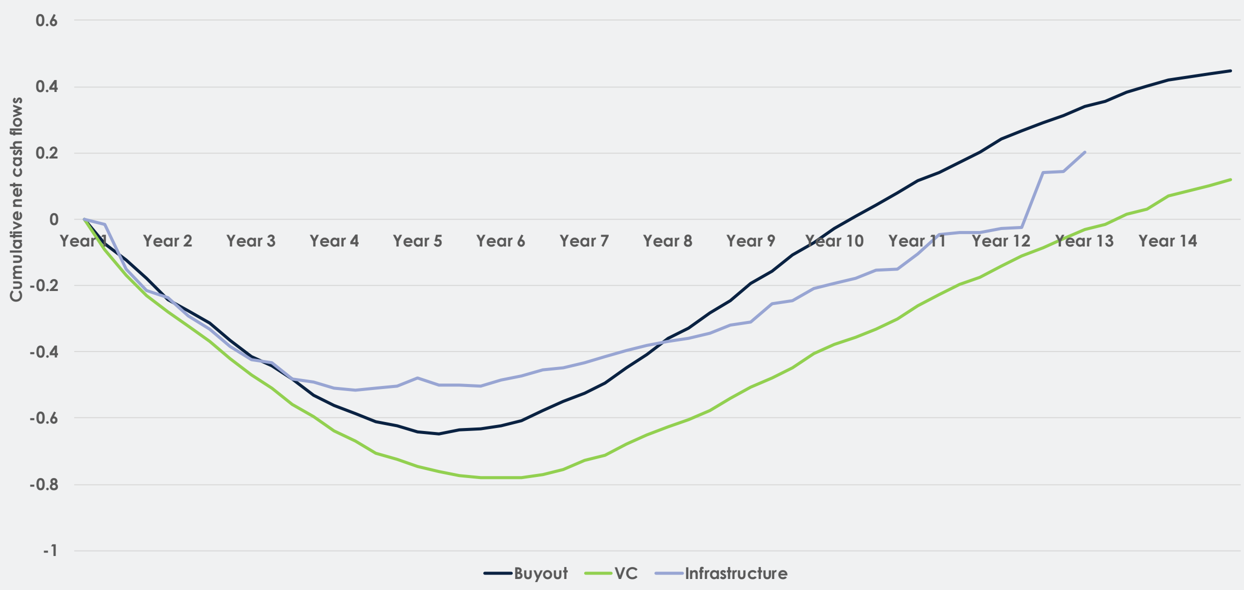
Infrastructure funds are created for 13 to 15 years and their average holding periods are seven to eight years. This explains the long duration of investments and the specific shape of the J-curve. Although this could be at times analyzed as a risk, it is clear that the long period during which funds show net negative cash flows is related to the long holding periods of assets. In that respect, the specific shape of the J-curve and the long duration are not a risk associated with infrastructure investing, but a dimension of this type of investment, similar to investing in VC.

Figure 1 – Cumulative distributions to committed capital of private infrastructure, buyout and venture capital funds



Source: eFront Insight, as of Q2, 2019

Figure 2 – Cumulative net cash flows of private infrastructure, buyout and venture capital funds

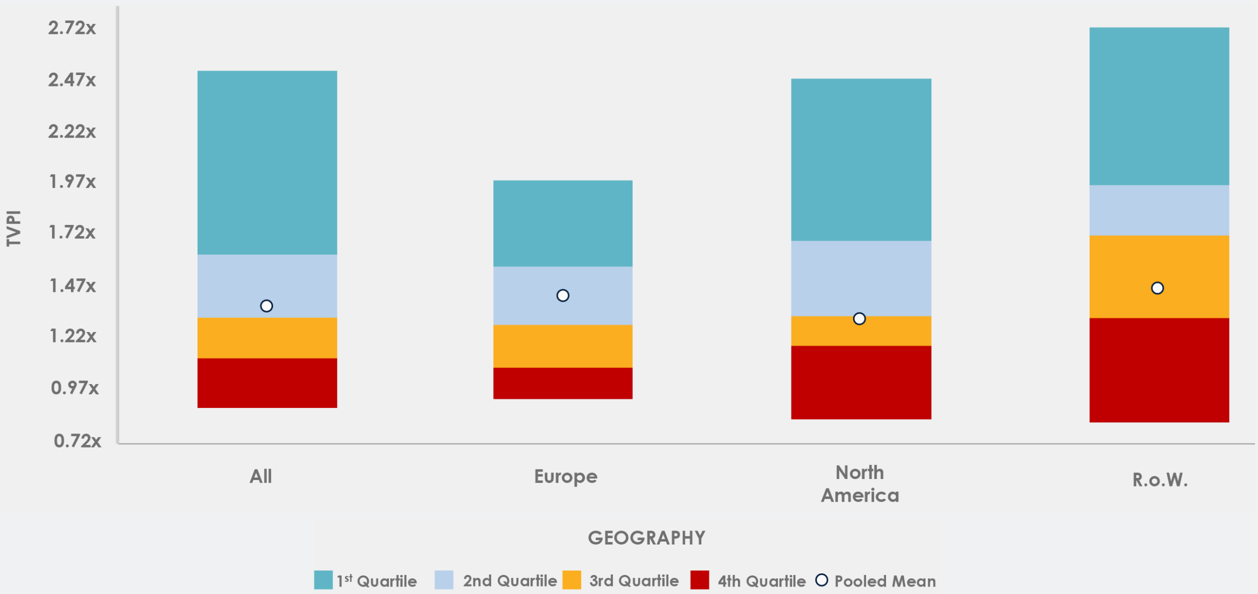


Source: eFront Insight, as of Q2, 2019

Where to look when assessing the risks of private infrastructure investing

Two sources of risks associated with private infrastructure fund investing are the selection of funds and the loss ratio. The dispersion of returns between the best and the worst funds is an indication of the risk associated with selecting private infrastructure funds. Figure 3 provides a perspective by region. We have selected the US dollar as a currency of reference. Further analyses would require the use of local currencies to better assess performances in detail.

