Roundtable
Canada

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Distinctively Canadian

Six investment professionals sat down with **Kalliope Gourntis** to discuss what Canada has done right, what it can do better, and how it has managed to distinguish itself from a general 'North American' category when it comes to infrastructure

Canada is known for many things – hockey, maple syrup, harsh winters and a pioneering spirit. That last characteristic can be attributed not only to the people that explored, settled and made the country what it is today, but can also be used to describe how Canadian investors have approached infrastructure as an asset class.

Canadian pension plans, for example, were one of the first to invest in it and one of the first to do so directly. That may then lead to the question "what is their relationship with general partners/fund managers?"

Infrastructure Investor had a chance to find out when it recently brought together three independent fund managers, executives from two large pension funds and an adviser from KPMG to sit around the table for a conversation focusing on the Canadian infrastructure market.

"I think we have an interesting relationship," Greg Smith, president and chief executive of asset management firm InstarAGF says. "It's a nice complementary relationship to the fund manager model that also exists in Canada and I think it's one of the few

"We will selectively target large-scale, high-quality PPPs where we're comfortable with the risk profile" Sherman

jurisdictions that have both opportunities at play. We complement each other in terms of how we approach the market, the value proposition that we bring to the table," he remarks.

The variety in opportunities and the different approaches result in each side describing a different experience.

SIZE MATTERS

"If you look at the past five or six years, infrastructure investment globally has been relatively stable," Andrew Claerhout, senior vice president, infrastructure at Ontario Teachers' Pension Plan (OTPP), says.

"The number of investors that has poured into the industry has been growing and growing. We've had a supply-demand imbalance for some period of time and that just appears to be getting worse and worse. What it's resulting in is returns getting lower and lower," he adds.

While Claerhout's comments refer to the infrastructure space on a global scale, the same can be said of the Canadian market.

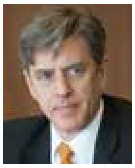
As a result, OTPP, the largest single-profession pension plan in Canada, and Borealis, the infrastructure investment arm of the Ontario Municipal Employees' Retirement System (OMERS), which last year closed an unlisted co-investment platform, the Global Strategic Infrastructure Alliance (GSIA), on more than $12.5 billion, look beyond Canada's borders for their investment opportunities.

"We haven't been particularly active in PPPs [public-private partnerships] but we will selectively target large-scale, high-quality PPPs where we're comfortable with the risk profile," comments Sebastien Sherman, Borealis' executive vice president and senior managing director, North America.

AROUND THE TABLE

Andrew Claerhout, senior vice president, infrastructure, OTPP

Before being tapped in September 2013 to head OTPP's infrastructure group, Claerhout served as vice president, private capital, where he headed the consumer, retail, and industrials group. He joined Teachers' in 2005 and was in charge of the London office from its opening in 2007 until returning to Toronto in 2009.



Paul Huebener, managing director & head of Americas, DIF

Huebener joined DIF from Macquarie Capital Markets Canada in October 2012 when the Dutch asset management firm established its presence in Canada, opening an office in Toronto, which Huebener heads. He has over 20 years of experience in energy and infrastructure projects in Canada, the US and Southeast Asia.

Sebastien Sherman, executive vice president & senior managing director, Borealis

Responsible for Borealis' Americas infrastructure business, Sherman also manages the Toronto and New York-based infrastructure team. He has over 12 years' experience originating, acquiring and managing large-scale infrastructure investments at Borealis. Before joining the organisation, Sherman spent seven years with investment banks such as Morgan Stanley and RBC Capital Markets.

Gregory Smith, president & chief executive officer, InstarAGF Asset Management

Having served in a number of leadership roles at Brookfield Financial and Macquarie, Smith has more than 20 years of experience in the investment of infrastructure, real estate, power and utilities. He founded Instar and has been serving as president and chief executive of InstarAGF since the joint venture was launched in January 2014.

John Walker, managing director, Kensington Capital

During his 40-year career, Walker has been a founding director of the Greater Toronto Airports Authority in 1992; has chaired the committee that oversaw the multi-billion dollar construction of Toronto Pearson's terminal complex; and was co-founder and a founding director of the Borealis Infrastructure Fund in 1997, now owned by OMERS.

Craig Walter, partner, deal advisory - infrastructure investments, KPMG Canada

Walter leads KPMG's Canada-based Energy and Infrastructure Investments team, advising pension funds, infrastructure funds, and corporate clients investing in infrastructure globally. He has 20 years of advisory and direct investment experience in North America, Latin America, Asia and Europe and also serves as a vice chair for the Canadian Council for the Americas.

