Frontier International

International research insights from Frontier Advisors

Real Assets Research Team

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.

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Creating value from asset management

"Asset management" in the infrastructure sector is a term that can be used in a number of ways, but broadly refers to the strategies and techniques used to maintain or add value to an infrastructure asset over the life of an investment. Frontier views asset management as one of the crucial levers in the infrastructure investment lifecycle, which starts in the initial due diligence phase and only ends once an asset sale has been completed.

As Frontier continues to see heightened competition for core infrastructure assets globally, pushing up pricing and bidding down equity returns, effective asset management becomes even more important in driving performance and limiting the downside for investors.

With this backdrop in mind, Frontier's Real Assets Team undertook a research trip during June 2015, in part to review global best practices in infrastructure asset management. This involved meeting with fund managers, portfolio companies, operators and investors located in London, Paris, New York, San Francisco and Sacramento.

Frontier paid particular attention to the influence of environmental, social and governance (ESG) factors, given the long duration nature of infrastructure investments.

What Frontier found was that, while there are different approaches and a no "one size fits all" solution to asset management, there were common themes that emerged in our discussions. A key takeaway was that the financial strategy and analysis toolkit is only half the requirement - relevant industrial experience, credibility and human (social) skills complete the profile of an ideal infrastructure asset manager.

Building positive, sustainable relationships with stakeholders (be it management, co-investors, regulator or contractors) forms the basis of best practice in asset management.

"Asset management is more than buying well, selling well and doing good refinancings"
- European fund manager.

Common Themes

Many of the themes identified are sensible and logical (you might even say obvious!) However, history shows that implementing the obvious is as powerful as being creative.

Control

A form of control (typically joint or majority) is critical for influencing the direction of an asset, allowing greater input into business strategy, board composition and members of the executive team.

Some managers prefer not to hold the entirety of an asset, as a strategic, well aligned partner can bring complementary and relevant skills and experience to the investment.

Operational skills

The most consistent theme that arose from our meetings was that operational or industry expertise is critical for effective asset management. What varied was where this expertise was located – at the fund manager, consultant, a board director or an industry partner (i.e. an aligned co-investor).

How this expertise is accessed is influenced by manager style and strategy. For example, managers focusing on greenfield investments would typically have industrial experience in house, whereas core managers holding minority stakes would often utilise external consultants or align with industry partners.

Relevant operational experience can provide a technical perspective on how the asset can be managed, insight into the value drivers of an investment, beneficial industry networks, and perhaps most importantly, credibility with the executive team of a portfolio company.

Board composition

Approach to directorships varies between managers. Many asset managers will appoint one of their own staff to the board of investee companies, while some viewed appointing an external director with appropriate experience as a strong positive.

A common theme was that alignment and positive governance of an asset is enhanced by a board comprising complementary skill sets, which is independent and has in place robust formal structures.

Quality of management

Not surprisingly, almost all asset managers stated that a strong executive team was critical to the success of the investment. It was pointed out a number of times that while asset management includes influencing the portfolio company to achieve the objectives of the business plan, it does not involve running the day to day business of the asset. Hence, management needs to run the company and effective company management will solve problems and generate ideas on its own.

Achieving quality management teams is not straight forward. In some situations, the asset will already have a strong management team, while in others, changes will need to be made at the outset. Management can also be trained by an external party (often to implement robust procedures, compliance and reporting). An interesting observation was that the willingness of management to accept external input was typically correlated to the quality of the management team.

A more extreme approach is to bring in an outsourced management team, generally known to be of high quality. It will only work for particular types of assets (such as those that are reasonably simple and similar to other assets). A closely related approach is to outsource operations and maintenance and for the asset manager to effectively manage the asset directly. This is a much more active approach and not typically associated with broader core infrastructure.

Another way to leverage a quality management team is the "platform" approach. This is where the skills of the team can be applied across a platform of assets, either through organic growth or bolt-on acquisitions.

Relationships

Building positive, sustainable relationships with stakeholders (be it management, co-investors, the regulator or contractors) is best practice in asset management. Achieving this level of relationship is not necessarily straightforward; ultimately the person building the relationship needs to be seen as credible and valuable to the entity. Having operational experience, achieving "quick wins" shortly after acquisition and/or providing valuable input to the portfolio company can all bring credibility to the relationship in a timely manner.

Secondments into the company is another way to establish relationships early and also allows the asset manager to develop a more intimate understanding of the asset.

