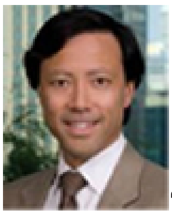
Infrastructure private equity

Investors putting their money into emerging Asia's infrastructure are looking for better returns than they'd get in developed economies, although they're not looking for 'PE-style' returns.

Cognisant of Asia's long-term need for investment to build and expand infrastructure projects, investors are "probably" looking for investment yields "in the mid to high teens at the most from Asia," rather than 25 per cent or more, says **Andrew Yee**, global head of infrastructure principal finance at Standard Chartered Bank.

He adds they're "therefore expecting something that's relatively solid but maybe with some growth" as opposed more steady returns from developed markets.



"Frankly some people will say, 'well, look after the crisis I can get 15 per cent out of developed markets, so you're going to have to offer me at least 20 or 25 (per cent) in Asia to make me go there' but I'd suggest that given the implosion of some of the developed market models, I'm not sure that 15 (per cent) is actually a real figure."

"From a developed market point of view, what LPs (limited partners, or investors) around the world seek from the infrastructure asset class are those long-term stable cash flows which they can use to offset their long-term pension liabilities."

"Can emerging Asia provide the sort of operating cash flows to match those long-term pension obligations? I would suggest that it is unlikely given the huge amount of growth that emerging Asia needs in terms of infrastructure." Emerging Asia, Yee adds, is at a stage where, given the massive need for first-time, new-build infrastructure, assets do not typically provide the sort of 'dividend yields' seen from developed market infrastructure funds as they are at an earlier stage of development.

Speaking at INSEAD's inaugural PE conference in Asia, Yee noted that China and India alone reportedly need more than US$1.5 trillion for infrastructure development in the next five years. As such, investors could reap higher returns from recycling operating cash flows of existing infrastructure projects into new or expansion projects, rather than by paying dividends, he says.

Although Yee believes that the long-term outlook of Asia's infrastructure sector is positive, the global credit crunch has made it harder for many new projects to secure financing, although good quality operating assets continue to get funding, as do well-established local operators with a combination of operating assets and significant brownfield and greenfield developments which would provide high growth, often absent from developed market infrastructure investments.

"Banks are much more gun shy and much more conservative when it comes to greenfield, single-project financing, in this post-crisis environment," Yee says.

Improving deal flows in India

For fellow panelist **Raja Parthasarathy**, the global credit crunch has helped improve PE deal flows in India. In 2007 and early 2008, many small and medium-size companies could directly access the public capital markets. But in the wake of the global financial crisis, these companies are turning to PE investors to raise capital, says Parthasarathy, an INSEAD alumnus and a managing director at IDFC Private Equity, an India-focused firm with US$1.3 billion under management.

But with the rapid rebounds in global equity markets bolstered by stimulus spending, company valuations are high and "getting into attractively-priced investments is hard," says Parthasarathy. As such, his company will be focusing more on exiting investments than making new ones for the next 12 months.

And notwithstanding the tentative global economic recovery, many PE firms – particularly those that adopt the developed market infrastructure investment model – have imploded in the wake of the global financial crisis, says Yee. He notes that much more capital on a percentage basis is flowing into Asia's emerging markets, especially China and India.

"We're actually getting a bigger percentage of the pie, even if the pie momentarily has shrunk … It's a very good time for Asian infrastructure."

Riding the 'green' investment wave

Amid the global attention on the Copenhagen summit on climate change, many investors believe 'green investing' is "the next big wave", says Parthasarathy, who warns of a growing investment bubble.

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"You're going to find that a lot of people are moving towards the green sector not because they are 'good boys', not because it's good for the earth, but more importantly it addresses two key things," says fellow panelist **Vijay Pattabhiraman**, managing director of the Asia Infrastructure Group at JPMorgan Asset Management, which focuses on Korea, China and India, and has US$1.7 billion under management.

"One is you're making money now. If you're being green, if you consume less energy when you're making a product, it actually impacts your cost structure positively,"

"Second is it gives you a lower risk. Your sustainability index goes up, which means you're safer as an industry if you're not polluting - an ideal investment for me."

