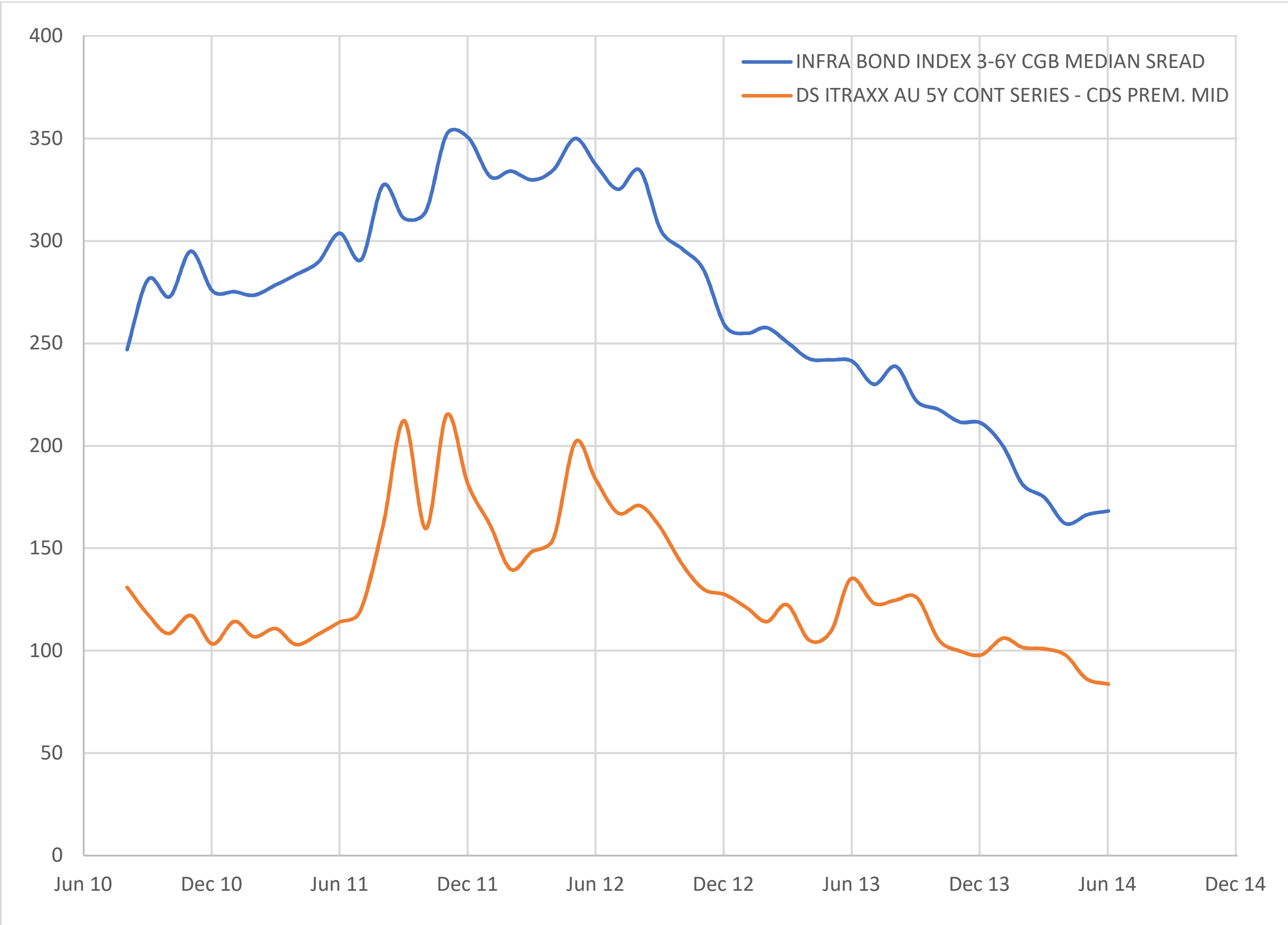
Introduction

For the second instalment of our quarterly newsletter we've included our regular news and market commentary update together with one piece questioning the use of leverage in infrastructure investing. Technically with this piece, we're talking down our own interests (debt), and perhaps it's slightly controversial, but we hope it spurs thought and interest amongst our readers.

Markets update

The table below provide an update on credit markets on a rolling 5 year basis. Spreads have continued to tighten reflecting more accommodative monetary policy around the globe. The hunt for yield continues….



New issuance and refinancing

The table below provides a list of publicly available deals.

