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INVEST EUROPE

BRIEFING

Europe's economic foundations:

Investing in infrastructure

European infrastructure requires an investment of 3.6% of GDP to keep our economy growing. At a time when public expenditure is under strain, private infrastructure investors help to bridge the funding gap, offering a vital source of capital and expertise. As we demonstrate in this report, these investors channel capital into the companies that operate our infrastructure assets, investing in improving efficiency and maximising their capacity for the benefit of all European citizens. This reduces the need for governments to embark on costly and lengthy new greenfield projects, while also ensuring the region has world-class infrastructure to underpin economic development.

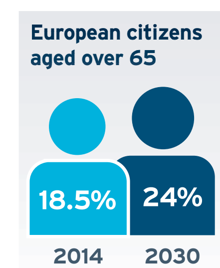
Michael Collins
Chief Executive, Invest Europe

Why Europe needs infrastructure **investment**

Infrastructure underpins the way we live and provides the necessary tools for companies and public services to operate. European citizens use infrastructure assets daily as they travel to and from work, whether they use roads, trains or airports, as they drink water, wash their clothes, cook, heat their homes or visit hospitals when they are sick. Businesses rely on infrastructure to communicate with suppliers and customers, transport goods and power offices and manufacturing plants.

Investment to meet EU aims

These essential assets need investment – both to keep them operational and to improve what they can offer. This is especially true as Europe's population ages – the proportion of European citizens over 65 will increase from 18.5% in 2014, to 24% by 2030 – and places increasing demands on the region's healthcare infrastructure. The globalisation and digitisation of the economy also adds new pressure for infrastructure investment as supply chains become longer and more complex and products and services are delivered to customers in new ways. Investment in infrastructure is central to ensuring European markets remain competitive on a global stage. The European Commission, for example, highlighted the importance of improvements to energy and transport in a recent paper:



> "Investment in cross-border energy infrastructure is needed to improve the EU's energy security and the functioning of the market. Energy and transport are also central to the EU's strategic transformation towards a low-carbon economy."

Investment in environmental and green infrastructure is also vital if the aims of the Paris climate conference (COP21) of limiting global warming to 1.5°C are to be met. While the social necessity of such action is clear, there are also more immediate economic benefits. In a recent speech European Environment, Maritime Affairs and Fisheries commissioner Karmenu Vella pointed to the green infrastructure investments in the urban regeneration of Malmo. These helped reduce unemployment in the area from 30% to just 6%.

The funding challenge

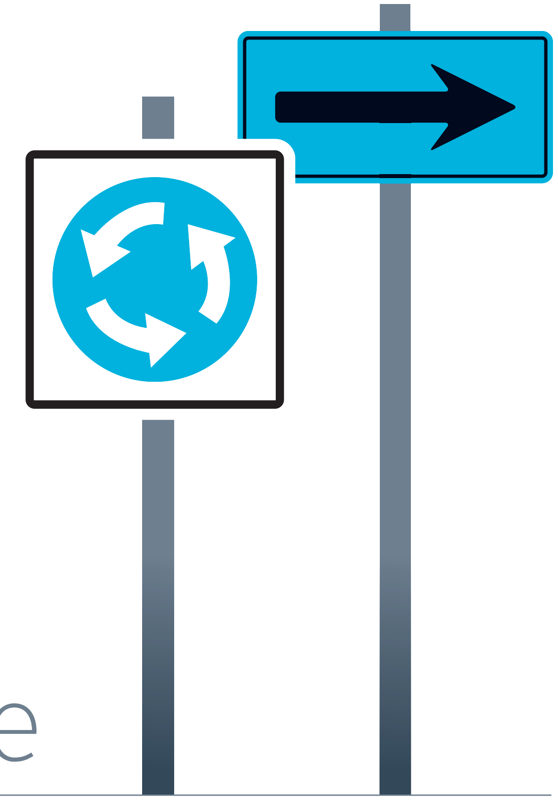
2 trillion

Investment for economic **growth**

Europe needs €2trn of investment in infrastructure by 2020, according to the European Commission. Meanwhile the European Investment Bank (EIB) estimates that the region needs to invest 3.6% of GDP, including into social infrastructure. **This investment is vital if Europe's economy is to continue to recover and be set on a path of sustained growth.**

