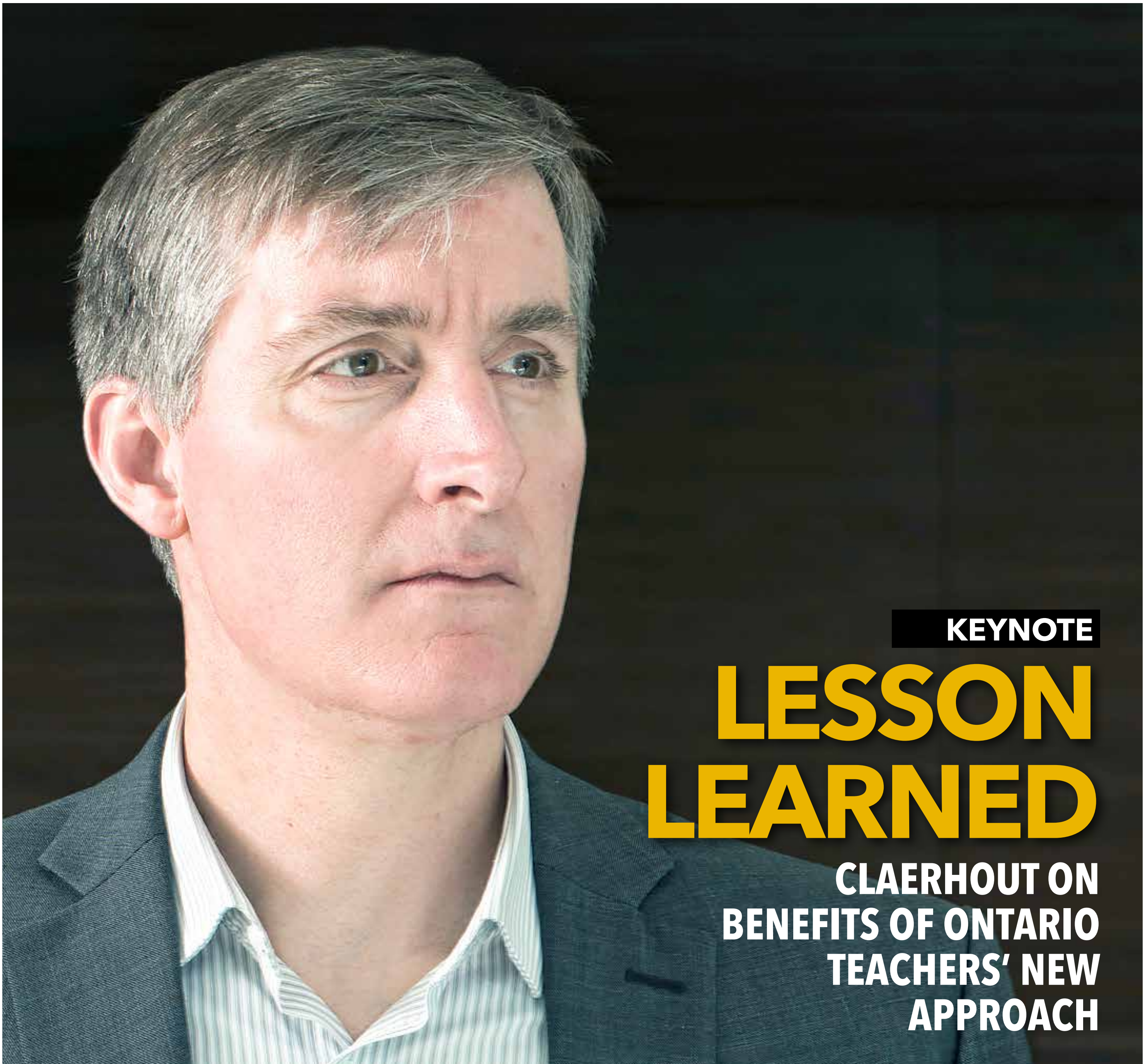
PEI Alternative Insight

Issue 83 | June 2017 | infrastructureinvestor.com

FOR THE WORLD'S INFRASTRUCTURE MARKETS

INFRASTRUCTURE INVESTOR



KEYNOTE

LESSON LEARNED

CLAERHOUT ON BENEFITS OF ONTARIO TEACHERS' NEW APPROACH

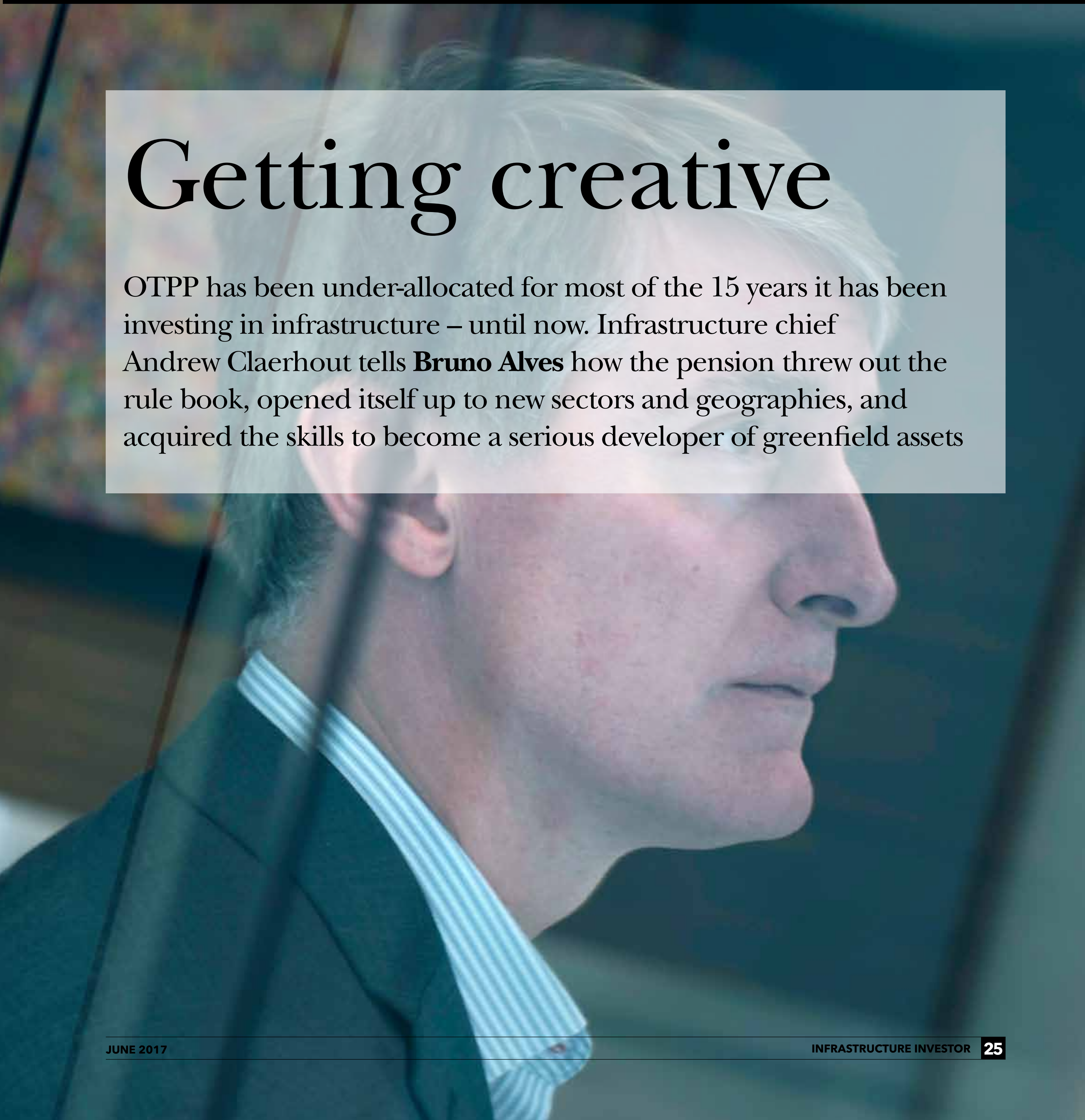
PHOTOGRAPHY: MARCUS ROSE

Keynote

Andrew Claerhout,
Ontario Teachers' Pension Plan

Getting creative

OTPP has been under-allocated for most of the 15 years it has been investing in infrastructure – until now. Infrastructure chief Andrew Claerhout tells **Bruno Alves** how the pension threw out the rule book, opened itself up to new sectors and geographies, and acquired the skills to become a serious developer of greenfield assets



When we last caught up with Andrew Claerhout, head of infrastructure and natural resources at the Ontario Teachers' Pension Plan, two years ago, he was roughly halfway through "a journey", as he then put it, that had started when he took over the C$180 billion ($132 billion; €120 billion) pension's infrastructure unit in late 2013.

That journey had a simple objective: to analyse how infrastructure had changed since Teachers' first started investing in it 15 years ago and adjust the pension's strategy to the new reality, one that included a significantly expanded competitor landscape and a correspondingly compressed returns environment.

