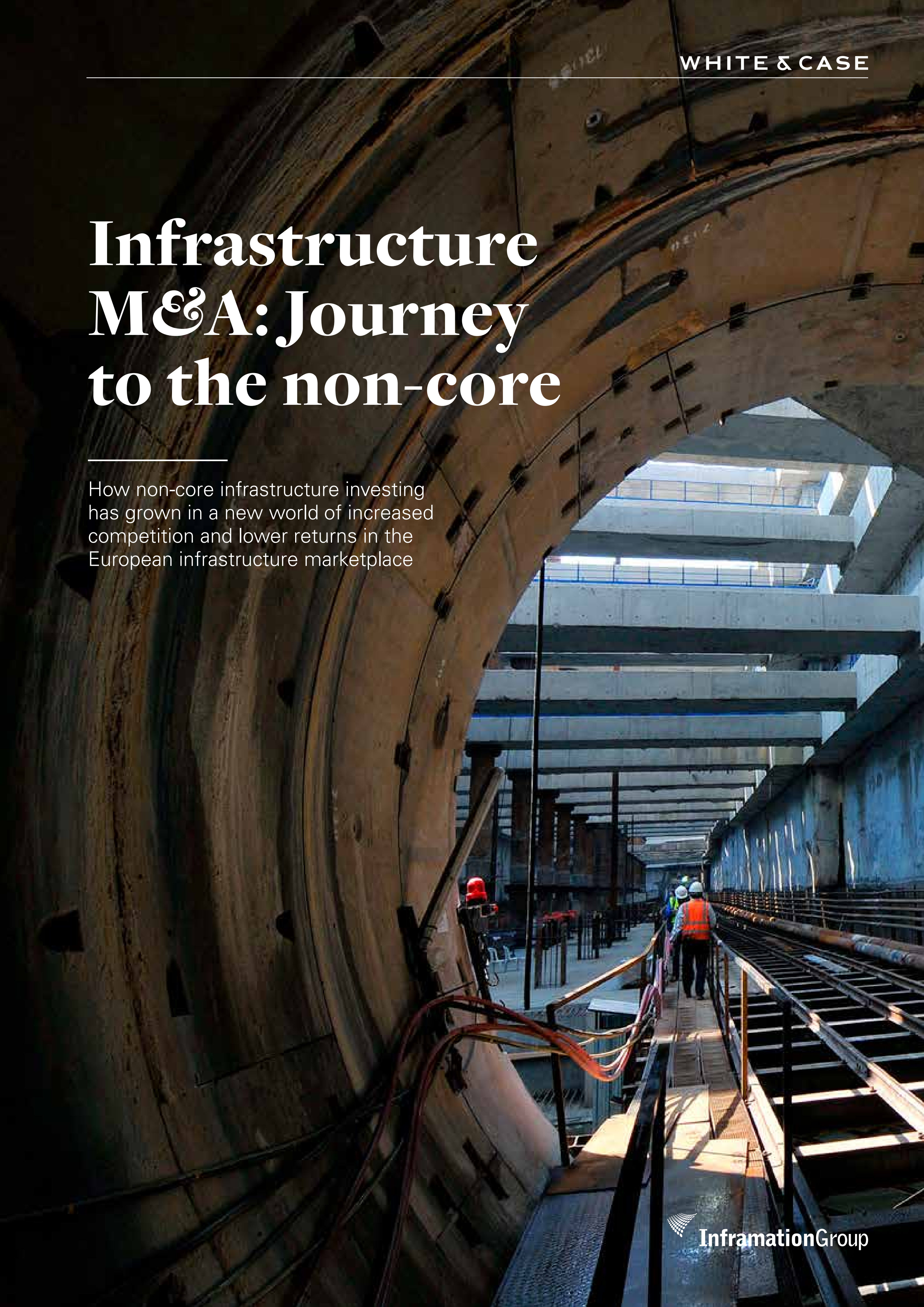


WHITE & CASE

Infrastructure M&A: Journey to the non-core

How non-core infrastructure investing has grown in a new world of increased competition and lower returns in the European infrastructure marketplace

InframationGroup

Contents

Methodology

For this report, InfraDeals analysed European M&A transactions that reached financial close in the infrastructure sector between the years 2010 and 2016. InfraDeals is concerned solely with infrastructure transactions that have been financed with private sector equity investment. For the purpose of this report, M&A transactions were categorised as the sale of equity in operational assets across the transport, power, environment and telecommunications sectors in Europe.

These sectors are defined as:

- **Transport:** airports, roads, rail, ports, bridges, tunnels, light rail and car parks
- **Power:** project-financed energy generation, oil and gas storage, plus energy transmission and distribution
- **Environment:** waste, wastewater and water treatment facilities transmission
- **Social infrastructure:** healthcare, education, prisons, defence, social accommodation, street lighting, leisure
- **Telecommunications:** fixed line, wireless

InfraDeals categorised these transactions as either core infrastructure investments or non-core infrastructure investments (see Glossary, page 5).

The evolving landscape of infrastructure dealmaking

Institutional investors are increasing their investments in core infrastructure and aggressively competing with funds. This increased appetite has forced fund managers to search for riskier assets outside of the mainstream.

Over the past seven years, institutional investors and funds have been battling each other for the most prized infrastructure assets. This competition has led to a steep increase in both European infrastructure M&A and a corresponding drop in returns from such assets.

