Roundtable

North America

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Getting ready for a market correction

The North American investment environment is shifting, though what investors expect from infrastructure isn't. Five industry experts tell **Jordan Stutts** how to stay on strategy

The possibility of a correction and how it could be a good thing for valuations is one of the first topics that arises during our discussion with a banker and four fund managers, who have gathered in midtown Manhattan to discuss how the infrastructure asset class has changed over the past decade and what the future may hold.

Perhaps it comes as no surprise that the banker, Laurie Mahon, CIBC's vice chair of global investment banking, broaches the topic first.

"You have so much money pouring into this sector and not enough assets to invest in," Mahon says. "We're probably ready for another correction in valuations. Sometimes a little regulation or boundaries on the revenue side will actually produce better deals."

But what is surprising is that the four fund managers, who are invested in the assets Mahon says might drop in value, agree with her.

According to Gregory Smith, president and chief executive of Toronto-based InstarAGF Asset Management, high valuations can sometimes disguise investments that may not necessarily fit the bill of what's considered infrastructure.

"As the market corrects, you'll start to see the true nature and underpinnings of deals – the contracting, regulatory and monopolistic characteristics that assets should have," Smith says. "If there is an economic correction, you'll see if non-correlated features actually materialise. It will become evident very quickly which investors are being true to the definition of infrastructure."

Mark McComiskey, co-head of infrastructure at AVAIO, a firm spinning out of US construction company AECOM, agrees that a correction would expose exactly what types of assets fund managers are investing in as new capital pours into the sector. Smart fund managers that stay disciplined should remain unscathed, he says.

"If you've been prudent in your capital structure, you can survive a downturn and the imperfect correlation between the revenue protection arrangements in place for your assets and what actually happens in the economy," McComiskey explains.

Stefano Mion, managing director and co-head of Ardian Infrastructure US, adds: "It's a function of whether the asset is essential infrastructure. When we bought assets over the past three or four years, we knew at a certain point a correction would happen. You should stress to investors your valuation, making sure you don't lose money even in corrections."

BROADENING DEFINITIONS

For George Theodoropoulos, a managing partner at Fengate Asset Management, staying with the strategy a fund manager promised

> If you've been prudent in your capital structure, you can survive a downturn" **McComiskey**

AROUND THE TABLE

Laurie Mahon, vice chair of global investment banking, CIBC
Mahon has worked at CIBC since 2013, first joining as managing director and global head of the infrastructure finance group. Her experience in infrastructure ranges from banking to public sector manager, executive and consultant. Prior to joining CIBC, Mahon held posts at McKinsey & Company, on Wall Street as an investment banker and at New Jersey Transit.

Mark McComiskey, co-head of infrastructure, AVAIO
McComiskey is co-heading a new infrastructure venture called AVAIO that is spinning out from the capital investment arm of construction company AECOM. Throughout his career, he has invested more than $4 billion of equity in energy infrastructure and transportation assets. Prior to joining AECOM, McComiskey was a founding partner of Vanwall Capital, a senior managing director at Prostar's energy private equity fund and co-head of First Reserve's private equity business.

Stefano Mion, managing director, co-head of Ardian Infrastructure US
Mion co-heads the US infrastructure portfolio of French private equity firm Ardian. Already one of Europe's largest infrastructure players, Ardian has expanded its horizons; raising its first Americas-focused fund last May. Mion has been with Ardian since 2007, previously working for Merrill Lynch's European leveraged finance team and at UBS Investment Bank and JPMorgan.

Gregory Smith, president and chief executive, InstarAGF Asset Management
Smith is the head of InstarAGF, a firm which last year closed its inaugural infrastructure fund on C$740 million ($560.4 million; €495.2 million). Prior to joining InstarAGF, Smith headed Brookfield Financial's Global Infrastructure Advisory Group and was president of Macquarie Capital Funds Canada.

