

Morgan Lewis

collaborate  
Infrastructure Investments

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**Louis Singer**  
**Georgette Schaefer**  
**Jonathan Morris**  
**Richard Zarin**

[www.morganlewis.com](http://www.morganlewis.com)

# Introduction

- Infrastructure Investment Programs: Definitions and Coverage
- Means of Investing in Infrastructure
  - *Direct Investments*
  - *Fund Investments*
  - *Listed Funds*
- The Market: Needs and Opportunities

# Structure

- Use of closed-end private equity fund model
- Asset Class still in early stages
  - 10 – 15 years behind private equity
- Longer term investment fund structure needed
- Exits not primary method for generating returns
- Stable cash flow
- Buy and Hold strategy - Long term nature of assets and associated contracts
- Public – Private Partnership (PPP) v. Privatization

# Fees and Expenses

- Fee generation similar to Real Estate Funds
  - Fund sponsor/affiliates provide services to the Fund for fees not offset against the Management Fee
- Capital intensive; High initial capital outlays
- Should there be lower fees upfront with more to sponsor based upon the returns (returns lower but more stable than private equity)

# Issue

- Fees paid to affiliates should not be included in capital under management for calculation of Management Fee
- Agree upon type of services to be provided and schedule of fees up-front
  - Acquisition fees; transaction fees; due diligence fees; financing fees; development fees

# Investment Period and Investment Purpose

- Investment Period tends to be shorter: Two – Three Years
- Fund Terms tend to be longer
- Not unusual to see a 20 year term due to the nature of the assets which have a long life-span
- Focus on purpose clause and investment restrictions

# High Use of Leverage

- Like LBO and Real Estate Funds, use of leverage is very high
- Financing sources are critical to Infrastructure Funds
- In current credit environment it is more likely that an infrastructure deal will get done than an LBO deal
- Predictable cash flow and historical information important for debt repayment
- Capital crunch validation of infrastructure as an asset class – values generally maintained

# Issue – Credit Facility Requirements for Investors

- Investor Acknowledgements
- Guarantee of payments
- Pledging of interests – security interests in the investor's interest; UCC Financing Statements
- Opinions of counsel
- Power of Attorney
- Catch-all provisions

# Realizations and Achieving Liquidity

- Highly illiquid
- Longer time for exits due to nature of assets
- Durable assets with steady cash flows
- IPOs

# Issues

- Must make sure fund documents work correctly for possible IPO.
- Focus on proper termination of LP “giveback” provisions; Investor obligations, indemnifications
- Investors will hold publicly traded securities or be cashed out
- Valuation and pricing issues
- Investor approval

# Sponsor Option to Purchase Assets

- Independent third party valuation
- Responsibility for fees and expenses
- Sponsor obligation to widely market the portfolio before having the option to purchase

# Termination and Dissolution Rights

- Institutional Type Funds: key person and no-fault divorce protections may be difficult to achieve
- Focus on other remedies such as removal/replacement for cause rights.

# Valuations

- Typically less volatile assets
- Cash flow more predictable; historical performance available
- Assets typically valued by third parties, with the asset then carrying that valuation until its next appraisal (unlike Private Equity funds)
- Valuation of assets can be complicated and expensive; Pricing issues

# Reports/Transparency

- Replacement of the public service provider with private enterprise for services that are critical to the public and leads to greater public scrutiny
- Transparency a greater issue
- Books, records and reports

# What Are The Basic Opportunities for Infrastructure Investments?

- Brownfield Investments
  - Existing Assets
  - Performance History/Predictable Returns
  - Developed Markets
  - Established Legal, Political and Regulatory Framework
- Greenfield Investments
  - New Assets
  - Greater Capital Needs
  - Undeveloped Markets
  - Higher Return/Higher Risk

# What Are The Unique Attributes of Transactions to Acquire Infrastructure Assets?

- How are the economics different?
- Regulatory Matters
  - Regulation at the national, state, local and quasi-governmental (e.g., public authorities) levels
  - Consents
  - Regulators are seeking long term partners that will invest in the assets
  - Consent process can be a lengthy process

# What Are The Unique Attributes of Transactions to Acquire Infrastructure Assets? (cont.)

- Impact of consent process
  - Operation of business during interim period
  - CapEx during interim period
  - Efforts to obtain consents
  - Termination
- CFIUS
  - Critical Infrastructure Assets
  - Energy Assets