In the main, these contests have been over "core" infrastructure—defined as regulated, monopolistic energy, transport and environmental assets. These are viewed as the safest and most attractive way for institutional investors to secure the types of long-term yield required to match their liabilities.

As a result, infrastructure funds that have traditionally been active in the sector are being pushed to work harder to source the types of deals that will generate the returns that they have enjoyed in the past—and that their limited partners have come to expect.

Corporate-owned, neglected core infrastructure assets can still provide some of the deal flow for infrastructure funds, but the search for an adequate level of exit potential that provides robust returns has increasingly pushed asset managers into areas of "non-core" infrastructure. These assets are seen as having greater market risks, such as power price exposure, short-term contracts, geopolitical risks, less sophisticated regulatory regimes and/or contract renewal risks, but they often offer better returns than core assets.

Although this recent trend towards non-core investing by infrastructure funds has been noted, the maturing nature of the non-core infrastructure space has now opened the door for institutional investors to move into the space. Institutionals have, like their more nimble asset manager counterparts, increased their risk appetites and are now prepared to acquire non-core assets and to do so in an increasingly competitive fashion. With allocations to the infrastructure asset class projected to double over the next decade and the competition for core infrastructure showing no sign of receding, this non-core shift will only accelerate in the coming years.

This report, developed with the Inframation Group, explores the shift in infrastructure dealmaking by institutional and infrastructure investors alike in the non-core infrastructure space. We investigate where the key battlegrounds are in the increasingly competitive infrastructure landscape; the opportunities and challenges for both sets of investors; and we ask how funds can survive and thrive in this brave new world of infrastructure dealmaking.

How the European infrastructure M&A market is changing

HEADLINES

■ Overall appetite for infrastructure investment remains strong. M&A deal value rose 75 per cent from 2010 to 2016. Deal volume grew 196 per cent over this period ■ The number and value of investments in core infrastructure rose in 2016, compared with 2015, with 88 deals (up 15 per cent) valued at €19.4 billion (up 19 per cent) ■ Investment in non-core European infrastructure more than tripled over the last seven years, from €4.23 billion in 2010 to €14.46 billion in 2016. Deal volume rose by 315 per cent from 13 deals in 2010 to 54 in 2016

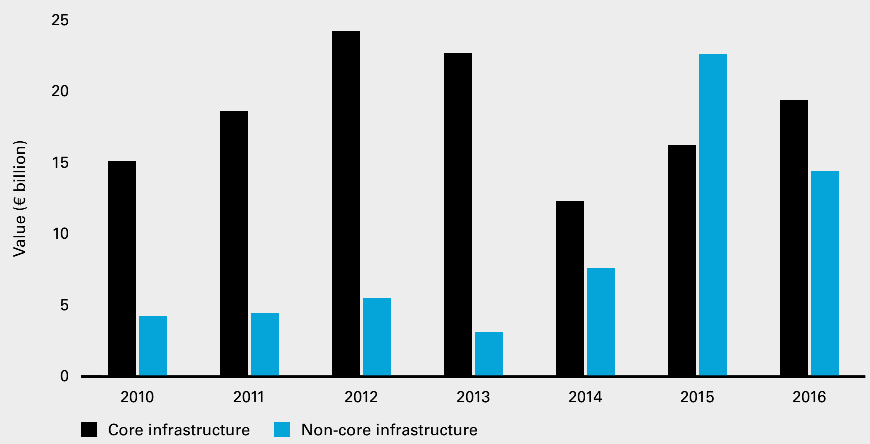
Since the turn of the decade, infrastructure M&A deal value has grown by 75 per cent. With the continued low interest rate environment at the global macroeconomic level, the yields on offer in the infrastructure asset sector have become increasingly attractive to institutional investors and limited partners alike. Indeed, fundraising for asset managers targeting infrastructure assets hit record levels in 2016.

Institutionals dominate the core

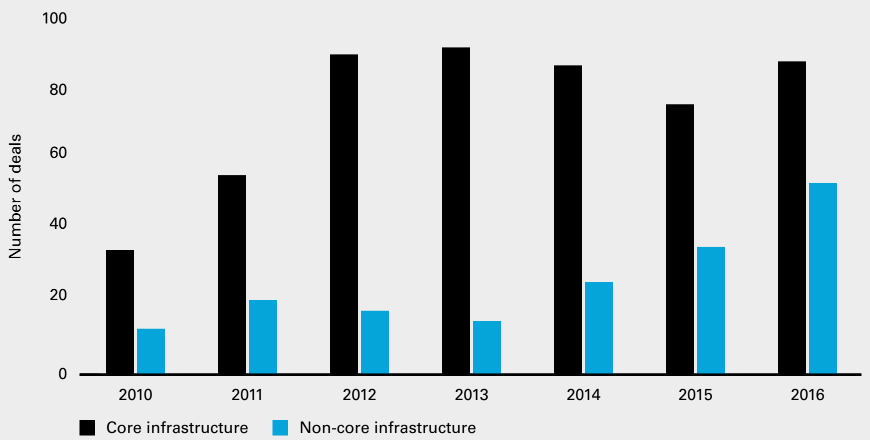
Since 2010, and particularly in the early years of the decade, core infrastructure capital allocation has dominated the marketplace, both in terms of volume and value. Over the period, assets have largely been split between power (51 per cent) and transport (34 per cent), with environmental, social and

