



Australian toll roads

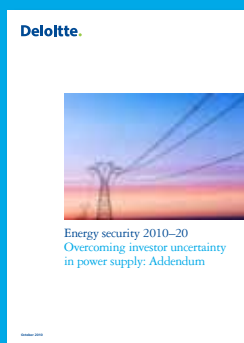
An opportunity for Canadian pension funds?

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Introduction

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- Case studies/deal evaluation.

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In recent years foreign investors, particularly Canadian funds which accumulate funds by virtue of Canadian pension/superannuation requirements, have demonstrated a growing interest in investment in Australian infrastructure assets, specifically in respect to toll road assets and have offered bid prices in excess of those offered by Australian investors.

This monograph explores some of the factors that contribute to an Australian investor not providing a higher offer against a Canadian pension fund, particularly when Australian fund investors routinely include the value of franking credits in their bid models.



General analysis of investment drivers: Canadian vs Australian pension/superannuation funds

Value placed on the 'long tail'

Canadian pension funds are typically defined benefit rather than accumulation funds. Members of Canadian pension funds therefore do not suffer should a fund's performance decline. Rather, employers are required to make up the difference so that payments to members are maintained at predetermined levels. These funds accumulate without net withdrawals for some years. However, consistent with the ageing population of Canada, Canadian pension funds will be required to pay out large volumes of benefits to members from 2020. Consequently, the key investment feature valued highly by Canadian pension funds is long term stable cash flow profiles with the expectation of returning value in the long term.

Toll roads represent assets with a similar investment horizon to the funds, therefore enabling Canadian pension funds to match assets and liabilities. They are also relatively easy to manage and offer protection against inflation. Canadian pension funds which are defined benefit funds are likely to bid more aggressively to secure assets with these feature in order to manage the long term tail of their cash flows.

By contrast, most Australian superannuation funds are accumulation funds and arguably place relatively lower value on stability or the very long term profile. Australian funds tend to view infrastructure as an alternate asset class which is counter cyclical to the market, therefore the focus is not necessarily to match liabilities with funds invested but to seek investment opportunities with relatively long term stable returns that are expected to outperform the market.

Approach to investment

Canadian pension funds have taken a proactive approach to investment in the infrastructure sector, establishing large in-house direct investment and asset management teams, which are able to conduct their own in-depth research and analysis into the sector and specific infrastructure asset opportunities on a global basis as well as their own deal origination. The scale of these teams and large allocations to the sector has effectively enabled Canadian pension funds to create their own private equity model, with a focus on direct investment, thereby enabling them to take an investment stake which affords them the ability to influence the management and operations of assets acquired. The teams also have KPIs linked to how funds are employed and the long term success of the investment. Consequently, they have the funds and resources to undertake very large deals and acquire controlling/majority positions. In addition, the funds have been observed to invest via infrastructure funds or alongside infrastructure funds with existing controlling positions.

In comparison, individual Australian fund investors' in-house resources are much more limited and the scale of deal able to be pursued is smaller than that of a Canadian investor. With some exceptions, Australian funds have tended to date to take minority positions only.

Risk assessment

It is possible that recent poor performance of Australian toll roads in early stages of operation, such as the Clem Jones Tunnel (CLEM7) in Brisbane owned by the RiverCity Motorway Group, could contribute to a higher risk rating and perceived uncertainty by investors.

It has been observed in transactions to date that Canadians tend to invest in toll roads that have demonstrated their ability to return stable cash flows over an extended period of time. For example, Transurban has been in operation since 1999 and has been operated by the private sector since 2000.

Discount rate

It would be expected that Canadian and Australian investors have a similar view on the valuation of Australian toll road assets, via the application of an Australian-denominated discount rate to (equity) cash flows, projected in Australian dollars. However, whilst the derivation of discount rate is likely to be similar, Canadian and Australian investors may have differing views on each of the variables, such as:

- **Risk free rate** – While typically based on the yield on a 10 year Australian Government bond the rate adopted could be slightly different based on the method of calculation (i.e. point estimate versus an average calculation over a specified time period)
- **Equity market risk premium (EMRP)** – While Australian investors typically currently adopt a rate of around 6%, Canadian investors would determine EMRP based on the relative perceived risk of Australia compared to Canada. This perception could differ from the EMRP typically expected by Australian domestic investors. Similarly, whilst we would consider Australia and Canada to have a similar sovereign risk rating, Canadian investors may have a different view of the risks associated with investing offshore. Subsequent to the global financial crisis (GFC) an increasing level of government interventionism on strategic assets has been observed (primarily in the resources sector, i.e. the mining super profit tax in Australia or the Canadian government opposition to BHP Billiton's bid for Potash Corporation) which could affect global investors' perspective on Australia's or Canada's sovereign risk
- **Tax rate** – based on the Australian corporate tax rate of 30%, it is likely that these assets would have the ability to offset taxable income with tax losses for a considerable number of years.

