NORTHERN EUROPE: WHERE WILL THE DEALS COME FROM?

IN BRIEF

- **The UK, France and Germany dominate private infrastructure investment in Europe and remain preferred destinations for most infrastructure funds because of regulatory, political and economic stability.**
- **Many of the big drivers of the market in recent years, such as energy unbundling and privatisation, have almost run their course.**
- **PPP markets remain quiet, although the UK government is trying to find ways to tap into private money – as are local governments in France.**
- **For now, the market will be driven by corporate disposals.**
- **Established infrastructure investors are being forced into unregulated assets by intense competition.**

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DOWN, NOT OUT

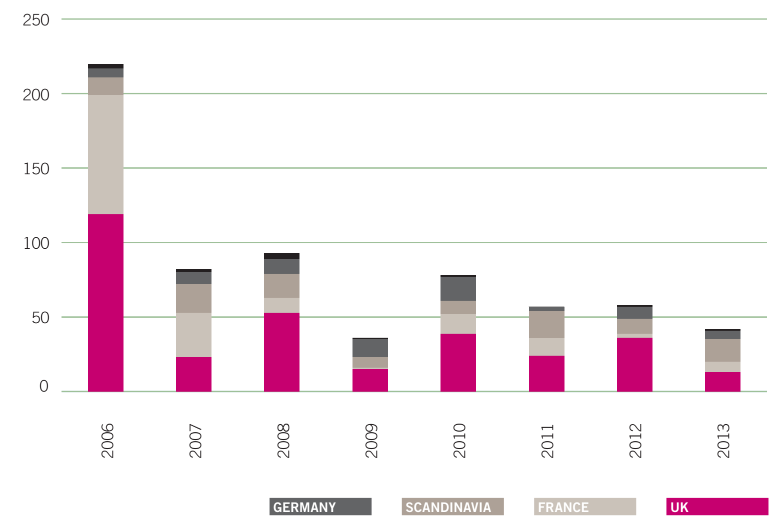
With infrastructure investments very sensitive to political and regulatory stability, the economies of northern Europe remain obvious targets for new investment. Absolute values have crumbled since the crisis, but the region continues to dominate private infrastructure investment in Europe.

The infrastructure M&A market in the UK, France and Germany has been worth an annual average of US$45bn between 2010 and 2013, almost double the US$24bn notched up in the southern European countries of Italy, Spain and Portugal. In the first half of 2013, the PPP market in the UK alone was worth more than that in southern Europe combined.

Despite investors' preference for northern Europe, they are being forced to look more widely for deals. "The problem is that there are few suitable deals out there," says Ralph Drebes, a Linklaters partner in Frankfurt. "Therefore, funds are being forced to stretch risk appetite by looking at deals they wouldn't normally consider."

MEAG, the investment arm of German insurance giant Munich Re, is typical of the trend. On behalf of Munich Re Group, MEAG is implementing a global infrastructure investment plan with an intended volume of €1.5bn, as its parent looks for stable, long-term investments. "We prefer to focus on central and northern Europe, along with the US and Canada," says Alice Forster, Senior Investment Manager at MEAG, because "we are looking for government and especially regulatory stability." She accepts, however, that MEAG might be forced to look more widely for deals over time. ▶

Fig. 3.1 Infrastructure M&A deals by value (US$bn) SOURCE: THOMSON REUTERS



INFRASTRUCTURE M&A MARKETS IN THE UK, FRANCE AND GERMANY WORTH US$45BN BETWEEN 2010 AND 2013, ALMOST DOUBLE THE US$24BN NOTCHED UP IN THE SOUTHERN EUROPEAN COUNTRIES OF ITALY, SPAIN AND PORTUGAL

COMPANIES, NOT GOVERNMENTS CASHING IN ON THE DEEP POOL OF PRIVATE INVESTMENT MONEY AVAILABLE

AIRPORTS' RELATIVELY PREDICTABLE REVENUES MAKE THEM POPULAR WITH FINANCIAL INVESTORS AND CORPORATE BUYERS, THE LATTER LOOKING TO IMPROVE RESULTS THROUGH BETTER MANAGEMENT.

