QIC

Infrastructure requires active management and a focus on portfolio diversification to deliver robust, resilient and predictable cashflows

Recently, **Chase McWhorter,** Institutional Real Estate, Inc.'s managing director, *Institutional Investing in Infrastructure*, spoke with **Ross Israel,** head of global infrastructure for QIC. Following is an excerpt of that conversation.

Competition continues to be very strong for unlisted infrastructure. How is QIC differentiating itself, and how successful has your strategy been to date?

There is no question it has been competitive in this low-interest-rate environment, and unlisted infrastructure has been extremely attractive for investors to continue to add to their portfolios.

To weather and perform across multiple market cycles, we focus on our duration as an investor, creating robust and resilient portfolios with a thematic and sector-centric approach. This is through our top-down approach driven by long-term investment themes and a bottom-up approach driven by the three core sectors that we focus on: transport; energy and utilities; and social infrastructure. Within those sectors, we are deconstructing industry value chains to find relative value across the different markets. This has allowed us to be successful in executing multiple investments along the following key themes: distributed energy, healthcare, freight logistics, gateway transport nodes and mobility-as-a-service.

To what extent has the current lower-for-longer environment impacted your strategic investment approach?

Subject to the market dislocations emerging from COVID-19, which will present investment opportunities, we have seen the low-interest-rate environment influence our approach in four key ways, the first being origination. There are obviously a lot of investors who are seeking yield and competing and compressing returns, particularly in core infrastructure. In addition to our targeted thematic approach, we have seen a heightened importance on trying to find bilateral opportunities. This has led to us consummating five bilateral investments over the past two years. However, if we are competing in processes, we are focused on differentiating through early planning and the preparation of a differentiated business plan.

The second key thing is looking at the relative value proposition, which involves assessing core and core-plus combinations of assets that provide diversification across macro and asset-level exposures, in particular across sector, life cycle and regulatory regime.

The third factor focuses on business planning and exploring how we can extract additional value, particularly in a more active asset management sense, i.e., how the business is being run.

Finally, the last element that has been important is debt management. Searching for competitive finance, but also de-risking capital structures through extending maturities and diversifying funding sources in order to derive a resilient and sustainable capital structure.

There is a competition challenge taking place between the fundraising and deal sides of the equation. How are you seeing that impact the assets you are selecting?

We are certainly seeing increased competition from very large asset owners, increased segmentation, and growing allocations to the asset class from institutional investors.

Our response to that is focusing on a portfolio objective and constructing a combination of assets across an agreed risk-and-return spectrum. We are trying to differentiate by building diversified portfolios. This elevates the importance of trying to find uncorrelated return and diversification.

Sourcing through bilateral opportunities, strategic partnering, finding relative value across sectors and geographies, and trying to introduce a business-plan advantage are all key components in trying to meet that competitive challenge.

We've seen significant market distress and volatility stemming from COVID-19. How does your investment approach cater for this?

When we build portfolios, we seek to build resilience across market cycles, so that our portfolios can weather a downturn such as we are seeing from COVID-19. This involves focusing on several factors.

The first is prudence in the capital structures of the businesses that we own — we are aware that illiquidity has been a major issue stemming from debt distress or a credit crunch.

Secondly, ensuring that we have the right governance structure and control of the assets to have the ability to change levers in the business.

We are also focused on the payback period and tracking forward indicators of the businesses we own.

And lastly, we want to make sure we have a combination of assets, which are centered around themes that are resilient across cycles. So, we have been elevating portfolio construction and testing sensitivities and shock outcomes that may affect our portfolio companies.

We continue to hear that infrastructure is defensive, but it does obviously require what you are explaining — active management to increase the defensive nature of infrastructure. Do you worry investors may get too passive in infrastructure?

The reason many investors cite infrastructure's defensive aspect is because of its long duration, offset against long-term liabilities, particularly from pension funds and superannuation funds. However, the major risks that duration brings into play are disruptive technology that changes the way a business may operate, potentially stranding assets; climate change; and an increased focus on long-term stewardship.

For example, technology is having a big impact on electricity where we are seeing disruption in the value chain, which has not changed significantly over the past 100 years. Renewables, battery storage and micro grids are key contributors to this disruption.

Climate change and the increasing political and regulatory environment that we are in is also elevating the active management required in infrastructure assets.

I do worry if infrastructure investors are not thinking with this long-term mindset or implementing an active approach to manage these duration risks. They are also potentially missing opportunities to capitalize on investing with patient, long-duration capital.

How do you think the definition of infrastructure has changed, and how do you think it will evolve in the coming years?

Most people associate the asset class with predictable and stable cashflows. They want strong asset defensive characteristics, resilience from essential-service delivery, revenues that are inflation linked, and diversification benefits.

