Why value creation matters

As investors increasingly warm up to core-plus strategies, Partners Group's global co-head of private infrastructure Brandon Prater explains how the firm approaches value creation and why being able to draw from its different business lines plays a key role in adding value

Q Why do you think several industry players such as Partners Group have gravitated towards core-plus strategies in recent years?

BP: It all comes down to how our investors' objectives are best served. Partners Group and certain other firms are looking for risk-weighted returns where you are actually getting paid for the risk that you take and where you have a certain amount of control over mitigating risk. We believe there's better return on a risk-weighted basis by creating value compared to buying it.

I think many in the industry have seen the very high valuations paid for core assets, given the stability of their cashflows versus the risk inherent in these assets that you take on, and are worried about the returns to their investors, particularly if risks outside of the control of investors are realised. Another aspect of core assets is that a lot of the value creation has already been realised, leaving upsides relatively capped.

Additionally, when you have the capacity as a firm to construct or make an infrastructure asset better through hands-on value creation, you are in control of some of the investment risk. In contrast, if all you've done is pay for the asset and your returns are dependent on regulation and/or the location of the asset, you don't have a lot of control – you end up paying a lot for the privilege of the cashflow generation of that asset and potentially misjudging the amount of risk.

Q Core and core-plus can be notoriously tricky to define. How do you distinguish between them?

BP: You can define it by stage of investment, whether it's development risk, construction risk or just operating risk. Operational investments are probably more in the core sector. I consider a built airport with defined traffic patterns as a core investment. I think greenfield/development projects fall out of the core bucket in that you take development risk in an investment and there is less certainty of being able to successfully implement the project. Construction-ready, permitted projects are probably also excluded from a core definition, despite attractive risk-weighted returns, due to construction risk. Partners Group considers this last category as a pillar of its relative-value strategy, where risks related to construction can be significantly transferred to construction counterparties.

I think you can also break core and core-plus down by markets or sectors and where they operate. We've seen some of our peers make investments in things that are outside of our typical infrastructure space, such as medical testing labs, funeral services or elderly care. Here the definition of infrastructure gets stretched. In addition to sectors, market risk is also a defining characteristic of core and core-plus. While infrastructure should have a defined user base because it tends to be an essential asset – or provide an essential service – willingness to take a real demand risk for the asset means it would probably be in the core-plus space.

Q Some believe these labels are unhelpful to the industry. What is your view on this?

BP: I think it's unhelpful in the sense that it's not standardised: core and core-plus mean different things to different investors. As a manager, you can call your strategy whatever you like, but the proof is in the implementation. Also, there can be a grey area, as some assets have more core characteristics than others. We also find that core investors do non-core and core-plus investors look at core – it's a bit fluid.

Q How would you describe Partners Group's strategy then?

BP: Our strategy, in a nutshell, is to take some of those core-plus risks and create assets that, once value creation has been completed, are much more core, if not purely core. Some of our assets actually have a lot of core aspects and we're just making them more so. I believe if you are going to go for a core-plus strategy, you have to have the capacity to execute on value creation plans. When considering a core-plus investment we have to ensure we have the capacity in the team to build value in the business and reduce risk in its operation.

Q Can you give an example from your portfolio? And can you speak to the impact this strategy has on your returns?

BP: We recently invested on behalf of our clients in a solar platform in the US, where there was potential risk in the pipeline execution. Valuing and taking pipeline execution risk is not part of a core strategy, however, looking deeper into the pipeline showed that not only were PPAs executed in a significant number of these projects, but the eventual development of the projects was highly probable. Over the last 12 months, the platform has completed construction of over 150MW of solar production capacity with an average offtake of 20 years. While we do consider construction risk when we are able to transfer this to construction counterparties, we do not tend to look at very long construction projects and our typical value creation phase is a three- to five-year period.

In terms of returns, it depends. In the US, competition for solar investments in certain parts of the country had resulted in high valuations. Our platform focuses on more bilateral offtake agreements in states

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where the development of renewable energy was in the early stages. In terms of relative value, returns in this contracted portfolio are expected to be at least 4-5 percent higher than comparable assets in Germany or the UK. I do think, just generally, that there is a significant difference in returns when you're creating value rather than buying, because you're taking on different risks.

Q What would you advise other investors to be wary of when pursuing non-core assets?

BP: On the core-plus side, it really is about having the capacity to create value. And I think, at the same time, you have to be cognisant that it takes a while for that to happen. Core investors pay high valuations for stable cash-generation. We're pursuing a strategy where there's going to be a delay in getting yield while the investment is in the value-creation phase. But for that, we believe you're getting better total investment returns for the risk you take.

Q How much co-operation exists between Partners Group's infrastructure division and its other asset classes in identifying core-plus investments?

BP: We not only rely on our colleagues – and them on us – to find investment opportunities, but we also rely on their expertise. For example, if we look at a portfolio of motorway service areas as an investment opportunity, while we believe they have infrastructure characteristics, they also have real estate characteristics; in this case we would seek advice from our colleagues in the real estate investment team. Similarly, we would rely on our private equity colleagues' expertise in certain areas of telecom infrastructure. The fact that we can rely on the platform expertise of over 700 investment professionals globally provides an in-house resource that an infrastructure-only platform would not necessarily have. This is especially the case with value creation, where the private equity crossover is highly valuable. To take that experience and transfer it to infrastructure is really powerful.

Q Are there any sectors within the core-plus market that you envisage being classed as core in the near future?

BP: Communication infrastructure is a sector that hasn't historically been considered as core until recently. While there are probably some investors who think telecom towers, and telecom infrastructure generally, are not core, many consider telecom infrastructure more like utilities – especially when you think about the explosion in data demand. Government programmes and policies to catch up on digital infrastructure are becoming really topical right now. People need to be connected in a much faster way. ■