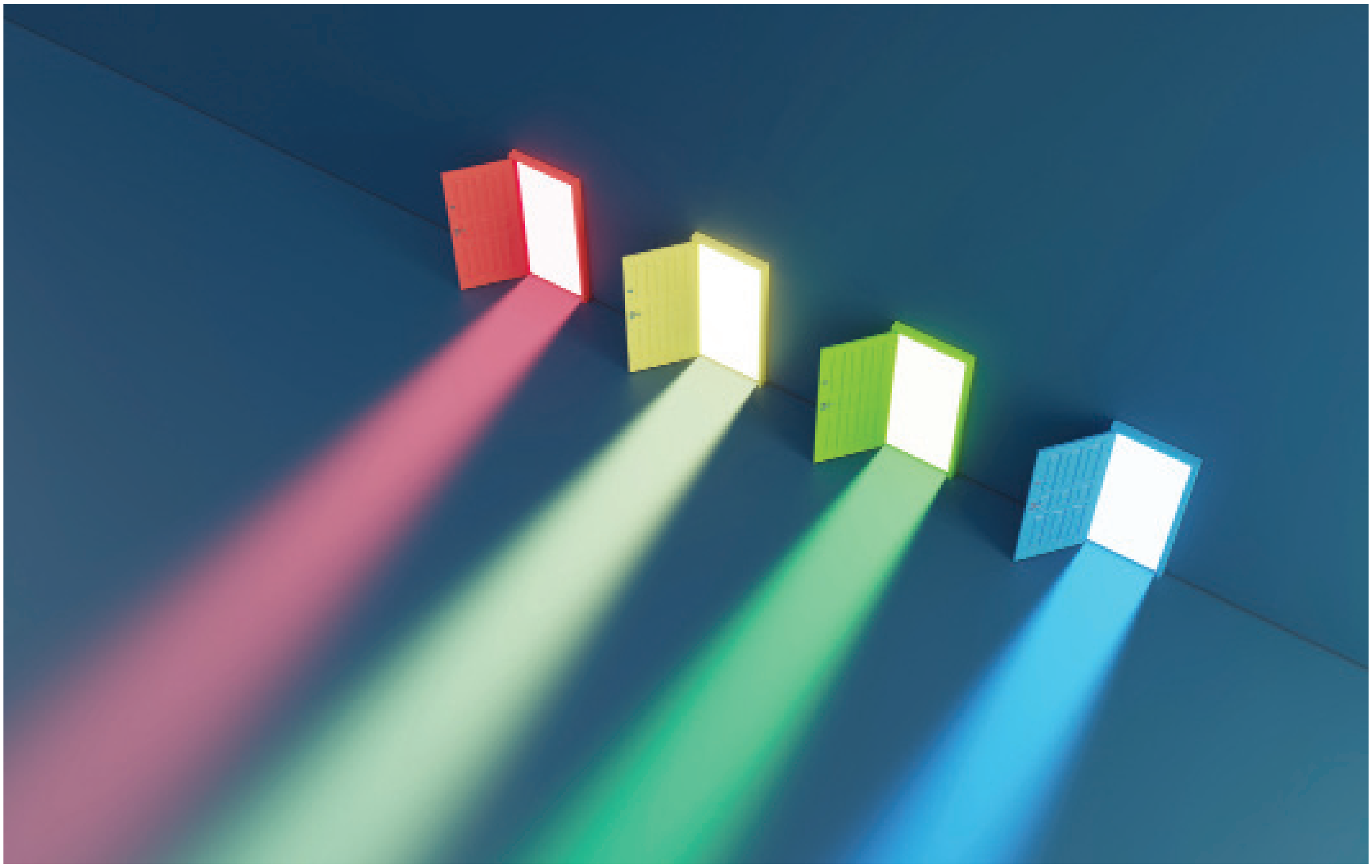


Strategies for many seasons

The benefits of secondary transactions, continuation vehicles and open-end funds

by Drew Campbell

The market for investing in infrastructure has matured considerably during the past 15 years. It used to be that closed-end funds were the primary way to access infrastructure businesses and assets, and while they still garner most of the attention, the market for other strategies to serve infrastructure investors is growing, giving investors more options to build and manage portfolios.

