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The *buy* side

On the *right track*

Investors in infrastructure often look beyond the financial statements to find important information about a company's operations and performance, say two of the portfolio managers of the Maple-Brown Abbott Global Listed Infrastructure team. *Tim Cooper* finds out more.

Infrastructure has been grabbing headlines since Donald Trump promised US$1t of investment in the sector during his US presidential election campaign. If he can stimulate significant investment, it will go some way to addressing the huge problem of aging infrastructure in the country, which is mirrored in many other Western nations.

Andrew Maple-Brown and Lachlan Pike, two of the portfolio managers in the Maple-Brown Abbott Global Listed Infrastructure strategy team, say that Trump's election, and promises of infrastructure investment from other politicians globally, may create opportunities for owners of existing assets. But they believe the biggest impact on valuations will continue to come from other, more asset-specific factors.

More research work is needed to identify and analyze these factors, and the fund managers say they usually need to look beyond the financial statements of infrastructure companies. Fortunately, says Maple-Brown, infrastructure companies often provide the extra detail they require within regulatory disclosures.

The fund's investment process starts by identifying around 115 companies with the basic attractive qualities of core infrastructure assets, such as low cash flow volatility and natural inflation-linked returns. Around half of these are regulated businesses such as water, gas and electricity suppliers; a quarter are in transportation, such as toll roads, airports and railway tracks; and the rest are subject to long-term contracts – for example, pipelines and telecommunications assets. The fund managers then narrow the list down to 25–35 stocks, on the basis of criteria such as discount to the team's valuations and qualitative assessment of the company's management.

The FTSE Global Infrastructure 50/50 index – one of the more popular infrastructure indices – includes more than 200 companies. But Maple-Brown says many businesses in the index, such as stevedoring and railway services, are potentially cyclical in nature and receive earnings from activities that do not have core infrastructure characteristics. They may therefore result in a more volatile return profile, which is less attractive to the infrastructure investor.

"We use a bottom-up approach to choose a more concentrated portfolio of stocks in which we have a high conviction," says Maple-Brown. "Our investment process relies on digging deep and using as much publically available information as possible, much of which is not necessarily produced for financial investors such as ourselves."

SPLITTING OUT EARNINGS

Maple-Brown says that, in the case of regulated utilities, the financial accounts are helpful in providing a snapshot. "They tend to provide the greatest information in areas such as debt facilities, interest rates on debt, interest rate hedging and the balance sheet," he says. "But, as they don't have the granularity we need to make forward-looking assumptions, we use the much more detailed reporting on operational information available through the company's regulatory filings.

"For example, for larger companies with multiple assets, if we just rely on the financial accounts it can be difficult to split out the earnings and the balance sheets of individual assets. This splitting can be important, because these assets can have very different durations and revenue drivers."

The importance of good governance

Maple-Brown Abbott strongly emphasizes corporate governance in its investment process and welcomes recent improvements in environmental, social and governance (ESG) reporting in infrastructure companies.

Maple-Brown says governance is particularly important in the infrastructure sector because many assets were originally in public ownership. This can create weaknesses in corporate governance; for example, if the state continues to own a stake in the business.

"Also, infrastructure investments are typically large in value and have long lifespans," he adds. "This means that any bad management decisions can destroy a lot of value. We use a scoring system to select stocks and a fifth of that score is based on our assessment of the management and corporate governance in each company. It is the second most important factor in the process, after our valuation. The factors we consider for scoring include management alignment with shareholders, management skill and strategy, board independence, whether certain shareholders have a higher split of decisions, and board length of tenure."

Maple-Brown says the level of governance disclosure has improved in recent years, but his team's analysis shows that some regions score more strongly in this area than others. "Generally, infrastructure companies in North America, the UK and Australia have stronger corporate governance, while some emerging markets are weaker," he says. "Also, management alignment in Europe is often weaker. For example, management teams in Europe don't tend to hold as much stock as elsewhere and may have limited alignment with shareholder returns."

He says the big improvement in ESG reporting is due to companies recognizing the importance of environmental factors, as well as increased shareholder activism, including proxy voting and shareholder requests to companies for information on ESG.

"The G20 initiatives on climate-related disclosure are also driving that and affecting what information is released," he adds. "This is important, as it helps us ensure that companies focus on these issues."

Building a better working world

PROFILE

Citywire A-rated Andrew Maple-Brown (left) joined Sydney-based Maple-Brown Abbott in December 2012 and has more than 20 years' experience in investing in infrastructure; he previously worked at Lend Lease and Macquarie Group. Lachlan Pike (below left) has more than 12 years' experience in financing and investing, with the majority in infrastructure, and previously worked in Macquarie's global infrastructure team. The Maple-Brown Abbott Global Listed Infrastructure strategy has institutional investors in nine countries around the world.

He says this is true in North America, where many of the regulated assets in the fund are based, and in most other countries too.

"We also use regulatory filings when analyzing regulated water, gas and electricity businesses across Europe, Australasia and Latin America," he adds. "For companies that report under IFRS, financial reporting does not follow regulatory reporting, so accessing the regulatory filings becomes even more critical in evaluating the drivers of asset value.

"For example, when researching UK regulated water utilities, we need to analyze closely the total expenditure allowances from the regulator, which are provided in regulatory documents. The regulator applies a ratio to the total expenditure to derive the costs to be recovered from revenue and the value added to the regulated asset base. These regulatory splits are crucial to modeling the UK water utilities and are different to the statutory reporting of operational expenditure and capital expenditure."

VALUABLE SOURCES

Pike adds an example of pipeline companies in North America. "When analyzing these companies, we build dividend discount models of at least 10 years, focusing on variables such as contracted positions and annual tariff adjustments," he says.

This information can be found in documents including the 10-Q (quarterly) and 10-K (annual) US Securities and Exchange Commission reports, which are detailed, but relatively standardized across companies. But, as Pike explains, major interstate natural gas pipelines also have to submit filings to the Federal Energy Regulatory Commission (FERC), such as Form 2, which is a compilation of financial and operational information with up to 200 pages of detail.

These filings are typically used by shippers or producers, but are also valuable sources of information for financial analysts. "For example," Pike says, "in a 10-Q or 10-K, you only have to report major customers over a certain size. But

"Infrastructure companies often provide the extra detail investors require within regulatory disclosures."

the FERC filings typically disclose all of the contracted customers on the pipeline."

The team monitors a wide range of regulatory filings on potential investments. But the largest source of information comes in regulatory rate cases.

The rate case examines the value of investments into the asset so that the regulator can determine a fair return. It also calculates a total revenue requirement, which is used to determine customer charges. Maple-Brown explains that these rate cases give much more information than SEC filings, including a detailed, asset-based breakdown, current revenue requirement and a forecast of revenue growth through the regulated period. They also provide capital expenditure forecasts, customer and sales forecasts by customer type, customer bill comparisons and more detailed tax breakdowns.

"In most regulated assets, we have a clear decision-making process that runs through the revenue requirement, asset base and expenditures," he concludes. ■

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