As an example, Pattabhiraman says he has invested in cement production with new technology in China, where his production plants use 50 per cent less energy than his rivals and enjoy a cost structure that is 25 per cent lower.

"In the commodity business, if you have a 25 per cent advantage in cost structure, you're king," says Pattabhiraman, who's also looking at an investment opportunity in Korea to turn waste into energy. He notes that in the wake of the global financial crisis, the South Korean government committed more than 80 per cent of its economic stimulus package to the green sector, which makes it attractive to invest there.

Pattabhiraman also argues that 'green investing' provides three points of sustainability which are good for business.

"One is I'm socially sustainable. I don't fire people, I'm actually creating jobs … I do something good for the society, I feel safer as an investor."

"Second is economically sustainable, which means I'm the lowest cost provider. If I'm the lowest cost service provider or product provider, then I'm safe again. I'll always be there."

"Third is environmentally or ecologically sustainable. More and more people are moving towards (being green) … You're going to find that its sheer economic rationale is going to bring green to the mainstream."

Investing in China and India

In terms of making infrastructure bets, Standard Chartered's Yee is bullish about China and India's power sectors, as annual per capita power usage is significantly lower than in developed countries.

For instance, annual per capita power usage in the US is 17,000 kilowatt hours (kWh), 12,000 kWh in developed parts of Asia such as Singapore and Hong Kong, and 3,000 kWh in China and just 700 kWh in India, Yee says.

"It's extraordinary the electrification needs in India and China, relative to what we use in the developed world."

Yee, who has made infrastructure investments of US$300 million in the region, says China is currently the world's second largest power market, adding it should eclipse the US in the next couple of years.

"It's been adding 75 gigawatts per year, which is about the total capacity of Britain, each year for the last 10 years. India only has about 150 gigawatts, still the fifth largest power market in the world but it needs to treble that in the next three to five years."

Yee also notes the need for road infrastructure in China and India, where less than half the roads are paved. With sales of 13 million cars in China this year (or some 35,000 new cars each day on Chinese roads) and just 30,000 kilometres of toll roads, Yee says China will need to increase its roads to 85,000 km by 2020. In contrast, India has only 10,000 km of toll roads, with two per cent of the roads carrying 40 per cent of traffic. "So there's just a massive, massive need here," he says.

And in terms of wastewater treatment, Yee says less than half of the wastewater in China is treated, compared to almost 99 per cent in Singapore, 90 per cent in Europe and more than 80 per cent in the US.

IDFC's Parthasarathy agrees with Yee's assessment. Supply and demand drivers will remain very strong in India for the next 20 years, he says. "Anyone who's travelled to India knows that the infrastructure is bad, and that's the reason why we're in business."

Parthasarathy points out that India currently spends about 3.5-4.0 per cent of its GDP on infrastructure projects, which will have to rise to 8.5-9.0 per cent for India to achieve GDP growth of more than 8 per cent.

In particular, India's power sector is attracting strong investment interest. "Even if all the power generating units that are currently in the market to raise finance do actually get implemented, India will remain in a power deficit situation 10 years from now," says Parthasarathy.

But in his view, the single biggest bottleneck to India's economic growth is education.

"There is no way that the toll roads, the power plants, the water treatment distribution, companies, etc., can be built without actually educating people."

"And what I mean is simple training at the vocational level. India does not have a formal training programme for masons, bricklayers, electricians, plumbers. And the requirements to educate people in order for them to be able to build the infrastructure are huge."

Parthasarathy adds that, according to research, two-thirds of Indian IT graduates are unemployable because they lack the required skills to succeed in the workplace.

Although Parthasarathy is bullish on India's education sector, he is concerned about the sector's ability to attract investment, given India's socialist legacy and a common perception that education should be a non-profit sector. As such, the challenge is for investors to set up education companies that can be subsequently listed, he says. So despite his misgivings, Parthasarathy says he has committed US$25 million in an education company and hopes to set up more such companies.

INSEAD launched the Global Private Equity Initiative (GPEI) in August 2009 to combine the energies and talents of the school's research and educational capabilities with INSEAD's alumni and global professionals in the PE industry. For more information please contact GPEI's Director, Laura Morales.

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