

A fool and their money are soon parted

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The English language is rich in proverbs and this one (the headline) happens to be one of the many imparted to me by my grandmother – a rather splendid woman who had a strong influence on me from the earliest age.

One of the European intelligentsia of the day, married to a scientist of some considerable renown (the apple fell a comfortable distance from the tree), she would gayly intone adages that will ring true till the end of time.

Among her favourites were that “a fool and their money will soon be parted” followed by the likes of “empty vessels make most noise” and wise words on “cutting your cloth according to your coat”.

There was no end to these proverbs and they appear frequently in these pages as bon mots to sum up a point nicely, while also serving as an ongoing tribute to a rather wonderful woman who I will forever miss.

In recent times so many of these proverbs have applied... and that leads on to the subject of today’s Friday Editorial – asset valuation by infrastructure funds in a challenging market – which is increasingly being raised as a point of some concern by contacts across the industry.

This follows on nicely from last week’s editorial on [fundraising woes](#) as the spotlight turns to assets held by vehicles as “infrastructure” became increasingly “sexy”... which I’ve always considered to be the case.

What’s true for the UK...

Here in the UK, there was some rather worrisome news last month (October) that the Financial Conduct Authority (FCA) will by the end of this year launch a probe into asset valuation – primarily focusing on real estate and infrastructure.

Grant Thornton published a useful article on the matter shortly after news broke that the FCA was planning to launch this review into private market valuations.

In this piece, the GT authors point out that the UK is not alone as US regulators have asked private funds to make more disclosures about performance and expenses to increase transparency and accountability.

Furthermore, GT points out that earlier this year (July) the European Central Bank published the results of a review of banks’ exposures to rapidly rising interest rates and how that risk could spread to other sectors.

Infra funds

So, how does all this impact the infra fund community? Well as one old chum who has been kicking around the infra fund



community for longer than his complexion would imply says: "The world is now upside down." And I'm rather afraid he's right.

The fundamental tenets of infrastructure investment now no longer stand true.

Think back to days of yore and the wisdom espoused by fund managers in this space that the focus was on long-term investments, monopolistic traits, core assets where the definition of "infrastructure" had not been stretched. You know, good old boring infra... PPP and the likes. The sort of asset you can take to the bank. Or can you any more?

Well, that's not the sort of investment that a fund manager – should it be unable to sell the asset as the vehicle approaches maturity – is considering for rolling over into continuity vehicles. Value add assets (beyond Core+) will be flipped into a new vehicle without hesitation, the rest need to go.

And that – as my old friend points out – is "upside down". But, by the same token, it also kinda makes sense.

While assets that have the lowest business risk – essentially Core leading towards Core+ – attracted the lowest cost of capital, they have to lowest ability to drive earnings and so are most exposed to downward pressure on value from higher rates.

The focus is squarely on "higher risk" businesses where there is greater potential to grow earnings – particularly given a high inflation rate environment – which drives up valuations, even at a time when the cost of capital is higher.

As an industry source says: "The impact is not linear. The lower the cost of capital, the greater the impact of a 1% move upwards in terms of IRR... so 6% to 7% hurts a lot more than 15% to 16%."

This sits uncomfortably with recent (depends how long you've been around) history. Looking back over the last 10 years, funds competed heftily to acquire assets at a time when cost of capital was assumed to be ludicrously low.

Yet another industry veteran questions: "How do these assets fare from a 'value/return' perspective in an environment of high cost of capital for a period of time? Are funds willing to sell at prices which are adjusted for the current environment – and will this lead to funds holding assets for much longer, say push for continuation funds?"

Well now – there's a question that has fund managers assume the lemon-sucking pose. Sell at a discount? Not on your nelly.

This course of action would provide the FCA with all the ammunition – hard data on asset valuation – it needs to dig a lot deeper.

That aside, funds are reluctant to sell at a discount. As one source says: "If a fund sells a stake at a loss, they have to make the NAV down, which impacts fee income and track record. So... things are quite gummed up, particularly at the Core end."

Net asset value is a bugbear for listed funds where we have all been a bit taken aback by the slump from trading at a premium to trading at discount. You can only read into this that investors – the market – do not buy into valuations and discounted cash flow (DCF)... which can be deemed excessively optimistic.

One household infra fund name says: "There is a wider issue of redemptions from UK defined benefit pension funds which is forcing some sale processes.

"If you are generally in growth assets then the macroeconomics have less impact, but if you have Core/Core+ then you will be looking at probably 1-2% increase in discount rate applied to cashflow valuations."

This surely heralds an end to investments into stable assets in favour of more frothy alternatives.

The name adds: "If you need to sell, you're looking at crystallising the loss – which sits today in the fund, but is less directly visible."

The market does look to be facing a number of forced sales – which will likely have to be agreed at a discount – as the challenging fundraising environment continues unabated... all the while the heavyweights plough on regardless.

But they don't want Core. All they seem to want is what one source describes as assets with “blue-sky growth business plans”.

The glory days of financial engineering appear to be drawing to a close and all those people passing themselves off as private equity specialists (mostly banking re-treads) might struggle to hold on to their jobs as sector specialists become flavour of the day.

And so we enter the era of value creation where EBIDTA growth is key.

Vive l'évolution.

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