Issue Date	Security	Issuer	Volume (AUD M)	Tenor (years)	Issue spread to swap (bps)
April 2014	Loan	Sydney Airport	1,500	3/4/5	110/125/140
April 2014	Bond	Sydney Airport	1,012	10	122.50

May 2014	Bond	Adani Abbot Point	100	6	250
June 2014	Bond	Port of Brisbane (USPP)	750	15	~200
June 2014	Loan	APA Group	1,250	2/3/4	100/110/140
June 2014	Bond	Port of Brisbane	200	7	145
June 2014	Bond	SP Ausnet	100	10	150

Equity and other news

It's been another strong quarter for infrastructure sales:

- **Port of Newcastle:** The NSW government has also sold the world's largest coal-export terminal, Port of Newcastle for $1.75 billion (27x) to a consortium including Hastings Fund Management and China Merchants Group.
- **Queensland Motorways Limited:** A Transurban lead consortium (including Australian Super and Tawreed) acquired QML for $7.057 billion (28x), well in excess of the expected sale value of $5 billion.
- **Sydney's second airport:** Prime Minister Tony Abbott announced Sydney's second airport would be built at Badgery's Creek, with work expected to commence in 2016.
- **Port of Melbourne:** The Victorian government has issued a request for tenders for the sell-side advisory position, with the transaction expected to take place in the first quarter of next year.
- **NSW Poles and Wires:** The NSW government has announced that, if re-elected, they will sell 49% of it's transmission and distribution businesses. The sale proceeds will be reinvested in new infrastructure.
- **ANZ Terminals:** Macquarie has acquired ANZ terminals from Morningside Private Investors for $525 million (13x). The asset comprises 4 terminals in Australia and 4 terminals in New Zealand.
- **Envestra:** Cheung Kong Infrastructure (CKI) has offered $1.32 conditional on gaining a 50% interest in Envestra (pre-bid CKI 17.46%, APA 33.05%). The offer trumps APA's 0.1919 script offer for Envestra. As at 30 June Envestra is trading at $1.36 and APA at $6.89. Envestra shareholders are encouraged to wait until after the final dividend record date (18 July) before accepting.

Why do superannuation funds leverage their infrastructure investments?

Infrastructure is flavour of the month with superannuation funds. Recent high profile Australian transactions include Port Botany, Port of Brisbane, Queensland Motorways and Port of Newcastle. These transactions involved over $15 billion at an eye-watering average EV/EBITDA multiple of 26 times. A key theme is that all involved superannuation funds (domestic or foreign) as part of the winning bid.

Why do superannuation funds love infrastructure? Infrastructure offers the promise of stable long term inflation linked cash flows. Superannuation funds hope that increasing investment in infrastructure:

- reduces exposure to equity risk (i.e. short term volatility) without the give up in returns of investing in bonds;
- provides yield/cash income which is particularly attractive for pensioners and members near retirement (particularly given the cash yield should rise with inflation over time); and
- provides some protection against further falls in long term interest rates (as lower bond yields should push the value of long term cash flows up). This is particularly appealing to defined benefit funds. It is

important to remember this is a two edged sword, rises in bond rates (and bond yields are very low in a historic context due to QE) would be expected to drive down the value of infrastructure assets (and any other asset involving long term cash flows).

The history of infrastructure assets, even including the GFC, supports these characteristics on an ungeared basis. For example, through the GFC both Sydney Airport and Transurban showed steady growth in underlying operating earnings (EBIDTA). But this steady growth of underlying earnings was in marked contrast to their equity returns over the period – both entities share price more than halved during the GFC. Hardly consistent with a picture of steady underlying earnings growth!

Why did infrastructure equity investments get hit in the GFC? They underperformed because the cost of debt increased substantially and for highly levered investments, this substantially cut cash flows available for equity. It was a case of the underlying asset performing, but equity getting smashed by leverage.

Since the GFC, listed infrastructure companies have changed their approach to debt. For example, Transurban now only pays equity distributions out of underlying operating cash flows (rather than by juicing returns by increasing debt over time). Similarly, Sydney Airport has reduced leverage from over 10x EBITDA to around 7x.

This caution stands in contrast to recent unlisted transactions. For example, the Port Botany and Port of Newcastle transactions both involved more than 10x debt/EBITDA. This raises the question whether these investors have truly learned the lessons of the GFC?

A further contradiction is that at the same time superannuation funds are investing in leveraged infrastructure equity they also allocate a significant part of their portfolio to fixed income. Couldn't they achieve the same result – and save a lot of fees and credit margins to the banks – by investing in infrastructure on an ungeared basis and holding a little less fixed income?

Possible explanations:

- without the leverage deals wouldn't meet investor's expectations of returns. Yes, but if this is the case, will investor's expectations of infrastructure offering low risk returns be delivered?
- leveraged deals are more likely to deliver performance fees to fund managers … but is this in the best interests of fund members?
- Super funds need their fixed income to be highly liquid but unlevered infrastructure would be illiquid. Yes … but funds typically hold 15-20% in fixed income … does all of this need to be liquid?

Maybe when Australian superannuation funds were a lot smaller, and fewer were investing in infrastructure, leverage made sense to allow medium sized funds to invest in large transactions while maintaining diversification. However, in today's world, where the largest investors seem to struggle to be fully invested in the asset class, does this still make sense?

Contact Us

We're always happy to chat (and learn new things!) if you want to know more, contribute more on a particular topic, or wish to discuss any of the above topics in greater detail feel free to drop us a line. Also, please don't hesitate to send us ideas for future articles.