> **The yields on offer in the infrastructure sector have become increasingly attractive to institutional investors and limited partners alike**

Core infrastructure vs non-core infrastructure by value, 2010 – 2016

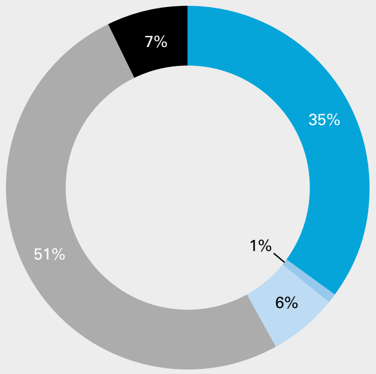


Core infrastructure vs non-core infrastructure by volume, 2010 – 2016

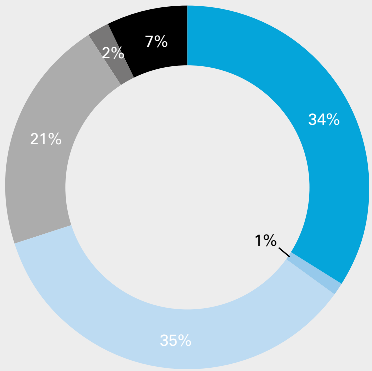


Source: InfraDeals

Core infrastructure analysis by value, 2010 – 2016



Core infrastructure analysis by volume, 2010 – 2016



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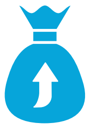


75%

Rise in infrastructure M&A value from 2010 to 2016

54

Total number of non-core investments in 2016, up from 13 in 2013

telecommunications infrastructure receiving a more modest share of investment levels.

A hallmark of the European infrastructure market has been the increased domination of institutional investors in competitive auction processes for core assets such as major international airports and national gas distribution networks. This competitive drive has correspondingly driven down returns. When combined with the increased appetite on the part of Asian investors and Middle Eastern sovereign wealth funds, the European infrastructure marketplace has never been more competitive. The Ontario Teachers' Pension Plan–led acquisition of London City Airport from Global Infrastructure Partners in March 2016 is just one example in a long line of institutional investor-dominated M&A processes.

There are certain exceptions within the core infrastructure space where infrastructure funds are still ready to invest. These include neglected assets owned by corporates that do not have the incentive to spend time boosting the performance of a particular division.

In these situations, the relevant assets can be carved out and optimised by infrastructure funds. They have the necessary operational expertise and technical knowledge to drive up cash flow and revenues while also driving down costs, increasing efficiencies and improving capital structures. One such example is Affinity Water, which Morgan Stanley Infrastructure Partners and Infracapital acquired from Veolia in 2012. As Morgan Stanley managing director Alberto Donzelli says: "There continues to be a lot of opportunities in this space across the European market—be it in utilities, transport, telecoms or leasing companies."

The rise of non-core

However, as competition has forced down anticipated returns for core assets into single digits, infrastructure funds have increasingly turned their attention to the non-core sector over the past six years.

This is evidenced by the fact that core infrastructure has ceded ground to non-core infrastructure with a decrease in total market share from 78 per cent in 2010 to 57 per cent by 2016.

Non-core investment by volume has been continuously on the rise since 2013, climbing from 15 transactions to 54 in 2016. And, in the past six years, capital invested in non-core infrastructure has increased from €4.23 billion to €14.46 billion—a 250 per cent rise.

In the beginning, this increase could largely be attributed to the focus shift of infrastructure funds, but more recent transaction data demonstrates a growing contribution from institutional investors to the non-core sector as well. And, as we will see in the next chapter, the battle for the best non-core assets in Europe is heating up.

> "Non-core investment by volume has been continuously on the rise since 2013, climbing from 15 transactions to 54 in 2016

Glossary

Institutional investors: These include insurance companies, public and private pension funds, and sovereign wealth funds.

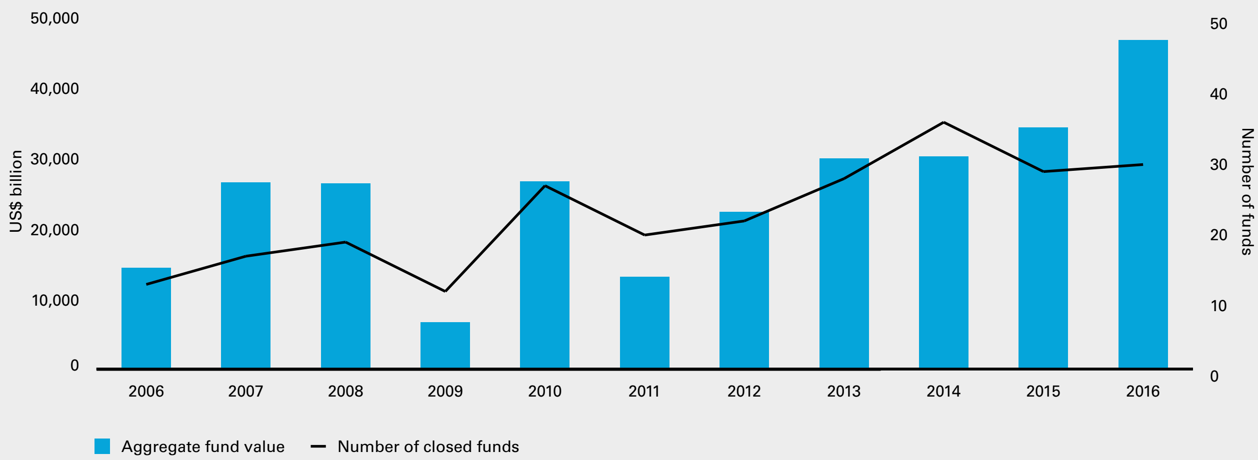
Core infrastructure: This includes assets with the following characteristics:

- Generation facilities that are operational and have a long-term off-take agreement with an investment-grade counter-party, or gas or electricity distribution businesses operating in a stable regulatory environment
- When the asset is a public-private partnership (PPP) and/or its revenue stream is contracted on a long-term basis with an investment-grade counter-party
- Assets that provide essential services and have a monopolistic position in their sector and/or region

Non-core infrastructure: These assets lack the properties noted above, and are more exposed to factors such as demand and construction risk as well as increased competition.

Examples of core infrastructure assets include UK-regulated water utilities or the recently sold Nice and Lyon airports in France. Non-core infrastructure examples include airport equipment leasing or crematoria businesses.

Global unlisted infrastructure fundraising, 2006 – 2016



Source: InfraDeals

The shift to non-core infrastructure—who's investing where?

HEADLINES

■ Between 2010 and 2016, more than half (53 per cent) of all non-core infrastructure investment was made by infrastructure funds ■ In value terms, transport (41 per cent) and power (28 per cent) are the main sectors for non-core infrastructure investment, with assets such as car parks, motorway services and midstream oil and gas assets leading the way ■ Western Europe is the main region for non-core investment, with the UK market leading the way. From 2010 to 2016, non-core investment levels in the UK market amounted to €16.67 billion—double that of Germany, the second-most popular market for non-core capital ■ Despite the UK's impending exit from the EU, UK investment levels are forecast to hold up in the coming years

The investment levels in non-core European infrastructure assets have more than tripled over the last seven years. And infrastructure funds have been the most active players in the non-core infrastructure space—accounting for between 44 per cent and 66 per cent of investment volumes in non-core infrastructure M&A activity between 2014 and 2016.

Although the crowded core infrastructure space and lack of quality returns were the main factors that led to this migration, InfraDeals data shows that these same dynamics are increasingly forcing their way into the non-core space.

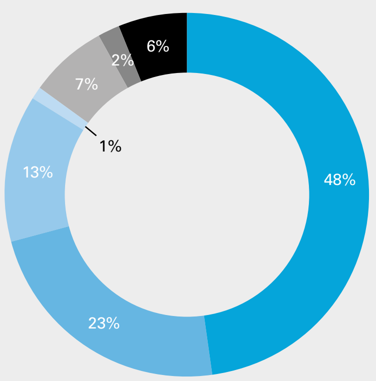
A review of the most recent deals in the space shows that institutional investors are now steadily following their infrastructure fund counterparts into this lucrative area.

In 2011, infrastructure funds were largely the only investors in non-core infrastructure. However, in 2013, for example, institutional investors contributed a 48 per cent share of the segment, although this plummeted to just 3 per cent in 2016. Fluctuating levels of institutional investment in non-core can partially be explained by the cyclical nature of infrastructure fund asset disposals—large non-core divestments do not necessarily occur every year. While there have certainly been ebbs and flows in the level of institutional investor involvement, it is clear that infrastructure funds can no longer take the non-core marketplace for granted.

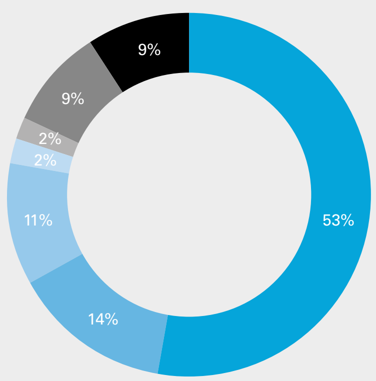
Non-core sector watch

On a sectoral level, InfraDeals data reveals that transport (41 per cent)