One observation is that the level of interaction (number and quality) with company management is influenced by the level of expertise and input provided by the asset manager. Given most fund managers have a team biased towards a financial skill set, interactions generally only increase during commercial activities such as debt refinancings.

While this is no doubt beneficial for company management, financial skills are common among fund managers; a broader interaction is likely to be more effective and easily achievable by someone with an operational background.

Whether due to cultural affinities or avoidance of language barriers, continental European fund managers are more likely to establish stronger relationships when members of their team are of the same nationality as company management. This was less of a concern in English speaking countries like the UK or US.

Alignment

An almost universal approach to creating management alignment was to put in place short and long term incentives for key executives, which are influenced by the achievement of certain key performance indicators within the business plan. Other approaches included providing company management with equity (or a security structure like equity).

A related theme that frequently emerged was that company culture can provide positive alignment that is non-financially oriented. Achieving such a positive culture is not necessarily straightforward, but one perspective was that it comes from the top (i.e. CEO).

An interesting approach to creating alignment (or at least to remove misalignment), was to change the CEO shortly after acquisition. This means removing someone with preconceived ideas or attachment to the "old way' of doing things and being replaced by someone who brings a fresh perspective and can be influenced by the asset manager. However, this wasn't a common approach and it can introduce additional risks.

Sharing experiences

Sharing experiences between portfolio companies is a theme that arose a number of times across infrastructure managers. This includes bringing staff together from across the portfolio to discuss best practices, such as holding health and safety, CEO or CFO days. It can also involve bringing together members of companies that operate in similar markets or face similar challenges to generate ideas and improve processes. Other possibilities include non-competing companies creating synergies through initiatives such as combining purchasing power.

Not only can these initiatives allow the spread of best ideas across the portfolio, but it also demonstrates the value of the asset manager to company management; improving credibility, alignment and ultimately assisting to establish a more sustainable relationship.

ESG (environmental, social and governance)

ESG was discussed with all the managers Frontier met with on the recent offshore trip. Naturally governance was a focus of all asset managers and is extensively covered in the themes above. All asset managers also considered environmental and social factors to some extent, though this was typically more focused on social factors, and particularly occupational health and safety. In terms of the reasons for explicitly considering ESG, most managers considered it a risk mitigation tool, though some did note it can drive performance – particularly when it came to energy efficiency.

A point raised a number of times was that management of ESG factors should ultimately mean a more sustainable business, which is particularly important given the long duration nature of infrastructure investments.

In some respects, sustainability could be considered as a whole of life approach to managing an asset and at the asset manager level this was often encouraged through a whole of life approach to the investment i.e. the initial deal team goes on to manage the asset and maintain positive, sustainable relationships with stakeholders.

How ESG is managed overlaps with a number of the other themes we have covered already. As an example, a positive ESG approach can help with the development of positive, sustainable relationships with key stakeholders such as the community, employee workforce and government. One asset manager also commented that ESG can be an indicator of management quality, because if management can't handle tasks such as compliance and health and safety, then it can't be relied on to manage a company more broadly.

Creating value from asset management

Based on our meetings offshore and prior experiences domestically, Frontier would consider the following to be best practice in infrastructure sector ESG management (particularly focused on the “E” and “S”):

- ESG factors are covered in the initial due diligence and steps are put into place to address any weaknesses. Bringing in external auditors is a positive way to receive an external perspective.
- ESG should be a critical focus and firmly embedded in the culture of both asset manager and portfolio company. ESG factors should also be tied to management incentive structures. One asset manager noted it has structured remuneration packages so senior management is significantly impacted if occupational health and safety targets are not met.
- An asset manager should be a signatory to the PRI and have a corporate social responsibility charter. Investee companies should also have a corporate social responsibility charter.
- Ongoing monitoring and reporting of ESG should occur in each investee company, covering compliance, health and safety, and further social and environmental factors.
- Investee companies should receive certifications in applicable ESG related areas (e.g. compliance with appropriate standards covering sustainability, governance and safety). This allows the companies to be audited and for consistent standards to be applied across the portfolio of assets.
- Specific staff should be designated (including senior investment professionals) and committees set up at the asset management level to focus on ESG matters.
- Taking a proactive approach to managing ESG and changing the culture throughout an organisation can reap positive outcomes. An example of this is at Pisto, where each site has a “days since last incident” sign at the entrance, and different sites compete to have the most days since an incident (see below).