In fact, returns were very much on Claerhout's mind when we talked to him in May 2015. Some of the high valuations being assigned to infrastructure assets then were leading people to accept risk-adjusted returns that were less than optimal for what Claerhout essentially called "highly illiquid levered equity".

For a pension struggling to meet its 10-12 percent infrastructure allocation target, the situation called for a change in thinking. "Our target for the next several years is to get to C$18 billion," Claerhout said at the time.

"We're at C$13 billion currently, so we're significantly under-allocated. We're not changing that goal, but the path that we follow in order to get there may need to be more creative, because the market has become more competitive."

RIGHT-SIZED

Fast-forward two years and OTPP is in a very different position. "Our current infrastructure portfolio stands at about C$18 billion," Claerhout tells us on the sidelines of our Berlin Global Summit. "Our view is that infrastructure should be between 10 and 12 percent of total assets [C$180 billion, as of 31 May], which means we have room for growth. And we can exceed 12 percent – it's not like it's a hard target, it's more of a guideline."

For the first time in its infrastructure investing history, OTPP is, as Claerhout puts it, "right-sized. Our entire history in infrastructure, from the time we formed 15 years ago, we have always been under-allocated. So, we were always chasing a target, wanting to be bigger, but not quite finding the right opportunities".

That has all changed now and the reason behind it dates back to Claerhout's strategic review. "We've had tremendous growth and it has come from executing on our expanded strategy, where we decided to be more open-minded on geographies, sectors and, to a certain extent, approaches as well, in order to put more money out."

The strategic review was a classic 'throw-out-the-rulebook' moment, where OTPP challenged all its assumptions to infrastructure investing. "We used to have a one-size-fits-all approach in that we were a control-oriented, brownfield infrastructure investor," Claerhout recalls. "So we set out to look at all those things. Do we need to be control-oriented? I think so. Do we have to be just brownfield? No, we can push into greenfield. Do we have to do everything by ourselves, be direct? No, we can be indirect through management teams, by partnering with people that have skills that we don't have."

As a result, the Canadian pension spent last year clinching its first deals in Mexico (Arco Norte, a toll road investment, together with the Canada Pension Plan Investment Board) and the Netherlands (Koole Terminals, a storage provider, in partnership with JPMorgan Asset Management); branching out into toll roads (Arco Norte and the Chicago Skyway); leveraging subsidiary Ontario Airport Investments to purchase London City Airport; and fully embracing greenfield development, increasing its exposure to renewables platform Cubico (spun out of Santander with PSP Investments) as well as buying electricity grids platform Anbaric.