Infrastructure assets are long-lived — bridges, roads, airports, water and power systems all are built to serve communities for decades. Investors invest in infrastructure in part because of the opportunity to hold cash-yielding investments for a long period of time.

But there has been a mismatch between the investment strategies available to investors and the desire to hold infrastructure assets longer term. Closed-end funds, which have a typical lifecycle of 10 years, are the most popular avenue to investing in infrastructure and have served investors well. Investors who want to invest for a longer duration, however, have to look at other options, and increasingly, these are becoming available. The markets for secondary investing and open-end funds are growing and giving investors more options to hold investments over the long term.

"There is a mismatch for some assets, not all, but some," says David Perrin, partner with Campbell Lutyens' secondaries team. "Those with private equity investment structures generally have 10-year lives and don't offer that long duration some investors are after. Open-end funds are a solution to the desire for long-term holds by investors. There are also long-term closed-end funds, 25 years," he adds.

Open-end funds offer similar characteristics for investors and, as the name suggests, allow investors to decide when to exit.

"In our view, the long-term contracted and monopolistic cash flows inherent in the sector are better matched with longer term, and primarily open-end funds," says James Hennessy, managing director with Harrison Street. "From a grantor or off-taker perspective, a long-dated fund provides more certainty of continuity vs. a closed-end fund that — without a continuation vehicle — must sell the asset. The fund structures also align well with opposite ends of the risk-return spectrum, with closed-end funds primarily taking more risk and targeting higher returns."

Continuation vehicles, which are a type of secondary transaction, allow managers to recycle their capital, without requiring investors to dispose of prized assets. "In many respects, this can be an ideal solution," says Hennessy.

SECONDARY MARKETS

Secondaries investments can help infrastructure investors meet their objectives in managing and fine-tuning portfolios, including the ability to hold investments longer, diversify portfolios, and get invested and earning returns more quickly. More open-end funds, meanwhile, are coming onto the market, offering investors options for holding investments longer and getting invested more quickly, as well.

In a secondary transaction, investors in closed-end funds — primary-market funds — sell their holdings to other investors or restructure funds to extend the lives of these investments. Each of these can offer routes to achieve longer-term holds. Investors access the secondaries market for a number of purposes, from managing portfolio concentrations and diversification to exit timing, and even to help start their infrastructure programs.

"These transactions can be used to kickstart a program," says Perrin. "We've seen many Asian investors getting into infrastructure using funds and then secondaries to mitigate the J-curve [the time it takes for an investment to begin generating a return] and get instant net asset value. Whereas a primary fund will typically take three to five years for this."

Perrin also says secondaries can be a good solution for investors who are underallocated to infrastructure and are wanting to get invested more quickly. These strategies are also beneficial for investors who want to vary the strategies they are using to access the market by using a mix of primary funds, direct investments and secondaries, Perrin adds.

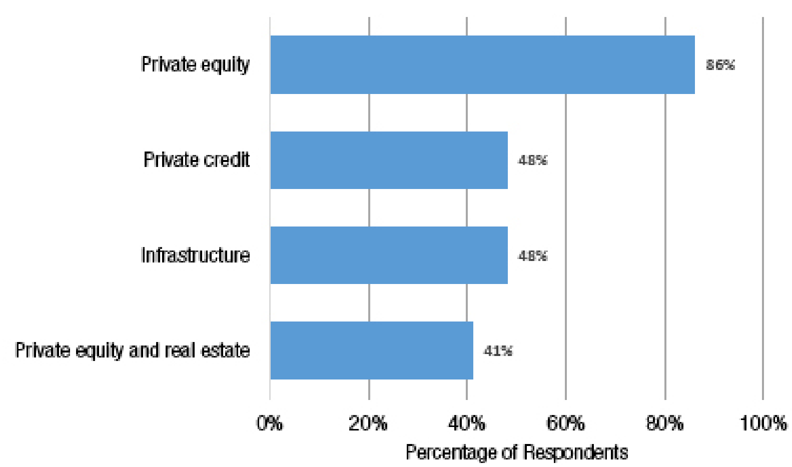
But not all investors can execute on secondaries transactions because the deadline to decide is condensed compared to primary funds.

