Roundtable

The US market

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Left to right: Matthias Reicherter; Adil Rahmathulla; Salim Samaha; Mark Weisdorf

How to make the most of midstream

Changing energy dynamics in the US have created exciting opportunities for infrastructure investors – but how best to exploit them? Yvonne Li met with four experts in New York to gather clues

The US shale gas boom has fundamentally changed the dynamics in the energy market, with many saying that it presents the country with a need for trillions of dollars in infrastructure development due to the new and upgraded facilities required to move oil and gas products from source to consumer.

The US and Canada will need to invest about $30 billion a year in midstream infrastructure for natural gas, crude oil and natural gas liquids up to 2035, analysts estimated in a recent study by the Interstate Natural Gas Association of America (INGAA).

Such analyses have prompted abundant capital flows into the midstream infrastructure space at a time when many large investors are frustrated with the returns from traditional investments, such as US Treasury bonds or other fixed-income products.

"The US market today offers probably the most compelling risk-adjusted returns relative to what we see in Europe and non-OECD markets. It is especially true for energy and utility assets in the current marketplace," given their exceptionally strong underlying fundamentals, says Adil Rahmathulla, partner at I Squared Capital (ISQ), a global infrastructure fund manager focused on mid-market infrastructure across OECD and non-OECD markets.

BUYING WELL

The rise of midstream Master Limited Partnerships (MLPs) has somewhat inflated the valuations of midstream infrastructure assets. Investors from around the globe are paying premiums for such assets with the expectation that they will generate a long-term steady stream of income that can counterbalance

lower yields from investments in other asset classes, such as US Treasury bonds.

For infrastructure fund managers today, in such a competitive environment, they are faced with one pressing question: What is the key to buying well?

"There is a need for a highly idiosyncratic approach to risk and return," says Rahmathulla.

Shale gas basins in the US have different economics and have various regulatory and policy issues for investors to consider depending on their locations. "Each opportunity therefore involves a unique set of risks that must be measured and priced, using an idiosyncratic approach," insists Rahmathulla.

"There is no concept of 'one yield fits all midstream assets'," he adds.

Some infrastructure fund managers say the market today is not evaluating risk-adjusted returns appropriately against a backdrop of expensive valuations.

"Too frequently, risk is not properly priced," says Salim Samaha, partner at New York-based fund manager Global Infrastructure Partners.

"One thing we've done from the onset is to pursue industrial partnerships," adds Samaha, referring to GIP's partnerships with Chesapeake Energy and El Paso as two such examples.

The collaboration with Chesapeake led to the formation of Access Midstream Partners, which GIP exited from earlier this year.

The firm still holds an interest in Ruby Pipeline, its partnership with El Paso, which is now part of Kinder Morgan.

"These two companies have very different corporate cultures and yet we formed successful partnerships with each of them; if you have the right industry expertise, operational expertise, relationships, and an understanding of how such organisations operate, you can become their partner and invest in platforms rather than simply buying assets…and can capture more of the growth in the energy sector," he adds.

From a portfolio-building point of view, "we (as a financial investor) want to see the assets our funds are targeting to have some hair on them when we are targeting the energy space … partnering is definitely the right thing to do," says Matthias Reicherter, principal and head of infrastructure at Golding Capital Partners, a Munich-based fund of funds that represents German institutional investors including pension funds and large insurance companies.

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Rahmathulla also hails industrial partnerships as "a very clever way to add value" to underlying portfolios while allowing the industrial partner to also benefit.

ISQ has adopted a similar strategy through its partnership with Veolia Energy North America to invest in the combined heat and power space across North America, where it deploys the majority of the capital while Veolia takes on day-to-day management. That "produces valuable synergy," Rahmathulla stresses.

It holds particularly true when costs that can be quite high for a stand-alone asset, such as insurance or labour, are subsidised by a global platform of Veolia assets through a cost-sharing arrangement, he notes.