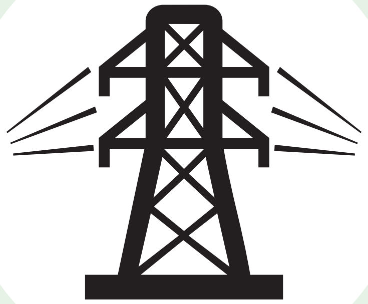
What's left to sell?

Airports' relatively predictable revenues make them popular with financial investors and corporate buyers, the latter looking to improve results through better management. Financial investors are also looking at rail and road concessions where revenues are long term and, provided regulation is stable, predictable.

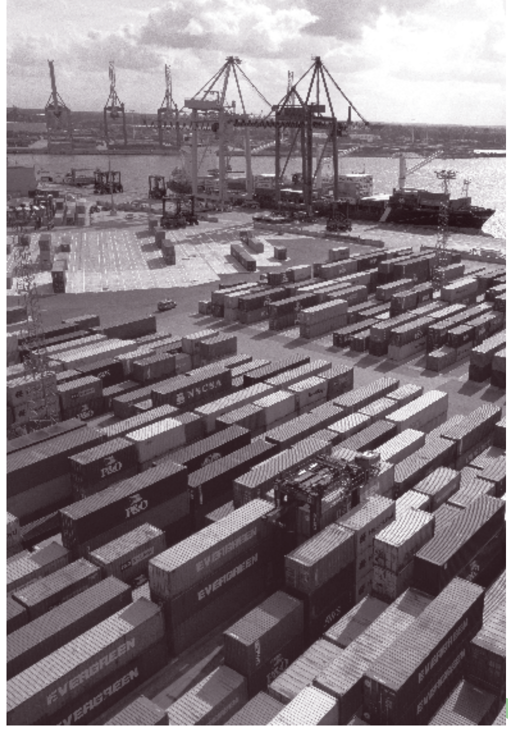
This contrasts with sea ports, traditionally considered more reliant on GDP and trade growth to interest investors looking for stable long-term revenues, although increasingly attractive to financial investors (see case study: *Arcus – Unlocking the hidden potential*). For assets such as these, specialist companies acquiring interests can provide the expertise to manage the asset, opening the door to financial investors taking minority stakes in assets they might not be comfortable managing themselves.

In the short term, it is more likely to be companies than the governments of northern Europe cashing in on the deep pool of private investment money now available. Many of the deals will come from companies struggling both to raise capital and to pay down debt or needing to streamline their business. Already, this is leading to a series of transactions where big utility or energy companies sell minority stakes to financial investors. "With share and energy prices low, it's the only realistic way for them to raise new capital," says Peter Taylor, Executive Director at Hastings, an Australian infrastructure investment specialist with some US$6.5bn of assets under management.

There are plenty of examples of this sort of deal brewing. In November, France's energy and transport company Alstom announced some big job cuts, as a public spending squeeze and a flat economy hurt demand. It is considering the sale of a minority stake in its transport arm to raise capital. In July, Japan's Sumitomo announced that it had bought minority stakes in two Belgian wind farms. "Many European energy companies are considering selective asset sales to free up capital for either reducing debt or funding capex requirements. These asset sales may be minority positions or outright sales and provide opportunities for infrastructure investors," says Nicola Palmer, a partner at the fund manager Arcus Infrastructure. ▶



TRANSPORT-RELATED ASSETS REMAIN A TARGET FOR MANY INVESTORS. HOWEVER, INFRASTRUCTURE IS MORE THAN TRANSPORT: THE BIGGEST RECENT TRANSACTIONS HAVE BEEN IN ENERGY UTILITIES



CASE STUDY

ARCUS: UNLOCKING THE HIDDEN POTENTIAL

"In the early to mid-2000s we concentrated on regulated assets, especially in the UK. And when we launched a new infrastructure fund in 2007, we expected to follow the same approach, albeit pan-European," says Nicola Palmer from Arcus Infrastructure. "But, in fact, we found significant price competition for regulated assets. So we used our knowledge and experience to find new infrastructure asset sub-classes which provide attractive balances of risk/reward."