The nature of essential-service delivery is changing, which is leading to augmentation of the traditional definition of infrastructure. Many of the subsectors are transitioning away from very centralized systems to more decentralized models, driven by technology.

This decentralization is observable in energy and in healthcare. For example, one of our recent investments was into a day-surgery hospital platform, which provides more cost-effective and efficient essential services than can be provided in a centralized hospital system.

The decentralization currently occurring is driving a need for different types of operating and asset management models. It is resulting in a more dynamic delivery of some services through smaller assets that were traditionally centralized. This positively makes the service more resilient to disruption and potentially lowers its delivery costs.

Rooftop solar is another example of decentralization but, this time, in the generation of electricity that has traditionally been largely centered on large power stations. As the asset class evolves, investors need to be aware of how sector value chains are evolving to avoid obsolescence risks in assets they may already own. They also need to be aware of the changing nature of assets, which are increasingly becoming essential in the modern, digitalized economy — such as telecommunication towers, data centers, fiber-optic cable — potentially changing their risk profile.

You could argue there is a natural evolution of the definition of infrastructure. Some of the style drift in the definition of infrastructure may actually be delivering more resilience into portfolios.

If you are thinking about singular investments, which is an asset owner's default mindset, managing disruption risk could be quite challenging. However, if you think in terms of building portfolios and balancing risks with core and core-plus assets, you take a different mindset to weighing those different risk assets for the benefit of an overall outcome.

How integral is ESG when considering your long-term active management of assets?

We believe it is essential, and it is becoming ingrained in nearly everyone's investment process — and most certainly in ours. We are a signatory to the UNPRI and achieved an A+ rating in 2017 and 2018.

As a long-term investor, embedding ESG factors into our investment decisions and active asset-management approach is an important factor in maximizing long-term shareholder returns to our clients. When we look at long-term stewardship, we are looking at how we deal with three key stakeholders: regulators; governments (state, federal, municipal); and customers.

We are also finding that an increasing number of our investors are seeking guidance as to how their assets can meet community and social obligations; ESG is only growing in its prominence.

What impact do you think technology will have on future infrastructure investments?

Through data analytics, artificial intelligence and automation, there is an enormous opportunity to lower operating costs and make capital expenditure more efficient. This will require owners to be more active in their management and aware of how technology can disrupt the way the business operates, and the way customers want to engage with the business.

At the heart of technology risk is an investor worrying that an asset will become obsolete. How will Uber, electric vehicles and autonomous vehicles impact parking assets? We have actively reviewed this, including the repurposing of parking assets adding new revenue streams (e.g., charging stations); ensuring concession agreements have flexibility to adapt with mobility solutions; and changing structures for an evolving transport system, including ride-sharing. Technology will also play an increasing role in infrastructure by enhancing the ability to build and maintain assets in a more cost-effective manner. Through the use of drones and sensors, we can see a movement away from time-based maintenance to condition-based maintenance.

How do you assess infrastructure for its cyber security?

The more interconnected infrastructure assets become, the greater the risk of cyber interference. The increase that we are already seeing in our assets related to this threat is quite significant. To mitigate this threat, you need hard and soft infrastructure, and you need to be addressing cyber security, which comes with digitalization.

What key attributes are you looking for when building the right team, which can execute on your strategic vision?

We want to promote diversity of thought and, as such, we have a global team of 45 dedicated investment professionals and 27 non-executive advisers across five offices. Operational experience, and a deep understanding of the respective sectors, is becoming increasingly important. Thirty-five percent of our team members have operational backgrounds, and more than half have worked across multiple markets. Being able to leverage lessons learned in other markets is an important attribute.

Across the team, we speak 16 languages, which is increasingly important in working with partners and engaging with investors with an OECD global mandate. We want to build relationships across a diverse range of people and are really focused on having a clear investment philosophy and set of beliefs to govern how we invest capital as a fiduciary.

CORPORATE OVERVIEW

QIC is a long-term specialist manager in alternatives offering infrastructure, real estate, private equity, and liquid market strategies. It is one of the largest institutional investment managers in Australia, with US$58 billion in funds under management. QIC has over 1,000 employees and serves more than 110 clients. Headquartered in Brisbane, Australia, QIC also has offices in Sydney, Melbourne, New York, Los Angeles, Cleveland, San Francisco, London and Copenhagen.

QIC's Global Infrastructure team operates an established global platform with an active management approach and proven, 14-year track record. With a global team of more than 45 professionals across five offices, it manages US$10 billion across 19 global direct investments and has realized a further US$5.1 billion of investments for its clients. Its sector-centric and thematic-based investment strategy deconstructs risk across sector value chains, identifying relative value for investment across market cycles. This drives a targeted origination approach, enabling the firm to build diversified portfolios for its clients.

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