While there was a reasonable level of variation, Frontier was very pleased overall with the level of emphasis ESG considerations receive amongst the asset managers we met.

Pisto, France

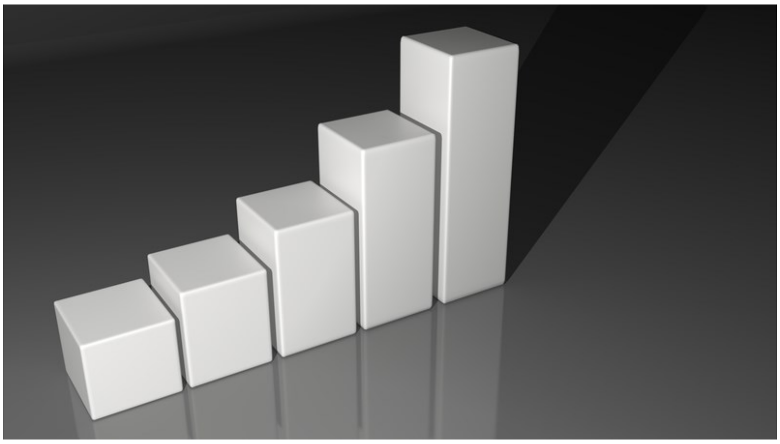
Benefits of effective asset management

Downside protection / risk management

Given most investors seek defensive characteristics from their infrastructure exposures, downside protection/risk management is critical in the management of these assets. This can come in the form of stringent due diligence prior to acquisition, structure of the investment (enabling a minimum return for example), getting comfortable with downside scenarios and/or regular communication with company management to discuss and be on top of any issues arising at the asset. Strong and effective asset management will mean risks that arise will be identified and managed, enhancing the defensive characteristics of the asset.

Driving performance

Effective asset management not only means limiting the downside of an investment; it is also important for accessing upside or growth opportunities which can help drive the performance of an asset. Strong asset management means identifying, assessing, prioritising and implementing growth opportunities, and can be particularly effective if these are driven by the portfolio company (with the support of the asset manager). An indirect benefit of supporting these opportunities is that it can motivate management and strengthen the relationship between the two parties.



Deploying capital

Strong asset management skills can lead to deploying capital in a manner that is less competitive or non-competitive with other capital sources. This is extremely valuable in the current market where accessing deal flow is becoming more and more challenging.

Sourcing complex opportunities in order to reduce competition is an effective way to deploy capital; more attractive pricing is likely to be achieved and a broader range of potential investments can be accessed.

There are a number of strategies employed, which can involve structuring a deal so a bilateral negotiation arises (such as creating a partnership between the seller and purchaser), or accessing complex deals that will require considerable work after investment (for example, purchasing a combined generation and transmission business and on-selling the generation component).

Note that experienced internal resourcing will be required when pursuing and implementing such deals.

Effective asset management also leverages the existing asset base to deploy capital. This can occur though the form of additional capital expenditure (organic growth) or through bolt-on acquisitions (that is, roll-up strategy or a platform approach).

While the strategies outlined can still occur without a particularly active asset manager (for example, be management led), a strong asset manager is more likely to identify such opportunities and drive management to achieve these outcomes.

Stansted Airport, UK

Conclusions

Approaches to asset management vary by manager and strategy and there is not a "one size fits all" best practice. Common themes emerged in our offshore discussions that highlight the importance of blended, relevant experience in an asset manager.

These themes included the importance of operational skills and building positive, sustainable relationships with key stakeholders (be it management, co-investors, regulator or contractors). Having the financial toolkit is important, but it is only part of the skill set required for effective asset management.

Frontier recognises the importance and benefits of effective asset management, particularly in an environment where acquiring reasonably priced assets is becoming more and more challenging. Downside protection, driving performance and finding ways to deploy capital in a non-competitive manner are some of the key benefits to a comprehensive asset management strategy.

While typically viewed as the domain of core-plus and opportunistic managers, effective asset management is just as important for core managers, particularly in the current environment.

Management of ESG factors should ultimately mean a more sustainable business, which is particularly important given the long duration nature of infrastructure investments. Taking a proactive approach to managing ESG and embedding this in the culture of asset manager and portfolio company will reap positive outcomes at the asset level and ultimately stronger performance of the investment.

Frontier encourages investors to spend more time on asset management when evaluating existing investments and seeking new opportunities in the future.

FRONTIER ADVISORS