Nicola cites the 2008 acquisition of Angel Trains in the UK as an example of how Arcus can use its specialist knowledge to unlock deals. Angel leases rolling stock to UK rail-operating companies under long-term leases, so the company enjoys strong medium-term cashflow visibility, a manageable risk profile and appropriate returns.

Arcus also believes that certain seaports can make good infrastructure investments, despite financial investors' traditional wariness of the GDP risk associated with ports.

In 2009, Arcus invested in Euroports, which is a diversified portfolio of ports handling a variety of cargo types in countries including Germany, France, Belgium, Finland, Spain and Italy, such that the portfolio is not overly exposed to the risk of a single country or product. "You need to assess the prospects for each type of cargo being transported through the ports, as well as the quality of the port's hinterland, rather than just looking at national GDP," says Nicola.

In 2011, Arcus bought Forth Ports in the UK, which has also performed well, despite a flat economy, because of booming oil and Scottish whisky exports.

Governments need to take the initiative

Governments should be looking for new ways to funnel cheap private money into public infrastructure. One obvious solution would be to revive the PPP programmes that were popular before the financial crisis.

A small number of countries continue to have a healthy pipeline of PPP deals, including Ireland which launched a US$4bn economic stimulus plan in 2012. However, PPP activity in most of northern Europe has dwindled. Germany remains one of the most important markets for private infrastructure financiers with many German infrastructure assets fetching the highest prices in the sector. Yet, despite this, the German government continues to launch relatively few PPP projects. Germany saw just one PPP deal closed in the first half of 2013. Britain's pipeline of PFI projects shrank, too, when the government decided to rethink the structure of its programme.

France was able to keep PPP deals flowing after the crisis, effectively guaranteeing the debt of some big transport projects. However, deals have dried up over the past year after President François Hollande allowed the guarantees to run out. Even François Bergère, head of the government's PPP unit, accepts that more big national projects are unlikely in the short term. He is, however, hopeful that local governments will begin to launch new projects after the municipal elections deadline in April 2014. "France has barely scraped the potential of social infrastructure," he says. Paul Lignières, a Linklaters partner in Paris, agrees. "The PPP market will now shift to smaller, regional or municipal projects with local governments short of state cash for building work," he says. Cash-strapped local governments also offer the best hope for privatisation deals in France, with municipal-owned sea ports and regional airports identified as possible targets for sale. "But this is very hard politically, with fierce trade union opposition," says Paul Lignières. "Nonetheless, for almost the first time there is a chance for foreign investors to enter the French market, buying brownfield projects such as the recently built motorways owned by contractors or perhaps bidding for smaller, local, PPPs."

FOR ALMOST THE FIRST TIME THERE IS A CHANCE FOR FOREIGN INVESTORS TO ENTER THE FRENCH MARKET, BUYING BROWNFIELD PROJECTS SUCH AS THE RECENTLY BUILT MOTORWAYS OWNED BY CONTRACTORS OR PERHAPS BIDDING FOR SMALLER, LOCAL PPPS.
Paul Lignières
Linklaters partner
in Paris

There are signs that some countries are actively looking for ways to funnel available private money into state infrastructure projects. The UK, for example, launched a new version of PFI, dubbed PF2, at the end of 2013. This scheme allows the government to take direct stakes in projects, following complaints that the state lacked influence over PFI projects once launched. This will be reflected in the National Infrastructure Plan, last updated in December 2013 and with the aim of investing US$600bn in sectors including energy, transport, water and communications.

Some 75% of the financing will be private and part of the planned infrastructure splurge will be funded through privatisation, with the government doubling its sales target to US$30bn over the next six years. That should yield some good deals for investors, including the sale of the state's 40% stake in the rail company Eurostar, a portfolio of student loans and property owned by London & Continental Railways.

