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Claire has also gained experience in Structured Finance in Institutional Banking at Commonwealth Bank, looking at cross-border tax financing opportunities, as well as a Senior Tax Consultant at PricewaterhouseCoopers specialising in corporate tax and financial services. Claire holds a Bachelor of Commerce (Accounting & Finance) from Monash University and a Graduate Diploma with the Institute of Chartered Accountants Australia (ICAA).



Anne Osborn (née Kuleshova)

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Anne Osborn is a member of the Infrastructure Research Team and

the Private Equity Research Team, as well as a member of the Direct Investments Unit. Since joining JANA in 2014, Anne has been conducting research on domestic and overseas investment managers across infrastructure and private equity. In addition, Anne's responsibilities include conducting due diligence on direct unlisted investments.

Before joining JANA, Anne worked in Mergers and Acquisitions (M&A) at Macquarie Capital and in M&A and Valuation at Deloitte Corporate Finance. Anne holds a Bachelor of Commerce (majoring in Actuarial Studies) (Honours) from the University of Melbourne, and is a Fellow of FINSIA.

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DEVELOPING TRENDS IN INFRASTRUCTURE INVESTMENT

JANA's Infrastructure Research team recently completed a research trip to Europe and the US. Our objective was to explore several themes developing in the infrastructure space, including:

- Demand for infrastructure is at an all-time high despite infrastructure looking expensive, why is this so and what do we need to consider when investing in this market?
- Is Trump's pro-infrastructure mandate likely to open the flood gates for private capital investment, including for Australian investors?
- What markets present the best opportunities for infrastructure investments?

Infrastructure allocations: a wall of capital

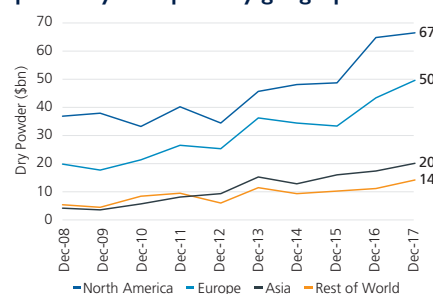
Demand for infrastructure is at an all-time high, buoyed by the search for yield and increased allocations to the asset class as investors become more familiar with this relatively 'new' asset class. Many of JANA's clients who have been early investors in infrastructure have benefitted from strong returns off the back of global demand for real assets and the compression in discount rates as bond yields have fallen.

The weight of capital looking for a home in infrastructure is significant. Preqin¹ note that in the US alone, the majority of US-based institutions allocate a comparatively small proportion of the total assets to infrastructure; with 76% of institutional investors holding less than 5%. Additionally, two-thirds of US investors remain underweight compared to their target allocations, indicating additional capital is likely to flow into the market as opportunities are identified.

At the same time, 'dry powder' held by infrastructure funds is at an all-time high since the Global Financial Crisis (GFC) and is estimated to be around US\$150 billion (Chart 1).

Early investors in infrastructure have benefitted from the recent strong returns off the back of global demand for real assets and the compression in discount rates as bond yields have fallen.

Chart 1: Unlisted infrastructure dry power by fund primary geographic focus



Source: Preqin Infrastructure Online.

In addition to the demand from infrastructure funds, 'direct investing' by large sovereign wealth funds and institutional investors ('Directs'), is also on the rise. Directs will typically target core, traditional infrastructure often through an auction process. Given the sheer weight of capital able to be deployed by Directs, pricing in the core space has now become very expensive, with levered returns quoted as low as 6-7% per annum.

As a result, infrastructure funds that have traditionally been active in the core sector, are avoiding competing against Directs, and instead are often targeting markets and assets that provide 'complexity' in an effort to limit competition and achieve a more attractive risk-adjusted return. This dynamic has increasingly pushed asset managers into riskier, more complex assets, that often require a private-equity or transformational style of investing to de-risk and/or optimise the returns.

¹ Preqin is a global data provider for alternative investments.

Trends in the infrastructure market: the risks and complexities for investors

In an environment where investors continue to stretch and squeeze for superior returns, they often accept greater risk to achieve these returns, all the while reducing the margin of safety if something goes wrong.

The following section explores some of the trends JANA is observing in the current market that pose potential risks for investors:

Style drift

Within the infrastructure spectrum, there have always been managers that operate 'at the edge', employing a more private equity style of investing. These managers target 'riskier' assets and in return seek much higher returns.

Such managers are very well equipped to undertake this style of investing with established practices, networks, intellectual property and a very strong emphasis on asset management. However, the investment vehicles including fees are often more closely aligned to private equity than core infrastructure.

Nonetheless, for managers that have historically operated in the core infrastructure space, the gravitation to the more core-plus to private equity style of assets, which is in some instances outside their core area of competency, poses risks for investors.

While we have observed a significant shift in the importance of asset management, and noted the influx of industry experts over investment bankers to bolster the asset management ranks, there will no doubt be mistakes made. For investors, understanding the skillset of the manager, their strategic advantage, the discipline and the depth of due-diligence will help mitigate some of these risks.

Pricing

In the current market, it seems new price records are being set and broken on a regular basis. For example, last year London City Airport sold at GBP 2 billion which was estimated to equate to around 30 times earnings before interest, taxes, depreciation and amortisation (EBITDA); whereas ten years prior in 2006, the airport traded for GBP 750 million, and prior to that in 1995 the asset was sold for just GBP 24 million, according to Financial Times. Such lofty valuations often leave investors scratching their head and wondering 'what was in their business plan?'

