INTEGRATED ASSET MANAGEMENT

The strength of experience

Due diligence and a strong credit culture are what Integrated Asset Management will rely on for its new senior infrastructure debt strategy.

When is a new strategy not a new strategy? When the team behind it has already been doing it for years. And that's the case with Integrated Asset Management, the Canadian asset manager busy launching its first infrastructure debt fund.

The firm is working on its fifth corporate debt fund but, as the team explains, infrastructure projects have always found a home in IAM's cautious portfolio. The strong structures, low risk (once through the start-up phase) and decent returns offered by smaller projects have been a good fit for IAM over the firm's first decade of debt fund management.

The only problem was maturity. The vehicles IAM raised couldn't lend for any longer than 10 years which is less than half the tenor of many infrastructure loans.

With project finance-like loans making up around 25 percent of their corporate lending, the team started thinking about an infrastructure-specific strategy as far back as 2008, Philip Robson, president of the private debt group at IAM explains. The global financial crisis, unsurprisingly, got in the way but the plan remained and last year, IAM executed a study to confirm with hard data their intuitive feeling about the opportunity.

The study identified infrastructure projects under CAD125 million in size and came up with a total of around CAD8 billion-worth of projects. "The average cheque [for those projects] would be around CAD50 million to CAD60 million, which is typically too small to attract the interest of larger institutions and which are of the long-term, long duration that the banks can't finance; more important, with our strategic focus on mid-market opportunities, these projects fall right within our sweet spot where we have been successful in achieving superior risk adjusted returns," explains Theresa Shutt, chief investment officer for the private debt group.

> "THE GOVERNMENT HAS A PUBLIC PRIVATE PARTNERSHIP (PPP) PROCESS BUT WE'RE JUST NOT PATIENT ENOUGH TO BE PART OF THAT."
> **Robson, IAM**

WHY DEBT?

As an asset manager with an existing real asset base – the firm has a real estate group – moving into infrastructure on the equity side was an option. But the IAM team feel strongly that infra debt is a better option than the equity option. Continuing return compression and increased volatility in infrastructure assets as well as the growing pile of cash already collected for equity strategies all influenced the decision.

Those issues do not translate across to the debt side, the IAM team point out. The Canadian infrastructure deficit is estimated at $145 billion by a number of government bodies. Insurers and global banks have traditionally dominated the financing of projects but following the financial crisis global banks exited the Canadian market and with heavy capital weightings for long-term loans, there's little incentive for the remaining lenders to get into the game. And with debt to equity leverage percentages ranging between 75 and 90 percent, the debt side frankly needs more money.

For investors, senior infrastructure debt offers predictable and substantial free cash flow, attractive risk-adjusted returns, diversity as well as access to unlisted illiquid assets, says Robson.

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THE PLAYERS

We're talking in *PDI*'s office in London. Robson and Shutt are on the phone while vice-chair and former chief investment officer Don Bangay, who is in London visiting family, admires the view of St Paul's Cathedral.

The team have an easy rapport with Robson and Bangay gently ribbing Shutt, an Alberta native, who as she updates them on the regional general election where the conservative government lost in Alberta for the first time since the 70s.

Robson is the longest serving member of the team. Following stints in investment banking and running his own manufacturing business, he joined what was then First Treasury in 1996 before it was acquired by IAM in 2001.

Bangay was brought on board in 2001 as IAM was starting fundraising for its first investment grade corporate debt fund, the $600 million IPD LP I. Bangay has worked at Newcourt Credit Group as well as spending 25 years in investment management at The Canada Life Assurance Company. He was chief investment officer before taking on the vice-chair role in October last year.

IAM Private Debt have gone on a hiring spree over the last few years both as a result of expanding activity as well as part of a conscious succession planning programme.

"Our customers look at us and ask; 'Who's going to collect the last dollar?' In the context of 25 year infrastructure debt, that's critically important. It became clear to us three or four years ago that we had to have a perpetual succession plan," notes Bangay.

After building credit experience at BMO Corporate Finance following roles at Royal Bank of Canada and Scotiabank, Shutt joined IAM in 2013 and has taken over as chief investment officer. She, along with Robson and Bangay, emphasises that while processes are easy for new recruits to learn, it's important to also transmit the culture of the firm. That was the way that Shutt herself was integrated with over a year heading portfolio management alongside Bangay before he handed the reigns of both investment and investor relationship management to her.

"I would say we have a very strong credit culture. Our approach is cradle to grave; when the account manager originates the deal, he or she owns that loan for the term which results in really strong post-closing portfolio management," Shutt explains.

