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WEBINAR Briefing

Investing in U.S. Infrastructure

From the Privcap webinar
"The U.S. Infrastructure Opportunity"

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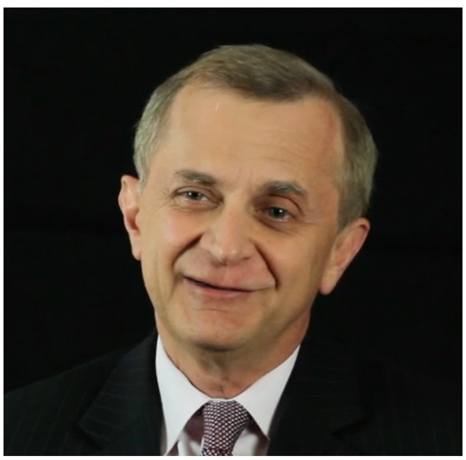
Investing in U.S. Infrastructure

As talk ramps up about the potential within the U.S. infrastructure sector, two industry experts participated in a Privcap webinar to sort through myths and realities about the space

The Panelists



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Founder,
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➜ BIO

Weisdorf is formerly a managing director and CEO of J.P. Morgan Asset Management's Infrastructure Investments Group. Previously he was head of private market investments at the Canada Pension Plan Investment Board and held senior investment banking and equity capital markets positions with CIBC World Markets and HSBC Securities (Canada). He obtained his bachelor of commerce degree from the University of Toronto and is a chartered accountant, chartered business valuator, and CFA charterholder.

➜ BIO

Kuchel is the chief operating officer for the Macquarie Infrastructure Partners (MIP) and Macquarie Infrastructure Partners II (MIP II) funds, which manage infrastructure investments across a number of sectors, including utilities, toll roads, ports, renewable energy, waste, and telecommunications. He serves as a director of WCA Waste Corporation and also acts as a board member for the majority of MIP and MIP II's portfolio companies, including Waste Industries USA, Inc., and Broadrock Renewables. Kuchel is also a chartered accountant.

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Privcap: Talk to us about the rising allocations from limited partners and from institutional investors. What is behind those rising allocations? What do they hope to achieve in infrastructure?

Mark Weisdorf, Mark Weisdorf Associates: I've been speaking to investors around the world about infrastructure for some 15 years, and clearly things took a bit of a pause during the global financial crisis of 2008-2009. But what we saw over the last two years, and looking into 2015, is dramatically growing allocations and commitments to the space.

Behind it are the characteristics of infrastructure: It has low correlation to equity and fixed income, whether those be private or public equity or fixed- income strategies. It gives you diversification. There's a fairly high component, at least for core infrastructure, of total return that comes from cash flows, from distributions, from assets that are monopolistic in their nature. And that cash flow helps to dampen volatility and therefore generates relatively predictable low-volatility returns. That's very attractive.

If we look at what's been happening in the other major asset classes, what we see is fixed income where interest rates are approaching zero. Rates continue to be low. We're all expecting rates to come up, but in the meantime they're quite low. And very few pension plans can meet their required rates of return in the 7 percent to 8 percent category with 10-year Treasuries sub-2 [percent] and with 30-year Treasuries sub-3, 3.5 [percent]. That's very difficult.

On the equity side, what we've seen big time in the last few weeks is volatility. So while investors and institutional investors are very happy that equity prices have returned from their post-crisis lows to post-crisis highs, that comes with an awful lot of volatility that really translates into risk. The two other asset classes, the two other main arrows in an investor's quiver, have challenges.

Karl Kuchel, Macquarie: The U.S. is viewed as a very attractive market for infrastructure investment in the global context. And certainly over the last couple of years, we've seen the U.S. LP community become increasingly interested in investing in infrastructure as a distinct asset class, and also rising interest from non-U.S. LPs coming into the U.S. market and wanting to deploy capital here relative to other infrastructure markets. The U.S. is a bright spot in terms of LP interest globally.

Let's further that analysis with what you think of as the opportunity for private capital to partner with infrastructure investors, in the U.S. specifically.

Kuchel: Quality of infrastructure has a positive correlation with global competiveness, given that infrastructure in many cases supports or drives economic activity. What I would highlight, though, is the U.S.'s approach for investment in the public sector. Investment in infrastructure over most recent times has not been sufficient to maintain the quality of infrastructure. And that's really what generates the opportunity for a number of investments from all pools of capital. But given that traditional funding sources for infrastructure investment—which [traditionally] have been the public sector—face some physical challenges, there is an increasing private sector opportunity to invest in infrastructure in the U.S.

