

KEYNOTE INTERVIEW

Value-added infrastructure



*With the possibility of a downturn on the horizon, execution-driven value creation strategies are an investor's best course, say **Todd Bright** and **Simon Merriweather** of Partners Group*

Q What does value-added infrastructure mean for Partners Group and why is it an attractive investment strategy?

Todd Bright: For us, value-added infrastructure means driving returns, not through leverage or market factors, but through execution-driven value creation throughout the hold period. We think it is an attractive part of the infrastructure market because it represents the best balance between a principal protected way of investing and the ability to add value through active ownership.

Simon Merriweather: We describe our strategy in terms of three specific investment categories. First, there is operational value creation. A great example of that is

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USIC, a provider of underground utility locating services, which we acquired in late 2017 on behalf of our clients.

The focus there is on top-line growth, improved customer-facing performance and more efficient operational management. For example, we launched a Quality First programme to reduce customer damages, improve the bottom line and help win future contracts.

Additionally, we are investing in IT infrastructure to provide better data analytics for key processes such as route manage-

ment, headcount management, and workload and queue balancing.

The second strategy is platform expansion. That is where we invest in companies with the potential to grow their asset base through accretive acquisitions or enhanced project pipelines. One example is Covage, which we are in the process of exiting on behalf of our clients. It is a fibre optics communications business based in France, with 45 separate networks covering three million homes. The business operates by bidding for new concessions from the local community and then, if awarded the concessions, it builds the fibre and enhances its use. During our ownership, it was all about building and enhancing the existing platform.

The third strategy is building core. This is where we invest in core infrastructure assets that are in the process of being developed and built. Value creation comes from successfully delivering the projects safely, on budget, on quality and on time. The example I would point to there is a 400MW wind farm, Merkur Offshore, which is 45km off the German coast. That asset has strong cashflow visibility with a 14-year feed-in tariff with the German government.

We achieved commercial operation for that project in July 2019, having closed the investment in 2016 on behalf of our clients. We renegotiated contract terms and project financing, built a management team and then managed the construction over that period.

Q Which sectors are particularly attractive when it comes to a value-added strategy and have they changed over time?

TB: They certainly change over time and they also differ between geographies. That's why it is important to maintain a flexible mandate across subsectors and regions. We look at the global opportunity set on a purely relative-value basis, aiming to identify those investment opportunities that we believe will offer the best risk-adjusted returns.

That said, there have been sectors that have shown themselves to offer better relative value than others over recent years.

Onshore wind is a large global opportunity set, for example, but we have seen better value in Australia. This is driven by fundamentals around brown power prices, the very significant yield compression between the construction and operational stages, the simple renewables incentive scheme and the ability to sell power through PPAs in a straightforward manner.

Meanwhile, offshore wind in Europe offers a mature supply chain, deep management expertise and a well-established buyer universe. Those things can't be said about offshore wind anywhere else in the world right now.

We have also been active in midstream energy infrastructure in the US, with projects like pipeline exports of US gas to Mexico and support infrastructure for energy-intensive manufacturing industries, leveraging off the US as a low-cost energy supply base.

Solar in Asia has also been active. There is a fundamental need for domestically produced power, coupled with good feed-in tar-

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TODD BRIGHT
Partners Group

iff regimes. That creates an opportunity for early movers that can acquire and aggregate the land – ie, the solar resources. We have done this in Japan and are now doing it in Taiwan. Scale brings rewards.

Finally, I would point to grid support for renewables as an emerging opportunity set. Wherever renewables have significant penetration in the grid, intermittency creates the need for a different kind of energy mix, as base load coal- and gas-fired plants are replaced by renewables in combination with flexible thermally fired plants or battery storage.

Q How do you use digitisation as a value-creation lever?

SM: Digitisation is playing a significant role in our operational value creation businesses. In one of our portfolio companies, we are rolling out fleet enabling connectivity that optimises the client-visiting schedule in real time. That improves customer satisfaction but also reduces operating costs. That's a very practical example of digitisation at work.

Q What about ESG as a source of value-add?

SM: ESG is fundamentally embedded into our investment decision process and we have a dedicated team that supports that all the way through – from pre-investment validation and then into improvement action plans, implementation and monitoring. It's important to remember, too, that ESG is far more than just the environment.

