

# MyConsultant

NEWSLETTER November 2015



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Andrew is a Senior Consultant and part of JANA's Direct Investment Unit ("DIU") which is responsible for assisting clients in analysing, structuring and executing direct investments, predominantly in the infrastructure and property sectors. Since joining JANA in 2013, Andrew has advised clients on a number of transactions including an Australian capital city port, a European electricity distribution network and a European transport project. Andrew is also part of JANA's Infrastructure Research Team through which he has undertaken detailed due diligence on a number of managers, as well as contributed to various research pieces.

Prior to JANA, Andrew worked with Macquarie Group for eight years across the infrastructure and private equity sectors. Andrew spent three years in London where he was heavily involved in the asset management of a large UK water utility.

Andrew holds a Bachelor of Economics and Bachelor of Commerce (Finance and Business Information Systems) from the Australian National University.

## Is it time to waive the white flag on Infrastructure?

Infrastructure has traditionally been viewed as a stable asset class, which provides an element of defensiveness. Characteristics including moderate volatility, stable income and a long-term capital growth profile, have made Infrastructure attractive. This perceived attractiveness, particularly in the context of the current low interest rate environment, has increased over recent years, driving up the prices being paid for Infrastructure assets. In this article, we discuss pricing trends within the asset class and our view on the valuations of Infrastructure going forward. We also look at the implications of current pricing in Infrastructure assets and what that means for investors.

It seems that after every Infrastructure transaction is announced to the market, the inevitable question from a variety of industry participants is "*was the price paid fair?*". Whether it be a toll road, an airport or an electricity distribution network, it is almost guaranteed that a successful bidder will not be able to celebrate the months (and sometimes years) of hard work, without having to justify the price that they paid. But is this criticism warranted, or is it just a case of sour grapes by competing bidders?

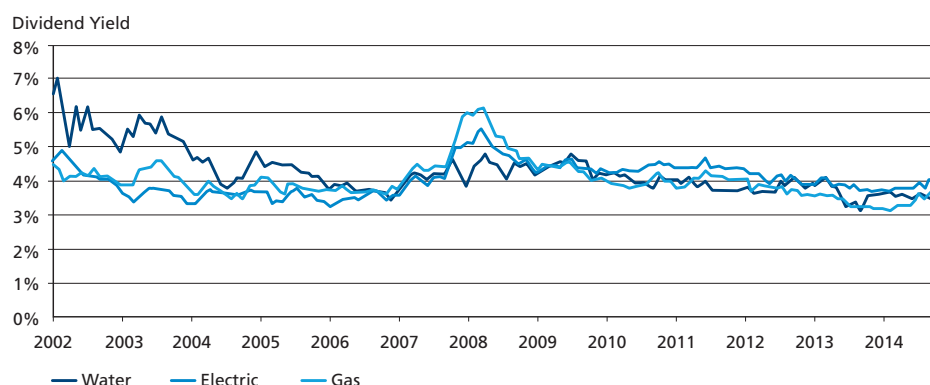
There have been a number of examples over the past two years which, prima facie, would lead a rational investor to conclude the Infrastructure sector is overpriced. The fact that some unlisted Infrastructure assets have traded at multiples of over 30 times earnings has caused many to believe the market is "overheated". Similarly in the listed markets, we have seen many Infrastructure stocks, particularly those in the utilities and energy sectors, reach the pre-GFC highs before tapering off over recent quarters. This has led many investors to question whether Infrastructure is overpriced, and whether the asset class is still worth investing in from a risk-return perspective. In order to determine if the sector is in fact "overpriced", it is worth considering the drivers behind the increasing valuations. JANA's view is that valuations are primarily being driven by two factors.

### Pricing trends within Infrastructure

Firstly, Infrastructure in a global context is a relatively "immature" asset class. Superannuation funds in Australia, Canada and Europe have been investing in Infrastructure assets for a number of years, however there are other regions, particularly in the US, Asia and the Middle East, which have only started to invest in the asset class. A significant amount of capital flows from these investors into the sector in recent years has created somewhat of a demand-supply imbalance, and this has pushed prices up accordingly.