Differences in the discount rate variables selected by Australian and Canadian fund investors are likely to contribute to lower rates applied by Canadian investors when assessing bid prices.

The 10 year Government bond rate in Canada was last recorded at 3.11% with an inflation rate of 2.40%, in comparison to the current 10 year Australian Government bond rate of 5.53% with an inflation rate of 2.80%.

In particular, we note that Canadian investors typically consider potential investment options globally, based on relative returns between different markets. As these funds are global players, they consider returns comparatively.



Currency strength

With the Australian dollar (AUD) and the Canadian dollar (CAD) currently similarly valued against the US dollar there is no compelling argument to suggest that relative currency strength would contribute to the likelihood of a Canadian investor bidding in excess of an Australian investor. Given the similarities in the economies of Australia and Canada (which are both driven by commodity exports), there may be an expectation that the AUD and CAD are naturally hedged and therefore follow similar trends.

Possible tax differences

Canadian investors are not able to access the same benefits from Australian franking credits compared to an Australian investor, which places them in a potentially less favourable tax position. However, given the anticipated tax profile of such investments, notably the likely ability to offset taxable income with tax losses for a considerable number of years, we would not expect such tax differences to have a material impact.

Relative weighting of unlisted assets to listed investments

Given the scale of Canadian pension funds in comparison to Australian funds, they are not as exposed to relative risk weighting impacts of a fluctuating market, which may put Australian funds at risk of selling down unlisted assets in the event of declining stock market conditions in order to maintain relative asset class weightings across a portfolio, consistent with possible fund requirements. This risk would be factored into an Australian fund's assessment of value when considering investment in unlisted infrastructure assets.

Ability to diversify portfolios In order to diversify investment risk, Canadian pension funds are seeking investment alternatives outside of domestic options. In addition, recent changes to foreign investment rules in Canada have removed the previous 30% (approximate) restriction on foreign investment.

Canadian pension funds have limited domestic investment options, therefore investment in Australian infrastructure assets enables geographic and sector diversification.

Summary

It would appear that there could be a number of factors that are highly valued by Canadian pension fund investors and therefore contribute to higher bid prices offered for Australian infrastructure assets relative to domestic investors, although none of them are compelling reasons for why an Australian investor would not be in a position to provide a competing offer against a Canadian pension fund. The most compelling arguments are that Canadian investors are better resourced and structured to pursue infrastructure investment.

It seems worth noting therefore that where similar situations apply for defined benefit pension fund investors in other key jurisdictions, then interest and activity from additional sources could be expected in the future.

Case study: Transurban

In May 2010, the Canada Pension Plan Investment Board (CPPIB), along with CP2 and Ontario Teachers' Pension Plan (OTTP), proposed a AUD 7.2 billion bid for Transurban, Australia's largest operator of toll roads. This was the second offer received for the company and both offers were subsequently rejected by Transurban. There have been no further offers received for the company.

Following the rejection of these two offers, Transurban raised AUD 542 million in equity placements to support the AUD 630 million upgrade of Sydney's M2 and M5 tollways. As a result of the equity placement, OTTP sold its investment in Transurban, on the basis that the equity placement diluted its existing shareholding.

The second offer was AUD 0.65 higher than Transurban's last traded price of AUD 4.92 per share before the stock was suspended in May following a capital raising announcement and represented a 13% premium to its then current price.

Case study:

The recent Intoll transaction

The takeover of Intoll via a scheme of arrangement from Canada Pension Plan Investment Board (CPPIB) is indicative of continuing interest from overseas pension funds in Australian listed infrastructure vehicles, albeit one in which the major asset was Canadian.

CPPIB, Canada's second-biggest pension manager set up its infrastructure division at the end of the 2006 fiscal year, and as at September 2010 had CAD 6.2 billion worth of infrastructure assets under management. The fund indicated it expects to continue to be a big investor in private equity with an expectation to more than double its assets under management from CAD 139 billion over the next decade.

After the successful takeover of Macquarie Communications Infrastructure Group and a failed attempt to acquire Transurban, Australia's largest toll road investment vehicle and operator, CPPIB has now moved its focus to Intoll, whose main asset is the Highway 407 expressway north of Toronto.

Intoll directors unanimously recommended and Intoll shareholders have approved an AUD 1.52 (revised) cash offer from CPPIB.

