MAPLE-BROWN ABBOTT

INVESTMENT MANAGERS SINCE 1984

Research paper

Management and governance in listed infrastructure

Does effective management and strong corporate governance in listed infrastructure improve returns and reduce risk?

Global Listed Infrastructure
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Justin Lannen B Eng B Comm CFA
Portfolio Manager

Justin has over 18 years infrastructure & utilities experience. He was previously at Colonial First State where he was the lead analyst responsible for infrastructure & utilities when they were the largest listed infrastructure investor in Australia. This was followed by five years managing global listed infrastructure portfolios at Macquarie Group in both New York and Sydney.

This research paper was developed by Justin Lannen, in close association with Portfolio Managers Andrew Maple-Brown, Lachlan Pike and Steven Kempler.

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Background

As part of our investment philosophy, we believe investing in listed infrastructure companies with quality management and strong corporate governance is one way to both improve investment returns and reduce risk. This view is based on our experience in the infrastructure sector and is supported by various academic studies over the years.

Maple-Brown Abbott have had a long standing commitment to good corporate governance. This commitment was formalised in 2008 when the board approved the Environmental, Social and Governance (ESG) policy and the firm became a signatory to the United National Principles of Responsible Investing (UNPRI). The focus of this research paper is on the management and governance of global listed infrastructure companies.

Management and governance focus: Why does it have an impact?

Academic research is typically based on listed equities, but we believe there are parallels with listed infrastructure equities. Academics at Harvard University and The Wharton School, University of Pennsylvania (Paul A. Gompers, Joy L. Ishii and Andrew Metrick) found in a study of about 1,500 companies in the 1990s, that the companies with better governance and the 'strongest shareholder rights' performed materially better than those without. Indeed their research showed that investing in the 'strongest rights' decile of their Governance Index and selling the 'weakest rights' decile provided abnormal returns of 8.5% per year during the sample period[1].

Similarly, at Georgia State University (Lawrence D. Brown and Marcus L. Caylor) researchers created a scoring system for corporate governance for 2,327 firms. They found that better-governed firms are relatively more profitable, more valuable, and pay out more cash to shareholders. Within the categories of governance that they analysed, executive and director compensation was most highly associated with good performance[2].

[1] Paul A. Gompers, Harvard Business School, Joy L. Ishii, Department of Economics Harvard University, Andrew Metrick, Department of Finance, The Wharton School University Of Pennsylvania and NBER. 'Corporate Governance and Equity Prices', *Quarterly Journal of Economics 118(1), February 2003, 107-155*

[2] Lawrence D. Brown, Georgia State University, Marcus L.Caylor, Georgia State University; *'Corporate Governance and Firm Performance'*, December 7, 2004

An integral part of the investment process

The nature of infrastructure businesses is that they provide essential services to their users and they should also generate reliable, growing and inflation linked cash flows to their shareholders. Infrastructure assets often occupy a privileged position within the economy making their returns predictable. However, in the case where such an asset is run by poor management with inadequate corporate governance, the economic opportunity and the potential returns available to shareholders can be negatively impacted.

There are four tenets of our infrastructure stock selection at Maple-Brown Abbott: valuation, inflation protection, low volatility and management and corporate governance. We derive a long-term cash flow based valuation for each infrastructure company. We then consider the risks that could prevent this valuation in real terms being achieved at a future date. Each of these principles, including management and corporate governance, is looked at closely by our research team and each aspect is awarded a score.

As part of our management and corporate governance analysis we focus on factors such as:

- Management's alignment of interest – this includes share ownership by key employees and economically appropriate short and long term incentives that do not encourage excess risk taking
- Track record of the management team – how long the management team have been in place and the business results they have delivered during this time
- The appropriateness of corporate strategy and capital management – is the company being taken in the right direction, and does the company's balance of debt and equity fit with the asset profile and corporate strategy?
- The overall governance framework – are management and board aligned to company goals appropriately and does the governance framework ensure potential conflicts of interest do not exist?

We conduct our research through on-site asset visits, management interviews and reviewing public disclosures. Our analysis is peer reviewed and compared to other infrastructure companies around the world before calculating a 'management and governance' score. This score forms part of our investment process, and ultimately portfolio stock selection.