The other driver of increased valuations in the sector has been the low interest rate environment. We have seen that over the last three or so years, many sub-sectors within the listed Infrastructure market have appreciated strongly. This has been primarily in those sub-sectors with strong yield characteristics, such as listed utilities and other energy Infrastructure stocks (energy Infrastructure stocks are generally not directly linked to energy prices, however can be exposed to energy volumes), as investors search for yield outside of traditional bonds. This is shown in figure 1, with yields steadily decreasing across water, electric and gas utility companies since the GFC.

**Figure 1: Utilities dividend yields steadily decreasing over time**



Source: RARE

In this instance, given the yield profile of these underlying investments, these investments are generally priced on a “yield basis” rather than an assessment of overall total return.

Whilst this is typical of listed market investors, recent prices paid for some private assets, particularly large-scale utilities, may indicate that long-term Infrastructure investors with an indefinite investment horizon are pricing these assets in a similar way. That is, long-term investors are viewing these regulated assets as “bond substitutes” given the strong yield characteristics, and as such one could argue are being priced as a margin over bonds.

In addition to both equity and debt, some investors are willing to accept lower returns for their investments as the cost of capital has come down. The cheaper cost of debt has meant that Infrastructure projects can also support higher amounts of debt, meaning that the overall cost of capital is further lowered given the change in the financing mix between lower cost debt and higher cost equity.

This now raises two very important questions. Firstly, “are Infrastructure valuations (and returns) sustainable in the long-term?” and if so, “is Infrastructure attractive vis-à-vis other asset classes?”

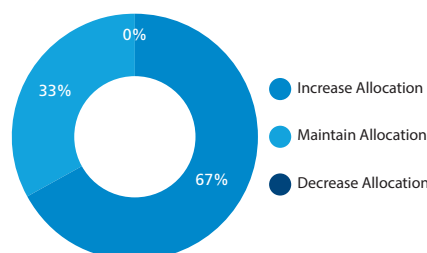
## 1. Are Infrastructure valuations sustainable in the long-term?

In order to assess whether Infrastructure valuations are sustainable in the long-term, we need to consider each of the above drivers in isolation.

With respect to increasing awareness of the asset class, JANA’s view is that this is set to continue in the medium to long-term. A report by Prequin<sup>1</sup> stated that as of Q1 2014, US public pension funds had an average

current allocation of 1.9% to Infrastructure, compared with a target allocation of 4%. This is in contrast to many Australian superannuation funds which typically have allocations of 5-10%. Some Canadian pension funds, who many consider were pioneers in the asset class, have allocations as high as 20%. JANA’s view is that there is still a large amount of capital to flow into the asset class from US and Asian-based pension funds as awareness in Infrastructure assets continues to grow. Additionally, we are seeing a number of “new” investor-types enter the market in the form of insurance and sovereign wealth funds (predominantly Middle Eastern), which will continue to support capital for the asset class. This dynamic is illustrated in figure 2 and shows that over the “long-term”, two-thirds of investors intend to increase their allocations to the sector.

**Figure 2: Investors’ intentions for long-term Infrastructure allocations**



Source: Prequin Investor Outlook: Infrastructure H1 2015

The low double digit returns generated by Infrastructure over the last decade in part reflects the early mover advantage for early investors into this asset class. Going forward return expectations will need to be moderated, to reflect the progressive maturity of the asset class.

Many Infrastructure investors have asked the question “is this the new normal?” in relation to asset values and forward return expectations. Whilst this is an extremely difficult question to answer, our view is that the weight of capital due to enter the sector should continue to play a significant part in supporting prices.

The risk to valuations from an increase in interest rates is less clear. A rise in interest rates can either impact valuations by a change in the underlying cash flows being discounted, or can translate into a higher discount rate applied in valuing the assets (to maintain the margin over bonds), which can result in a lower valuation.

Given the ability to forecast cash flows for many Infrastructure projects over the long-term (due to the relative stability of the earnings of the businesses), the primary method for valuing Infrastructure companies is a discounted cash flow, whereby cash flows over a 20 or 30 year time period are discounted using an appropriate cost of equity. The cost of equity is based on a risk free rate and an equity risk premium, determined by reference to the market risk premium and asset beta.