# What Are The Unique Attributes of Transactions to Acquire Infrastructure Assets? (cont.)

- Financing Acquisitions
  - Predictable cash flow
  - Tangible assets
- Due Diligence
  - Engineering
  - Regulatory
  - Political
  - Environmental
  - Contractual
  - Liquidity

# What Are the Unique Attributes of Owning Infrastructure Assets?

- Capital Expenditures
- Rate Increases
- Risk of Ownership

# Words of Caution

- The next bubble?
- Managers
- Expansion of definition of Asset Class

# Overview—Investor-Related Tax Issues

- Fund structures similar to private equity or real estate fund models
- US taxpayer investors
  - Typically includes principals or managers of US-based fund
- US tax-exempt investors
  - Concern regarding unrelated business taxable income (“UBTI”), including from debt-financed income
  - Government pension plans
- Non-US investors
  - Concerns regarding US trade or business effectively connected income (“ECI”) and income subject to US withholding tax
  - Tax haven
  - Treaty eligible

# FIRPTA

- Significant proportion of US infrastructure investments likely to include equity rights in US real property
- US tax concern for non-US investors, who are taxed on gains from sale of US real property assets, including US real property holding corporations (“USRPHCs”), under the Foreign Investment in Real Property Tax Act (“FIRPTA”) rules.
- Tax structuring alternatives include holding interests through a US blocker corporation, or in some circumstances through a non-US partnership that checks the box to be treated as a corporation for US tax purposes.

# Operating LLC or Partnership

- Potential for passing through tax benefits for US taxpayer investors, and eliminating second level of dividend tax.
- UBTI concerns for US tax-exempt and ECI concerns for non-US investors
- Use of alternative investment vehicle and blocker structures
  - Possible other planning opportunities—warrants, options, notes, derivatives
- Publicly traded partnership
  - Mix of passive assets and income may make this a possible exit.

# Overview—Investment-Related Tax Issues

- Capitalization, deduction and depreciation
- Structure—corporation, partnership (LLC) or contractual arrangement
- Leverage

# Depreciation and Capitalization

- Newly constructed or improved assets may provide opportunities for current deduction, or tax depreciation over time, of costs.
- Acquired assets may provide similar opportunities, as well as the opportunity to deduct intangible assets (e.g., licenses, permits).
- Rules regarding timing and amount of deduction, versus capitalization, of costs, are complex, and tax consequences can be significant.

# Leverage

- Adds potentially significant interest deductions.
- Concern for US tax-exempt investors subject to tax on unrelated business taxable income (“UBTI”), including debt-financed income.
- “Fractions” rule provides the potential for structuring leveraged real estate investments in a manner that does not result in UBTI, but rules are difficult to comply with.
- Customary non-US blocker corporation approach raises concern, noted above, regarding FIRPTA.

## Leverage (cont.)

- Potential for tax-exempt municipal bond financing.
- Potential mix of debt and equity investment by investors.
  - Debt-equity concerns.
  - Potential US withholding tax on cross-border interest payments, to the extent not treaty-eligible or portfolio interest.

# Non-Income Tax

- Transfer tax (e.g., real property recording tax) on sale
- Real estate tax abatements, other local inducements

# Alternative Transactions

- Sale leaseback
- Contractual arrangements
- Derivatives

# Non-US Investments

- Non-US withholding on dividends or interest
- Income or gains tax on sale
- Treaty eligibility issues
- Use of treaty blockers
- Permanent establishment
- Transfer pricing

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# Contact Information

- Louis Singer
  - [212.309.6603](tel:212.309.6603); [lsinger@morganlewis.com](mailto:lsinger@morganlewis.com)
- Georgette Schaefer
  - [212.309.6607](tel:212.309.6607); [gschaefer@morganlewis.com](mailto:gschaefer@morganlewis.com)
- Jonathan Morris
  - [212.309.6636](tel:212.309.6636); [jmorris@morganlewis.com](mailto:jmorris@morganlewis.com)
- Richard Zarin
  - [212.309.6879](tel:212.309.6879); [rzarin@morganlewis.com](mailto:rzarin@morganlewis.com)