- **But many sources of infrastructure investment have been in decline**, in particular since the financial crisis.
- Public expenditure on infrastructure in the EU currently stands at around just 1.25% of GDP, according to the EIB, with many EU countries having to restrict public spending in the face of concerns that their levels of debt have become unsustainably high. EU government debt to GDP was over 90% in 2015, up from 65% in 2007.
- This expenditure is well below historic averages and significantly less than is needed to meet Europe's future challenges.
- At the same time, **banks have had to rein in the kind of long-term lending necessary in infrastructure investment both to comply with new regulatory requirements** such as Basel III funding and liquidity ratios **and as a reflection of the increasing scarcity of capital**.
- The crisis also led to the **disappearance of monoline insurers**, which played a crucial role in lowering the cost of credit for infrastructure investment.

Some solutions



Improve existing infrastructure

With traditional sources of investment under severe strain, **Europe needs to focus not only on developing new infrastructure, but also on ensuring that existing assets are being used as efficiently as possible.**

A World Economic Forum paper[3] explains why:

"By optimizing existing capacity, Operations and Maintenance (O&M) best practice can reduce the need for new construction (and, in reducing the costs of existing infrastructure, it can also free up financial resources for new construction), O&M can ease current congestion far faster than new construction... With the vast existing infrastructure asset base worldwide, even a modest improvement in O&M will make a significant impact"

Infrastructure funds: part of the solution

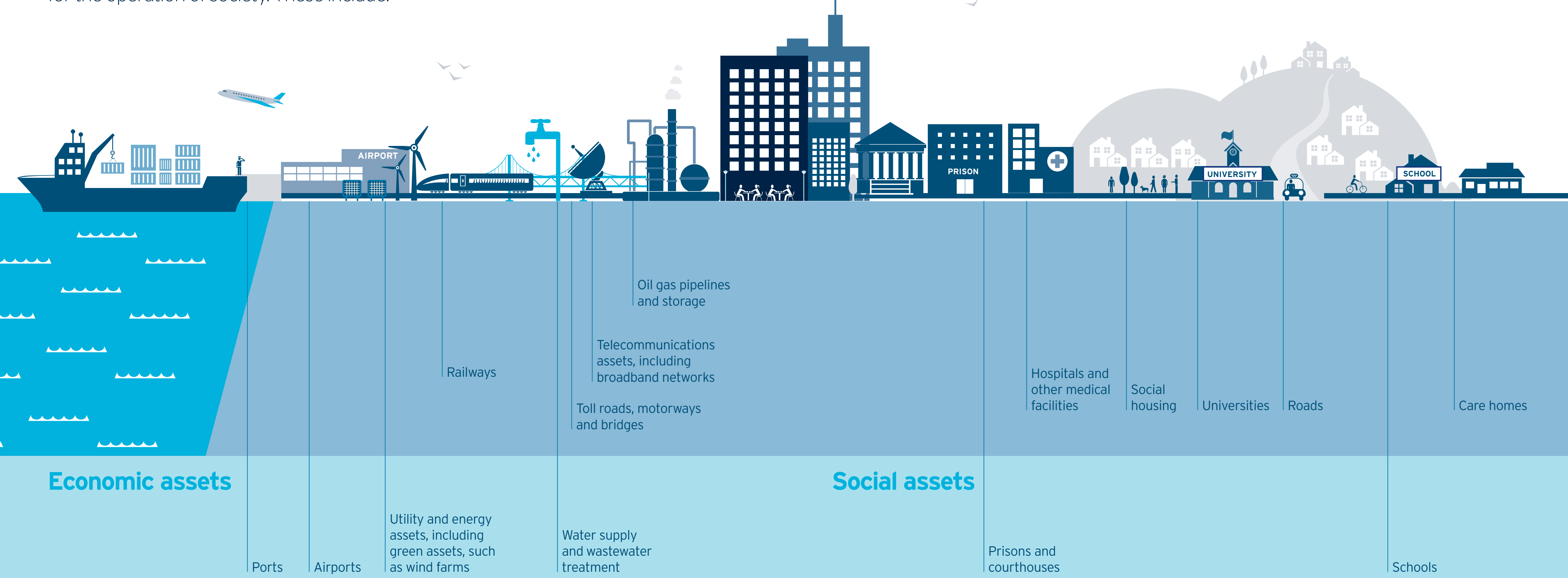
There is a clear need for alternative additional infrastructure finance providers if Europe is to maintain and improve its infrastructure. While the new European Fund for Strategic Investment will provide some of the necessary capital, Europe's funding needs stretch far beyond its current capacity for investment. As this report sets out, infrastructure fund investors, with their finance and expertise in improving the operations of existing assets, are a part of the solution. However, they can only help build Europe's future prosperity within a supportive regulatory environment.