Figure 3 – Multiples of invested capital of private infrastructure funds by region and quartiles



Source: eFront Insight, as of Q2, 2019

The purpose of the analysis is simply to assess when funds cannot reach the 1.0x multiple threshold. Interestingly, only funds within the bottom quartile do not reach this threshold (Fig. 3). The analysis of the loss ratio provides a more granular perspective. On aggregate, the pooled average TVPI of private infrastructure funds is of 1.38x and the median 1.33x. The bottom quartile reaches on aggregate 1.16x. None of the vintage years tracked by eFront Insight shows a performance of bottom quartile funds below 1.05x. Even in the world of private real assets, this is an impressive achievement.

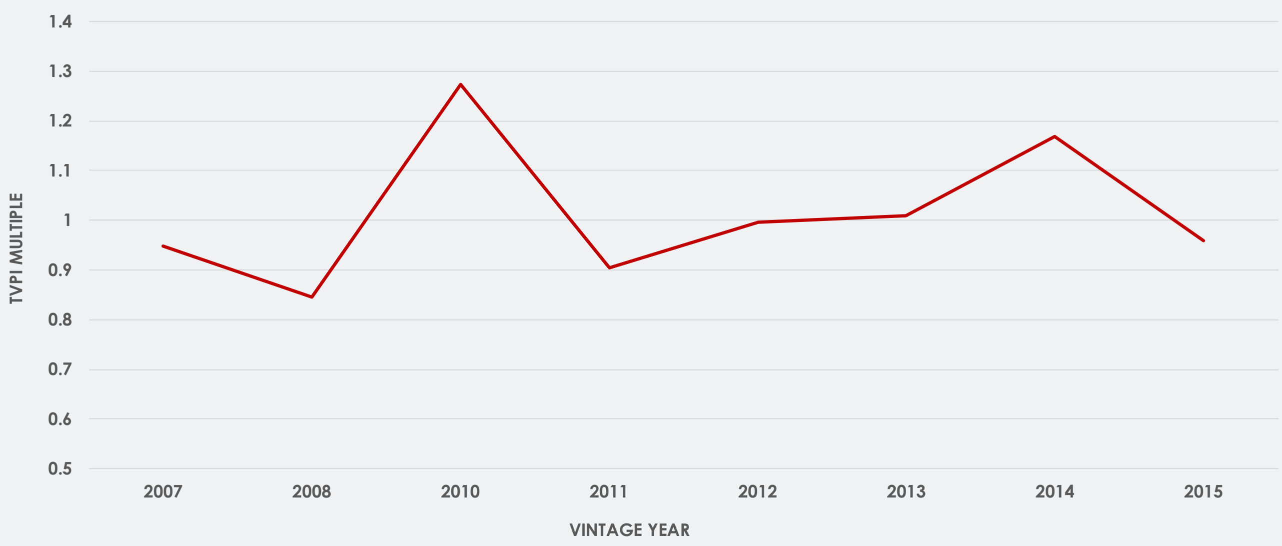
Private infrastructure funds provide some form of downside protection associated with an income and some form of capital gain which is akin to a form of a mezzanine debt instrument. The difference is that the drivers of performance of infrastructure investments are the actual use of the assets by clients who pay a fee for it.

Bottom quartile funds show a positive performance each vintage year.

Handling losses

However, investing in private infrastructure funds still carries some risks. Not surprisingly, funds belonging to the bottom 5% lost capital on aggregate. Their multiple of invested capital is 0.90x. Out of the individual vintage years tracked by eFront Insight, 63% bear a loss of capital (Fig. 4). Still, this means that some years do not record losses on aggregate when specifically considering the bottom 5% funds. It would be tempting to draw definitive conclusions, but Figure 2 shows that the break-even point of private infrastructure funds is in Year 12.

Figure 4 – Multiples of invested capital of private infrastructure funds in the bottom 5%



Source: eFront Insight, as of Q2, 2019

Looking at Figure 4, the majority of these vintage years have not reached their maturity. Only the vintage year 2007 has reached a distribution to total value ratio of 83%. The other vintage years are realized at 34% (2008) to 43% (2013). Even though funds of vintage year 2010 belonging to the bottom 5% seem to have already collectively booked a profit, the jury is still out on the performance of most infrastructure funds.

Conclusion

The logical conclusion is that, historically, private infrastructure funds have shown fairly resilient performances and a very low loss ratio. However, they require a lot of patience and the ability to handle net negative cash flows for a fairly long time. One of the risks associated with infrastructure investing can appear from a sudden mismatch between the long commitment of an investor and an immediate need of capital.

Another risk is that as infrastructure investing gains popularity, past performance and risk assessments become less relevant. As assets mature slowly, changes might appear later than in other private markets.

The jury is still out on the final performance of most infrastructure funds.

Finally, unlike in real estate, the number of existing assets is fairly limited, and some have been acquired by long term investors. These assets might not come back to the market for a long time. Deploying capital could become more challenging in the future if large investors investing more directly contribute to the reduction of investment opportunities.

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on cash-flow data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

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