"I hear Andrew [Claerhout]'s comment on the large-scale side, but when we look at the mid-market, I still think there's an extremely attractive value proposition there," InstarAGF's Smith says.

"We see a lot of projects," Kensington Capital's managing director John Walker agrees. "The trick in this business is to try and lower your pursuit cost; not bid on everything that runs along in front of you. Instead, negotiate deals and go after small to medium-sized projects where there isn't a lot of competition. People don't want 7.5 megawatt (MW) or 10 MW power plants – I do."

However, large institutional investors like OTPP and Borealis will also pursue opportunities in the mid-market, but they will do so through their portfolio companies. An example is a deal announced last December, where OTPP together with the Public Sector Pension Investment Board (PSP) and Spain's Banco Santander, acquired a renewable energy and water infrastructure portfolio that until then was solely owned by Santander.

This transaction enables "us to get more money to work in smaller, renewable energy projects around the world, which is hard for me and my team to do, first because we don't have the skill set," Claerhout explains. "Second, because the individual checks related to these projects are too small for us to feel satisfied from the return on effort."

Returning to the large-size end of the deal spectrum, some major capital projects do come to market. Would OTPP or Borealis be interested in an asset such as the Champlain Bridge in Québec, for example?

"When we look at the mid-market, I still think there's an extremely attractive value proposition there" **Smith**

BEYOND PPPS

"If you look at the way the PPP is structured in this country, they're extremely friendly in terms of the debt you can raise, so a lot of times the asset is 90 to 95 percent levered with debt," Claerhout explains. "That makes a large project that could have an enterprise value of $1 billion, maybe only a $50 million or $60 million equity check," he says, noting that after thinking about such projects long and hard, OTPP concluded there is no easy way to make "an adequate return on effort on these projects".

According to Claerhout – and everyone around the table agrees – PPPs are really a procurement method, but there are other, more 'open-minded' ways for government to attract private capital.

"Perhaps 10 to 15 percent of the government's infrastructure needs are best served by PPPs. But then there is 85 percent of the other infrastructure needs that require different procurement tools, other types of risk transfer," InstarAGF's Smith points out.

An example cited several times, not just by Smith who was involved in the deal, but by a number of participants, was Billy Bishop Toronto City Airport. The Nieuport Aviation consortium, of which InstarAGF was a member, acquired the airport's passenger terminal in January.

"It was a private sector initiative that actually built the terminal in the first place," Smith says, referring to the seller Porter Aviation, which built the new terminal and launched a ferry service in 2006 to 2007. "You might have found just a few passengers in 2006 to 2.4 million passengers in 2014 – a 40 percent annualised growth rate for a piece of essential infrastructure that didn't exist in the format it exists today," Smith notes.

"If you're going to attract major investment, there has to be some private sector corporate governance," says Walker.

Claerhout agrees: "Anyone who has sat on a public company board and on a private company board controlled by a few shareholders will know that you have more ability to bring in positive change in companies through the private model."

"The trick in this business is to try and lower your pursuit cost; not bid on everything that runs along in front of you" **Walker**

> "It's easier to blame the government, so people somehow feel safer if it's in government control"
> Huebener

"We don't only provide capital," Claerhout continues. "If all we're providing is capital then shame on the industry. Hopefully, what we provide is to act as a positive change agent in the company to allow it to do more than it would without our participation."

"As long as the bureaucrats control these assets, you're not going to have private sector corporate governance," Walker says.

LAND(S) OF OPPORTUNITY

The conversation then turns to other geographies.

"One of the markets that's done a particularly good job of this is Chile," Craig Walter, a partner at KPMG, Canada points out. "All of the water assets in Chile are private or in private hands but they're still regulated by the government. So the government is still playing its role so that there is reasonable pricing and quality water and sewage service is being provided to the Chilean public."

Australia is another prime example, particularly when it comes to recycling assets, a process that involves re-investing the proceeds from the sale of a state-owned asset into additional infrastructure.

"I think what's made it a success is that the federal government has offered financial incentives to the state governments for those that raise capital from infrastructure leases to fund the development of new infrastructure," Borealis' Sherman comments. "So if you had Ottawa transferring funds to provinces as a percentage of the monetisation that they would re-invest in greenfield infrastructure then I think the electorate would be more supportive of monetisations."

So where does the resistance to privatisation stem from?

"It's easier to blame the government, so people somehow feel safer if it's in government control," responds Paul Huebener, who joined DIF as managing director to head the Dutch fund manager's Toronto office when it opened in 2012. "But your cell phone service is privatised; there's no reason you can't get comfortable with privatised water. Water is still a very political essential service but there's no reason that with strong regulation all of these sectors – electricity, water, telecoms – can't be funded through the proper regulatory environment."