Core infrastructure analysis by equity investor type, 2010 – 2016

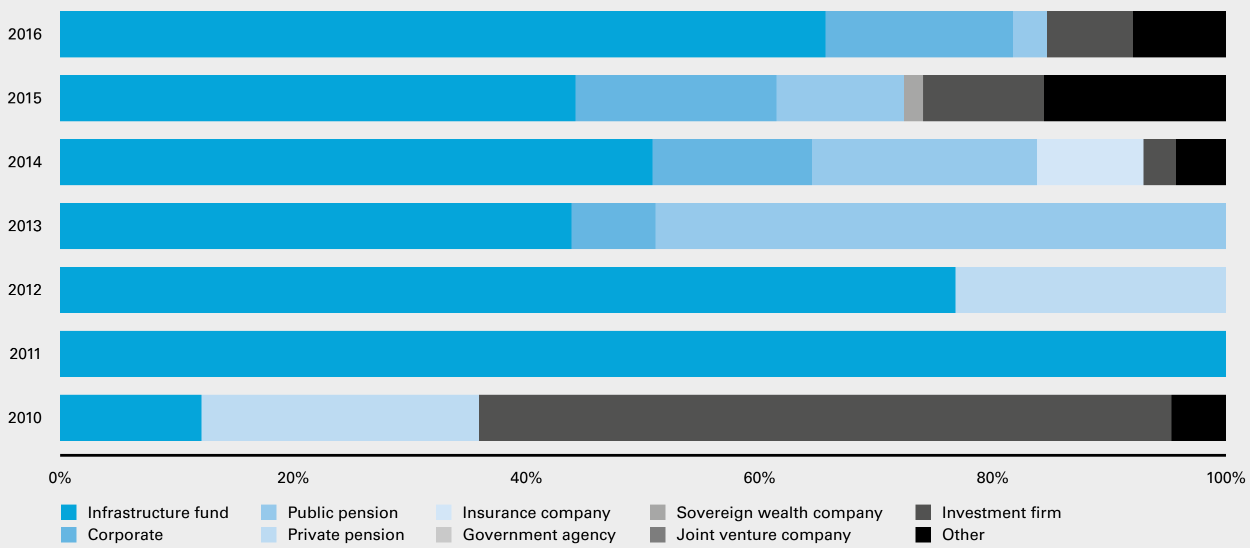


Non-core infrastructure analysis by equity investor type, 2010 – 2016



Source: InfraDeals

Non-core infrastructure analysis by equity investor type by value, 2010 – 2016



Source: InfraDeals

and power (28 per cent) lead the way for non-core investments—although such transactions tend to occur sporadically across a diverse range of sectors.

Within the transport sector, rolling stock remains a popular non-core infrastructure sector. While rolling stock in the UK has passed into the hands of institutional investors and is viewed largely as a core asset, in continental Europe rolling stock assets fall within the non-core classification. This is due to the increased competitive dynamics within the sector as markets continue to free up and investors look to capitalise on the trend of train-operating companies moving away from owning their own fleet.

While PSP Investments, Arcus Infrastructure Partners and AMP Capital continue to back Luxembourg-based Alpha Trains, originally part of the Angel Trains Group acquired back in 2008, there are numerous other examples of these transactions in recent years. Morgan Stanley Infrastructure Partners acquired a minority position in German-based VTG, and Deutsche Alternative Asset Management took a 50 per cent stake in France-based Akiem in 2016. Looking ahead, J.P. Morgan is understood to be

66%

Proportion of non-core infrastructure investment made by infrastructure funds in 2016

41%

Percentage of total capital allocations deployed to non-core assets in the transport sector

in exclusive talks to acquire UK-based group Beacon Rail from Pamplona Capital Management.

These assets have strong market positions but all are exposed to competition. To add value, investors must improve operational performance. This includes tightening up maintenance and scheduling while also pursuing acquisitive growth strategies through bolt-ons and opportunistic acquisitions of smaller rolling stock fleets.

Getting smart

Smart metering is another non-core asset class that has attracted interest from both infrastructure funds and institutional investors alike. For several years, EU countries have promoted the rollout of smart gas and electricity meters as a way of aiding consumer energy efficiency efforts, and this deployment is now in full swing. KKR Infrastructure's acquisition of Calvin Capital from Infracapital at the start of 2017 is the most recent example of a deal in this sector.

However, it is an area that comes with a number of challenges. For example, the German smart meter market is unregulated, with revenue derived from short-term contracts. This is a feature bidders will have to factor in if, as anticipated, Macquarie-owned Techem is put up for sale this year. In the medium to long term, the market will also be exposed to technology risk as the metering and energy servicing space continues to digitalise.

Strong support

Funds are also increasingly targeting services groups that support the operation of infrastructure assets. The asset-heavy nature of these businesses makes them attractive, as this serves as a barrier to entry for any potential new entrants.

AMP Capital and 3i Infrastructure's acquisition of Danish company ESVAGT—a provider of emergency response and rescue vessel services to the Nordic offshore oil and gas industry—in 2015 is a clear example of this trend. Deutsche Asset and Wealth Management and 3i Infrastructure's acquisition of Belgium-based airport equipment leasing business TCR in 2016 proves that it is likely to continue.

However, such transactions can throw up financing challenges for supporting banks that do not always know whether to categorise these deals as private equity or infrastructure.

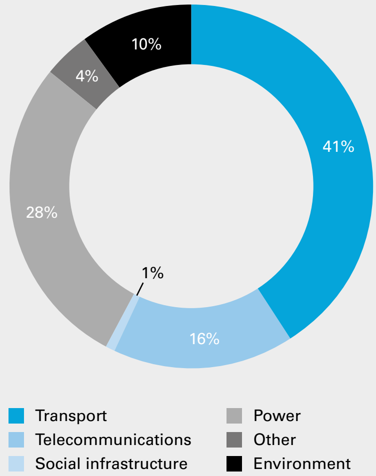
Five of the best

The table below shows five of the highest value non-core European deals between 2015 to 2017