The policy framework provided by the EU is vital to ensuring investors can commit to long-term investment funds and to creating a market that encourages investment in the assets and services that are essential to a well-functioning economy and society – infrastructure.

3 Strategic Infrastructure: Steps to Operate and Maintain Infrastructure Effectively and Efficiently, April 2014

What do **infrastructure investors do?**

Infrastructure investors provide capital and expertise to privately owned companies that run essential facilities, services and installations that are needed for the operation of society. These include:



How can infrastructure investors **help**?

"**Infrastructure funds have a vital role to play in improving existing infrastructure**. We know what best practice looks like and how to push it through so that energy plants, for example, can increase their efficiency through investments in technology and improvements to the way the operating companies are run."

Marc-Philippe Botte, Omnes Capital

There are **two main routes** for channelling private capital into infrastructure. **Funds** invest capital on behalf of institutional investors such as pension funds, insurance companies, family offices and sovereign wealth funds. Many of these institutional investors also invest directly into infrastructure companies, sometimes alongside funds as **co-investors**. Both channel much needed, long-term capital into private, unlisted companies that run infrastructure assets that have, or have the prospect of, strong, reliable, protected cash flows and significant opportunities for value creation.

More than capital – Benefits to infrastructure projects

- **Most infrastructure investors provide equity capital for infrastructure companies, meaning that they buy a share of the business, although some – around 10% of infrastructure funds – provide debt funding.**
- **They invest for the long term, typically 10-15 years, and in some cases for longer.**
- **These investors offer more than capital – they are a source of smart money, often taking seats on the companies' boards of directors, with the long-term goal of nurturing it, helping to foster growth and creating additional value.**
- **With their expertise in the sector, private capital providers can also ensure that assets are run in the most efficient way possible.**

Benefits

The benefits to Europe

This flow of funding and expertise helps Europe and its economy in a number of ways:

1

COMMITTED LONG-TERM FUNDING

The money invested provides long term funding to run and improve existing infrastructure such as airports, motorways, ports, telecommunication networks and energy or utility assets that are already operational (as in the case of most investments) or to build new, greenfield assets such as wind farms or solar parks.

2

A SOURCE OF STABLE RETURNS FOR INVESTORS

The investment provides a source of predictable, non-cyclical yield (stable, income-type returns), plus a return generated from the eventual sale of the company, to help fund long-term savings schemes such as retirement funds.

3

EUROPEAN COUNTRIES CAN MAKE BEST USE OF THEIR EXISTING INFRASTRUCTURE

This diminishes the need for costly investment in new projects and reduces public expenditure on maintaining current assets. As the World Economic Forum explains:

"Private-sector participation can improve O&M [operations and maintenance] by tapping the private sector's financial resources, as well as its skills in operating and maintaining infrastructure efficiently and effectively on a whole life-cycle cost basis. Many benefits tend to emerge, in efficiency and quality of operations, as well as in revenue and service innovation."

For instance, investment and operational improvements made at London City Airport included enlarging the departure lounge, increasing the number of aircraft stands for larger aircraft and improving co-operation with air traffic control. These measures contributed to an improvement in capacity from 32 to 38 air traffic movements per hour, allowing it to increase its annual air passenger numbers by over 650,000 between 2011 and 2014 to 3.65 million.