The almighty business plan

The business plan, quite simply, is the plan of how the business will achieve its goals and ultimately deliver investors the stated return objective. In such a competitive environment, where due diligence costs can be eye-watering, losing bids by a small margin can hurt.

Hence being creative and finding value where others can't, may mean you can justify paying a higher price to win the bid. The risk is that you overreach. No-one has a crystal ball and assumptions must be made, but in a pro-risk environment, with significant demand pressures, the temptation to present an overly optimistic business case is heightened. Examples may include, assumptions on the outcome of major contract renewals, development approvals, a change in regulation or that interest rates will remain low for an extended period.

Making heroic assumptions in business plans, without adequate downside protection, leaves very little room for error and can very quickly result in poor performance being locked in.

New worlds

In the search for strong returns, new frontiers have been explored for investment, including Eastern Europe, South America and Asia. In addition to new geographies, new sectors such as battery storage, data centres, fibre, and decentralised energy are also being considered.

Investors in the infrastructure space can be rewarded by being first-movers as has been the case with some assets we see in portfolios today such as the Australian airports. Nonetheless, new assets and peripheral markets can present risks that require detailed due-diligence and the pursuit of prices that appropriately reflect the additional risk.

Interest rate risk

There is a real risk that investors are becoming complacent about the potential for interest rates to normalise, as is evidenced by the fact that some investors are bidding very aggressively on infrastructure assets. If interest rates rise, the market will apply a higher discount rate, which may lead to a fall in the valuation of the asset.



Source: snbchf.com/swissgold/incrementum-chartbook-gold-bulls/

Debt pricing in the current cycle is incredibly low and well below historical averages. Investors need to ensure longer-term assumptions relating to refinancing take into account historical long-term pricing, as opposed to assuming that the current low interest rate environment will continue.

That said, financial leverage has been more conservative in the period following the GFC, and many managers have secured long-term debt, which provides some protection.



Trump's US\$1 trillion infrastructure plan: a long road ahead?

During our research trip, one area we were keen to explore is whether the US was going to present meaningful investment opportunities off the back of President Trump's ambitious US\$1 trillion infrastructure plan.

However, there remains a long road ahead for any significant infrastructure reforms that could translate to meaningful investment opportunities, as discussed below.



President Trump holding up the Permitting Process Flowchart for a Federally-Funded Highway Project in the U.S. Photo by John Angelillo/UPI

Building bridges between Republicans and Democrats

Any policy consensus between Democrats and Republicans on the scope of the initiatives is likely to take some time to reach, and the scale of any programmes may not be as ambitious as envisaged by the President.

Although much has been reported in the Australian press regarding the US potentially privatising assets, the US Federal Government is heavily reliant on the individual States to undertake privatisation, as most infrastructure assets are owned by the States.

New infrastructure investment opportunities are constrained by a lack of political will. It will require strong leadership from local governors and mayors to take on the task of promoting the long-term benefits of privatisations, which in some cases may not be realised for a number of electoral terms.

Municipal bond markets and financing

At the same time, the municipal bond markets are available to fund government-backed projects and remain the most competitive form of funding. For equity to compete, a more level playing field would need to be established.

Legislative agenda and policy detail

Finally, infrastructure reforms remain behind other policies on the legislative agenda, such as President Trump's attempts to repeal 'Obamacare' and introduce tax reforms. The lack of policy detail can, in part, be attributed to the lack of undersecretaries to work out the policy design, predominantly due to President Trump being slow to nominate for positions, with 114 of 210 positions vacant across the various agencies as of 20 July 2017.

Overall, in the short- to medium-term, meaningful privatisations seem a long way off, and the investment opportunities in the US continue to be dominated by energy sectors, which are subject to very competitive bidding.

Europe and the UK: Open for business

Compared to the US, Europe and the UK continue to present a relatively deep market of opportunities both in terms of sectors and deal sizes. Governments continue to privatise assets and corporates continue to sell down non-core assets. In addition, first generation closed-ended infrastructure funds continue to sell assets.

Utilities continue to present a strong pipeline of opportunities, as do airports and toll roads. Energy security is a key concern across the UK and Europe, with reliance on imported gas, predominantly from Russia, presenting some opportunities in midstream gas assets.

Although there is a relatively broad set of opportunities in Europe, pricing remains competitive, and there are no 'bargains' in either the large-cap and mid-cap space. As a result, some managers are becoming more sophisticated in terms of developing and implementing business plans for new acquisitions, although there remains a range of capabilities and competencies amongst managers.



Source: <https://www.reuters.com/article/us-germany-russia-crisis-insight-idUSBREA2J15720140320>

Conclusion

In an environment where we continue to stretch and squeeze for superior returns, we often accept greater risk to achieve these returns, all the while reducing the margin of safety if something goes wrong. JANA considers the fundamentals relating to the underlying assets within the infrastructure asset class are generally stable, however considers investors need to exercise caution.

Investment discipline and extensive due diligence of the assets becomes increasingly important when the prices of many infrastructure opportunities appear extended. In addition, a detailed and in-depth knowledge of infrastructure managers' activities over time can provide important insights into how they assess and price risk, as well as their ability to navigate and evolve in the current market.

From a global perspective, Europe presents a relatively deep market of opportunities but it also underscores the challenge of investing in infrastructure assets when facing 'stretched' valuations. European markets are not immune from the competitive pricing that exists globally and investors need to continue to be vigilant as managers are increasingly seeking more risky investment opportunities in pursuit of returns.

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