George Theodoropoulos, managing partner, Fengate Asset Management
Theodoropoulos manages Toronto-based Fengate's infrastructure investment business. In September, a consortium led by the firm, was selected to develop a new rental car facility at Los Angeles International Airport. Before joining Fengate in 2009, Theodoropoulos worked as a director at RBC Capital Markets and served as head of RBC's Canadian Infrastructure Advisory Group.

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> **Smith**

its investors is what's most important. "The number one thing we hear is 'stay on mandate'. Investors spend a lot of time allocating capital and figuring out where they want to invest their money. They have you in a certain bucket and they want you to stay in that bucket."

"I remember when investors talked about infrastructure in 2003 and 2004. It was always, 'buy me a transmission line, a power plant, a PPP'," Smith recalls. "If you were starting in infrastructure, you would typically begin with large global names and a core portfolio. Now, some LPs have matured and are expanding their asset set to pick up value-add and opportunistic strategies. Everybody's definition is broader because experience in the sector is broader."

"We've given up on the definition," Mion counters. "We just go for essential infrastructure, assets that have real barriers to entry, whether that's a concession or a physical barrier."

The five industry experts sitting around the table spell out and reach agreement on the various definitions that apply to different types of infrastructure investments. Core infrastructure, they say, typically refers to assets that are de-risked and have the hallmark asset class characteristics – contracted or regulated cashflows. Core-plus means there are opportunities to de-risk the asset, while value-add means the asset can be improved through capital investments and operational improvement.

They also agree that mid-market investments are those that range from $50 million to $200 million.

Where they differ, however, is on the size of opportunities available in North America given the heightened attention the sector is drawing.

Smith says he jokingly likes to tell other fund managers the North American market is overcrowded, in an attempt to throw competition off the trail. But in reality, he says, there are many attractive opportunities to pursue here.

"Comparing North America with the rest of the world, there is quite an interesting niche in the mid-market," Smith explains. "Big deals get the headlines, and big pension plans pursue the megadeals, but looking at the numbers, 70 percent of transactions in North America are less than $1 billion in enterprise value."

GOING 'UPSTREAM'

Others offered a different view. McComiskey and Theodoropoulos argue that in recent years, competition for assets has led some fund managers to pursue new strategies to obtain still-attractive returns.

"An enormous amount of capital has flowed into funds buying existing assets," McComiskey says. "Still good deals to be done there, but we have concluded that it is better for us to focus on the less competitive build-to-core segment rather than trying to be smarter than everyone else at buying core."

Theodoropoulos adds: "If you want to capture higher returns, you've got to go upstream in respect of risk with the appropriate in-house expertise […]. We're putting our chips down with developers that we would like to capture exclusivity with on their deal pipelines, thereby obtaining higher returns through investments that have very significant yield compression."

The one caveat in expanding into greenfield, he says, is taking on added risk, which investors seeking infrastructure exposure generally want to avoid. "Our investors are primarily pension funds, and are conservative investors," Theodoropoulos explains.

From a lending perspective, Mahon points out: "There are a lot of places equity wants to put money that isn't necessarily where banks want to put money. I think there will be an interesting inflection point in the market between debt and equity, and you're seeing it already, where investors are having to use more equity to back deals. People may be willing to pay 21 times EBITDA on something, but the bank is only willing to lend six times."

LPs' CONFLICTING DESIRES

Determining what it is investors want from a changing infrastructure market may be easier said than done, according to McComiskey.

"We offer fund lives of 20 years. Some investors say, 'but we like the discipline of a five-year investment period and a five-year hold-and-sale period'," he explains. "The reasons many give for investing in infrastructure is to own long-lived, steady-returning assets that match the tenor of their liabilities, but, with some exceptions, investors seem wedded to traditional fund structures that have a shorter life."w

Mahon agrees, saying she's seen investors place heavy emphasis on exit strategy recently. "Most infrastructure assets are not held in a structure that is perpetual," she notes. "A lot of assets are owned through concessions. We've been seeing a lot of attention from people in

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the marketplace saying, 'when and how do I get out? Who decides when I get out? Can I decide?'"

