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INFRASTRUCTURE FUND RECAPITALIZATIONS

CBRE CALEDON

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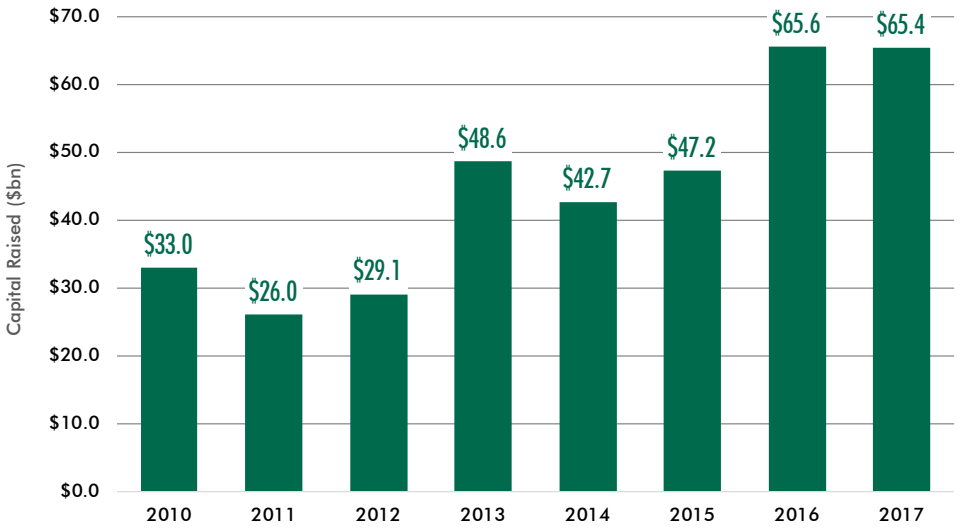
EXECUTIVE SUMMARY

Investments in private infrastructure have steadily grown buoyed by existing and new investors entering into the alternative asset class. The most common method of accessing infrastructure investments is still commitments to private infrastructure funds, which have raised $358 billion of capital since 2010 (including $65 billion in 2017)[1]. The strong demand for infrastructure funds confirms the appeal of infrastructure assets and the specialized skills required to access them.



Source: Preqin 2017 Private Capital Fundraising Update, Preqin Q3 2017 Infrastructure Quarterly Update

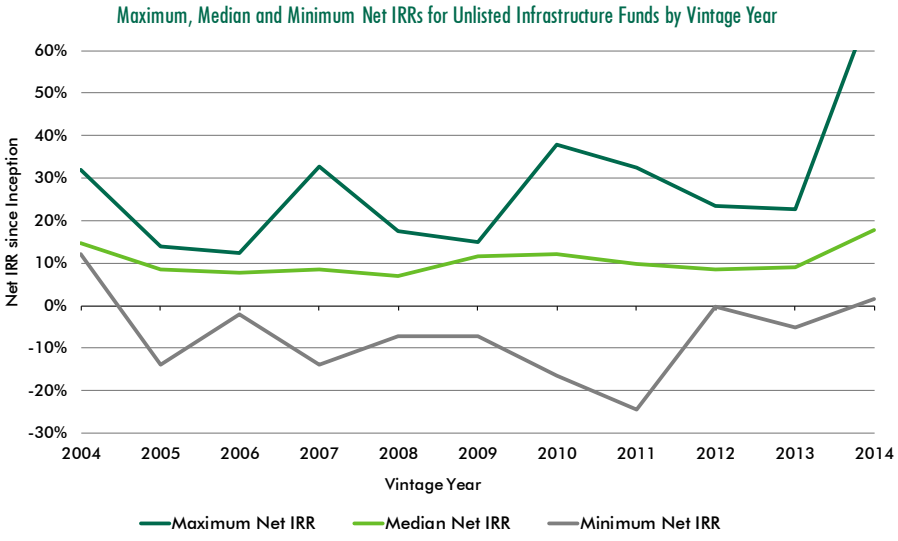
Early adopters of the infrastructure asset class have been rewarded with steady dividend yield, capital appreciation and non-market correlated returns. This has been demonstrated through the strong performance of earlier vintage infrastructure funds as these funds now have sufficient track record history to confirm the early assertions that the asset class can offer multiple benefits to investors. According to Preqin, median returns for infrastructure funds for the 2002 – 2010 period average approximately 11%[2].

The focus of this paper is on the unique opportunity to invest in earlier vintage infrastructure funds approaching the end of their lives. In several transactions since 2014, managers have been seeking liquidity for their investors through fund recapitalizations. These secondary transactions are being pursued instead of the conventional liquidity path of discreet sales processes for individual assets. The emergence of these transactions is well underway with several transactions having occurred recently and more expected in the near future.