Australia is likely to continue to be on CPPIB target list. According to CPPIB's senior vice-president for private investments:

“There are certain markets that are certainly more favourable to private ownership of infrastructure assets. Australia is one of them, UK is one of them and I think Canada is certainly moving in that direction”

Very few in the market are surprised by the acceptance of Intoll's shareholders of CPPIB's offer.

The offer, which implies a multiple of 26.6 times FY10 EBITDA on a look-through basis, was recommended by Intoll directors on the back of their recently (June 2010) lowered net asset-backing value of the company's assets (following an increase in discount rates for 407ETR from 9.5% to 11% and apparent difficulty in the sale process experienced by Cintra of its 10% stake in 407ETR) which is broadly in line with the offer.

More recent developments on the Cintra sale of 10% interest in 407ETR further support the offer as it appears that a full control premium is being paid for Intoll's 30% interest in 407ETR. CPPIB has recently reached an agreement to also acquire Cintra's 10% interest in 407ETR. The purchase price for this transaction (CAD894 million) implies a discount of 1.5% to 15% to the market value of 407ETR as estimated in the Independent Expert Report included in the Scheme Booklet prepared by Intoll. Whilst that 10% interest provides entitlements broadly similar to the 30% interest in 407ETR owned by Intoll, the discount may be explained by the lower number of seats on the board of directors of 407ETR (one for every 7.5% equity interest) to which Cintra's 10% interest is entitled to on a pro-rata basis.

Given the specific attractiveness of Intoll to CPPIB and the implied valuation, a higher offer from an alternative bidder was highly improbable.

Current issues

In contrast to CPPIB's activity we do not observe similar activity from Australian superannuation funds in the infrastructure sector, with the exception of the privatisation of Port of Brisbane. The consortium acquiring this asset comprises Industry Funds Management (IFM) (27%) which acts on behalf of Australian industry superannuation funds and is the second largest infrastructure investor in the world. The other partners in the consortium are a multinational infrastructure investment specialist – Global Infrastructure Fund (GIF) – and two state-owned entities Queensland Investment Corporation (QIC) and Abu Dhabi Investment Authority (ADIA). Despite this transaction, individual Australian superannuation funds' investments in infrastructure assets appear still marginal in relative terms compared to offshore pension funds.

We attribute this discrepancy to regulatory and market factors. The majority of offshore pension funds (i.e. Canadian, US, UK, Japanese) are largely defined benefit schemes whereas, Australian superannuation funds are typically based on defined contribution schemes, which makes steady, long term and low risk returns such as those delivered by listed or unlisted infrastructure assets more attractive. Australian superannuation funds are more likely to be attracted by capital growth, liquidity and a greater risk profile given they compete for fund volumes based on performance.

Australian superannuation funds do not currently have the scale to compete with large overseas pension funds. Australian Super, the largest Australian superannuation fund, has AUD 32 billion of assets under management. Larger funds can set up in-house M&A teams rather than outsourcing advisory services to managers and can bid in autonomously rather than via consortiums, which can give them greater flexibility and more rapid execution. As a result, Australian superannuation funds have generally taken only passive minority positions such as that in relation to the recent privatisation of Port of Brisbane, with the exception of the recent transfer of the highly geared Queensland Motorway Corporation to QIC.

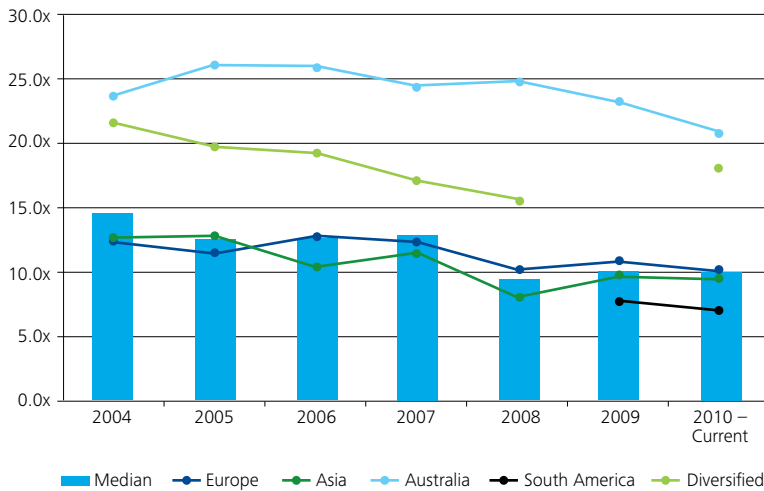
Canadian investors, including pension funds, have the ability to raise funds publicly through subscription receipts (SRs) (from both retail and institutional investors) in order to provide certainty to a vendor of an asset that they are able to execute a transaction. The funds are held in trust until the completion of the transaction and in the event that the transaction is successful, the SRs typically convert to equity (or some hybrid instrument). Conversely, if the transaction does not proceed the SRs effectively unwind, thereby avoiding any risk of dilution. Australian investors do not have access to SRs, and may be required to raise funds to provide certainty that a transaction can be adequately funded. In the event that an Australian investor is not successful in proceeding with the transaction, this could have a dilutive impact on the Australian investor.

