BKI INVESTMENT COMPANY LIMITED

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QUARTERLY REPORT

HUNTING ELEPHANTS: BIG OPPORTUNITIES IN AUSTRALIA'S INFRASTRUCTURE-TYPE ASSETS

Hunting elephants: a term used to describe a strategy of going after very large customers to sell goods or services, as well as targeting large companies for acquisition.

The takeover offer for Sydney Airport in early July has reminded the market of the inherent value many investors place on long duration infrastructure assets. In this latest Quarterly Report, the 30th in the series prepared by Contact Asset Management, we consider a few listed companies that may likely attract the attention of investors with long-term investment strategies. We believe there are several dynamics driving demand for these assets, namely (i) cheap money / low interest rates; (ii) the increasing involvement of Industry Superannuation Funds in Private Equity and (iii) demand from offshore capital.

The Sydney Airport example

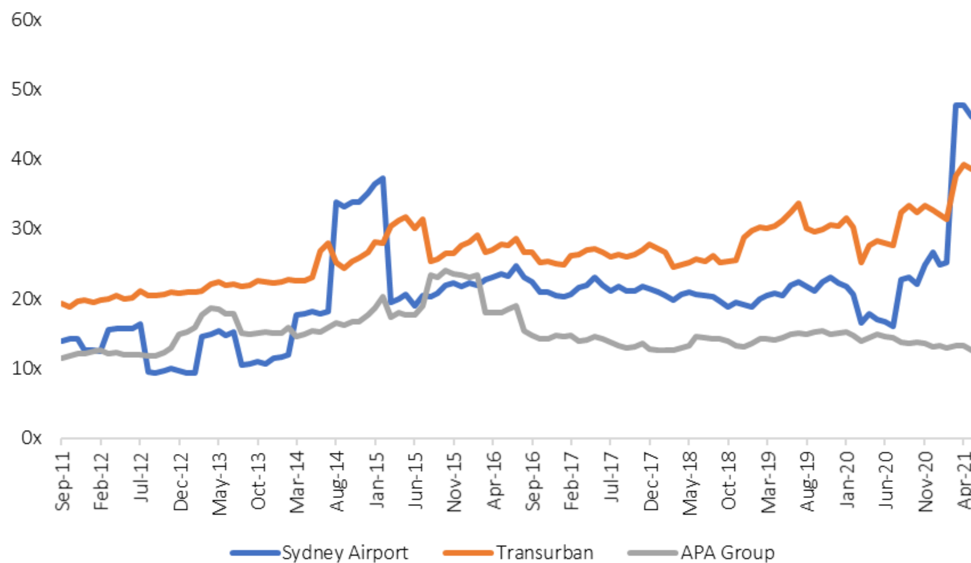
In early July, Sydney Airport (SYD) announced that it had "received an unsolicited, indicative, conditional and non-binding proposal from a consortium of infrastructure investors ("the Consortium") to acquire, by way of scheme of arrangement and trust scheme, 100% of the stapled securities in Sydney Airport at an indicative price of A$8.25 cash per stapled security". The Consortium comprises IFM Investors, QSuper and Global Infrastructure Management. Of note, another large industry super fund, UniSuper, already owns approximately 15% of Sydney Airport's total securities.

The approach is interesting for several reasons, not least of which is the timing. As noted by SYD, the Proposal has been made during a global pandemic which has deeply affected the aviation industry. Passenger numbers are a fraction of what they were pre-COVID-19 and the path to "normal" is unclear. In its 2021 AGM to discuss the results for calendar year 2020, SYD noted that in 2020: passenger numbers declined by 75%; NPAT fell by 150% to a loss of $108 million; and the distribution was cut to zero. During 2020, SYD conducted a $2 billion equity raise and issued a $600 million USPP bond. For full disclosure, all Contact managed Portfolios sold out of SYD in 2020 and did not participate in the raisings. The lack of a distribution and the fact that there is little prospect of a distribution for some time makes an investment in SYD difficult given we value income so highly.