LARGE VS. SMALL AND MEDIUM

Samaha says he sees the potential to extract operational value from investments of all sizes. However, "despite the fact that there's a lot of available capital, there aren't a lot of investors that can write the really big equity cheques; when an industrial company is looking for a partner, if they have to talk to two or three parties that have partnered up to write a large equity cheque, they face a lowest common-denominator effect and it becomes more challenging to close a transaction."

GIP bought a 25 percent stake in Freeport LNG in July for $850 million, securing a key position in the midstream space as the US transforms itself into a major natural gas exporter to global markets. In June, it sold its remaining interest in Access Midstream Partners to existing shareholder Williams Partners for nearly $6 billion.

Nonetheless, not all infrastructure firms are adherents or supporters of large transactions.

ISQ primarily focuses on mid-market infrastructure because it has great potential for exclusive deals and better risk-adjusted returns than large assets – especially at a time when capital is abundantly available, according to Rahmathulla.

Rahmathulla says his firm sees a tremendous amount of activity across the energy spectrum, not only in midstream, but also in power generation, transmission and distribution and shale-related logistics sectors as well.

"Electricity capacity prices in certain markets that are capacity constrained are much higher than the average electricity prices that are often quoted... so we (also) see opportunities on the power side," he says, referring to ISQ's combined heat and power portfolio.

Shale-related logistics are an attractive play on what is essentially midstream risk but with higher risk-adjusted returns, while transmission and distribution offers compelling opportunities to invest in the US' under-invested grid, he adds.

Mark Weisdorf, founder and managing partner of Mark Weisdorf Associates, also makes the point that the small and medium-capital space provides good investment opportunities.

He gives an example of the electricity sector in parts of Canada and Mexico where higher

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Reicherter

energy prices may offer "sustainable" opportunities in the long run.

Pockets of opportunities are to be found in those regions as natural gas will be adopted and will provide electricity at a much lower price than it was available for in the past.

"So it pays to pursue either a roll-up strategy or development strategy…(and) you can find those opportunities that offer asymmetric risks, but they are specific to certain regions and sub-sectors," says Weisdorf, who was previously head of the infrastructure group at JP Morgan Asset Management and ran private markets at the Canada Pension Plan Investment Board (or CPP Investment Board) prior to joining JPMorgan.

PLATFORM INVESTING

Rahmathulla describes platform investing as "a natural corollary" to its mid-market strategy.

It is an effective value-creation strategy because "it ultimately allows you to monetise a portfolio of middle-market assets – acquired individually at attractive entry prices – as a single large geographically diversified platform that appeals to buyers of large assets," he says, adding that ISQ is undertaking this platform approach with both its combined heat and power and run-of-river hydropower portfolios.

Partnering with capable and experienced developers is key to platform investing, Weisdorf says. "Platform investing is not necessarily partnering with a large industrial corporate partner… it may involve partnering with a capable experienced developer who would benefit from assistance with matters such as strategy, raising capital, and systems to build and manage a larger growing business," he says.

Weisdorf thinks a crucial distinction with platform investing is "are you investing in a business that you are growing as opposed to a business that you are restructuring where you are going to be cutting jobs to make it more efficient?"

When a small capital business is grown into a mid-sized or a large one through the platform, "you get multiple expansion," Weisdorf says.

EXITING WELL

When it comes to exiting investments, there is no substitute for having bought a good business at the right price.

The key is to buy "seemingly complex" assets, de-risk them during the holding period, and monetise them as a simple asset, according to Rahmathulla.

For example, ISQ has invested in a chilling system in Cincinnati where it focuses on increasing customer sales, while for its power plant investment in Cambridge, it is focused on re-configuring the plant layout to minimise discharge.

"There are different levers to add value. In both scenarios, when we acquired the assets, there were controllable risks we were comfortable underwriting due to our operational teams," says Rahmathulla.

"However, even in downside cases where, for example, the customer growth does not pan out or the reconfiguration is delayed, we still look to achieve attractive 'floor' double-digit returns. Value creation and downside mitigation must go hand in hand," he adds.

For Samaha, the optimal exit is "when you buy a business with a little bit more operational complexity and scope for improvement; you work with customers to increase the tenure of their contracts, increasing cash flow and improving cash flow stability. You do the same thing to the cost structure. You get through a couple of regulatory hurdles that you've man-

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aged very actively. At the end, you have a much stronger and simpler story that appeals to a broader set of investors; that's when you are likely to have the best possible exit."