Governments across Europe recognise that there's a big pot of private money they can tap into for infrastructure. And some are starting to do so.

ATTRACTING FOREIGN INVESTMENT

The UK is also working hard to attract foreign investment. In October 2013, the government announced a deal for a private consortium led by France's EDF to build a new nuclear power plant at a cost of around US$26bn. Two Chinese investors, China General Nuclear Corporation (CGN) and China National Nuclear Corporation (CNNC), will take a combined 30-40% stake in the consortium.

"The Chinese interest is squarely in technology transfer," says an investor from another Asian country. He admits that his own firm sees an opportunity to win a foothold in Europe "because European contractors cannot raise finance at competitive rates, allowing us to win contracts on price." No one is suggesting that the Chinese companies will lose money on their investment in the nuclear plant, but they are funding it very modestly as they buy both a foothold in Europe and access to modern nuclear technology.

The UK government clearly hopes to build on this budding interest from Chinese investors and is structuring deals to appeal to them. The government is shaping the HS2 US$80bn high-speed rail development to be investor-friendly by shouldering the construction risk, in contrast to the old PFI model. The speculation is that Chinese companies will not build the railway but might buy concession rights to run it after the work is done.

THE EU'S SOLVENCY II RULES MEAN THAT INSURERS NOW HAVE THE CONFIDENCE TO MAKE LONG-TERM INFRASTRUCTURE INVESTMENTS

Insurers: The hidden force

When the UK government announced the latest updates to its US$600bn National Infrastructure Plan in December 2013, six big insurance companies said they would spend US$40bn on infrastructure over the next five years. Their announcement highlighted the key role that insurers can play in infrastructure investment.

A key source of uncertainty for life insurers over the last few years has been the treatment of long-term bond holdings under Solvency II, the EU's new prudential rules for insurers. That uncertainty was finally resolved in November 2013, with the European legislators agreeing a package of measures that will assist annuity providers (and others) in holding long-term bonds and similar instruments to match long-term liabilities.

"Solvency II previously created a lot of uncertainty about long-term investment," says Victoria Sander, a Linklaters partner in London. "The terms of the directive are now agreed at a political level and implementation is set for January 2016. This now gives insurers much greater comfort to make long-term investments into infrastructure bonds, without the risk of artificial capital volatility, making infrastructure a more viable asset class."

Some concerns do remain in relation to market risk capital charges for long-term bonds, as capital charges increase with bond tenor. However, this point is expected to be resolved during the course of 2014, when the detailed implementing measures are finalised. Ultimately, insurers will weigh capital charges against yields and the availability of matching adjustment relief on the liability side, and are therefore likely to remain interested in high-yielding long-term bonds.

"We're targeting returns that offer a significant premium to those offered by government bonds, with a risk premium that can be considered as moderate," says AXA Real Estate's Charles Dupont. AXA wants long-term investments that match the long-term liabilities of its life insurance side. And, in infrastructure, it sees "a gap in the market for loans above €69m with a duration exceeding five years" because of the restrictive regulation now applicable to long-term bank financing.

Andrew Liau at Ardian echoes these comments, saying that his fund is very active in pursuing proprietary mid-market deals worth US$1.5bn-3bn and much more selective regarding "mega sales where competition from direct investors is too fierce and drives returns too low." It's similar at MEAG which looks for deals in transport, electricity and gas transmission and telecoms towers. Their basic strategy, according to senior investment manager Alice Forster, is to concentrate on minority stakes yielding steady cashflows, teaming up with industry players who can manage the asset. In May 2012, for example, it teamed up with the Australian investment bank Macquarie and some other financial investors to buy Open Grid Europe, a German gas transmission company, from EON for US$4.4bn in total. Macquarie provided the management expertise to run the asset.

Insurance companies are expected to play an increasing role in infrastructure investment, both as primary investors and also as partners for corporates wanting to partially invest in infrastructure assets or perhaps wanting to sell down an existing investment whilst retaining a stake and management control.