The price being offered by the Consortium is below SYD's pre-pandemic share price, however the financials are vastly different. The prolonged impact from COVID-19 has highlighted the extent of debt being carried by SYD, which was previously acceptable for an infrastructure company with a high degree of recurring revenue and monopoly-like assets.

The rationale for the transaction can be justified in many ways, not least of which is that SYD is a world class monopoly-like asset. However, we find two other points interesting; (i) the Consortium is made up of investors with very long-term investment strategies who can afford to be patient, and (ii) there is a glut of cheap money available in this ultra-low interest rate world, which makes SYD's debt obligations more palatable.

In all, it is a seemingly full price at 22.8x SYD 2019 EBITDA. As depicted in the following chart, the price is huge based on 2020 EBITDA. Nevertheless, the Proposal gives us pause to consider what value might be placed on other long-duration assets for those investors taking a longer time horizon. Firstly, we consider APA Group and Transurban Group.



Source: Factset, Contact Asset Management

APA Group

APA Group (APA) is a leading energy infrastructure business. APA controls 15,000 kilometres of natural gas pipelines that connect sources of supply and markets across mainland Australia, connecting 1.4 million Australian homes and businesses to natural gas. APA also owns or has interests in gas storage facilities, gas-fired power stations and renewable energy generation (wind and solar farms). All up, APA owns or manages and operates a portfolio of assets of around $22 billion and delivers half the nation's natural gas usage.

APA's primary source of income is the fees they charge the gas producers and exploration companies to transport gas through APA owned pipelines. These fees are usually calculated on the spot price for gas as well as the volumes required to be transported. They also have a small number of energy generation assets and gas storage assets primarily along the east coast of Australia. APA currently earns approximately 63% of revenue from unregulated pipelines.

Contact considers APA to be a high-quality business with an excellent market share position in Australia and scope to grow domestically and abroad. The business is well managed and has a good history of attractive cash flow generation which is expected to underpin distribution growth for many years into the future. Contact expects APA to offer a growing distribution stream and offers an attractive total return profile with valuation upside. Contact values APA at $12.28 using a DCF valuation (7% discount rate and 3% terminal value). If we placed APA on a similar multiple to the recent SYD takeover offer, being c.20x EV/EBITDA, the implied valuation for APA is over $18.00 – double the current share price.

APA is a stock that has attracted corporate interest in the past. In 2018, Hong Kong based CK Infrastructure made a $13 billion bid for the company. APA's market cap is currently $10.5 billion.

Transurban Group

Transurban Group (TCL) was founded in 1996 and is today one of the world's largest builder and operators of toll roads. TCL's network is a Monopoly set of assets, they currently have 19 roads under operation across Melbourne, Sydney, Brisbane and North America (Greater Washington and Montreal). The assets are long life. Over its network, TCL's Average Concession Expiry is 37 years and has an Annual Average Toll Escalation Growth rate of 3.0%

Future growth opportunities exist, with WestConnex in Sydney and the West Gate Tunnel in Melbourne to be delivered over the next 2-5 years. These projects will also now be fast tracked due to infrastructure stimulus announced by State and Federal governments. Future projects that Transurban will also play a vital role in design, construction and management include the Beaches Link, Western Harbour Tunnel, Sydney Gateway and M6 in Sydney.

Contact values TCL at $14.99 using a DCF valuation (7% discount rate, 3% terminal value, net cashflow in year 6-10 of 5% and CAPEX growth of 5%). TCL provides investors with a very robust and consistent earnings stream. As depicted in the preceding chart, the stock has re-rated slightly in recent months. The stock was volatile in 2020 when lockdowns created volatile traffic numbers. We would consider any significant weakness during the current Sydney lockdown to be a buying opportunity. Like SYD, TCL appeals to long-term investment strategies. Unisuper is the largest shareholder with a 12% stake.

Other companies with Infrastructure-like characteristics

Telecommunications

The telco sector is another segment of the market with increased corporate activity. In late June, Telstra (TLS) disclosed that it had agreed to sell 49% of its Mobile Towers business to a consortium of infrastructure investors. The company achieved a higher value than most expected. TLS will use roughly 50% of the proceeds (~$1.4bn) to pay down debt. The balance (~11cps) will be returned to shareholders. This is a positive transaction and comes at a time when we are seeing continued signs of a return to more rational industry pricing. The last two months have been positive for mobile pricing and this should, hopefully, be maintained.

