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Guest speaker spotlight:

ATLAS
INFRASTRUCTURE

In Week 6, David McGregor and Alex McNee, alongside SMF Alumni Luke Farrar & Ash White from ATLAS Infrastructure joined the Fund to discuss their approach to analysing and valuing infrastructure companies. ATLAS is an investment company based in Sydney and London that specialises in global listed infrastructure. The discussion was particularly centred around the key drivers and factors to consider when valuing toll roads, which informed the Active Australian Equities team's research into Atlas Arteria (ALX). Questions asked and answers provided by the ATLAS team are summarised below.

What do you think are some factors that investors tend to overlook that can lead to outperformance or underperformance in the infrastructure sector?

David: Infrastructure entails long-dated assets. When analysing toll roads in particular, three things matter – revenue, capital structure and tax.

For companies that hold assets with a 'concession' to operate over a specific horizon, the capital structure and distribution profile often changes dramatically over time. Additionally, the operating structure may entail investment in entities that hold the assets and a holding company, meaning that leverage and tax may be incurred at different levels within the value chain. These complexities often encourage the players within the listed markets to take simplistic approaches in their valuations, such as applying valuation multiples or focusing on dividend yields. Most market participants fail to undertake the comprehensive DCF modelling that captures the intricacies of revenue, capital structure and tax liabilities. This can open up opportunities for investors who undertake rigorous analysis.

For companies with assets spread across multiple concessions in differing structures, how do you think about the leverage? Do you consider leverage on a consolidated or asset-by-asset basis?

Alex: We conduct a bottom-up analysis, building up from an asset-by-asset basis. We also examine the combined leverage from a top-down perspective, but this is informed by analysis of each individual asset and its profile.

Ash: This is exemplified by ALX's Dulles Greenway Road, which is in a cash flow lock-up at the moment having breached its debt covenant. Whilst the consolidated balance sheet of ALX looks healthy, when viewed from a project-by-project cash flow basis leverage could be problematic. In the infrastructure sector it is important to conduct asset-by-asset analysis, as the context surrounding their governance and access to cash flows can be highly variable.

How do you assess the risks and drivers of each asset individually?

David: When looking at differentiation between assets, especially toll roads, a key thing to be aware of is the nature of any competitive advantage. A toll road's competitive advantage relates to the 'time-value' to its users, which is the time they can save by using the toll road and what that user believes their time to be worth. This 'time-value' differs across assets and countries, noting that it is often governed by domestic policy. For example, Spanish toll roads are required to have comparable and free routes that mirror its route, and so show greater elasticity of demand due to ease of substitution that acts to limit their competitive advantage. In times of diminished demand – such as during the late night or early morning – their revenue is affected much more severely than (say) French roads.

It is useful to look at where the assets are located, and how any changes affect users. We may begin modelling trip volumes with reference to GDP or population growth, and then adjust for competitive position of the asset. In addition, infrastructure assets often have inflationary mechanisms in place that allow for rising costs to be passed onto users. The terms of these agreements and their effect on revenue and demand must also be modelled.

In the forecasting of invested capital, we know that for many assets this is going to be mainly maintenance capital spending (capex). What are some good approaches for forecasting capex, including major repairs and replacement of infrastructure?

David: In the case of projects such as toll roads, the initial cost of purchasing and preparing the land contribute the majority of capex during construction, with the concrete and then re-paving (i.e. maintenance capex) being relatively minor. Costs will generally be consistent even 100 years into the future, with concrete only needing to be occasionally re-sheeted. Hence the history of maintenance capex should provide a reasonably accurate guide.

Ash: Naturally this will change depending on the project. Generally, you can rely on management guidance for the level of future capex, as well as if they are engaging in a pro-active or re-active expenditure cycle.

David: For most assets, you observe low or negative returns on invested capital at the beginning and very high returns on invested capital towards the end of their concession periods. It is important to analyse the 'back-end' of the capital projects, where invested capital is low and cash flow release is high. Due to this cash flow profile and the incredibly long life of some of these assets, earnings and cash flow multiples are often misleading and DCF modelling is best.

How do you incorporate ESG concerns into your modelling of infrastructure companies?

David: At ATLAS we do a lot of work on integrating ESG factors, especially around those which will heavily affect our financial outcomes. We consider *environmental* effects related to carbon transition, and have mechanisms to allow for aspects such as switching to alternative transport modes, for example trucks being replaced with rail. From a climate change perspective, we also estimate the total emissions emitted from a toll road through the burning of fuel.

From a *social* perspective, we consider the 'social-local contract' and the perspective that the users have of the infrastructure asset. We ask questions such as: *"Is the asset delivering a social good? Is it providing a service to its local users? Is the company that operates the asset generating value for society?"* We also consider how the implicit social contract may impact on the bargaining ability of the company in response to political, social, or economic changes; or the ability to renegotiate concessions as they come to an end.

The key *governance* concerns occur in the last 10-15 years for a concession asset, as this is the time when existing contracts are approaching their end. From a management perspective this can be quite daunting. A company in this position faces the possibility of going from high EBITDA to essentially nothing if they are unable to renegotiate their contracts. It is also the time when management may be tempted to seek additional assets to maintain earnings, supported by the availability of strong free cash flows to deploy. The key risk is they overpay to secure assets to the detriment of shareholders.

Report prepared by Joseph Bamber (Relationship Team)