The latter development is, of course, highly significant, especially since OTPP

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created its own dedicated greenfield team about a year and a half ago.

"We didn't really know what we would find in greenfield," Claerhout recalls. "When I asked OIivia Steedman to run that team, I told her she'd have to go out and recruit some people with different skill-sets to do this. And I told her if we do all the work and it turns out the risk-adjusted returns are worse, then we won't do a greenfield strategy."

But while Claerhout pretty much ruled out pursing OTPP's greenfield strategy through funds – or even separate accounts, which he calls "funds of one" – he did not necessarily feel the pension had to go 100 percent direct. Instead, he preferred to partner with experienced teams, set up platforms with them, and use those partnerships to acquire the requisite expertise.

"If you look at what we did with BlueEarth [in 2010], we identified a management team that had experience developing power projects, we gave them an equity line of credit – a chequebook – and some initial capital to get an office and start business. But we own the business: the team has options in it, but we own the business. You could say the same thing about Cubico."

Anbaric, which unlike renewable energy developers BluEarth and Cubico, focuses on high-voltage grids and microgrids, was a little bit different, in that it was already in existence. But OTPP approached the partnership in much the same way.

"In the deal we did with them we provided three sources of capital. Firstly, we used $75 million to both buy a 40 percent stake in the business, with management owning the remaining 60 percent, and provide a pool of money for development purposes. And lastly, we gave them a commitment that when those projects are developed, we will be their natural funders, which we expect could lead to up to $2 billion of equity being invested into them.

"This allows us to put money towards opportunities that we would not see and be these projects' ultimate funder. We make some money on the development, but what we really care about is that the development company is originating and developing those projects to the construction-ready phase that we will then fund." The

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upside, in addition to securing proprietary dealflow, is knowledge transfer. “This is why we strongly prefer direct investing over investing in funds,” he explains, pointing to the advantages of sitting at the table with the management teams Teachers’ backs.

It also gives OTPP control over what projects get funded through construction. The latter has been crucial in getting the Canadian pension comfortable with greenfield risk. “If you look at risk on a greenfield project, it’s very high at the beginning, but the capital against it is very low. And then as the risk comes down, the capital goes up, ironically. When you get to the building stage and it’s time to write a large cheque, the risk is actually much lower than when you’re spending $5 million developing a project. And that’s how we got comfortable with it. We wouldn’t be betting the farm – these are controlled experiments, which we control during the development stage and we only commit significant capital after that stage is successful.”

The endgame, for OTPP, is the ability to take on even more risk in the future. “Once we’ve been doing this for five to 10 years, we’re going to actually be positioned to take on even more risk because we will understand how to quantify and mitigate those risks. That’s why we didn’t want to compromise on having control,” he says.

Of course, OTPP can also look at taking on more risk because, unlike some of its pension peers, it is a well-staffed direct investor. At the moment, the pension counts 40 people in its infrastructure team, with that number nearing 50, if you count the employees of its fully-owned airports and Latin America-focused subsidiaries. It also does not hurt that OTPP can pay its employees well.

“We’ve taken the approach that we need to pay competitively to attract, retain and motivate the right staff. In this sense, the Canadian pension plans have taken a very different approach to the UK and certainly the US pensions. We think that if you attract the right team, capable of generating a superior return, then that more than pays for the cost of recruiting, motivating and retaining staff,” Claerhout says.

EXPLORING THE OUTER EDGES

When Claerhout and his team decided to be more open-minded about how they invest in infrastructure, they did not just have new geographies and sectors in mind, they were also willing to venture into the asset class’s outer edges. Like Westerleigh, the crematorium business it bought with the UK’s Universities Superannuation Scheme from French manager Antin Infrastructure Partners.

"We took a look at it and asked ourselves: is cremating the deceased infrastructure? Let's get real, is it? And we gave our deal team a real hard time on this because we have looked at deals in certain markets that people have called infrastructure and we've just laughed," he recalls.

What convinced him then?

