

# MyConsultant

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## Consultant

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## Superannuation funds and direct investing

Investing directly into “real” assets such as property and infrastructure is becoming increasingly prevalent amongst Australian superannuation funds. But why, with the breadth of strong managers and quality, well diversified portfolios available in the market today, are funds employing this strategy? In this article we explore the evolution of investing directly into real assets, and why many larger funds are now choosing to do so. We also look at some of the key factors that funds should consider before venturing into the world of “direct investing”.

The confluence of rising markets, continued inflows of funds via mandated contributions, and aggregation of superannuation funds as one of the consequences of growing scale pressures, has led to a substantial increase in the size of the average fund, but with correspondingly fewer entities. With size has come the natural desire to have a greater say in investment outcomes. This has led to many large superannuation funds switching their approach for some asset classes from investing via pooled vehicles to one of investing directly in individual assets.

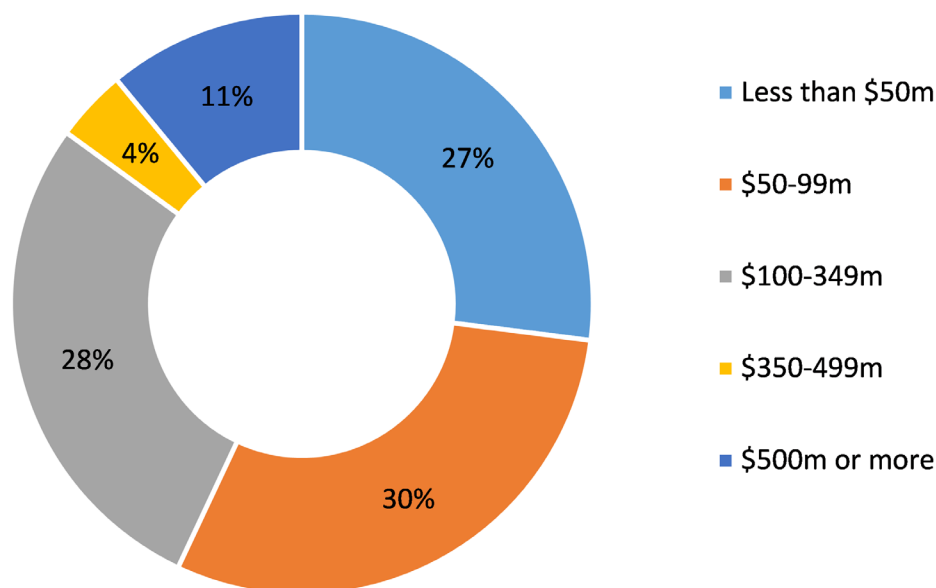
But before we look at the benefits of investing directly in assets, and why some funds may undertake this strategy, what exactly do we mean by “direct investing”? In its strictest sense, direct investing is simply the by-passing of a pooled vehicle managed by an investment specialist, and investing directly in a company, entity or asset itself. Whilst direct investing could be classified as any investment from a minority share in a listed company to a wholly-owned acquisition of a private company, we tend to associate direct investing, particularly for the majority of Australian superannuation funds, as investments into real assets, predominantly property and infrastructure, where some degree of control or influence over the asset can be achieved.

Direct investing is not a new concept, particularly amongst offshore pension funds. Notably, Canadian pension funds have been investing directly in real assets for a number

of years. The reasons for this are two-fold. The first is the sheer size of Canada’s pension funds, with the two largest funds, Canada Pension Plan and Caisse de dépôt et placement du Québec, each having approximately C\$200 billion (approximately A\$194 billion) of assets under management. The other reason is that Canada’s pension funds tend to have greater allocations to real assets, such as infrastructure, compared with other pension funds. By way of example, one of Canada’s largest pension funds, the Ontario Municipal Employees Retirement System with assets under management of C\$65 billion (approximately A\$63 billion), is reported to have an allocation to infrastructure of 20% of total assets.

It is not only the Canadian pension funds that are writing large equity cheques for real assets. Funds from some of the largest pension systems in the world such as the US, UK, Netherlands and Australia are also investing directly into real assets, and this is a trend which seems set to continue, particularly amongst the larger pension funds where more meaningful investments can be made in order to achieve a degree of influence over the business. The chart below from Preqin’s February 2014 edition of Infrastructure Spotlight shows that 11% of the 2,100 global investors surveyed are planning to invest over \$500 million in infrastructure over the next 12 months. Interestingly however, 83% of this subset of investors have a preference for making direct investments.

Figure 1: Capital allocations to infrastructure over the next 12 months



Source: Preqin Investor Outlook: Alternative Assets, H1 2014

The size of these investors, and the greater allocations to real assets such as infrastructure, mean that these funds can invest large quantum of capital, which, as we discuss below, is vital for a successful direct investment strategy.

## Key benefits of direct investing

Having discussed direct investing as a concept, we now look at what are the advantages of investing directly in assets, and consequently, why some superannuation funds are moving towards a direct investment approach. We see the three primary reasons why a direct investment strategy may be beneficial for a fund as being (i) discretion over the investment decision, (ii) ability to influence the performance of the asset and (iii) control over the investment hold period. Each of these factors is discussed below.

### 1. Discretion over the investment decision

One clear advantage of investing directly rather than through a pooled fund is the investor has discretion with respect to the overall investment decision. Pooled funds generally operate in such a way that the manager determines if an investment is appropriate for the vehicle in which they manage, rather than the investors themselves. These pooled vehicles may be appropriate for those funds which either have small amounts of capital to allocate to the space, and which otherwise would have difficulty accessing quality investments on their own, and/or those that do not wish to take on the commitments in terms of resourcing and decision-making that investing directly requires. Larger funds which can invest large amounts

of capital and take meaningful stakes in assets have the luxury of assessing investment opportunities on a case-by-case basis. This is particularly important for superannuation funds given they often have various restrictions over what they can and cannot invest in.