[1] Preqin 2017 Private Capital Fundraising Update

[2] Preqin Quarterly Update: Infrastructure, Q3 2017

This paper answers several pertinent questions regarding these transaction including their broad characteristics and the necessary skills required to execute upon them. The benefits and complexities to investors of accessing this space will also be addressed. CBRE Caledon has been focusing on the rise of these deals and has participated in virtually every infrastructure fund recapitalization process. Through this experience, the Firm can provide insights to those looking to capitalize on these opportunities in the future.

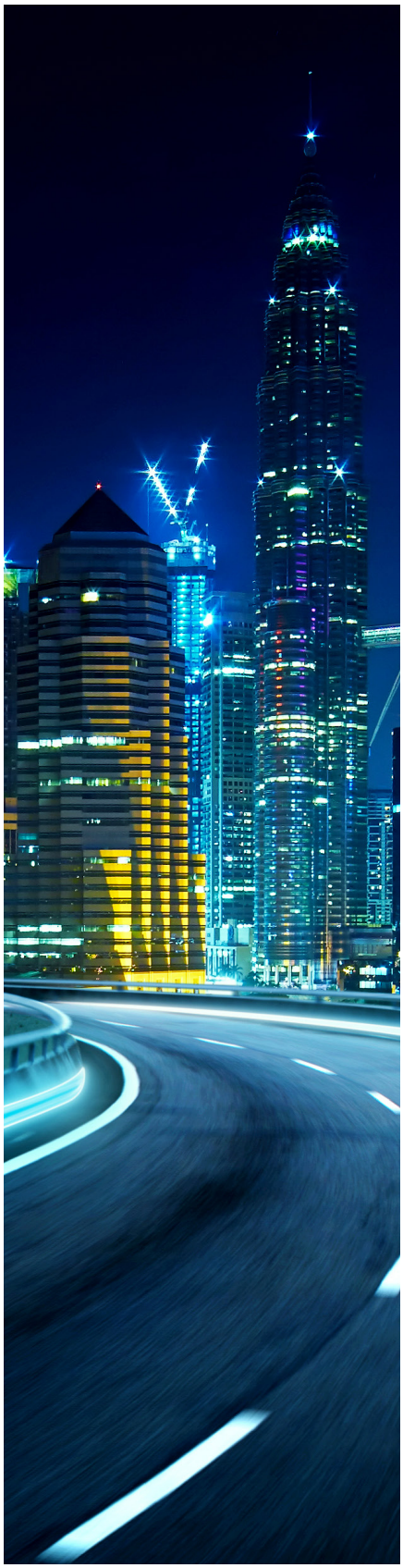


Source: Preqin

INFRASTRUCTURE SECONDARY MARKET

Like private equity and real estate, secondary investments in infrastructure funds have grown in recent years as dedicated secondary fund buyers and other entrants seek to invest in these interests. However, unlike in private equity or real estate, the infrastructure secondary market has been slower to develop due to the relatively younger age of the asset class, in addition to the lack of supply and lower return expectations (relative to private equity). For example, Ardian Secondary Fund VII Infrastructure surpassed its $1.5 billion target in 2017, which was the largest amount ever targeted by an infrastructure secondary fund[3]. As a comparison, there are approximately 25 private equity secondary funds that have each raised at least $2 billion since 2015[4].

As the asset class continues to mature, there should be additional secondary deal flow. According to Preqin, many of the infrastructure secondary interests originate from funds with vintage years between 2006 – 2009. Preqin reports the value of infrastructure assets in those vintages to be $82 billion, providing a significant potential supply of secondary market volume going forward. As several funds are approaching the end of their fund lives, managers are devising ways of providing end of life liquidity to investors who would otherwise trade their stakes via the secondary market. Fund recapitalizations represent one way for managers to achieve such a purpose.



[3] Inframation News

[4] Preqin Data

INFRASTRUCTURE FUND RECAPITALIZATION EXAMPLE

To describe an infrastructure fund recapitalization, this paper will describe the steps required to complete it through a hypothetical example called "Project Recycle". In practice, each transaction is unique and will differ from Project Recycle both in terms of the transaction features and stakeholders involved. Regardless, examining the main players and their objectives is helpful when attempting to understand these types of transactions.

PROJECT RECYCLE

BACKGROUND

In 2006 a fund manager raised a $2.5 billion infrastructure fund from over 100 institutional investors. As a typical infrastructure fund for that vintage the manager had a 10 year fund life with two one-year extensions. Terms:

- 1.5% management fee
- 20% Carry over 8% hurdle rate

CHALLENGE

Over the course of the Fund's life, the manager executed upon its strategy successfully. By 2018, 80% of the Limited Partners ("LPs") capital had been returned. With only four assets left in the portfolio and a fund life set to expire, the manager is seeking the best exit option for its LPs, its current options are as follows:

- Sell the four assets individually in a condensed timeline. However, the manager is concerned that this approach will not maximize value for its LPs.
- Approach LPs and ask for a further two-year term extension to sell the remaining assets. However, the manager has concerns that this extension will not be granted.
- Distribute the ownership of the four assets in kind to LPs. This approach will be problematic in establishing asset value. Furthermore, the manager is certain that several LPs are seeking a clean, cash liquidity event.