"Large, sophisticated investors who are experienced in direct investments, in co-investments and in funds can meet a four-week deadline. But others will need an extension of a few months," says Perrin.

Transaction activity in the secondaries market has increased recently, as interest in infrastructure investing grows and commitments to primary market funds continue to increase.

"What is happening in the secondaries market is driven by the primary market," says Lars Pace, principal with Hamilton Lane. "If you look at the primary market, it has increased considerably in the past five or six years and naturally the secondaries market will grow with that increase in size. We estimate that 5 percent of primary

Private asset classes likely to see secondary market expansion in the next three years—investor views



Source: Coller Capital Global Private Equity Barometer Winter 2021-22 investments will trade in the secondaries market five years out," he notes.

Fundraising in the primary market has experienced a continual ramp up and that is going to translate into more secondary transactions. "We are seeing that already in terms of deal flow on the secondaries side, compared with what we saw five years ago," he says.

According to Coller Capital's winter 2021-2022 *Global Private Equity Barometer,* a survey of 102 private market investors in North America, Europe and the Asia Pacific region, including the Middle East, investors expect to see continued growth in the overall private equity secondaries market, including infrastructure secondaries.

> *The market for infrastructure investment is maturing and new strategies, including open-end funds and secondary investments, are becoming more available to investors. These vehicles can offer investors opportunities to extend investments, quickly get invested in infrastructure and fine-tune portfolios.*

"We will see more secondaries," says Perrin. "These will mostly be GP-led transactions, which is about 70 percent of the market."

There are several types of secondaries transactions, Perrin continues, including single-asset continuation funds, where managers or investors want to hold an asset longer than the life of the fund and exit at a later date. There are also multi-asset continuation funds that are formed for similar purposes as single-asset funds but hold more than one asset. Annex funds are another type of secondary. These transactions are typically through infrastructure funds with solid businesses that investors and managers want to hold, but who also want to further build out the investment platform. To do this, a portion, or strip, of investments within a fund are sold and the proceeds are invested in new assets to diversify or build out the portfolio.

"Secondary investors provide development capital for operating assets that need new capital," says Perrin. "An asset that is providing, for example, a 7 percent to 8 percent return can go to a 10 percent return with the additional capital."

OPEN-END FUNDS

Open-end funds have more core-focused opportunities, looking for assets that are operating very well and provide steady cash flows, and can be managed over a longer period of time, says Pace. Closed-end funds typically invest in core-plus and value-add opportunities, and investment managers in that market hold investments for five to 10 years before exiting.

There has been an uptick in open-end funds being created during the past couple of years, Pace continues. This is largely being driven by investment managers who started out on the value-add, closed-end fund side of the market and are now seeing a lot of deal flow in the core space.

These managers have not been able to put those investments in their portfolio because they did not meet their return objectives; however, on the core side they can find opportunities that are in the 8 percent to 10 percent return range and core funds are being established to access those opportunities.

Many investors include infrastructure investments in portfolios for several specific characteristics — inflation protection and current income are two of these. Protection from market downturns is another, thanks to infrastructure investments that are largely uncorrelated to other portfolio investments.

"Open-end funds allow investors to realize these desirable sector characteristics over a longer period of time," says Hennessey. They also participate in appreciation through regular third-party mark-to-market valuations, he adds. Because investments in an open-end fund are typically held over longer periods of time than with closed-end funds, there are fewer investment sales, which creates an absence of market-based valuations. In place of these, open-end funds will use third-party valuations to estimate the value of portfolios.

THE BOTTOM LINE

The market for infrastructure investment is maturing and new strategies, including open-end funds and secondary investments, are becoming more available to investors. These vehicles can offer investors opportunities to extend investments, quickly get invested in infrastructure and fine-tune portfolios. ❖

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