

# GIP Puts Operations at the Heart of Value Creation

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Randolph Walerius

**Global Infrastructure Partners, initially seeded with money from General Electric and Credit Suisse, puts its industrial heritage at the heart of its value-creation method. Infrastructure assets, like the two London airports in GIP's portfolio, have a lot of process in them, says GIP Partner Michael McGhee. The infrastructure asset class now has enough of a track record for potential investors to be more discerning in their choice of fund managers. *InfraNews'* Editor Randolph Walerius interviewed McGhee.**

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Infrastructure funds had an awful year raising capital in 2009. The conventional wisdom is that the financial crisis led pension funds, life insurance companies and other investors to closely guard their money. The idea has been that 2010 would be better as economies stabilized, bank margins came down, and deal flow resumed.

There are signs, however, that limited partners aren't any friendlier to fund raisers in 2010 – at least in the first three months of the year – than they were last year. Reports are circulating of funds paring back target sizes and others cutting fees to entice investors. The thought is taking hold that it wasn't just a financial crisis driving investor caution last year, but a deeper shift in their thinking.

One possibility is that the performance of fund raisers in the more benign economic environment of 2010 is a measure of the sector's much-discussed move into a new era. Infrastructure is now mature enough as an asset class to have a track record.

“I think what's happening – it's very clear – is an industry shakeout,” says Michael McGhee, a partner at Global Infrastructure Partners (GIP), a USD5.64bn fund. “What will happen will be survival of the fittest. The very best run funds will continue to prosper and be successful in fundraising. The really badly run funds will go out of business. They will fail to raise capital. In the current capital shortage environment, even the medium-well run funds will struggle to raise capital.”

In McGhee's view, the institutions that provided capital to infrastructure funds in the asset class's first phase are drawing conclusions from that experience.

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“It's a developing industry,” he says. “The pension funds, the sovereign wealth funds, the long-term investors who provide the capital for funds are being very very much more discriminating and discerning in terms of where they're putting their money, which I think is a very good thing for the industry.

“You’ve seen vastly different performances of funds,” he says. “A lot of those performances really don’t bear much scrutiny: excessive use of debt, excessive overpayment for assets, little genuine non-financially-related value creation.”

### **Demonstrating Delivery**

In other words, the funds in search of capital are going to have to do more than flash a blue-chip financial brand in front of potential limited partners. The issue isn’t one of limited partners preferring to invest directly or wanting lower fees. They are willing to commit capital to an infrastructure fund, but one that can demonstrate that it can deliver. Nothing demonstrates the ability to deliver like a record of delivery.

“There will be a role in the future for infrastructure funds who are able to represent the interests of a whole number of pension fund investors and other financial investors, thereby giving them access to some very attractive infrastructure assets,” McGhee says. “Given the people investment to get access to these assets and given the sheer sums of money involved to get a controlling stake, that’s beyond the means of the vast majority of pension funds.”

Like most in the industry, McGhee thinks only a few of the very biggest pension funds have the capability to invest directly. “The extent to which that happens is pretty much pension fund specific.”

There’s another way for those pension funds and other institutional investors to find their way to direct investment, one recently demonstrated by GIP.

In February, two months after GIP closed its purchase of Gatwick Airport in one of the biggest European infrastructure deals of 2009, the fund sold 12% of the equity to the Korean National Pension Service, the manager of the USD270bn National Pension Fund. (GIP also sold another 15% to the Abu Dhabi Investment Authority several days later.)

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Through GIP, South Korea’s largest pension fund found its way to a direct investment in the UK’s second biggest airport. Standing next to a fund that has, as the saying goes, “skin in the game,” provides a degree of reassurance about the quality of the decision. McGhee won’t comment on individual institutions that GIP does business with, but says their assessment of GIP is a large part of their assessment of the asset they’re putting money into.

“We will always have a controlling stake, or jointly controlling stake,” he says. “They have to be confident in us as managers and operators, custodians of the asset.”

### **Investors Want Options**

As with the choice between direct or indirect investment, no one size will fit everybody when it comes to fund structures. Investors will want options, McGhee believes. GIP is a closed-ended fund of more than 10 years, with options to extend. He accepts that longer-term funds will attract investors, but predicts the industry will have room for a range of structures.

“We ourselves don’t detect one is better than the other,” he says. “It very much depends on the investment strategy and capability that the fund manager is offering. There are pluses and minuses for both types of structure. What we will see is the industry being served by a combination of closed-ended funds and either open-ended funds, or very long-term funds. A

more passive fund manager may be better suited for very long-term buy and hold. For us, it's a closed-ended approach. Our focus is very much buy and improve."

Backed initially by USD500m each from General Electric and Credit Suisse, GIP's practice of using GE's industrial expertise to run its infrastructure assets has encouraged a view that the fund is closer to a traditional private equity fund than an infrastructure one. The case is that GIP makes operational improvements to ready the asset for sale. The quick disposal of 25% of Gatwick only two months after the purchase served to reinforce the view.

"All of our strategies really hinge around improving facilities and service levels."

But McGhee says the case doesn't add up.

"We are a long-term investor," he says. "We've made 10 investments and we haven't actually done a realization. We're very targeted in terms of specific industries, where we've built up expertise. All of our strategies really hinge around improving facilities and service levels. We think that is the best way to build long-term value."