In consultation with a fund advisor (placement agent) the manager decides that selling the assets would be the most preferable option. However each asset provides some difficulties, including:

Asset 1	Is subject to transfer restrictions including a right of first refusal ("ROFR") to current shareholders. This ROFR will impede prospective offers from buyers who are concerned about devoting resources to a deal when other shareholders can step in and buy the asset ahead of them.
Asset 2	Is dealing with regulatory uncertainty and is scheduled to undergo a regulatory review in September 2018. This uncertainty will be difficult for prospective investors to price.
Asset 3	Has benefitted from strong macro-economic tailwinds with the manager having the ability to contribute substantial growth capital expenditures at extremely attractive prospective returns.
Asset 4	Has only three years remaining on its concession life and the local government approached the manager to discuss extending the concession life in return for needed capital expenditures.

As a result of these challenges, the manager and it's advisor decided a fund recapitalization may be the most attractive alternative.

RATIONALE FOR FUND RECAPITALIZATION

A Fund Recapitalization would include pooling the manager's ownership in the remaining four assets and creating a new vehicle that would own the manager's stakes going forward. This vehicle would be operated by the manager and offered to prospective investors. This structure will accomplishing the following:

- **Solve for differing liquidity expectations among existing LPs.** LPs have mixed hold period intentions. Some LPs would rather continue to own the four assets to avoid re-investment risk, while others are seeking liquidity to redeploy elsewhere or invest in the manager's new fund.
- **Crystalize profits and allow GP to receive its carried interest.** By finding a market value for the four assets and providing liquidity to those LPs desiring it, the manager will fully realize the fund proceeds within its fund term and receive carried interest based on the realization of the remaining four assets. In addition, the recapitalization process should result in lower transaction fees and be less time consuming than launching four individual sale processes.
- **Renew its asset management mandate.** The manager is very experienced at managing the four assets and believes further value creation is likely over the next several years. To manage the new vehicle, the manager is proposing to reduce its management fee by more than 50% (annual 0.5% fee on invested capital) and a 10% carried interest over an 8% hurdle.
- **Allow new investors the opportunity to buy well-managed assets.** New investors would be interested in acquiring stakes in four assets at more attractive fees then a primary fund commitment. Additionally, the manager will be able to forge new relationships with these investors who could commit capital to future funds.

TRANSACTION PROCESS

The manager and its advisor identify 30 new investors who may be interested in the project. Concurrently, the manager explains the recapitalization process to its existing LP and asks each LP whether they might want to:

1. Stay in the assets by rolling their existing ownership
2. Sell based on the price determined by the process
3. Roll their existing stake and invest further as part of the process

OUTCOME

A two-phase process is completed and during Phase 1 prospective investors are asked to provide indicative offers, including their investment size and pricing. The manager, alongside its advisor, identify a lead investor from the Phase 1 offers who is interested in a significant portion of the assets and agree on pricing and terms.

Following the agreement, the manager reverts back to its LPs and determines which want to sell and which want to roll their exposure to the new entity and proceeds to arrange the sale or transfer of the LPs proportional ownership share into the new vehicle.

FUND RECAPITALIZATION BENEFITS

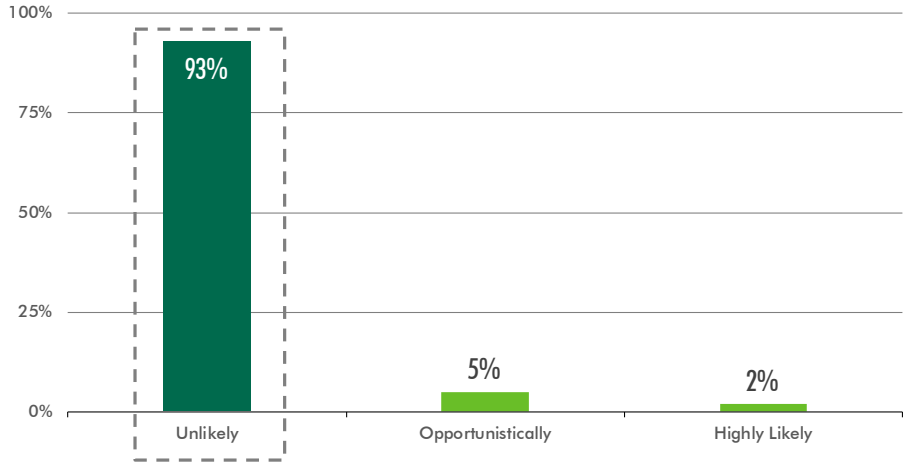
Thesis	Description
Limited Blind Pool Risk	Investors can evaluate an existing portfolio of four assets as part of their investment decision and have the unique opportunity to invest alongside existing investors of IF.
Immediate Exposure	Investors will have the ability to deploy capital at a quicker pace and will gain immediate exposure to four mature and established assets which are projected to provide dividend yield, mitigating traditional J-curve effects.
Diversification	Project Recycle provides investors access to four infrastructure investments diversified by geography, sector and revenue profile. Exposure to Project Recycle can complement investors' existing infrastructure portfolios by increasing vintage diversification.
Experienced Manager	GP has been managing the four assets since 2006 and is aligned going forward via newly established competitive fee terms for investors.

