

Improving fees in infrastructure

Introduction

While we are positive about the strategic case for investing in infrastructure as part of a diversified asset strategy for long-term investors, the fee arrangements make us much less supportive of some vehicles in which clients can invest. As a result, we are more in favour of cheap beta options, such as the low cost PPP/PFI (Public Private Partnership/Private Finance Initiative) strategies, than the abundance of higher fee core infrastructure funds. We are also more positive about higher-return value-added strategies, which verge on private equity, although we recognise that the fees that these managers charge are still very high. The large number of funds in the middle will, despite their strategic attractiveness, be of much less interest until we see a more attractive fee structure for our clients.

In this paper we therefore outline our views on the often complex fee structures involved when investing in infrastructure. Most of the infrastructure funds we research are structured as private equity type vehicles with similar fee structures that include:

- Fees based on commitments rather than invested capital.
- High management fees of 1-2 per cent.
- Hurdle rates of around 8 per cent.
- Carried interest of 20 per cent.
- Full catch-up (sometimes phased in).
- Additional fees and charges, such as transaction or financing fees and fund expenses.

We have concerns about a number of these features and outline the main issues on the following pages.

Fees on commitments

Infrastructure funds have, in many cases, adopted private equity type fee scales. In private equity, the rationale for charging fees on commitments stemmed from the days when the industry was immature. A firm raising its first fund needed to have reliable income from day one to remain in business. In addition, some managers argued that charging fees on invested capital would encourage the manager to invest too quickly. However, in infrastructure, very few funds are raised by managers who are new to the business and the argument for steady income is less compelling. Also, a well constructed performance fee should alleviate the risk of putting money to work too quickly and in unprofitable deals.

Fees on commitments generate a large part of the fee drag of investing in infrastructure and investors do not like to pay fees on uninvested cash.

Therefore, unless there are very strong reasons to the contrary, **we would prefer to see infrastructure fund fees charged on invested equity capital, not on commitments.**

High management fees

Management fees of 1-2 per cent are high relative to traditional active listed equity or bond mandates. Infrastructure as an asset class often generates lower returns than private equity, which is aggravated by charging similar fees. Management fees should just cover the cost of running the fund on a day-to-day basis. Given the size of the funds being raised and the size of the teams involved, we would suggest

that, in many cases, infrastructure managers view the management fee as a significant source of profits.

We would like to see infrastructure management fees that reflect the actual costs of running the fund.

Hurdle rates

Infrastructure funds appear to have adopted the same high hurdle rate as private equity funds despite the fact that the asset class is unlikely to generate the same level of return, or involve the same amount of risk. In our view, the hurdle rate should reflect the long-term return for the beta of the asset class so that the manager only earns a performance fee for added value. The hurdle rate should be different for a secondary PPP/PFI fund than it is for a development or more private equity type fund. In many cases the hurdle should be structured around inflation plus a margin or perhaps inflation-linked bonds. **We believe that an infrastructure fund's hurdle rate should reflect the particular strategy being followed and the manager should only earn a performance fee if it is generating alpha.**

Carried interest

A carried interest is probably not unreasonable if the hurdle rate and catch-up are properly designed. However, we see a number of fee arrangements where the carry goes to the firm rather than the infrastructure team, which we do not think is ideal from an alignment perspective. **We believe that the majority of the carried interest should go to the responsible team rather than the wider management firm.**

Catch-up

A well-designed performance fee should reward added value rather than beta. Catch-up provisions, whether phased in or 100 per cent, reward both. **We believe that in infrastructure there should be no catch-up and that carried interest should only be payable on excess returns, not on total returns.**

Additional fees and charges

Many infrastructure funds make additional charges. Some are reasonable and relate to the establishment of the fund, such as auditing the fund, and do not benefit the manager. In other cases, for example transaction or financing fees, the charges are not justified. They appear to have followed the practice of real estate funds but for no justifiable reason. In our view the manager should not make incremental charges such as transaction or financing fees. This work should be covered by the management fee.