Beyond management incentives and strategy, we also evaluate management on how well they maintain their privileged economic position through factors such as consideration for the environment and engagement with regulators.

We believe that our role as fund managers in the 'investment ecosystem' is to provide feedback on our views as an investor to both management and their boards so that business practices can be improved. It is in our interest as shareholders to improve management and governance practices via meetings and proxy voting which can enhance and protect our investment. The better governed companies will typically take this feedback more seriously.

Maple-Brown Abbott is a long only and long term investor. We should be strategically aligned with the board and management of portfolio companies. This alignment generally engenders long term relationships with company management.

It is also important to recognise that whilst management and governance is a medium to longer term investment theme, individual companies can change over time for the better or worse and this needs to be

continuously monitored. Indeed, incremental changes in either direction are a valuable insight for investment purposes.

For example, UK water company United Utilities' management were refreshed around five years ago. Since then, the new management have focused on the core water business and taken the operational performance from near the bottom of the comparable UK water companies in the regulator's eyes to modestly above the median. This has led to better returns for shareholders and we believe the journey is not yet complete.

The importance of capital investment discipline

In our experience, we have witnessed numerous failings (and successes) by management at infrastructure companies. Examples of such failings include new asset decisions such as airport terminals or runways being built prematurely or overcapitalised. This was evident at listed infrastructure company Beijing Airport in 2008 when they acquired an expensive large new terminal from a related party and controlling shareholder (the government). Management cared less about value and more about consolidating a 'trophy' asset. Later in the year of the acquisition, Beijing Airport issued an unquantified profit warning which amongst other things cited a substantial increase in costs related to the new terminal.

We've seen overinflated toll-road estimates particularly in bidding situations; inappropriate debt levels (both too high and too low); cross-border acquisitions or greenfield projects that are ill-considered, overpaid for or simply overly risky. Given the inherently strategic nature of infrastructure assets, we generally prefer management to focus on making investments and expanding their existing core infrastructure networks, rather than looking elsewhere to invest capital. Whilst this approach does not usually make financial media headlines, we believe this is typically of much lower risk and has the potential to create more value for shareholders.

Company structure is important

Within corporate governance structures, we look closely at board composition, protections for minorities, related party transactions and so called 'poison pills'. Majority or significant government ownership is often a warning sign in infrastructure companies. The risk is that the government representatives or a management team keen to appease the government can make decisions on important things such as capital allocations and cost structures which favour the government's interests over other shareholders. We often see this risk in emerging markets infrastructure.

The listed asset manager or externally managed vehicle model is one type of structure that is fraught with potential governance and agency risks. The model is prone to conflicts, high fee structures and the inherent risk of overpaying for assets in order to grow the entity instead of focusing on returns to shareholders.

In the early and mid-2000s we saw a proliferation of externally managed infrastructure vehicles listed in Australia. Typically these were trust structures that owned infrastructure assets with an external manager who managed the affairs of the listed entity, including acquisitions.

Many of these listed entities acquired too many assets, paid too much for them and used too much debt. The global financial crisis of 2007-09 saw the demise of several of these entities, but it was poor management and governance in the preceding years that sowed the seeds of destruction. Significant shareholder value was lost and it did not matter that the underlying infrastructure assets in many cases were of good quality.

Another type of externally managed entity is a Master Limited Partnership (MLP) which is used by many pipeline infrastructure companies in the United States. To qualify as a MLP, the entity must engage in certain natural resource related activities. US pipelines which qualify for MLP status need to have their incentives and governance closely scrutinised. Due to the ability for investors to obtain tax deferred returns and a need for capital to fund asset expansions, the number of US MLPs has grown significantly over the last five years, with much of the pipeline and energy gathering and processing infrastructure in the USA now being held under this structure. We often see a number of questionable incentives with the standard MLP structure from a management and corporate governance perspective. Typically, an entity described as the General Partner (GP) contractually possesses exclusive management powers over the business and affairs of the MLP, with staff and Directors reporting directly to the GP. Likewise often their incentive structures are linked to the performance of the GP and not the MLP where shareholders' interests reside. This two-tier corporate governance structure potentially allows for a significant reduction of fiduciary duties owed by staff and Directors of the GP to the MLP through the Partnership Agreement. Perhaps not surprisingly, we have seen a number of transactions where the financial interests of the GP have seemingly been favoured over those of the MLP, particularly when transactions have occurred between the two entities. In almost all cases we see company insiders preferring to own significantly more GP units of a given organisation rather than the MLP units and we think this is telling.