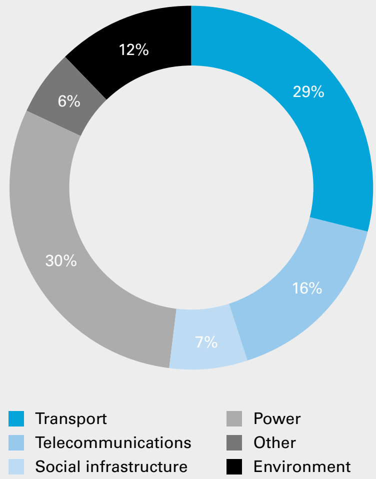
Asset/sector	Country/year	Buyer	Seller
Tank & Rast Motorway services	Germany, 2015	ADIA, Allianz, Borealis, MEAG	Deutsche Alternative Asset Management, Terra Firma
TCR Airport equipment leasing	Belgium, 2016	3i Infrastructure, Deutsche Alternative Asset Management	Chequers Capital
VTG Rail leasing	Germany, 2016	Morgan Stanley Infrastructure Partners	Private individual
Westerleigh Group, Crematoria infrastructure and services	UK, 2016	OTPP, USS	Antin Infrastructure Partners
Calvin Capital, Smart meters	UK, 2017	KKR Infrastructure	Infracapital

Source: InfraDeals

Non-core infrastructure sector by value, 2010 – 2016



Non-core infrastructure sector by volume, 2010 – 2016



Source: InfraDeals

Parking matters
Car park assets, which can offer good visibility on revenues, depending on where they are located, are another market segment attracting widespread investment. Investors are currently bidding for the Q-Parks car park business in the Netherlands for example. However, car parks are still subject to demand risk and varying levels of competition.

"The risk profile of car parks depends on where the asset is, there are some that are core—and there are others that are non-core—for the right asset, where there are high barriers to entry and it's a de-facto natural monopoly, I'm not surprised to see aggressive bidding," says Morgan Stanley's Donzelli.

Non-core cross-selling
Recent sector activity indicates some early investors in the non-core space have now sufficiently de-risked their non-core assets enough to entice institutional investors into their auctions and thereby contribute to the wider migratory trend of institutional investors into the marketplace.

EQT Infrastructure's divestment of Koole Terminals in the Netherlands in 2015 to OTPP and J.P. Morgan is one such example. In addition, non-core sectors including car parks—such as Vinci Parks in France, acquired by Crédit Agricole Assurances (CAA) subsidiary Predica, together with Ardian Infrastructure in 2014—and motorway services such as German group Tank & Rast, acquired by ADIA, Allianz, Borealis and MEAG in 2015—have recently drawn in large capital volumes from institutional investors who have grown increasingly comfortable with the risk profile and yield potential of these asset classes.

The regional picture
When it comes to regional investment in non-core assets, the data reveals a bias for investment in Western European markets, as these jurisdictions offer relatively low levels of political, regulatory and economic volatility.

The UK is the clear winner in terms of capital deployed to non-core infrastructure. From 2010 to 2016, it saw €16.67 billion being invested into its non-core sector, easily dwarfing the German market, which took in €8.06 billion over the same period.

In the UK, the transport sector received the lion's share of non-core capital led by big ticket investments into three UK rolling stock companies—Angel Trains, Eversholt and Porterbrook.

"

Transportation assets have strong market positions but all are exposed to competition. Investors must improve operational performance while also pursuing acquisitive growth strategies

Meanwhile, German non-core activity was dominated by the €3.5 billion acquisition of motorway services group Tank & Rast, although EQT's divestment of waste treatment and energy business EEW Energy from Waste to Beijing Enterprises also contributed €1.4 billion to the total.

Spain and France took third and fourth spots respectively. In Spain, non-core power transactions made up the bulk of activity, spearheaded by the €2.5 billion Macquarie and Kuwaiti sovereign wealth fund Wren House's acquisition of E.ON's power assets in 2015.

Spain suffered from a drop-off in infrastructure investment activity in the wake of the 2008 economic crisis and the controversial changes made to its renewable energy support system. However, the data reveals that international investor confidence is now returning, and the country is expected to cement its position as a key European market for non-core deals over the coming months.

Activity in France was led by investments in the country's telecommunications sector, in particular the €3.56 billion acquisition by Arcus, APG, Brookfield and PSP Investments of telco infrastructure operator TDF's French division from a consortium of private equity investors in 2015.