And I would break that down into two [categories]: population and other macro factors drive growth. There's a need for infrastructure to support that growth, so that's either new infrastructure or the expansion of existing infrastructure. But another theme that is key in the U.S. is the deployment of capital into projects to either reconstruct or bring those assets up to a quality that is acceptable to support current activity. One that's often cited is the interstate road network in the U.S., where there is a significant capital need to bring the existing network up to an acceptable engineering standard.

A common misperception is that the opportunity set revolves around public sector entities either looking to monetize existing assets or looking to work with a private sector partner to develop infrastructure. In fact, in the U.S., the majority of the capital that we deploy is through traditional sourcing channels being private transactions or privates of listed companies. The majority of the deal flow in infrastructure, investing our clients' money, is still through sources that you would see across other private equity strategies in other subsectors.

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There is an increase in PPP deal flow, and by that we mean public-private partnerships. Tell us about these and what this increase tells us.

Kuchel: This is an interesting point in that very well-established PPPs globally have been in place for at least a couple of decades where the public and private sectors partner to deliver infrastructure. The U.S., despite being a very large market and having a very large opportunity for infrastructure investment, has actually lagged behind the rest of the world in terms of deploying PPPs as a mechanism for delivering infrastructure.

More states recognize that due to fiscal constraints and other priorities, involving the private sector—and not just from a capital deployment perspective—is important and can be beneficial.

A key point to note is that in many jurisdictions around the world, infrastructure can be a federalist proposition where it's delivered on a top-down basis. In the U.S., however, it is a state-based approach where cities and municipalities are seeking to procure PPPs. It is a decentralized procurement model, which means that various states are at different stages in terms of their familiarity and execution of PPPs.

Weisdorf: In fact, the states and the municipalities have more impact and more influence on whether public-private partnerships go ahead or not than the federal government does. The federal government can provide some financing and needs to be supportive in terms of various approvals. But it seems to me that infrastructure is more local in the United States.

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Mark, when you say infrastructure, you're really talking about a lot of different types of assets. Walk us through what you see as the most important differences among the different types of assets under the infrastructure umbrella. And then tell us a bit about how you see the size of the opportunity in these different subsectors.

Weisdorf: Generally speaking, there are three or four categories. You can slice and dice risk and return, but the regulated utilities are, generally speaking, considered infrastructure: water and wastewater, electricity, gas. In the U.S., it's usually statewide regulation.

You have transportation assets, which have a different risk profile. And subsectors there would be roads, toll roads, airports, seaports, and even rail in certain situations. Those are all certainly hard assets that are required for the movement of energy and people and goods, but they exhibit a greater degree of economic sensitivity.

You have social infrastructure in some countries, although there's less availability of that in the U.S. We're talking schools, universities, hospitals, prisons. Infrastructure is idiosyncratic. You have to look at the specific asset in its specific location with its regulatory regime. And you have to look at the concession agreement to really determine where it sits on a risk-return spectrum.

And the only other thing I'd like to point out: energy infrastructure. Very broadly, it can include regulated electricity and gas, midstream and downstream, and storage for oil and gas. It can include electricity power generation, particularly if it's wind-, solar-, and gas-driven. But the reason I wanted to point out energy infrastructure is that in the U.S., you're dealing less with government and competing with tax-exempt debt.

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[Studies] suggest there's roughly $1T of need and opportunity in the U.S. over the next seven to 10 years. These independent sources have identified needs in the range of $400B in the regulated utility space. A lot of that is replacing coal-fired plants with gas and renewables—a $300B requirement—but there's also transmission and gas distribution required in the regulated-utility space. All this shale gas and tide oil that's been discovered not only needs to get out of the ground but needs to then find its way to refineries, to market, and there's a great deal of transportation infrastructure required.

There's been lack of appropriate investment in the water and wastewater sector in the U.S., [creating] tremendous need there and a lot of need in bridges, tunnels, ports, and so on. That all adds up to about $200B.

We know there's tremendous need for capital in U.S. infrastructure, but how much of that capital is actually going to translate into private-equity-style deals?

Kuchel: It inevitably comes back to the fact that while there may be a capital need, the terms around these deals, which are on an asset-by-asset or deal-by-deal basis, may not always be attractive to the private sector. Or the private sector may not be the logical party to actually finance them. There has to be a meeting of the minds by some of the capital-providing side as well as on the capital-needs side.

From year to year, there is consistent involvement. We're not talking about infrastructure ramping up and a huge amount of deals getting done now that weren't being done previously.