In some cases, there will be related party fees, for example advisory fees charged by an investment bank that is connected to the manager. These charges would be payable whether or not the manager uses its sister company for the advisory work. **We believe that advisory and other fees payable to a related entity should be transparent. A fee scale should be agreed in advance so that benchmarking can be undertaken and the actual fees paid should be communicated to current and prospective investors on a regular basis.**

Summary

To demonstrate what we believe to be appropriate fee structures, we outline model fee structures for PPP/PFI income infrastructure funds and for higher return, private equity like funds (that is, closed end funds).

While these examples can be seen as Watson Wyatt's ideal fee structures, we recognise that the individual circumstances surrounding individual funds will need to be reflected in the fee structures.

Given our research process attempts to re-evaluate a manager's ability to generate strong net risk-adjusted returns, our analysis of a fund's fee structure is an important part of our overall assessment of a product.

Fees for infrastructure funds

- **During the investment period** the management fee should be linked to the expenses incurred by the team on running the product, limited to no more than 1 per cent per annum of committed amounts for income infrastructure funds and 1.5 per cent for higher-return targeting infrastructure funds.
- **Post the investment period** the fees are rebased to the acquisition cost of investments. This should not be based on net asset value (NAV) as this incentivises increased valuations. As follow-on funds are raised, the fee level steps down to reflect the revenue (and focus) being generated by other funds.
- For **income infrastructure (PPP/PFI) funds, the carried interest** ('carry') is based on the net yield and should be above a

benchmark that links the yield to inflation (for example, inflation plus 4-5 per cent per annum). Carry should be based on three-year rolling cash-flow. There is also no catch-up on the carry, which means it is a true hurdle not a preferred return. The management fee plus the hurdle must be returned before the manager starts taking carry.

- For **higher-return targeting infrastructure funds, the carry** should be based on total return (above a hurdle rate that is appropriate to the strategy employed) with no catch-up. It should be calculated on net cash-flow returned to investors. When carry is earned it will be placed into an escrow account. The management team can access a third of the carry every year and there is a requirement for the total return to continue to be met to access the escrow.
- If this is a fund that can make bids for primary PPP/PFI projects, it is reasonable to split **bid costs** between the management company and the fund.
- If there are **start-up costs** it is reasonable for these to be shared with the fund for first time funds, although there should be no placement agent fees.
- There are **no transaction costs** and all fees earned by the manager in the management of the fund (monitoring fees, break fees) are offset against the management fee.

Watson Wyatt Investment Consulting

No action should be taken on the basis of any article without seeking specific advice. If you would like to discuss any of the areas covered in more detail, please contact your usual Watson Wyatt consultant, or

Duncan Hale

+44 (0) 7227 2993

duncan.hale@watsonwyatt.com

Glossary of terms

Alpha	Performance achieved in excess of the market return
Beta	Market return
Escrow account	An account into which a GP's carry is held prior to carry being recalculated and paid on a pre-agreed date
General Partner (GP)	The infrastructure manager
GP catch-up	After the preferred return is exceeded, this mechanism sees the GP generally receive a higher proportion of distributions until positive excess performance is split 80:20 between the LP and GP
Hurdle rate	No GP catch-up once the preferred return is exceeded
Limited Partner (LP)	Investors in the GP's infrastructure fund, for example pension funds
Management fee offset	The extent to which transaction, monitoring and other portfolio company related expenses paid to the GP are offset against management fees
Management fees	Fixed cost paid to the GP to make an investment into a infrastructure vehicle, for example 2 per cent per annum based on commitments
Monitoring fees	A fee paid to the GP by the portfolio company for monitoring work
Performance fees or 'carry'	Variable cost paid to the GP for positive performance, for example 20 per cent
Placement agent fees	The fees paid to a third party intermediary to market the fund on behalf of the GP
Preferred return	The minimum return that must be achieved before the GP is paid a performance fee, for example an 8 per cent IRR
Transaction fees	A fee paid to the GP upon buying a portfolio company on behalf of its LPs