REGULATORY AND POLICY RISKS

Regulations and legislation can add complexity to deals across the globe, regardless of asset class. Arguably, they are especially relevant to North America, considering the myriad network of regulations and current low Treasury yields that place downward pressure on regulated rates, infrastructure managers say.

"We think it requires active regulatory risk management through a team of in-house regulatory experts, both at federal and local levels, especially considering the complexity stemming from a combination of federal and state regulation," says Rahmathulla.

The US has the dual challenge of fund managers needing to deal with rules and laws not only at the federal level but at the state level as well.

The hard truth, according to Rahmathulla, is that it requires extensive interaction and coordination with both. "Policy decisions are ultimately felt at the local level yet a federal push is often needed to get things done and coordinated across states," he says.

"Because this interaction can never be smooth, unfortunately we are left with a fair bit of uncertainty that we have to price into our risk-return expectation and that we have to manage proactively," Rahmathulla adds.

It's important to manage regulatory and political risks in the infrastructure space, but it is even more critical to look for sustainable opportunities with asymmetric risks, according to Weisdorf.

"If you provide infrastructure that benefits a community and its citizens, or you offer a sustainably lower cost for a long time to come, regulators and politicians will allow you to earn a fair rate of return on behalf of your investors," he says.

"It's the best way to manage regulatory and political risk. If a Governor delivers on a promise to a state's citizens – to offer lower-cost natural gas for instance – that Governor is going to get re-elected," says Weisdorf.

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Samaha

Reicherter adds: "At the end of the day, you can't escape political and regulatory risks, so our advice to our investors is to diversify (in terms of) regions, sectors, jurisdictions and countries."

P3 MARKET

The US is lagging behind its peers in Europe when it comes to public-private partnerships (PPP; P3s) largely due to the fragmentation of the P3 market and the overlay of state guidance and laws, Reicherter says. So far, 34 states have created their own P3 legislation.

But the biggest hindrance to P3s in the US is the tax-exempt debt market, where municipalities and states take advantage of low-cost debt to fund transportation and water infrastructure, Weisdorf says.

Progress has been made, however, and more state governments have come to realise that the P3 can provide a sustainable full life-cycle financing strategy, fund managers say.

Another issue that prevents P3s from taking off in the US is the lack of education of stakeholders in toll roads, highways and rail.

"I'm not sure that the average American understands the benefits of the P3 market (and for good reason); this market has a political dimension and the industry needs to do a better job articulating the value proposition to different stakeholders," says Samaha.

FINANCING

Overall, the financing environment in the infrastructure space is unprecedentedly good in the US. Banks have come back to the space in increasing numbers after struggling for the past few years, while government-supportive funding sources, such as the Transportation Infrastructure Finance and Innovation Act (TIFIA) loans and Private Activity Bonds (PABs), help to fill in what funding gaps exist.

As of August, over $4.8 billion in PABs had been issued for 13 projects, according to data from the US Department of Transportation's Federal Highway Administration.

Moreover, long-term project finance for large greenfield projects has revived much more quickly than many expected, fund managers say.

After the global financial crisis, European banks had been struggling to fix capital ratios and balance sheets as they prepared for Basel III regulation, which stipulates higher regulatory charges for long-term project finance.

"Even here, the (European) banks are back pretty strongly. Japanese banks have also stepped in to add to the capital," says Weisdorf.

Still, when infrastructure owners look for long-term financing for seemingly complex assets, sometimes banks don't come to the table – due in part to issues with regulatory capital.

"These situations represent opportunities for investors to roll up their sleeves and take a hard look at what the real risks and rewards are. That's one of the reasons you are seeing more mezzanine-style funds coming up to take advantage of the opportunity," Samaha says.

The opportunity that the US market represents for infrastructure investors has been well documented, but Samaha's closing words are pertinent. Carefully assessing the "real risks and rewards" could make the difference between success and failure ■