4

EUROPEAN CITIZENS BENEFIT FROM UPGRADED FACILITIES THAT ARE EFFICIENTLY RUN

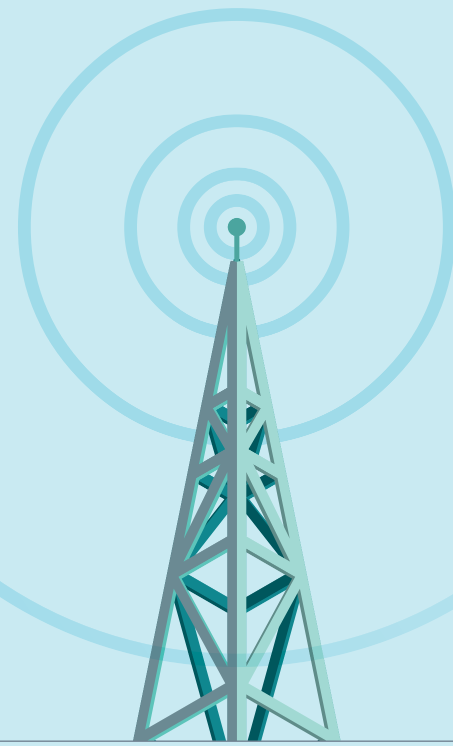
Whether this means greater access to public transport or road networks, better social housing or faster broadband access, the capital and expertise provided by infrastructure funds can improve the daily lives of Europeans as well as their personal economic prospects.

Infrastructure funds:

A **growing** Industry

While infrastructure funds have been around for decades, they emerged as a specific asset class for investors in the 2000s and in recent years these funds have grown rapidly in size and number to meet the increasing demand for private infrastructure investment and the growing desire from investors to get access to such opportunities.

- **Estimates by data information provider InfraDeals suggest that the annual number of deals worldwide now exceeds 1,200, of which a considerable proportion (45%) are in Europe.**
- **Funds targeting Europe have over €167bn of capital under management.**
- **Furthermore, 83% of capital raised for infrastructure funds globally has been raised since 2008. The amount raised remains small relative to the size of the infrastructure market. Funds therefore have huge growth potential over the coming years – provided they find a stable and supportive regulatory environment in Europe.**
- **They represent a growing pool of patient and expert capital that can be deployed to improve Europe's infrastructure and therefore the region's growth prospects.**
- **They play a particularly important role at a time when other sources of funding, such as public investment and bank loans may not be available.**



Increasing capacity:

A report by McKinsey Global Institute[1] states:

"Rather than investing in costly new projects, governments can address some infrastructure needs by getting more out of existing capacity. Our work with asset operators around the world has consistently demonstrated the potential for operational improvements to extract more capacity from existing assets, particularly in transport. More efficient use of rolling stock can boost the capacity of rail freight operations by 10 to 20%, for instance. More efficient terminal operations can increase the traffic capacity of seaports by 20 to 30%. Advanced air traffic control technology is allowing more take-offs and landings without adding runways at airports such as London's Heathrow."

Case Study:

Growing a French telecom towers business

When Antin Infrastructure bought a portfolio of French telecoms towers from Bouygues Telecom in 2012, the assets were not being used to full capacity. However, Antin spotted that the towers had good growth potential and following investment, created France's first independent telecom tower company, FPS Towers.

Antin put in place a new, experienced and high calibre management team, and set about supporting the team to improve the towers' efficiency through cost-saving initiatives, buying land plots and renegotiating rents and contract extensions. While maintaining a long-term contract with former parent, Bouygues Telecom, the company also signed a new contract with Free Mobile to provide towers to support its growth and attracted Sigfox as a new client. The investor also provided support and finance to FPS Towers to expand its rooftop site business, which has grown from 3,000 sites to 18,000 in 2015.

Antin has since acquired the whole FPS Towers business and since the original investment, has created nearly 70 jobs, and nearly doubled the company's revenues between 2012 and 2015, an annual growth rate of more than 30% and Europe's fastest growing Tower company.

Infrastructure funds
Key facts

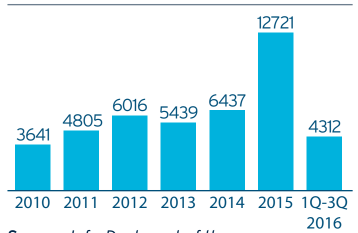
€2 trn

The amount of investment needed in European infrastructure by **2020**, according to the European Commission.

>€600 bn

The **annual spend** needed to keep Europe competitive, according to the European Investment Bank.

Infrastructure Fund Investments in Europe
Deployed Equity (€m)



Source: *InfraDeals part of the Inframation Group*

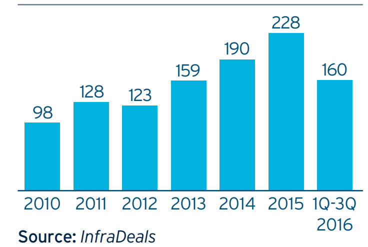
54%

The proportion of renewable energy infrastructure deals completed between 2008 and 2014 that were in Europe. This reflects the important role infrastructure investors play in helping the EU meet its aim of becoming a low carbon economy.

