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FOR THE WORLD'S INFRASTRUCTURE MARKETS

INFRASTRUCTURE INVESTOR

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Keynote

Marc Lipschultz & Raj Agrawal

Kohlberg Kravis Roberts & Co.

PHOTOGRAPHY BY MARK BYRON

Delivering on the promise

After investing in energy for more than two decades, launching a dedicated energy and infrastructure platform was a natural next step. KKR's Marc Lipschultz and Raj Agrawal offer their interpretation of the asset class and what enables them to find opportunities where others don't. *Kalliope Gourntis* reports

"The promise of infrastructure has always been consistent; how folks have delivered on it has varied widely," Kohlberg Kravis Roberts' (KKR) head of infrastructure, North America, Raj Agrawal, says as he comments on how investors continue to be confused by the asset class.

"We've been investing in the infrastructure business for years now and there's still a debate 'what is infrastructure?' he continues. "It's confusing because there are two approaches – there's a sector-based approach and there's a risk-based approach."

The KKR energy and infrastructure team has always taken the latter approach, aiming to be disciplined in how it applies a set of six criteria.

"Our definition of infrastructure is physical assets that are core to the economy, that are irreplaceable or have competitive advantages, are inflation-protected, have limited sensitivities to the economic cycle – that's a very important one - and long-term visibility cash flows," Marc Lipschultz, global head of energy and infrastructure, explains.

"That actually is our definition of infrastructure," he emphasises. "And I think it's atypical in so much as most infrastructure investors tend toward a categorical definition of infrastructure."

This definition has meant that for KKR a port or a toll road is not necessarily an infrastructure asset.

"We've seen what happens in a recession - ports can be deeply cyclical businesses."
Lipschultz

"Ports fit the common categories that people use but if we think about a typical port on the West Coast of the United States, a lot of the traffic in those ports is consumer goods coming from China," Lipschultz says, illustrating his point. "And we've seen what happens in a recession – the volumes of those ports [fluctuate]; they are deeply cyclical businesses."

A LITTLE HISTORY

The launch of a platform dedicated to energy and infrastructure was a natural evolution for the New York-based investment firm which had been investing in energy for more than two decades.

"When I joined the firm [in 1995], and really through the 90s, all of us at the firm were generalists," Lipschultz recalls.

In 2000, the firm made some strategic decisions that included the migration to an industry-focused model. It was at that time that Lipschultz began focusing on energy.

ELL: a 'pretty creative deal', says Olmos

Colonial Pipeline: KKR's first infra investment

"Those were the days when we invested in ITC, which is today the largest independent transmission company in America," he says. "We didn't, at the time, talk about it as infrastructure or not infrastructure, we just said 'wow, there's a really great opportunity.'"

As developments in the unconventional energy space started to unfold, it became apparent that there would be a vast need for new energy infrastructure.

Agrawal, who joined the firm in 2006, had more than a decade of experience in energy and infrastructure investing. However, his early career in energy was broad-based, covering the whole energy spectrum. He soon acquired deep expertise in the midstream space, a segment of the energy sector KKR had not previously invested in.

"As we, in 2008-09, decided to take advantage of what we thought was a tremendous risk-return opportunity in the infrastructure space it became natural, given that energy plays such a big role in infrastructure, for me to assume leadership of North American infrastructure at that time," Agrawal explains.

The first investment the group made was the acquisition of a 23.4 percent equity stake from Chevron in Colonial Pipeline, the largest refined products pipeline in North America, in October 2010.

Aside from faithfully adhering to the six criteria mentioned previously, the energy and infrastructure group also capitalises on the resources available to them at the firm.

AN INTEGRATED APPROACH

"What we're trying to do is to get the best of the integration which is idea sharing and relationship sharing," Lipschultz says.

"When you think about midstream, for example, understanding very well the upstream fields those midstream assets serve is absolutely imperative in making a correct assessment of the infrastructure opportunity," he continues.

Agrawal expands on this further: "Integration is critical not only for the understanding of the assets but also the sourcing of the deals."

It is this integrated approach that enables KKR to engage in what Lipschultz calls "a strategic dialogue" with a potential partner.

A case in point is the Colonial Pipeline acquisition.

"Sitting at the CEO level and having a discussion with KKR there may be four ideas we may be able to explore, which makes it a strategic dialogue," Lipschultz says. "But if it's just 'I'm interested in buying asset number 2B', that will most likely get referred to the M&A department and having your name placed on a waiting list."

Lipschultz goes on to make another distinction – that of a professional investor versus an asset accumulator.

"If you [approach the asset class] with

a view that 'an airport is an airport is an airport' and I just want to buy it and put it in a drawer and come back to it 10 years later, you're likely to be sorely disappointed with your experience."

KNOWING WHERE TO LOOK

KKR's energy and infrastructure group takes a different view and has been able to steadily make investments since it came into existence five years ago, in part due to its claimed ability to be creative and flexible.

"Two years ago renewables in the United States were out of favour, so we found that very appealing. Today, we have 'yield cos' that have emerged on the scene and have pushed pricing of lots of renewable resources to places we find less interesting," Lipschultz says.

So the team then looks for opportunities elsewhere.

One such opportunity presented itself when the City of Bayonne in New Jersey approached KKR to enter into a public-private partnership (PPP;P3).

At the time, the Bayonne Municipal Utilities' Authority (BMUA) had nearly $125 million in debt that soon had to be repaid. In addition to its financial worries, the utility was also concerned about the health of its underground pipes and its outdated meters that were providing unreliable readings.

KKR provided BMUA with capital upfront that allowed the utility to pay off its debt, improve its credit rating and have funds left over to re-invest in the city.