As [the need] becomes more acute, you'll see those parties requiring capital potentially adjusting the terms under which they'll interact with private capital. But I don't see the market at the moment moving into a phase where you're going to see doubling or tripling of deal flow.

Weisdorf: I don't think there will be a sudden ramp up in deal flow, but the next five to 10 years could potentially provide more deal flow and more capital investment opportunities than the last five to 10 years. I'm optimistic about that, based on the shale gas revolution. It's turning the United States from being a net energy importer to a net energy exporter.

It takes time to deploy all of the capital required to make use of the massive discoveries of shale gas and the new technology to extract gas and oil.

What are you seeing in non-energy opportunities?

Weisdorf: There's another $1T-plus of need in that space. But a number of experts believe there will be a gap in filling the requirements in the non-energy infrastructure sectors. Although there is improvement and understanding on a state-by-state basis of the potential for private sector partnership with government agencies, it's a slow process. There is increasing use of, understanding of, and willingness to work with the private sector on filling that gap.

Kuchel: Because it is a state-by-state or a city-by-city phenomenon, the deal flow is linked very closely to those various public sector participants reaching the stage of being comfortable with private sector money. It won't all come in one wave. There still will be pockets of more and less activity.

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How does the swoon in oil prices affect the infrastructure investment opportunity going forward?

Kuchel: The direct impact on infrastructure will be on the supply side. Therefore the production or transport to market inevitably is going to slow. It'll push capital expenditure plans out. It'll cause the cancellation of some infrastructure projects. The key point is, obviously oil is a very volatile commodity, and infrastructure investment opportunities will move with it.

If you're talking vertically integrated waste companies, they're running full truck fleets. You're talking about toll roads that are reliant on volumes. Lower gas prices are a positive for those sorts of companies, and so the indirect impact on other infrastructure assets is actually a positive.

Weisdorf: The other positive is that it will speed up capital investment in gas-fired power plants. You're going to see coal-fired plants that were going to take a while to retire being replaced much more quickly than you would have otherwise with gas-fired generation. You're going to see more LNG export plants, with gas being cheaper and being abundant in the U.S. You're going to see more capital invested to get that gas to countries like Japan.

Are there risk-return outlooks based on size, and are there deal flow considerations when thinking about mega-deals versus smaller deals?

Kuchel: There are inevitably pools of capital that have preferred deal sizes, but regardless of the size, you are coming back to those core characteristics and trying to understand how these assets will perform over their lives.

Weisdorf: It's a bit of barbell. Smaller deals do exhibit higher risk but also provide potential for higher return. There's no doubt that in smaller companies, smaller sets of assets don't have their profile diversified across as much of a region. They don't have as large and as diverse an executive management team. They might not have the systems that larger companies have. So the smaller deals do present more risk. But on the other hand, finding those companies, those collections of assets, putting them together, presents the opportunity to grow smaller companies and smaller assets into larger ones that are more efficient, that are more competitive and generate higher return.

To what extent do guaranteed cash flows come into play when you're doing these kinds of PPP deals? And are these often a deal killer or a deal impediment?

Kuchel: Guarantee is too strong of a word to use. When you look at infrastructure assets, you're looking at a volume-based revenue line, or you're looking at some sort of credit risk where a very strong credit-worthy counterparty is providing the availability or other payments to you. The U.S. hasn't been a market where the availability approach has been the dominant approach for procuring these projects, but I would say the U.S. is moving in that direction.

Social infrastructure, like courthouses or schools or hospitals, doesn't have a clear revenue line based on patronage. You are looking for the public counterparty to step up. That's an increasing focus in the U.S., but the U.S. has historically focused more on market factors to drive these projects and make them economic.

How bullish are you about the forward-looking U.S. infrastructure opportunity?

Kuchel: I certainly am optimistic. We've been deploying capital in U.S. infrastructure opportunities at about the same rate over the last one or two years as we have over the last decade or so. We see the pipeline across all of the sectors that we follow, offering those opportunities that are attractive. Clearly macro factors are a key driver of infrastructure opportunities, whether it's physical constraints that drive governments to want to use private capital, whether it's record-low interest rates or falling oil prices.

Weisdorf: I haven't been more bullish in all of the last 15 years than I am now. It comes down to two factors: One, the energy self-security and export opportunity is huge, and it will take trillions of dollars and a decade or two to get that properly built out. Secondly, more and more states and municipalities are utilizing various models to partner with the private sector to invest in, operate, and maintain infrastructure. ■