Mion says it seems like LPs today have "two conflicting points", wanting years of exposure to assets that are deemed steady and reliable but also wanting to deploy their capital quickly. "[Investors] like the fund formula where there is an exit plan," he remarks. "When an exit happens, if it's an asset the investor likes, they will try to stay in it either through a co-investment or a special-purpose vehicle."

The combination of what investors want and an increasingly competitive marketplace is leading some fund managers to pursue deals that may not completely fit the bill of an infrastructure deal.

EXPANDING STRATEGIES

"There is a lot that's being called infrastructure now that was simply private equity a few years ago. Container cargo rental businesses, laundry machines, logistics companies, are all things private equity firms have been investing in for a long time," McComiskey says. "Capital asset rental businesses have a long history in the private equity realm."

McComiskey adds that the expanding boundaries of infrastructure are driving up returns and creating higher expectations for the asset class that will be hard to meet when pursuing a strategy that is more strictly aligned with traditional definitions of infrastructure.

"The returns this sector has generated over the past 10 years are, on average, arguably higher than returns from private equity. There is little possibility that this may have moved expectations a little out of line in some quarters. You shouldn't consistently be able to generate 20 percent returns pursuing a core, core-plus strategy," he says.

According to Mahon, part of infrastructure's outsized returns of late comes from asset sales and fund managers' exit strategies. "If you take out of portfolio returns the accreted value upon exit and just look at cash-on-cash, which theoretically is the way everyone should be looking at infrastructure, then you get back to what I call normalised infrastructure returns," she says.

Smith argues that part of today's infrastructure returns is the result of macroeconomic factors. "We're inflated a little bit by decreasing interest rates. However, if there's a little volatility, on average I think you have better performance in infrastructure."

LACK OF PRIVATE EQUITY INVESTMENT

Mahon says she's annoyed by the misconception that there is a lack of private investment in US infrastructure. "Save me room on my soapbox," she exclaims. "I think every person outside the United States gets that wrong. Just remember who buys muni-bonds," she says.

McComiskey responds that "in theory"

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>
> **Mion**

the US is the cheapest market for funding infrastructure projects. "It's just that the cheap financing makes significant portions of the market not amenable to people like us," he says.

Smith adds that, while there may be private investment in US infrastructure through the bond market, private control and ownership in the US significantly lags Canada. "What makes the US different is its muni-market and tax code," he explains. "There's always been infrastructure investment in the US, but not in the same way we see it happening in other parts of the world today."

"One could argue that that is the traditional form and everybody else changed it," Mahon replies. "The only people talking about the lack of private investments in US infrastructure are those who have funds that need to invest in it. The people in the muni-bond market don't sit around saying, 'I can't wait to have more PPPs.' When looking at the US market, it's not a lack of private investment. It's a lack of private equity investment."

Smith adds: "The US market is not one homogeneous market from coast to coast and north to south. The US isn't going to adopt a PPP model that looks like Canada or Europe. The US will develop its own type of unique model."

KNOW YOUR ROLE

More than anything, change in the market is what the financiers that gathered in Manhattan agreed investors should expect from infrastructure going forward. But if an investor stays true to what makes infrastructure the asset class it is, then they shouldn't have much to worry about.

It's all about knowing your role, Smith explains. "We're not trying to solve all the needs of an institutional investor. We're trying to fill one niche, one part of their needs. How does that fit into the overall marketplace?"

Theodoropoulos echoed that sentiment, adding that infrastructure is still the asset class that will perform better than others through economic uncertainty. If a portfolio is built around assets that deliver on that, larger economic factors won't make as much of a difference.

"We've been through a very long, low-interest-rate cycle, and we're coming out of it now," he concludes. "If your asset is linked to inflation or the economy in general, you're going to come out of it. If your assets aren't linked to inflation, hopefully your returns are high enough to withstand the pressure." ■

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