"We also agreed to invest in new meters and we agreed to a capital expenditures programme to refurbish the pipes that they were worried about," Agrawal says. At the same time, KKR agreed to a rate scheme that, by the BMUA's own analytics, would increase rates at a slower pace than the city would have had to do, thanks to increased operational efficiency.

KKR was awarded a 40-year concession for the water utility in November 2012.

Since then, the firm's infrastructure team has made a number of other investments.

"The promise of infrastructure has always been consistent; how folks have delivered on it has varied widely"
Agrawal

In October 2013, it invested $100 million for the acquisition of a 16.7 percent stake in Associated Partners, a US wireless infrastructure business.

More recently, in April, the investment firm announced an investment, worth approximately €200 million, in European Locomotive Leasing (ELL), a train leasing business operating in continental Europe.

Both investments were made through the firm's debut infrastructure fund, which closed on $1.1 billion in June 2012. As of May this year, 75 percent of the Global Infrastructure Investors fund had been deployed.

While the investments are diverse in terms of sectors, geographically they are exclusively focused on North America and Western Europe.

"Consistent with our strategy, which is low risk and high predictability, we find the preponderance of those opportunities in North America and Western Europe where there's high consistency of regulatory regimes, counter-parties of high credit quality, enforceable contracts in court, […], and a lot of case law established," Agrawal says, explaining why KKR's strategy continues to be focused in these two regions.

"That said, we have a global presence as a firm and as an infrastructure team […] so we certainly look at and consider other investments," he adds. "To date, despite looking at a number of investments, we have not gotten comfortable with any single investment that meets the risk criteria we're looking for at an appropriate return, but we are absolutely open for business," he clarifies.

One market that is comparable with the US and Canada when it comes to shale oil and gas, is Australia, according to Lipschultz.

"There are certainly opportunities in other parts of the world [outside North America], mostly more nascent," he says. "Now an exception to that would be Australia – another place where there is significant activity in oil and gas."

While Lipschultz acknowledges that over the longer term shale developments will spread to other markets, he cites a number of features prevalent in the US and Canada – and to a large extent in Australia – that make these markets more attractive in KKR's view.

They include the presence of a highly entrepreneurial oil and gas sector, the notion of an interstate pipeline, a stable regulatory framework with a long history, private mineral ownership, and a skilled workforce.

"The shale revolution is much less about rocks and much more about the rocks added to the constellation of these critical characteristics," he says in summation.

An indication that KKR's energy and infrastructure team will be casting a wider net is the recent expansion of the firm's energy and infrastructure team in Asia.

The firm hired Tony Schultz as a managing director in Sydney and transferred Ash Upadhyaya, a director of KKR's energy and infrastructure team in New York to Singapore to work with Schultz in the region.

Schultz joined KKR from EIG Global Energy Partners where he served as managing director focusing on energy, minerals, and mining in the Asia Pacific region.

When the expansion was announced in March, it was unclear where the Asia team would draw capital from to make investments. According to a firm spokesperson, the team would be able to draw from several sources including the private equity fund and the global infrastructure fund.

With 75 percent of the debut fund deployed, KKR has already started fundraising for Global Infrastructure Investors II, which has a target of $2 billion.

Asked how he views the future of the asset class, Lipschultz replied: "We really think we're at the early end of the development of this asset class. The whole public-private partnership arena is very immature here in the United States, the need for redevelopment of infrastructure in all developed economies is substantial and the public funds are simply not available today. From our point of view, we think it's a really exciting business for a long time to come." ■

Olmos: The European perspective

Jesus Olmos, head of European infrastructure and head of Spain, joined KKR in 2009 to establish KKR's infrastructure business in Europe, the Middle East and Africa. With a background in engineering, he began his energy career at Spanish utility Iberdrola. He later worked for Endesa where he held various roles including chief executive of the Spanish utility's Italian operations. Based in London, Olmos was not able to attend the meeting that took place in New York but did provide a European perspective for the article in a phone interview, an excerpt of which follows:

Q How do you approach the asset class in the European market?

JO: In Europe as in the US, the main thing is to find businesses with the right risk profile – that means businesses with very limited correlation to the economy and with protection against inflation.

So according to this definition, we look for opportunities on the utilities side – we like electricity, gas and water in this division – and those are businesses that combine downside protection with the possibility of improving those businesses. We look at opportunities in the contracted energy space, including renewables and cogeneration.

We are also interested in non-energy related infrastructure. We have made two investments of that kind in Europe – a parking business that again combines long-term stability of cash flows but also offers the potential of improving operational efficiencies of the businesses.

And recently we did a pretty creative deal, in my opinion, which is we set up a locomotive leasing company that will allow us to buy locomotives from the main contractors and then lease them to train operators.

Q Are there specific markets within Europe that you find more attractive than others?

JO: Well, we're very focused on five major markets: the UK, France, Germany, Spain and Italy. We also pay close attention to Poland, but we haven't yet made any investments there. We are interested in Poland because it combines growth with stability and also it's a market of a size that will probably offer some opportunities in the future.

Italy is a market we also have not invested in either, but we would like to add some Italian risk to our portfolio as well.

Q In your view, has the European debt crisis presented more opportunities in south-eastern Europe or not?

JO: We have different pools of capital within KKR and that allows us to tackle the different kinds of opportunities that a market can offer. We have private equity money, infrastructure money, money for direct lending, money for distressed situations. We consider ourselves as capital solutions providers and we can use any pool of capital.

In terms of infrastructure specifically, what we have seen throughout this crisis is that many companies – developers, utilities, construction companies, other infrastructure companies – have sold very good assets in very mature markets because they want to expand into new, more emerging markets. So these assets that are stable and operating and are already giving some nice yield are great opportunities for us. ■