Active value creation

Neil Krawitz and **Francesco Nale**, partners at European fund manager Arcus, share their views on the evolution of infrastructure strategies and how they deliver their 'value-add' strategy

Q How have infrastructure strategies evolved over the past 15 years?

FN: Fifteen years ago, there were fewer investors who looked at infrastructure in a less specialised manner. As the sector evolved, with more players entering the market, we saw the definition of infrastructure becoming broader and investors' participation more segmented.

Today's infrastructure includes not only regulated assets, but also various asset types that either have a protected market position or provide essential community services. As dealflow and amount of capital deployed grew, there was further segmentation, which allowed investors to go directly into traditional infrastructure assets at the lower end of the risk spectrum, as they have gained a better understanding of those assets.

Fund managers, on the other hand, tend to specialise into sub-sectors where investments require higher sector expertise and more asset management with the associated resource requirements. For example, Arcus has evolved to focus primarily on mid-market European investments in three specific infrastructure sectors – energy, telecoms and transport – where we combine our deep sector expertise with an increasing number of opportunities.

Q What do you think about labels such as 'core', 'core-plus' and 'value-add'? Are they helpful and do they reflect the way Arcus positions itself?

FN: These labels are used differently by participants and sometimes overlap but are really a means to classify the opportunity spectrum rather than to define strategy. Arcus focuses on what we call "value-add"

Francesco Nale

investment opportunities. These are businesses in our target sectors, which have clear real asset infrastructure characteristics. The critical element for our value-add strategy is acquiring businesses that can be changed through Arcus's active asset management to generate additional returns. This includes businesses that have significant growth potential, where there are opportunities to improve management teams, where we can enhance revenue profiles through evolving commercial strategies, possibilities to restructure operations, optimise cost base or improve capital structures. In short, businesses that require Arcus asset management teams spending significant time working with investee company management teams to drive change and create value.

Q What are the critical components of Arcus's 'value-add' strategy then?

NK: The key differentiator of our value-add strategy is our active asset management approach, as we look to change key elements of the way a business works. Our approach is institutionalised within Arcus – it's been applied over a long period of time and this allows our value-add initiatives to be repeated across our portfolio, consistently generating alpha for our investors.

Q How does Arcus structure its asset management activities?

NK: There are three pillars – people, structure and processes – that are central to our active management approach. In addition to applying senior management resources, for good governance, our transaction team transitions to asset management post acquisition. We believe that it is an important alignment of the team over the pre- and post-investment periods for members of our origination team, who complete the transaction, to be appointed as the asset management team for the specific investment, responsible for delivery of the business plan that they identified pre-acquisition.

Secondly, we have developed a propriety asset management framework that outlines all our asset management initiatives, providing a toolkit for our asset management teams to ensure consistent and repeatable value creation across our portfolio.

Lastly, we have recurring processes that allow for exchange of best practices and experience of our team across our investment portfolio. Through these techniques, we ensure application of our value-add initiatives across our portfolio and provide collaborative forums for managing technological developments and industry changes.

Q Can you give us an example that illustrates your strategy?

FN: One of our realised investments – Angel Trains, one of the main UK rolling stock owners. Before we started looking at

Neil Krawitz

the Angel Trains transaction in 2007, we had individuals with significant rail experience and had spent years studying the UK's rolling stock market. When the opportunity arrived, we had already gathered essential resources and expertise in our team – particularly our understanding of the market and financial structures required for the acquisition, as well as developing a strategic plan for what we wanted to change to enhance the value.

It was important to make a complete shift in Angel Trains' commercial strategy towards longer-term value creation through improved stakeholder relationships and protection and growth of the asset base. So we carried out various initiatives, such as separating Angel Trains' continental European business (into a business now called Alpha Trains), introducing new management, implementing a stakeholder engagement plan and establishing a long-term sustainable investment-grade financing.

Following our initiatives, Angel Trains delivered over 10 percent growth in EBITDA, and, while traditional infrastructure asset returns would normally be in the range of 10 percent to 15 percent for this type of business, we achieved around double that, a level not usually associated with the asset class.

NK: At Alpha Trains, it's a similar story – the active asset management we implemented included changing the asset portfolio mix to match infrastructure investors' needs, appointing a new management team, reorganising the business's management and corporate structure, accelerating the growth programme with associated debt-raising and putting in place a long-term, investment-grade corporate debt platform. Over eight years we tripled the equity invested in Alpha Trains and its EBITDA. This has been hugely rewarding for our investors and provides evidence of the benefit of years of dedicated asset management implementing these initiatives.

Q Where do fund managers like Arcus find a competitive advantage when the market becomes more saturated, especially with the participation of direct investors?

FN: Since we focus on three specific sectors with our specialised expertise, and on mid-sized businesses that need significant asset management, we generally don't find ourselves competing with direct investors – we simply look at different things.

The assets we look at for potential value creation and implementing our business plans require a significant amount of our team's resources, which is something usually beyond direct investors' capability. This is our specialism and we believe our competitive advantage.

Q What are the main challenges when implementing your value-add strategy?

NK: Since a lot of what we look to do is to change the businesses that we own, that requires the right people to deliver and execute our plan in day-to-day operations. It is key to find the right way to work collaboratively with each of the business's management teams of different cultures, personalities and industry structures. Managing the partnership with our management teams is sometimes challenging but also very rewarding in generating value for our investors.

The other big challenge is to achieve a controlling position in an investment. In many cases, unless you are in a controlling position with strong governance – whether through full ownership, majority stake or being the largest shareholder – delivering value-add strategies, even if they are good ideas, can be difficult.

Q Can you quantify the impact of your value-add strategy, when it comes to returns and overall asset performance?

NK: Looking back over the past eight years, our portfolio has achieved several hundred basis points of return from quantifiable asset management initiatives that we undertook, in addition to market-driven performance. Many of the other initiatives we implemented for the good of our businesses are difficult to quantify. However, a lower discount rate is one of the benefits of making a business more sustainable, de-risking it and achieving scale and maturity – and Angel and Alpha Trains are good examples of this.

Q Looking ahead, in which direction do you expect infrastructure strategies to evolve in the next two to three years?

FN: We think it's likely there will be further segmentation and specialisation of participants to reflect individual strategies and sector expertise where investors focus on their strengths in order to compete and outperform the market. For Arcus, we will focus our strategy on value-add, mid-market European transactions where we have specific sector experience and a strong track record. ■

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