Next stop on the non-core journey

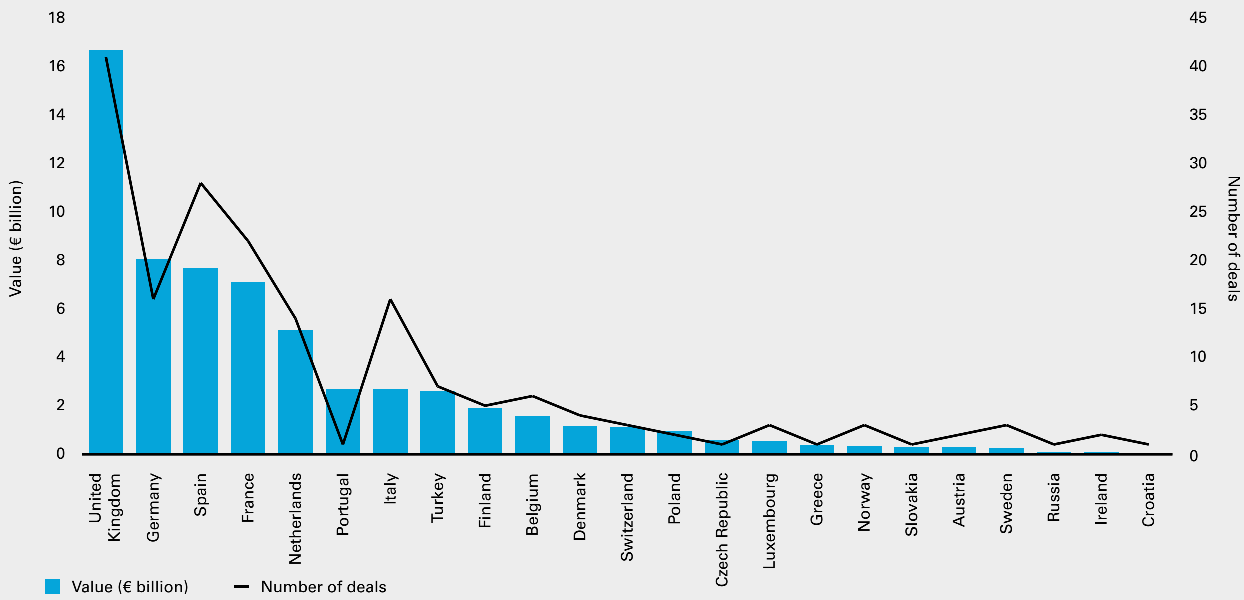
In 2017, infrastructure funds must now begin to adjust their investment and exit strategies in the non-core marketplace to reflect the reality that institutional investors are very much here to stay. Such investors will increasingly import the same level of competitive tensions seen in the core infrastructure space into the non-core arena. The non-core journey, contrary to popular belief, is well on its way rather than still being in its infancy, as previous market commentators have led many to believe.

While certain funds have already used this evolutionary step to their advantage by de-risking assets and packaging them up for exits to institutional investors that are moving into the non-core space, others will invariably be slower to react. They will be reluctantly pushed out to pursue even riskier non-core investment strategies in geographies and industries that may be ill-suited for their investment programme and expertise.

Only time will tell how the non-core marketplace will develop, but what is certain is that the competitive landscape has already permanently changed and only those that are willing to adapt and grow will be successful in navigating the journey towards positive returns.

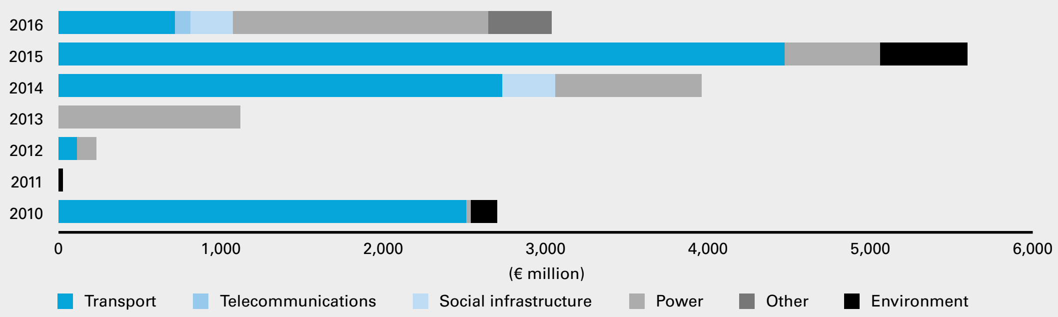
> **The non-core journey, contrary to popular belief, is well on its way rather than still being in its infancy, as previous market commentators have led many to believe**

Non-core infrastructure by country (value and volume), 2010 – 2016

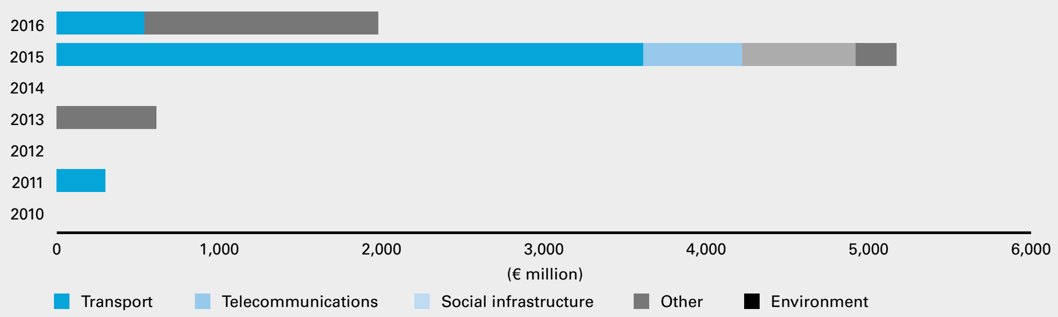


Source: InfraDeals

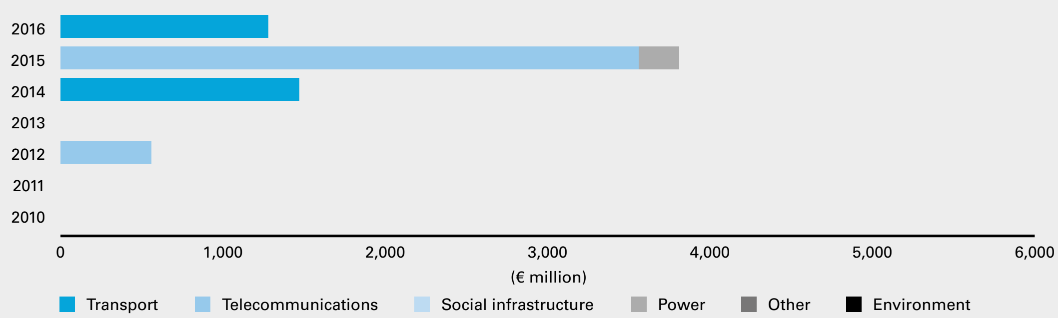
UK non-core M&A (value) by sector, 2010 – 2016