When interviewing a group there is inevitably one person who dominates the conversation complemented by another who says almost nothing. Not so with the IAM team. The conversation flows easily with all three contributing broadly equally. And the new strategy, while not entirely new (of the CAD1.3 billion IAM Private Debt has invested, around 25 percent of the deals were infra-like loans), energises them.

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Shutt, IAM

'I LIKE GREENFIELD'

Bangay, while describing how IAM has done both brownfield and greenfield projects, says that he prefers greenfield projects and that this is often a topic of debate within the office.

His point of view certainly goes against the conventional wisdom that brownfield projects – typically the expansion or renovation of an existing infrastructure asset – are a safer bet. There is an existing asset available as security and an extensive report by Moody's published last year showed that infrastructure default rates are low and when they do happen, it is overwhelmingly during the earliest phases.

"It's not fair and it's not right for me to say the banks have been sloppy, but my reading of the Moody's report is that a lot of defaults have been from lenders not doing proper homework on putting together a transaction," says Bangay. "Their due diligence with respect to thinking through what it's like to have exposure to these projects for 20 to 25 years is not as diligent as a term lender like us."

Bangay is quick to acknowledge that even the most intensive diligence process will not prevent all the issues that can crop up early in the project cycle like cost overruns and the firm can take a view in advance on how to deal with them. He cites a deal they're working on right now where start-up problems have made the cashflow a little "erratic", as he terms it.

"Bumpy," chimes in Robson, identifying the situation Bangay is thinking of.

MANAGING RISK

"Well the easy way to deal with that was to defer the start-up of amortisation by six months. So we, as single lender, can deal with that situation so there's not a default; maybe there's a technical default but there's not a monetary default. We'll successfully achieve the expected rate of return, sometimes with enhanced return because of all the trouble we go through," Bangay says adding that bank lenders are usually much faster to trigger a full default and seek recoveries.

Principal losses hit debt investors harder than most other alternative managers and so risk mitigation is high on IAM's list of priorities. "We tend to structure loans, because we often are the sole investor, with stronger and more frequent covenants which allows us to step in and intervene earlier and get the loan back on track," notes Shutt.

THE DEALS

With around 25 percent of their executed deals resembling infra in all but tenor already, the IAM team know what they like. "Water treatment, social infrastructure, independent power projects (IPP) like solar and wind [projects]; we've done a number of these deals and we have a brand and the expertise and, most importantly, we view it as a great opportunity for us," explains Shutt.

Large infra projects are not on IAM's radar, however. "The government has a public private partnership (PPP) process but we're just not patient enough to be part of that," says Robson.

IAM prefers to go directly to experienced developers with a smaller – CAD50 million to CAD150 million – project that won't qualify for PPP and offer to finance it. This strategy builds relationships with those developers and creates opportunities to do more deals with them while earning an attractive return from the steady flow of payments to the assets.

In terms of deal basics, the new infrastructure fund will lend for a minimum

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term of ten years with the maximum capped at 25 years with amortisation payments. No more than 15 percent of the fund will be exposed to any one investment giving a maximum loan size of around CAD50 million (though the right opportunities will be offered to LPs for potential co-investment up to a maximum of CAD75 million). The minimum loan is set at CAD10 million.

IAM has always given investors monthly cash disbursements of principal and interest payments and the infrastructure vehicle will offer the same flow-through.

REWARDS

Target returns are seven percent and IAM charges a modest 50 basis point management fee and only on invested capital. Upfront fees charged to borrowers also go to IAM but in the Canadian infra space, they are usually 50 basis points with any amount in excess of 1 percent being passed through to investors. Any waiver or prepayment fees go to supplement returns. The average interest rate on the infra loans IAM is targeting is between six and 6.5 percent, notes Shutt.

"We often get compared, and I think rather unfairly, to those private debt managers that are charging a two to three percent management fee who are also charging monitoring fees to the borrower, taking a performance fee and carried interest and maybe even taking some equity. We have a 50bps management fee, that's it, and we only charge on invested capital and we've only ever charged on invested capital," Shutt adds.

TRACK RECORD

Robson lists the infrastructure sectors that IAM has already lent to; biomass to energy, co-gen, wind farms, water treatment facilities, long-term care homes, transportation. It's a roll call of precisely the kind of deals that the new vehicle will be seeking. "I'd be surprised if the next portfolio looked a heck of a lot different," says Robson.

The IAM approach is comprehensive; intensive portfolio management in the early stages of project through to long-term people planning within their own team.

And it seems that both investors and their advisors are beginning to notice the attractive risk-adjusted returns that IAM works hard to deliver. The firm's pool of investors has trebled over the last ten years and the cold calls from consultants have started.

And, as has been the case for a decade, as the first dollars come in, IAM Private Debt has its eye on the last dollars to be paid out. ■