$400 bn

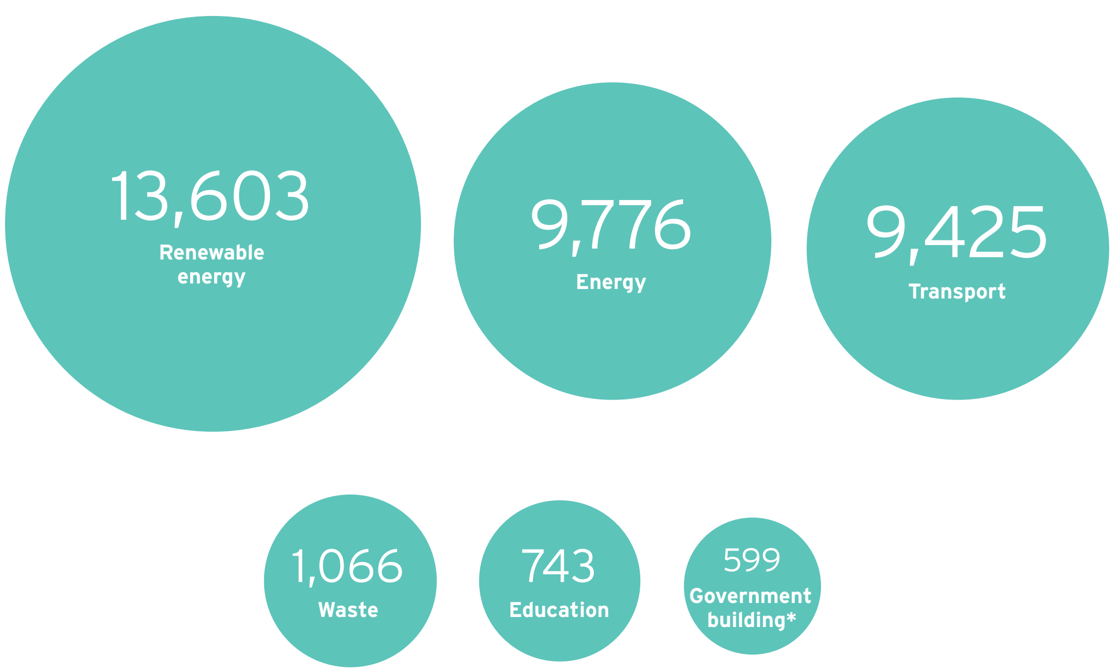
The amount of annual global investment that could be saved by making better use of existing assets, according to the McKinsey Global Institute. This translates into 15% of the investment that is needed each year to maintain projected global growth.

Infrastructure Fund Investments in Europe:
Number of deals



Source: *InfraDeals*

Total equity invested in Europe by sector 2010 – Q3 2016 (€M)