GIP focuses on select areas of transport, energy, and water and waste. Specifically, it encompasses airports, ports, freight rail, water distribution and treatment, waste management, power and utilities, and natural resources infrastructure. In addition to Gatwick, the UK portfolio includes London City Airport and waste management company Biffa. GIP holds stakes in Terra-Gen Power Holdings, a US renewable energy producer; Chesapeake Midstream Partners, a natural gas gathering business; and Ruby Pipeline Holding Company, a joint venture with El Paso Corp.

What the investments have in common is an operation that can benefit from GIP's industrial heritage, McGhee says.

### **Improving the Process**

"We believe a lot of the infrastructure business is very much process oriented," he says. "A lot of best practice, operational processes and management techniques have been developed in the industrial sphere. A large number of our operations team would have a manufacturing background. They are mainly former GE employees with the full industrial management toolkit: six sigma and lean, and so on."

Six sigma is the business management strategy, first developed by Motorola, that aims to improve quality of performance by identifying and removing the source of defects. Initially designed for manufacturing, the method was adopted for other applications. Long-time Chief Executive Jack Welch introduced the method to GE.

Gatwick, like London City before it, is a case in point.

"There's a lot of process in an airport, whether it's people that are being processed, bags that are being processed, aircraft that are being turned around," McGhee says. "The efficient design of those processes and the execution of those processes ... very much improves efficiency. That's what we've done at London City. At Gatwick, we have that task ahead. The target is pretty much to eliminate queues. We're applying specialist industrial management techniques to infrastructure businesses."

“The chief operations officer we have at Gatwick Airport moved across from London City, but he’s a former GE and Honeywell senior operational leader. He really spearheaded the review, overhaul and improvement of all the processes at London City Airport and he’s doing the same at Gatwick Airport.”

The job isn’t one for a fund with an early exit strategy. Transforming the airport and the passenger experience of Gatwick can’t be done over night, he says. “We’re trying to deliver a better service more efficiently and at lower cost. Once we have done that, we are a closed fund so we will eventually exit. But it’s not a two-year exit, or a three-year, four- or five-year exit. It’s a long-term approach.”

### **Gatwick Acquisition Strategy**

And two quick sales of equity stakes – McGhee says more are coming – had more to do with the entry strategy than an exit strategy.

“Remember the equity check was well in excess of a billion dollars, which is large amount for anyone,” he says, adding that GIP always intended to bring that exposure down. The fund decided that the most effective way to bid was alone, and to then syndicate the equity when the deal was closed.

“BAA knew we could deliver what we said we could deliver,” McGhee says. “We were not reliant on a number of partners. In the fluid and uncertain environment, it proved to be a major competitive advantage, being alone.”

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And for good measure, McGhee notes another distinction between GIP’s approach and that of traditional private equity. GIP doesn’t heavily leverage its assets.

“We have never used debt as part of our value creation approach,” he says. “We used debt, but on a very much more conservative basis than most other players. Most of our assets would be around 50:50 debt to equity. That’s relatively unusual in the industry and certainly at the peak. Depending on the particular type of assets, whether it was 80% to 90%, you saw some very high gearing levels and on a multi-tiered basis, not just limited to the asset.”

In addition to syndicating the Gatwick equity, GIP plans to refinance the bank debt in the bond markets. McGhee declines to be even vague about the timing.

### **Value Gap Between Buyers and Sellers**

The Gatwick deal was forced on BAA – or at least its timing was - by the UK’s Competition Commission. Forced sales, whether by regulators or by refinancing needs, are still seen as the most likely source of 2010 deals. Banks may be getting competitive, buyers may be willing, but asset owners remain optimistic about values.

“This recession is no different from previous recessions in that respect,” McGhee says. “The sellers of assets remember the prices from two or three years ago. The buyers of the assets are rather keener on the prices which they think should be prevailing at that stage. That value gap across the market is still there.

Such an environment doesn't pose just a test of patience. It's a test of judgment. The fund that gets it wrong is wasting a lot of its effort.

“The key issue for a fund investor such as ourselves is to make sure you deploy your time and resources in a productive rather than non-productive area,” he says. “We have avoided what we regard as a lot of kite-flying, where sellers are tempted just to test the market in the hope – maybe in many cases hope rather than expectation – that the prices are acceptable. That’s why you’ve seen very many processes that would seem to have started. No one quite admits that they end, but they basically haven’t gone anywhere.”

“We’ve really focused attention on high-quality assets, strategically targeted in our industry areas, where we believe that there are conditions for a transaction to happen. That could be a forced sale, or a quasi sort of forced sale. It could be, for example in some of our US projects, first-class, high-quality, value-creating investment opportunities where the key sponsor is looking for a partner to help execute. It isn’t the sale of an asset. It’s the joint pursuit of a really top class investment opportunity. In terms of how we’ve been devoting our time, it’s been very much targeted to those two areas.“

#### GIP Holdings and Year of Investment

- Gatwick Airport (2009)
- Terra-Gen Power (2009)
- Chesapeake Midstream Partners (2009)
- Ruby Pipeline Holding (2009)
- GIM Channelview Cogeneration (2008)
- Biffa (2008)
- East India Petroleum (2007)
- IPH (Jersey) Ltd. (2007)
- London City Airport (2006)