Infrastructure assets and, toll roads above all, match pension funds' investment requirements. Low capex (post-construction), GDP-linked growth profile, low risk and long term cash flow profile are key characteristics of toll roads and of a number of other infrastructure assets which are of interest to pension funds.

Favourable cross-border tax treaties and low income tax paid by pension funds magnify the benefits associated with the features above. In addition, toll roads are of particular interest because they are assets that are relatively easy to manage and it is common for tolls to be linked to inflation.

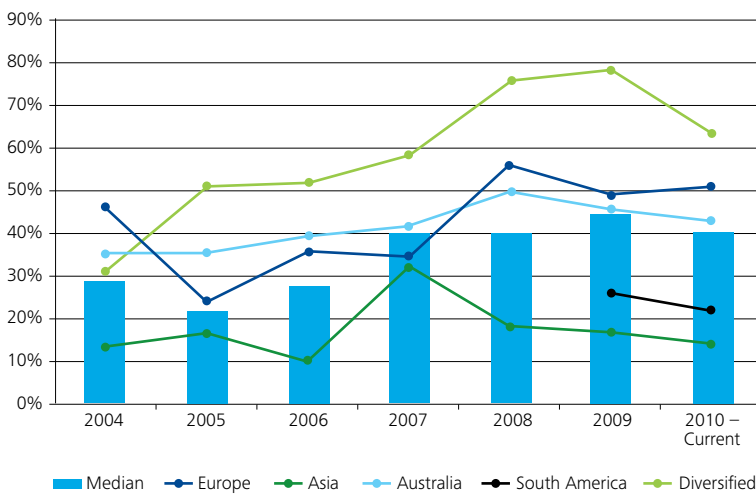
Toll road metrics: some global comparisons

EV/EBITDA



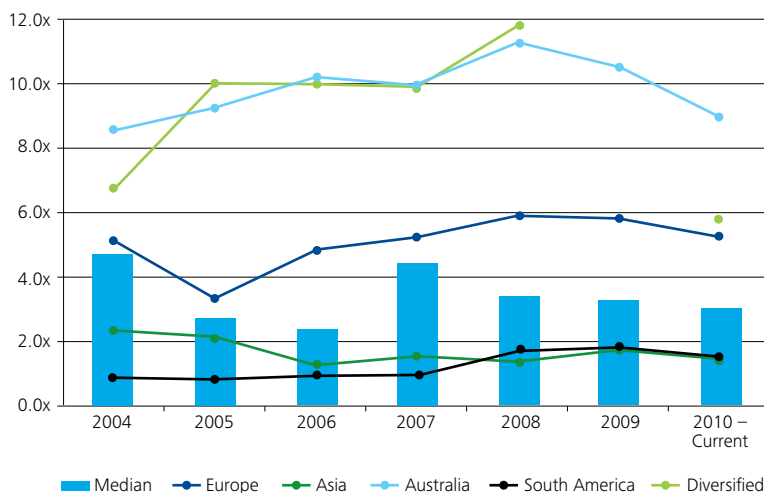
- EV/EBITDA multiples have been progressively decreasing over the past six years
- Australian listed infrastructure entities (which include Australian asset-focussed Transurban and diversified MIG/Intoll) have consistently been trading at a premium to the rest of their peers globally
- Groupe Eurotunnel, which built and manages the tunnel between London and Paris, has also been trading at relatively high multiples since its IPO in 1987.

Debt/EV



- Gearing levels have been increasing over the period observed, although in 2007 and 2008 this was primarily due to a sharp decline in equity values
- Deleveraging pressure resulting from the GFC is directly observable in 2010 when massive recapitalisations in 2008 and 2009 and a general recovery of equity markets resulted in a slight decrease in gearing levels
- Australian listed entities have historically showed higher levels of gearing.

Debt/EBITDA



- Asian listed entities have been maintaining relatively conservative levels of debt
- In Europe, relatively high Debt/EBITDA levels are observed in Groupe Eurotunnel.

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