A positive example: US electricity transmission company ITC

A listed company that we rate highly for corporate governance and management is the US electricity transmission company ITC.

Senior management has been very stable. Their track record with regards to finances, acquisitions, operations and delivery of large capital expenditures has been very good. Probably of greatest importance in our eyes is the strength of alignment between management and shareholders; with the CEO owning 1.8% of the company (valued at over US$100m) and the other executive officers and directors owning a further 1% combined.

Remuneration is also well structured, with a heavy skew towards incentive based payments that have appropriate thresholds. A small negative in our opinion is that the Chairman and CEO roles are combined (which is not unusual in the US), although this is somewhat offset by the board otherwise being solely comprised of independent directors, who each bring a strong skillset to the board table.

Additionally, ITC has no government ownership or blocking stakes.

What is the global experience?

Weaker governance structures are more often to be found in emerging markets, particularly when the government is a significant shareholder. We have seen examples of decisions being made by management that seem to favour the government (or majority shareholders) at the expense of minorities.

Pleasingly, both the management and corporate governance in Japan is improving with better capital discipline and more shareholder friendly policies such as share buybacks and higher dividends.

Meanwhile, some European infrastructure companies are choosing to allocate capital away from their low growth core assets and into potentially higher growth assets in Latin America. Whilst perhaps well intentioned, we are very wary of this trend due to the increased regulatory, economic and currency risk associated with investing in Latin America.

Typically certain countries such as the USA and UK have more advanced corporate governance regulation and practices such as greater board independence, management alignment and shareholder focus.

A strong theme within the infrastructure investment opportunity set is the long term trend of governments around the world privatising assets. One of the drivers of returns post privatisation is an improvement in management and governance of the newly privatised infrastructure asset. The degree of improvement in management and governance is variable. Most of the time, the resulting management team is better incentivised to maximise returns and operate the company in a shareholder friendly manner. However, in several countries such as Italy and Spain we often see too few management incentives to act in shareholder interests and too much government involvement in the board and governance framework.

The unlisted infrastructure experience

Listed and unlisted (private) infrastructure underlying assets are largely homogenous. One of the areas we believe private infrastructure owners can do well in, like their private equity manager counterparts, is to manage the assets in a way that maximises returns to equity holders. As for the external manager model previously referred to, there are potential governance concerns with some unlisted fund structures, but the actual asset management itself is generally effective. We believe that within the listed infrastructure sector universe, the quality of management and governance is more variable. It is this inconsistency that can create the investment opportunity.

Conclusion & observations

Whilst conducting our infrastructure research, we see both good and bad management decisions and incentives. Good and bad governance structures. The varying levels of management and governance are sometimes reflected in the company share price and sometimes not. Our goal as global listed infrastructure investors who are immersed in the fundamentals of each infrastructure company is to determine which management teams and boards are taking their companies in the right direction against a backdrop of sound corporate governance, whilst simultaneously maximising future cash flows to shareholders and managing for risk.

Further, it is our role as investors to engage with the management and boards of portfolio companies to ensure continual improvement and corporate governance best practice.

A summary of our observations:

Positives	• Maple-Brown Abbott is a long only and long term investor. We should be strategically aligned with the board and management of portfolio companies. This alignment generally engenders long term relationships with company management • We find management that are well aligned with shareholders typically have better track records and strategies • Capital discipline is critical. Investing in your network (rather than acquisitions) is usually better for returns and risk minimisation • Management and governance in Japan is improving – more shareholder friendly policy such as buybacks and dividends • Public to private is usually an opportunity to drive higher returns out of infrastructure assets, but governance concerns can remain • Certain countries have more advanced corporate governance regulation and practices such as greater board independence and shareholder focus. Eg UK and USA • Management and corporate governance is slow moving but it can change over time
Negatives	• Wary of listed asset manager model and US MLP structures – some have questionable governance and agency risks • Emerging Markets typically have weaker governance – controlling and government shareholders • Many European infrastructure companies are desperate to acquire assets and grow outside their home markets