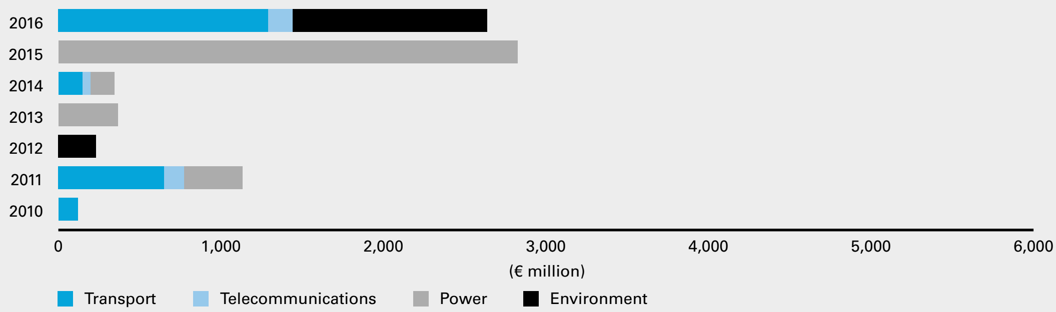
German non-core M&A (value) by sector, 2010 – 2016



French non-core M&A (value) by sector, 2010 – 2016



Spanish non-core M&A (value) by sector, 2010 – 2016



Source: InfraDeals

Six steps to non-core infrastructure success

Infrastructure funds are increasing their capital allocations to non-core sectors, although in doing so they will need to take on increased risk and operate outside an established regulatory environment. There are six key steps that investors should take to get the best out of the non-core market.

Success for investors in an increasingly crowded market will depend on fearlessness, efficiency and the ability to spot the right asset at the right time.

1. Non-traditional origination
Managers that can avoid the auction process and source assets on a bilateral basis have a real competitive advantage, as they won't get caught in a cost of capital shootout with institutional investors. The most effective non-core investors are marked by their ability to target deals from non-traditional sources.

2. Pursue avidly, manage effectively
As institutional allocations to infrastructure continue to rise, there will be pressure to find new areas of infrastructure in which to deploy capital. This process will require fund managers to enact operational improvements, push out the length of the contracts that underpin their revenues and, in some cases, cement the monopolistic position they inhabit in a given sector through acquisitive growth. Active management will enable fund managers to stay ahead of all but the best-resourced institutional investors who, in the main, would prefer to bid for more core infrastructure opportunities.

3. Keep an eye on new sectors
Non-core sectors expected to attract increasing infrastructure fund investment include smart metering businesses, asset-heavy infrastructure services groups and the European rail leasing market. Infrastructure funds have also begun to target data storage businesses and decentralised energy production, while aged care is viewed as a future opportunity.

Telecommunications infrastructure, midstream oil and gas, and car parks also continue to attract capital. Funds will also pursue outlier "infrastructure-like" opportunities such as crematoria or medical diagnostics businesses.

4. Check the definition
The infrastructure market is increasingly sophisticated, with investors finessing their investment approach by referring to opportunities as core, super-core, core plus or non-core to better reflect their risk profiles, and the types of returns they expect to achieve. However, to avoid a loss of trust with their limited partners, funds must be transparent about their strategies—and the risk they are looking to manage.

5. Don't be afraid of competition
Infrastructure funds are facing growing competition for non-core assets. Yet funds are increasingly being seen as performing the role of de-risking such assets to the point where they are ready to be acquired by institutional investors. As such, the growing institutional risk appetite for non-core can be viewed as a positive development for infrastructure funds.

6. Take exit opportunities
The movement of assets from infrastructure funds through to institutional ownership has been evidenced across a range of sectors including motorway services, UK rolling stock and car parks. This process, whereby assets are systematically de-risked, should provide a steady source of exit opportunities for infrastructure funds.

Antin and EQT Infrastructure are seen as being at the forefront of this transformation process. Antin's sale of UK crematoria business The Westerleigh Group in 2015 to the institutional investors the Universities Superannuation Scheme and the Ontario Teachers' Pension Plan is the most extreme example of this process, with the business case underpinned by the compelling long-term dynamics of the UK crematoria market. "Sometimes it's about de-risking and reducing complexity, but in other cases it's about making sure people understand the characteristics of businesses," says Antin's managing partner Mark Crosbie.

One definition—many sectors

The table below shows the breadth of non-core sectors into which Antin Infrastructure Partners invest

Non-core assets
Amedes Group, medical diagnostics, Germany
Eurofiber, fibre-optics network, Netherlands
Grandi Stazioni Acquisition, rail hub & services, Italy
Inicea, psychiatric clinics, France
Roadchef, motorway services, UK
Central Area Transmission System, gas transmission, UK

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