In our 2019 action planning, we were specifically focusing on health and safety, anti-bribery, cybersecurity and community engagement, for example. We have done sweeps of all our investments across those different categories and we see this as being a fundamental value-add to our investment approach.

Q What role do boards play in your value-add approach? Has your approach to board composition changed?

TB: We see the degree to which board directors are active in value creation as the big difference between private and public markets. In the public markets, boards tend to be compliance-driven and less able to think – and act – entrepreneurially.

We, however, see ourselves as entrepreneurial owners and business builders.

Consistent with that, we have made more and more use of senior industry advisors – or operating directors, as we call them – as part of our boards.

SM: In infrastructure, we have more than 100 of these senior advisors that have deep experience across different markets and geographies. It's part of what separates the purely financial 'engineering' from our industrial engineering approach to active management. This team of senior experts, alongside our in-house team of 60, apply their depth of knowledge and experience to creating value.

Q How would you describe the interaction between the investment and asset management teams throughout the life cycle of an investment?

SM: We travel through the investment life cycle hand in hand. The investment and asset management teams jointly own the success of our investments. We are incentivised with the same compensation structures, tied to the performance of those investments. There is a full partnership and certainly no silos.

The actual level of involvement depends on the stage of the life cycle. The investment team plays a larger role at the origination and transaction stages. The asset management team then focuses more on the onboarding and value-creation stages. But regardless of where we are in the investment life cycle, we are very much one team.

TB: I would agree with everything Simon has said. The asset management team is integral to the up-front due diligence and investment committee processes. Simon sits on the investment committee for infrastructure alongside me, for example.

Simon's team members are part of the investment teams, with a particular focus on assessing the viability of the value-creation plan that we are underwriting. They look at the capability of the management teams we are backing to execute on that plan and identify any gaps that need to be filled.

They then assist with building the right kind of board, as well as working alongside the investment team members and operating directors throughout the hold period to support in the execution of that plan. They may dig in a little deeper on some investments, if a portfolio company situation calls

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Partners Group

for that support or if they have particular relevant experience to bring to bear. But they are always an integral element of our active ownership.

Q How would you describe LP appetite for this part of the infrastructure asset class?

TB: Investors once wondered where to put this nascent asset class, typically placing it as part of a real assets category, lumped in with real estate and natural resources, for example. Those days are well behind us now. Today, investors typically look at infrastructure as a standalone asset class and then, within that, they are starting to segment the market into core and value-add – with other gradations in between.

In general, I think investors see value-added infrastructure as a good complement to their allocations to private equity. It tends to be less GDP-exposed than a lot of

core infrastructure. I also think core infrastructure is trading at very high valuations right now and so, in many cases, investors in core are getting what they think is low operational risk but in exchange for very high valuation risk.

That can be less of the case with value-added infrastructure where the asset is sitting before an inflexion point in terms of its value creation. This means entry prices can be more attractive and returns can be driven more by execution than by the macro environment. Value-added infrastructure also tends to have less capital markets and commodity price risk and be more principal protected than many private equity plays.

Q With an economic downturn potentially on the horizon, how do you see the value-added infrastructure space playing out?

TB: We are very mindful of where we are in the economic cycle and have been for some time, both in terms of our approach to our existing portfolio and our approach to new investments. This is reflected in our leverage levels, which are typically kept lower than theoretically would be possible, and in the way we think about refinancing risk. We make sure we have long tenors and fixed interest rates, for example. We also shy away from GDP exposure.

Where we are looking at GDP-exposed assets, we are testing those assets against a downturn scenario, which usually leads to us being less competitive on those opportunities. We also build in ample headroom when it comes to future exit metrics. And, of course, we focus a great deal on the value creation levers that are driving the returns.

We ensure cashflows are underpinned by contracts and if the contracts are short-term, we look for principal protection from the initial term of those contracts. For operating assets, we are looking for high historical renewal rates and long customer tenures.

We always start with principal protection in all elements of our underwriting, and from there we build a base case in execution-driven steps rather than market-driven factors. The possibility of a downturn on the horizon, within our hold periods, is very much on our mind. ■

Todd Bright is head of private infrastructure for the Americas and Simon Merriweather is head of private infrastructure asset management at Partners Group