FUND RECAPITALIZATION CHALLENGES

Challenge	Description
Experience Required	Investors need to have the ability to perform due diligence and value several assets concurrently. Gaining comfort on multiple assets and coming to a combined valuation is complex and requires experienced buyers with direct investment acumen.
Limited Universe of Investors	In addition to the knowledge required to diligence and value several assets, the universe of potential investors in these transactions is smaller as: • Buying several mature infrastructure assets in a single transaction often results in higher capital requirements. The larger transaction size leads to a limited pool of buyers. • Investors need to be comfortable deferring asset management and key governance decisions to a fund manager, precluding many direct investors from these types of deals. • Infrastructure returns have compressed in many instances to single digits. Similar return levels for fund recapitalizations are not sufficient for many fund-of-funds or private equity secondary funds that target double digit returns.
Unknown Take-up by Existing LPs	Existing LPs may wish to increase their ownership of the assets or sell. This uncertainty can make these transactions challenging as the ultimate investment capital available will be unknown until final terms are set.
Conflicts of Interest	The Fund Manager will need to carefully manage conflicts of interest. A key conflict is determining the value at which existing investors will be given the option to sell or roll their stake, as this value will have implications for the manager's carried interest. Price discovery through an auction process can help mitigate this conflict.
Work Alongside a Fund Manager	Most direct investors are not used to investing in funds and the subtleties of working with a fund manager. To execute a fund recapitalization transaction, new and existing investors need to come to terms with the fund manager on several agreements.
Other Counterparties	The fund manager needs to communicate and work with co-shareholders, regulators, banks, tax authorities and a host of counterparties to transfer ownership of existing assets to a new vehicle.

Fund recapitalization transactions such as Project Recycle are complex. Navigating the challenges provides an opportunity for sophisticated investors to gain attractive exposure to multi-asset infrastructure portfolios.

LIKELIHOOD OF INSTITUTIONAL INVESTORS TO BUY INFRASTRUCTURE FUND INTERESTS ON THE SECONDARY MARKET



Source: Preqin 2017 Global Infrastructure Report

OTHER FUND RECAPITALIZATION EXAMPLES

Below is a table outlining examples of fund recapitalizations CBRE Caledon has assessed. CBRE Caledon is an active participant in the infrastructure primary and secondary fund markets and expects several more transactions like this to become available as earlier vintage infrastructure funds approach the end of their fund lives.

	Transaction #1	Transaction #2	Transaction #3	Transaction #4
Size	~€600 million	~€1 billion	~€200 million	~€2 billion
# of Assets	7	8	5	8
Expected Returns (Gross)	~10%	~10%	~12%	~10 - 12%
Target Yield %	~3%	~9%	~10%	~5%
Follow-On Capital	~€50 million	~€100 million	N/A	~€1 billion
Terms	• 15-year term • 15% carried interest over 8% preferred return • Management fee to be negotiated	• 25-year term • Fixed annual fee of ~€5 million • An incentive fee to be negotiated	• 12-year term • A fixed annual fee of 0.75% • A performance fee to be negotiated	• 12-year term • Management fee of 0.6% – 0.9% based on asset maturity • A performance fee to be negotiated

CONCLUSION

As the "first generation" of infrastructure funds approach the end of their fund terms, some managers are choosing to pursue combined sales of several assets at once. This is presenting an opportunity for sophisticated buyers to gain exposure to multi-asset portfolios in an environment where accessing attractive infrastructure investments is difficult. These buyers will need specific skill sets to execute on these attractive opportunities, including the ability to perform due diligence on several assets at once and work with fund managers through complex transactions.

Experienced infrastructure investors who are willing to work with fund managers to invest in multi-asset portfolios will be well positioned to access these opportunities. The benefits of these transactions can include immediate exposure to a portfolio of assets with an experienced manager, mitigation of the J-curve, a lower fee option, an ability to build a new relationship with a fund manager and broader portfolio diversification.

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