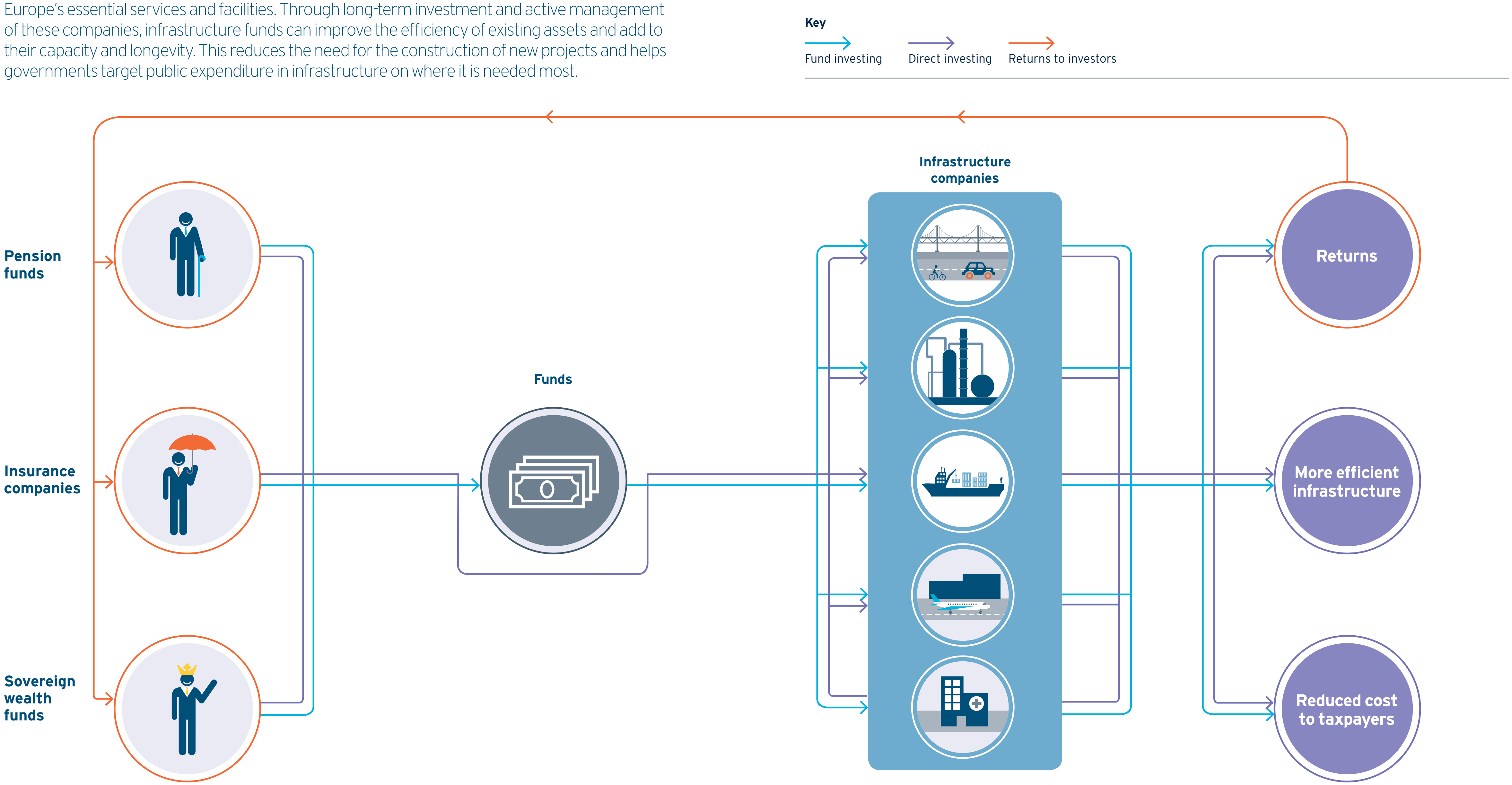
- Between 2010 and Q3 2016, infrastructure funds **invested total equity of €39bn in European infrastructure deals**
- By sector, **renewable energy deals** attracted the largest amount of capital from infrastructure funds, demonstrating their importance to Europe's ambition to become a low-carbon economy. Combined, renewable energy and energy deals accounted for nearly half of equity invested by infrastructure funds
- Since 2010, infrastructure funds have invested over €9bn in another of the EU's priority areas – transport

* Includes Accommodation, Leisure, Prisons & Social Housing
** Includes Utilities & Water Treatment concessions
Source: *InfraDeals*

Keeping Europe **moving**

How infrastructure funds work

Infrastructure funds provide vital long-term funding and expertise to private companies that operate Europe's essential services and facilities. Through long-term investment and active management of these companies, infrastructure funds can improve the efficiency of existing assets and add to their capacity and longevity. This reduces the need for the construction of new projects and helps governments target public expenditure in infrastructure on where it is needed most.



What do **infrastructure investors need**?

If Europe is to be an attractive destination for infrastructure investment, there needs to be a stable regulatory framework within which investors can operate. It needs to take account of the long-term nature of infrastructure investments. Barriers to institutional investment in funds should be removed in order to increase the flow of capital directed towards helping European infrastructure become world-class.

A recent OECD paper[4] highlights:

"**Increasing** private participation in infrastructure investment requires an investment regime that provides **clarity** and **predictability** for investors."

Policy action points

Long-term guidelines

Background:

The long-term horizons of infrastructure investors mean they need some degree of comfort that the assumptions they make at the outset of an investment will remain largely true in 10 or 15 years' time. Without this, investors cannot predict with enough certainty the costs and returns that are essential to developing a business case for investment. Uncertainty is inherent in making investments over the long term but if public policy, such as regulation or tax adds additional unpredictability, this makes private participation in infrastructure investment more expensive – investors need to achieve higher returns to compensate for added risk. One area of particular concern is the **fees and tariffs** that assets may attract, which have been **subject to** significant revision in the past – **sometimes retroactively** – eroding investment returns and investor confidence in some European markets.