### 2. Ability to influence the performance of the asset

Another advantage of investing directly is the investor's ability to influence the performance of an asset, both through appointment of Board representatives, and also through those business matters reserved for shareholders, especially where the size of the investor's holding provides them with certain control rights.

Governance issues are assuming greater prominence, and for this reason larger investors usually insist on a Board seat if their investment quantum warrants such a position. The ability to influence directly the future direction or strategy of an investment is vital. Well-regarded professional directors are able to act as an information conduit both ways, while at the same time recognising that their first priority is to the entity itself. In certain circumstances, shareholders can also have a direct influence over the operations and strategy of the asset. These are generally pre-prescribed matters which are agreed between shareholders which are considered over and above the normal course of a Board decision. Typical examples of matters reserved for shareholders include deviating from the agreed objective of the business, incurring expenditure in excess of the business plan, or acquisitions and disposals.

### 3. Control over the investment hold period

Finally, investing directly in an asset allows the investor greater control over the length of their investment period. Whilst real asset classes such as infrastructure are generally considered "long-term", the majority of pooled funds, particularly in North America and Europe, are closed-ended fixed term funds. Notwithstanding closed-ended funds generally contain some degree of extension provisions, often these require a significant majority of investors to consent. Whilst closed-ended funds can be viewed positively from investors given they offer a liquidity event, many investors in pooled funds regrettably find themselves having to involuntarily dispose of high quality assets at the time the fund reaches maturity and needs to be wound up. Having an investment directly in the asset allows an investor flexibility over the length of time they wish to hold an investment.

## Implementing a direct investment program

So how does one implement such a strategy, and what are the issues funds must consider before embarking on a direct investment program?

The approach taken by institutional investors in direct investing shows no distinct pattern. Each fund tailors its approach in recognition of its size, the experience of its internal team (if any), transaction size, risk tolerance, and asset allocation. For larger transactions, it is not unusual for several superannuation funds to club together to evaluate a transaction, with the pooling of ideas being seen as beneficial particularly for less-experienced investors. Funds also share work load and due diligence costs this way.

Transaction sourcing is generally not an issue; however, identifying "good" transactions is a more complex process and relies heavily on managers and/or intermediaries well-positioned around the globe which are able to identify opportunities, hopefully in advance of the rest of the investing world. Funds may benefit from forming alliances with strategic investors who may be able to provide increased access to exclusive / non-competitive deal flow, with the added benefit of investing alongside an experienced operator. A fact of life however, is that it is only the minority of transactions, certainly for the larger ones, which are able to avoid a public auction, which is almost always the case where Government assets are being privatised.

A crucial element of any direct investing strategy is the expertise to do so. Direct investing is not a "set and forget" strategy. It can be very hands-on with day-to-day decisions ranging from

business strategy, refinancings, acquisitions, disposals and responding to regulatory changes and market conditions. Any investment requires careful management; however in the case of real assets, not only is having a qualified financial analyst important to understand the underlying financing of the business, but industry experts are equally important to drive the operations of the business. Asset consultants can also complement an in-house team, with some of them, in response to the emerging trend in direct investments, establishing teams staffed with professionals from a range of industries who are experienced in sourcing, structuring, negotiating and closing transactions.

So far we have considered direct investing in the context of not investing in manager pooled products; however the reality is, at least initially, that superannuation funds will often invest directly into assets alongside an experienced manager. Apart from providing skilled additional resources when undertaking due diligence on a transaction, the manager may fulfil an ongoing role in monitoring an investment after a decision to proceed has been made. This relationship is particularly important where the asset is located offshore. Given real assets are generally operationally intensive, without a physical presence on the ground in the same geography as the asset, investors will find it difficult addressing operational issues the

asset will invariably encounter. For this reason, most investors see the fees they pay a manager for assisting with these tasks to be money well spent. Whilst not necessarily a key driving force for undertaking a direct investment program, in JANA's experience, managers are often prepared to negotiate attractive (that is, lower) fees for co-investors with substantial commitments and for whom an ongoing relationship is important.

It is not unusual for investors to work with different managers on different deals, as managers will have their particular strengths in terms of industry sectors and countries. The fact that an investor is working with one manager and competing with them on another transaction is considered normal.

Increasingly, many funds are following a "dual track" approach of investing in manager pooled funds in addition to building their own portfolio of direct assets. This strategy helps mitigate the concentration risk from investing in direct assets, as well as facilitating co-investment opportunities.

## Conclusion

The growth of Australia's superannuation funds, both through organic means and fund consolidation, is almost certain to drive further direct investment into real assets over the next decade. Direct investing is not a recommended

strategy for all funds, particularly those funds which are unable to meet the required investment size and/or do not wish to take on the commitments in terms of resourcing and decision-making that investing directly requires. However, for those funds large enough to contribute significant amounts of capital to single investments, direct investing possesses many advantages, not in the least the ability for an investor to own the investment decision and drive the performance of the asset through Board representation and shareholder initiatives. Despite its many advantages however, direct investing is not without its challenges. It requires significant resources, including both operational and financial expertise, which ultimately may come from a combination of an experienced in-house team, supported by asset consultants and managers.

JANA's Direct Investment Unit, which was established in 2006 and sources and assesses direct investment opportunities for our clients, has advised on nearly A\$2 billion of capital investments for our clients over the last 24 months. Investments include several portfolios of Australian airports, the new Sydney Convention & Entertainment Centre, Port Botany and Port Kembla in NSW, gas and electricity distribution networks in New Zealand, Finland and the Czech Republic, and a European transport project.

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