> "If all we're providing is capital then shame on the industry" Claerhout

Another reason is that many transformative PPPs often involve stakeholders with competing perspectives which often present obstacles to launching or closing infrastructure PPPs.

One example that comes to mind, albeit in the US, is the failed privatisation of the Pennsylvania Turnpike. Then-Governor Ed Rendell had negotiated a deal to lease the turnpike under a 75-year lease to toll road operator Abertis and Citi Infrastructure Investors for $12.8 billion. But the state legislature undermined the deal, enacting a piece of legislation, Act 44, in 2007 to block the privatisation. Act 44 authorised the Pennsylvania Department of Transportation (PennDOT) to borrow $450 million annually from the turnpike. Four years later, the turnpike found itself mired in debt having given PennDOT around $3 billion.

A less dramatic example in Canada is the Ontario 407 Express Toll Route (407 ETR). "It was a fantastic asset but unfortunately because of the way it was privatised with such a long lease and a lack of understanding around the concessionaire's flexibility in regards to pricing, there was a lot of politics around it," Claerhout states. "An attempt by the government to change the concession agreement – while unsuccessful – set a very unhelpful precedent."

POLITICS AND OBSTACLES

Once again it becomes evident that it's difficult to discuss infrastructure and investment without touching on the subject of politics.

> A fabulous outcome could be achieved if we de-linked the infrastructure investment cycle from the political cycle" **Walter**

"Imagine your worst nightmare," Claerhout says, asking everyone to put themselves in a politician's shoes. "You do all the right things as the government of the day, putting in place the building blocks to make this stuff available. You get voted out of office and the person cutting the ribbon and benefitting from these projects is the opposing party."

"A fabulous outcome could be achieved if we could de-link the infrastructure investment cycle from the political or electoral cycle," Walter says.

One way in which to do that is to start from the bottom up, meaning gaining support first in the community where the asset lies and which will be more directly affected.

"You're dealing with the community, not just the users of that asset but the community that surrounds it and the people, the employees that manage and run the assets," Smith explains.

"What we have found is that if you focus on that community engagement, that community engagement leads to public support, which in turn leads to government support. That government support then leads to strong regulation and legislation."

HITTING THE HIGH NOTES

Despite whatever challenges Canada may present in terms of infrastructure investment, there is no denying that it continues to be one of the most preferred destinations for private capital.

"We've come a long way," Walker says. "When I co-founded Borealis in 1997, the only pension fund that recognised this as an asset class was OMERS, which ended up investing in it at the time and then eventually bought the whole thing. They couldn't get the other pension funds across the country to join in the enterprise," he recalls.

Huebener reiterates that view: "I think the experience has been good and there's nothing that sells doing follow-on infrastructure better than a good experience. The mere fact that the infrastructure projects that have been done in Canada have been successful […] will pave the way for follow-on projects."

"If I look at Canada, there's more transactions today than there were 10 years ago. For me, that's in part due to the success of some of the provincial and federal programmes that exist," Smith comments. "There's a great area of innovation and investment opportunity that's going to take hold currently and over the next five to 10 years," he adds, referring particularly to the energy sector.

"You can't keep building new, you have to retrofit existing energy infrastructure," he notes. Another example he cites is that of Ohio State University, which last March released a Request for Qualifications (RFQ) seeking expressions of interest from the private sector for the management of its energy systems under a 50-year concession. "Looking at our municipalities, universities, schools and hospitals, think of what we can do across Canada if we follow similar models," Smith says.

Other opportunities will be driven by demographics and urbanisation. "In the Greater Toronto area alone, 180,000 people are moving here every year. That's putting tremendous pressure on our infrastructure," Walker points out.

In addition to the opportunities, there are also a number of strengths and attributes that deserve to be mentioned, such as Canada's regulatory framework, a healthy banking system and fiscal stability that withstood the global financial crisis much better than many of its peers, according to Smith. "So Canada has differentiated itself and become recognised on a global basis as a good destination for capital," he notes.

What's more, in addition to being world leaders in infrastructure investment, Canada also has world-leading construction and engineering firms.

"One of our businesses in this country is infrastructure," Walker states. "We started with the railroads, then we moved on to the St. Lawrence Seaway and we keep going. This is an infrastructure country. We talk about the financial sector, the investment sector, but we also have an infrastructure sector," he adds. "It just doesn't get commented on much."

With all these advantages there is no reason why Canada can't join the likes of Australia and Chile, but what does it need to do to get there?

The answer is collaboration. "It's about stakeholder engagement," Huebener says. "We're here to help and we're here to work in partnership with government to make sure things get done." ■