In addition, many projects have suffered from lengthy implementation periods, complex tender processes and there is a lack of transparency in many member states about future infrastructure projects, making it hard for infrastructure funds to predict deal flow and attract necessary resources.

To do:

Promote fee and tariff transparency and provide EU-wide guidelines on compensation packages in the event of change.

> This would provide assurance to investors around expected fee and tariff levels during their investment period, enabling them to invest capital in more assets that are currently considered at too great a risk of change.

Provide guidance on how procurement and tender processes should work and increase transparency about future projects.

> This should help improve the efficiency and speed of processes – leading to greater investor interest – as well as help funds allocate investment capital and resources according to a more visible and predictable deal flow.

Ensure the pan-European Project Pipeline is based on high quality data.

> This European Commission and European Investment Bank initiative to collect and make available information on upcoming projects in member states in a centralised hub is a welcome development and should take account of infrastructure investors' needs by including accurate information on timelines, project details and risk and return profiles of investment opportunities.

Encouraging investors to commit capital to long-term investments

Background:

Many regulatory changes governing pension funds (IORP), insurance companies (Solvency II) and banks (CRD IV and CRR) that have been implemented since the crisis have understandably focused on risk management. However, in some instances, the proposed approaches have **made it harder for these institutional investors to commit to long-term investments** in unlisted assets largely because they require investors to hold additional capital when they have exposure to private funds such as infrastructure. Any further legislation should be calibrated to avoid any further limitations to investments in infrastructure and other long-term, private funds, such as private equity. In addition, given the need for infrastructure funding in Europe, incentives could be put in place to encourage investment in infrastructure, including in the companies operating existing infrastructure assets.

To do:

Extend the EU definition of infrastructure for solvency requirements under Solvency II to include infrastructure corporates.

> The Commission's decision to allow infrastructure fund investments to benefit from a 30% risk weight, provided they meet the definition of an "infrastructure project entity", is a welcome move. However, the treatment of infrastructure corporates is still under discussion as investments in these entities is currently considered to be outside the scope of of this definition. If investors are not to face limitations on the type of infrastructure investments they can make, infrastructure corporates and funds should also attract a lower risk weight.

Ensure that a supervisory framework for pension funds does not discourage investment in long-term investments such as infrastructure.

> Any future changes to the IORP Directive should not propose Solvency II-style capital requirements as this may discourage pension funds from investing in the asset class.

4 OECD: Fostering Investment in Infrastructure, January 2015

Catalysing private investment from non-EU fund managers

As we've outlined, public funds available to invest in infrastructure are on the decline. There is therefore a real need for Europe to attract private sources of capital to invest in improving the region's infrastructure – wherever it may come from around the world.

While many infrastructure funds are based in Europe, around half are based outside the European Union. Many of these overseas funds have raised capital on the basis that some will be invested in the EU – they therefore have a vital role to play in helping boost European growth. Between 2010 and 2014, for example, €7.6bn of the €26.3bn invested by funds and institutional investors in European infrastructure came from non-EU investors[5]. Most of these funds also attract capital from European institutional investors and provide returns to European savers.

The marketing passport provided for under the European Alternative Investment Fund Manager's Directive enables EU-based (AIFMD-compliant) managers to raise capital from investors across Europe, yet there is so far no comparable regime for many non-EU fund managers. This potentially restricts the amount of capital available for investment in European infrastructure and the investment options available to European institutional investors.

In addition, many Europe-based funds invest on a cross-border basis. Barriers hampering international investment in European infrastructure assets should be removed and fair competition policies in member states encouraged if Europe is to be an attractive destination for capital.

Case Study:

Bringing affordable natural gas to more Spanish consumers

Redexis Gas is the second largest transmitter and fourth largest distributor of gas in Spain. It provides residential and industrial customers with access to an affordable and secure source of energy. The company operates in regions with gas penetration below the Spanish and European averages (estimated to be 28% and 46%, respectively), providing an attractive opportunity for growth.