"We were very sceptical about Westerleigh, but as we peeled back the onion, we realised it has most – if not all – the characteristics of core infrastructure. It's an essential service; it's not correlated with GDP because you don't choose when you die; it's a regional monopolistic service, since no one wants a crematorium in their backyard and they are very hard to get licenced; the pricing represents a very small fraction of the cost of burial; and the pricing is an inelastic market.

"So when we looked at it, we thought it looked a lot like core infrastructure, but priced more like core-plus and could be exactly the type of core-plus opportunity we like, one where we get better risk-adjusted returns because most people don't recognise what kind of business this is."

That is not to say there are not aspects of a crematorium business that differ from your average core-type infrastructure asset. Without getting into the nitty gritty of the funeral business, there is a minor leasing component to Westerleigh's revenue stream that is GDP-correlated, and, in times of hardship, could conceivably come under stress.

"It's the same with an airport, though, where you accept that you have aeronautical and non-aeronautical revenues."

WITH MATURITY COME ASSET SALES

The other change since we last spoke to Claerhout concerns OTPP itself. That is to say, OTPP as a pension fund, has continued to mature, which has a direct influence on its strategy.

"We think about maturity in terms of the ratio of active members versus retired members and today we are 1.4 active members to retired and over the next 10 years that's going to become closer to 1:1. So we are quite a mature plan compared to our peers and as a mature plan our risk tolerance has to be lower. Because if there is a major correction in risky assets we still have to pay benefits – and today we pay C$3 billion of benefits in excess of contributions. Secondly, you have less time to catch up and make up for any correction because of the maturity of our plan."

"We were always chasing a target, wanting to be bigger, but not quite finding the right opportunities"

That also means, though, that you will start seeing OTPP sell assets. "You're going to see it more often because of us being a mature pension. We're reaching the place where we are right-sized in infrastructure, so if we continue to see more opportunities to invest more capital and we're doing a good job with the ones we have, we're going to have to look at recycling capital. In that sense, we will look at some of our portfolio and try to match it with people that have a lower cost of capital, for example."

Are there parts of OTPP's infrastructure portfolio that are off limits though? "We have parts of the portfolio that are cornerstone, but one of the things we never want to do is fall in love with an asset. So even with the things we consider cornerstone, we will look at selling them if the right opportunity presents itself. Of course, there are things we prefer to keep because their attributes suit what we want from our infrastructure programme quite well."

Keeping with the open-mindedness that has characterised the strategic review, Claerhout does not look at divestment in a binary fashion, explaining he sees scope for outright sales alongside partnerships, for example. In terms of what is on the block, he mentions the pension is exploring the sale of a minority stake in its UK regional airports to a "more passive provider of capital" alongside a divestment of its stake in HS1, the country's only operating high-speed rail link, which it owns together with Borealis.

"One of the things we are looking at doing is increasingly partnering with capital providers that don't have the expertise to invest in and manage infrastructure, but would look to us for that. In the case of Bristol and Birmingham [airports], we are looking at selling to passive providers of capital, because we think there's a lot of capital out there looking for a home and that allows us to reduce our portfolio exposure without ceding control," Claerhout explains.

That sounds an awful lot like what a fund manager would say, which begs the question of why these more passive sources of capital should partner with OTPP instead of a blue-chip GP.

"I think there are many benefits to partnering with Teachers' as opposed to short-term capital," Claerhout argues, "especially if the nature of the institution is similar. We don't only manage assets, we also manage liabilities, so if we think about the type of assets that we want to buy into in infrastructure, they need to have very specific characteristics."

Is this the start of OTPP, the manager of third-party money, then, a la Borealis? Claerhout laughs the question off. "What we are seeking to do is punch above our weight with partners we are well aligned with and allow ourselves to reduce portfolio concentrations in a natural way."

That may be the case, but for managers already worried about facing muscular competition from direct investors in the deal space, here is another worry to add to their growing list. ■

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