The TLS Towers transaction was another deal executed at what would historically be considered a very full price: 21x EV/EBITDA. This is even more impressive when one considers that the sale of 49% ensures TLS retains 51% and control. This is important in TLS' goal to preserve a mobile network competitive advantage. The market responded favourably to news of the transaction with TLS shares closing 4.5% higher on the announcement.

This leads us to consider the potential intrinsic value in TPG Telecom's tower assets. We have long believed that the infrastructure and backhaul is an underappreciated asset for TPG. That may soon change as infrastructure becomes a more sought-after asset class. According to Morgan Stanley Research, an estimated value of $325-500 million is feasible for TPG's mobile towers. The broker makes the point that this only covers the towers and it is important to consider that while TPG has a smaller mobile tower portfolio than Telstra, it owns substantially wider telco infrastructure assets such as fibre. Last week, TPG made the following comments through the media, "For the last year, TPG has been integrating the multiple infrastructure assets of the group including mobile towers, macro and small cells, fibre and data centre assets owned by the pre-merger Vodafone and TPG businesses. These are significant infrastructure assets and we are always considering options to unlock more value for our business". We are watching this space.

Real Estate

While Real Estate is valued in a different manner to the purer infrastructure-type businesses discussed above, we thought it worth discussing a few opportunities in the sector. The themes in this report have several similarities to the drivers discussed above. Namely:

Real Estate is an asset class that is in demand from the large industry super funds, pension funds and global private equity. The flows into these mega-Funds show no sign of slowing. The increase in compulsory superannuation rates in Australia is an example of the tailwinds. Industrial assets and Office are two segments that have been strong in recent years because of the demand. Industrial has the additional tailwind of the eCommerce trend. Goodman Group (GMG) is an obvious beneficiary here. We consider GMG to be an extremely well-managed business with a strong Balance Sheet and a first-class portfolio of assets.

Globalisation is also a factor. In a recent report, Knight Frank noted that better returns from high grade assets is the major reason for the sharp increase in international demand for Australia's Corporate Real Estate. Investors from offshore targeting Australia can still achieve attractive returns relative to other global cities. For example, office yields in Sydney are 4% versus Hong Kong at 2.5%. Charter Hall (CHC) has done extremely well in attracting offshore flows to Australia. We are very optimistic on CHC's expected growth in Assets Under Management and the potential for earnings enhancement through performance fees.

Lower interest rates and cheap money have underpinned demand for Real Estate. This has put downward pressure on cap rates. Yet, different businesses have different approaches to how aggressively they value their property assets. As we've discussed before, we believe that Harvey Norman's (HVN) property portfolio is underappreciated by the market. While several of HVN's properties are interlocked with its retail operations, we do not view this as a negative. HVN is a high-quality retailer. We consider the HVN property portfolio to be very conservatively valued, particularly given the Annual Report disclosed cap rates between 6%-10% across the portfolio. This compares to some Bunnings assets being valued at low-to-mid 4% cap rates. We continue to be optimistic on the HVN investment case – its Balance Sheet is close to net cash, it is well managed by an aligned team and the dividend yield is compelling.

Conclusion

We believe that one edge possessed by Contact Asset Management and BKI Investment Company is our ability to think long-term. Many of the transactions discussed in this report are driven by investors with the long-term in mind. We believe the opportunities never cease and that these long-term investors will continue to seek high quality assets. The combination of cheap money, big mandates and significant capital flows suggests that we can expect several mega-transactions before this cycle is over.

With that, we conclude by quoting Lou Simpson. While little known, Lou ran Geico's (owned by Berkshire Hathaway) investment portfolio for 25 years and delivered excellent returns (over 20% per annum): "Attempting to guess short-term swings in individual stocks, the stock market or the economy is not likely to produce consistently good results. Short-term developments are too unpredictable. We are sort of the polar opposites of a lot of investors. We do a lot of thinking and not a lot of acting. A lot of investors do a lot of acting, and not a lot of thinking."

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