With respect to the discount rate, many investors and valuers are taking into account the risk of a rise in interest rates by adjusting the risk free rate (typically the 10-year Australian Government Bond Rate) to account for a more normalised long-term risk free rate. Now, whilst we cannot say definitively that all investors price Infrastructure this way, JANA has seen a number of examples where this is the case. As an example, JANA notes that one particular top-tier valuer used a risk free rate of 4-4.5%, compared with the spot 10-year bond rate of 2.9%. To some degree this conservative approach in using a more normalised risk free rate should help to mitigate any adverse valuation impact from higher interest rates.

Regarding the underlying cash flows, depending on the capital structure of the investment, an increase in interest rates will increase the debt service costs of the investment. However, given the long-term nature of the cash flows, any increase in interest rates will generally already be priced in the current valuation. Furthermore, there are generally offsetting factors to these higher debt costs, such as Infrastructure asset revenues having a degree of GDP or CPI-linkage to the extent the higher interest rates are due to stronger economic conditions.

<sup>1</sup> Prequin Investor Outlook: Infrastructure H1 2015

So are valuations at risk? Our view is that *generally* valuations in the Infrastructure sector, whilst perhaps will not grow at rates seen previously, should exhibit a moderate level of growth over the medium to long-term. Having said this, we do believe that some sectors will be subject to more short-term volatility, particularly if interest rates increase. As indicated earlier, we see this risk more in those stronger yielding assets, such as utilities and energy businesses. In fact, over recent months we have already seen some softening in these stocks, particularly in the US, as investors priced in an imminent rate rise.

Notwithstanding, to the extent that rates remain “lower for longer”, this should continue to benefit pricing in such sectors as Infrastructure. Of course, when pricing assets, discount rates are only half the story, and investors should ensure that assumptions being used to price assets are reflective of a true base case, including sustainable gearing levels.

## 2. Is Infrastructure attractive vis-à-vis other asset classes?

You may be wondering by now “so what does all this mean?” This may all be good in theory, but should I, as an investor, be worried about investing into Infrastructure at current prices?

When assessing whether an asset class is overpriced, the natural tendency is to consider current valuations in the context of historic valuations. Whilst this is useful, it can also be misleading, particularly in the current environment. The fact of the matter is that current valuations in most asset classes are on the expensive side of fair value, which leads to the obvious question, “*is Infrastructure overvalued relative to other asset classes?*”. Investors need to put their money somewhere.

JANA’s view is that Infrastructure still has an important part to play in investor’s portfolios, even in the current market at current prices. Yes, there have been instances where JANA believes that the prices paid for some Infrastructure assets did not accurately reflect the risk of the underlying investment, however, more importantly, we believe there continues

to be a number of attractive opportunities within the market. Our philosophy is to invest with active managers who have a track record of generating value through sound acquisitions and active asset management. In addition, having managers with the discipline to walk away from deals if the pricing does not compensate for the risk, is as important as doing the deal. This in turn can create new risks, as managers look to generate returns from more complex assets. Nevertheless, manager selection remains critical to our clients’ success, as well as our ability to assess direct investment opportunities through JANA’s Direct Investments business for those clients wishing to access Infrastructure outside of a pooled vehicle.

## Conclusion

There is little doubt that valuations of Infrastructure assets have increased over recent years, and as a result returns in the asset class over the last decade will almost certainly not be replicated in the next. Whilst some of this pricing can be attributed to the low interest rate environment, investors need to be cognisant that Infrastructure is still a relatively immature asset class, with many investors still having minimal, and sometimes nil, allocations to Infrastructure within their portfolios. There is considerable capital looking to invest into this asset class, and just as this is likely to support prices, it also translates into a lower expected long-term return as the risk premium in Infrastructure reduces to reflect the wider acceptance of Infrastructure as an established asset class globally.

Higher interest rates are a risk to future pricing, however to date valuers have shown sufficient conservatism in using more normalised risk free rates in their valuation models that allows some cushion, to at least moderate interest rate rises.

With prices rising and competition for deals never greater, disciplined and experienced managers and investment partners are more important than ever. Simply buying the asset class is unlikely to meet investors’ objectives. What is critical is buying the right assets. Overall JANA believes a well-managed Infrastructure portfolio will continue to provide reasonable risk-adjusted returns within a broad portfolio context, and that Infrastructure is here to stay as a key element in client portfolios.

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