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Fears mount of infra bubble

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Equity investors in the infrastructure sectors are beginning to worry about whether the market is entering bubble territory, as asset prices increase dramatically, fuelled by cut-throat competition and cheap debt.

At the Infrastructure Dialogue Berlin conference earlier this month, equity investors appeared uneasy with the spike in prices. Some suggested the competition for asset sales was increasingly driven by the decision by some bidders to pay "strategic prices" for certain must-have assets rather than by effective valuations.

"Infrastructure assets are fetching multiples north of 15x due to the availability of debt and the fact that pension and insurance funds need to deploy cash," said one investor. "The world is dividing. The largest infra funds, the Canadian, Australian and European pension funds and the sovereign funds are playing the [yield] curve. The question is how far can they go?"

The infrastructure head of a large insurer said that for core infrastructure assets even low returns remain attractive for institutional investors, given their long-term stable cashflows. Increasingly high prices and low returns, however, are risking making such assets illiquid, he added.

Investors might react to this environment in different ways, some speakers said. Some are looking to obtain higher returns, for example by investing in assets that would not be considered core infrastructure. Tank & Rast could be an example, even though it is already generating fierce competition.

Other investors are starting to consider taking on more risk, for example moving into greenfield projects and taking on construction risk. This would require careful management of construction contracts and might be feasible only for a few experienced investors. Others are starting to look more closely at peripheral countries – Spanish assets have recently attracted significant interest. Some institutional investors are looking at emerging market opportunities – Allianz among them.

As equity is put under increasing pressure, sponsors are looking to squeeze the most out of deals through aggressive leveraging. On some deals, such as German A-Model PPPs, debt margins are between 100bp and 120bp, equity returns are around 7%–8% and gearing is about 92%–93%, according to a banker. Debt pricing has gone down for some time and some think it might be close to bottoming out. The focus, however, has shifted on debt structures.

"Gearing is increasing. Tails are shrinking. Debt service facilities are coming back. Debt service coverage ratios are reducing," said another banker.

Some might simply decide to accept lower returns and continue to bid aggressively for assets, particularly institutional investors that are bound by regulatory requirements to invest in highly-rated assets.

"Investors prefer to have lower IRRs but sleep at night," said one.

Stable regulated infrastructure assets in developed countries are increasingly changing hands at record prices. Institutional investors are allocating a greater share of their investments to the deal-poor infrastructure sector in reaction to the general low-interest rate environment, leading to an overcrowded market.

Among the most recent deals to fetch record-high prices are the sale of two regulated energy businesses – Fortum's Swedish power grid and Morgan Stanley's Madrilena Red de Gas, a Spanish gas company.

Canada's Borealis and a group of Swedish pension funds bought Fortum Distribution for €6.6bn, or 19 times the asset's yearly Ebitda. Morgan Stanley sold Madrilena Red de Gas to a consortium including Dutch pension fund PGGM, France's EDF and China's Gingko Tree Investment. The buyers' bid was rumoured to be based on a 7% internal rate of return, valuing the asset at roughly €1.25bn.

The next big deal on the table is the roughly €2bn sale of Terra Firma and RREEF's Tank & Rast German motorway service station business, due next month. The deal features some of the biggest names in the infrastructure sector. According to the latest rumours, a group of Canadian funds PSP and OTPP was bidding but failed to be shortlisted, while other shortlisted bidders are said to include Macquarie and Borealis/Allianz/MEAG/ADIA.