Affiliates of two GS Infrastructure Partners II funds and certain co-investors acquired Redexis Gas in 2010 from Endesa, S.A., Spain's largest electric utility company. With GS Infrastructure Partners' support and a new management team, the company has invested over €700m in Spanish natural gas infrastructure over the past five years, developed new award-winning technology and generated over 290 direct and 2,000 indirect jobs.

Since 2010, Redexis Gas has almost doubled the size of its transmission and distribution network to approximately 8,700 kilometres and tripled the number of municipalities served to over 550. Gas is now available in areas with over five million inhabitants[6]. The company has grown its number of connection points faster than the sector average by focusing on efficient investments and by strengthening its commercial efforts.

5 **Source:** *InfraDeals data*
6 Proforma for the acquisition of 71,530 LPG connection points from Repsol announced on 30 September 2015.

Policy action points

Tax agenda

Background:
The Financial Transaction Tax (FTT) was proposed in the aftermath of the economic crisis as a punitive measure and a revenue-raiser by taxing the financial industry. The OECD work on Base Erosion and Profit Shifting (BEPS) was largely born out of the need to modernise tax rules in an increasingly global economy. Both work-streams have the potential to significantly impact on the cost of doing business for infrastructure funds if the final rules are not proportionate and unintended consequences are not avoided.

To do:
Create tax regimes and policies that do not allow tax avoidance mechanisms but that also foster European institutional investment into infrastructure funds.

- Ensure that any new tax rules respect the neutrality of infrastructure funds as a capital-channelling vehicle and do not impose additional costs/burdens on them. Specifically, investors into infrastructure funds should not be worse off by choosing to invest via that fund compared with investing directly in the same asset.

AIFMD: Allow third-country marketing access

Background:
The AIFMD, implemented in July 2013, allows EU-based managers to market funds to European institutional investors under a passporting system. The EC sought advice from ESMA, which concluded that there were no obstacles to extending the passport to fund managers based in a group of third-country jurisdictions.

Well developed passporting arrangements should encourage more fund managers to operate in a wider range of jurisdictions by lowering the costs of accessing those markets. This, in turn, promotes competition between fund managers and increases the diversity of options from which investors can choose, assisting them both in achieving returns and in managing risk.

To do:
Create a third-country passporting regime that allows European investors access to non-EU funds.

- Extend the marketing passport to third-country managers, on the proviso that its requirements are introduced in a proportionate and practical way, and its availability does not jeopardise the continuation of the national private placement regimes. The third country passport should be considered a complement to, and not a replacement for these national regimes.

Investment-friendly sector rules: the case of energy unbundling

Background:
Competition policy has an important role to play in encouraging private infrastructure fund investment. While moves to break up vertical monopolies in certain sectors are to be welcomed, care needs to be taken to ensure that fund investment is not discouraged. The energy sector is an example. The EC is currently working to create a single energy market across the EU to help address concerns around energy security and to increase competition. The effort at harmonisation across member states is to be welcomed as it reduces the complexity of investing in cross-border energy infrastructure assets. The unbundling of energy supply and generation from the transmission networks should provide investment opportunities for infrastructure funds, but the current stipulation that minority owners of energy supply and generation cannot hold stakes in transmission networks will limit funds' investment capability in the sector.

To do:
Ensure that unbundling rules do not prevent infrastructure investments.

- To make clear that infrastructure funds can invest in portfolios of assets that contain both supply/generation and transmission assets, provided that EU competition rules are met and provided that there is no conflict of interest.

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Invest Europe is the **voice of investors** in privately-held companies in Europe.

If Europe is to find the €2trn it needs for investment in vital infrastructure, private investment must be encouraged through the creation of an environment where funds and institutional investors do not face unnecessary barriers to providing capital and expertise. They need:

1. Stability, predictability and transparency around fees and tariffs
2. A regulatory framework under Solvency II that includes infrastructure corporates in the scope of a lower risk weighting
3. No Solvency II-style requirements for pension funds under the IORP Directive
4. Tax rules under FTT and BEPs that respect the neutrality of infrastructure funds as a vehicle to channel capital
5. The establishment of a regime that enables non-EU fund managers and smaller managers to raise capital from Europe's institutional investors without burdensome and costly requirements
6. Investment-friendly sector rules that encourage the flow of private sector capital into Europe's infrastructure companies

By creating the right conditions for investment, Europe's citizens will benefit from world-class infrastructure through a growing economy, increased employment opportunities through job creation and improved access to social and economic assets, making the region more competitive on a global stage.

For more details

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