INFRASTRUCTURE FOCUSED PRIVATE EQUITY FIRM

Exclusive interview for Private Equity Russia & CIS Journal of Johan Bastin, Chief Executive Officer of private equity firm CapAsia

Johan Bastin,
Chief Executive Officer, CapAsia

CapAsia represents the private equity firm (joint venture between CIMB Group and Standard Bank) focused on infrastructure investments in Southeast Asia and Central Asia. What does currently represent the company?

CapAsia was established in March 2006 originally as a joint venture between CIMB Group and Standard Bank. After Standard Bank exited most of its international private equity activities including CapAsia at the start of 2011, CIMB took full ownership and commenced the search for a new partner. Such partner now has been selected from a number of interested parties and it is expected that the new partner and ownership structure will be announced in a matter of weeks. As a result, CapAsia will become stronger and better positioned to pursue its planned expansion.

Currently, the CapAsia team comprises of 14 investment professionals across offices in Singapore, KL, Bangkok and Jakarta. We are currently expanding our staff to be well positioned for growth. As a whole, the firm has over 85 years of private equity experience and has deep experience and wide expertise in infrastructure investment in emerging markets, especially Southeast, South and Central Asia (we call this geography "non-BRIC emerging Asia").

With nearly USD 500 million in capital commitments raised, CapAsia currently manages

- South East Asia Strategic Assets Fund (SEASAF): USD147 million capital commitments focusing on South East Asia – this fund is in divestment mode;
- Islamic Infrastructure Fund (IIF): USD287 million focusing on selected Islamic emerging economies of South East, Central and South Asia where the macro-economic, legal and regulatory conditions are conducive for private infrastructure investment. IIF's focus countries include Kazakhstan, Azerbaijan, Indonesia, Malaysia, Bangladesh and Pakistan; and
- Asia Infrastructure Fund (AIF): USD96 million focusing on investment grade countries of East and South East Asia (fully invested). 50% of AIF's Limited Partner interests were acquired by SEASAF in 2009.

We recently launched SEASAF's successor fund, the CapAsia ASEAN Infrastructure Fund III (CAIF III). Like SEASAF, this fund will focus on mid-market infrastructure investment in South East Asia—especially Indonesia, Thailand and Malaysia. Its initial closing is planned for the first half of 2012, at a target size of USD300 - 350million.

What kind of companies are currently in your portfolio? How much of your capital is already invested?

Our current portfolio companies consist of

- toll roads in Malaysia and Thailand;
- power asset in Malaysia;
- two wind farms in Pakistan;
- a vertically integrated power utility company in Kazakhstan.

Last year, we made an exit of one of our portfolio companies in the education sector at an attractive return for which we received an award for Best Exit in 2010 by the Malaysia Venture Capital Association.

In total, we have invested and committed roughly half of the capital that we raised. We are currently in the process of finalising one investment in Indonesia and one in Pakistan. If all goes well, these should close in early 2012 bringing total investments to two-thirds (66%) of raised capital. With these two investments and one that we made under a managed account-like structure, we would have made six investments in one year—which is the investment pace that I have been targeting since joining CapAsia in mid-2009.

In what companies and under what conditions do you invest? What are the sums and expected returns on investments?

CapAsia invests in privately owned companies and project vehicles involved in the financing and provision of selected infrastructure assets and certain types of public services. We target mid-market companies in which we generally take non-controlling equity interests. We look for investments which offer significant potential for increase in value over the life of the investment through growth, expansion and acquisitions, efficiency improvement and EBITDA margin expansion and capital structure enhancement. CapAsia positions itself in the market segment between (generally rare) large scale infrastructure projects targeted by pan-ASEAN or global investment funds and smaller sized investments targeted by local investors. As such, we make single investments in the USD15-50 million range. While the Fund will mainly acquire minority interests, it will only take meaningful stakes, typically 20% - 50% of equity, with strong minority rights and negative controls.

We define infrastructure first and foremost on the basis of its investment attributes as opposed to its physical attributes. Infrastructure is generally to broadly defined in our view and we specifically narrow our investment focus to those opportunities that exhibit several or all of the following characteristics:

- Contractual and stable, often sticky, cash flows
- Limited commercial and market risk
- Steadily growing, predictable demand
- Capital intensive assets
- Leveraging on economic growth and increasingly affluent middle classes
- Mostly, and to differing degrees, regulated
- Often, natural Inflation and/or FOREX risks hedges.

Specific sub-sectors in which CapAsia invests in include

- Economic Infrastructure

- Transportation (specific types of toll roads and bridges, ports, airports, railway operations and logistics)
- Energy (mainly power)
- Telecommunications (chiefly infrastructure for fixed and mobile telephony and broadband)
- Environmental infrastructure and services (solid waste treatment and disposal, waste-to-energy)
- Bulk Water supply

- **Social Infrastructure**

- Healthcare facilities and services
- Higher educational establishments

- Renewable energy (wind, hydro, PV solar, biomass and geothermal).

Applying a premium for emerging markets risk, net target returns for CapAsia's funds typically stand at a 5% premium to the returns delivered by infrastructure funds active in OECD countries. However, in the light of the turbulence in European and US markets, it is debatable whether such a risk premium is always justified. Arguably, the macroeconomic and fiscal indicators and the respective country risks of Kazakhstan, Azerbaijan, Thailand, Malaysia but also Indonesia are materially better than those of Greece, Spain, Portugal and even Italy—all countries that in the past have attracted large sums of private capital for infrastructure investment and that have disappointed investors.

Nevertheless, CapAsia strives to focus on not-so-mainstream but inherently sound and profitable opportunities and deliver superior returns to its investors. As a marker, as of September 2011, SEASAF's net return to LPs is in excess of 20% and we expect to deliver a money multiple considerably in excess of two times once all portfolio companies are fully exited. To get there, we review on average three to four new leads a week. That means that we originate and see well over 150 investment opportunities per year of which we select 3%-5% for actual investment.

As we know you also look at greenfield projects. What is your approach to such investments? Can anybody with having just a project come to you and receive investments?

As an infrastructure fund manager we offer our investors a combination of current yield and capital appreciation. To this effect, we combine in a single portfolio investments in mature assets with those in greenfield opportunities. Generally, though, we only take construction and completion risk in very specific cases where we feel that such risks are manageable and limited. Examples of sub-sectors where we would take greenfield risk include wind and solar power, where technology is mature and construction brief and relatively simple, or smaller gas-fired power plants.

We also take ramp-up risk, for example in toll roads that have just been completed and where there is uncertainty over traffic volumes. Because of our deep experience and broad data base in these sectors we feel confident that we understand how demand will develop and are willing to assume start up risk. We also take limited development risk but only of companies that have already some cash flow producing assets.

With greenfield projects, partner selection is especially important as is a good understanding of industry trends in a specific sector and country. Two of IIF's portfolio companies are greenfield wind farm projects. The partners for these investments are experienced and well-established partners with whom we have good working relationships in the past. Also, the regulatory environment for renewable energy in Pakistan supports private investment.

The geography of your investments covers such CIS countries as Kazakhstan, Azerbaijan, Uzbekistan, Kyrgyz Republic, Tajikistan and Turkmenistan. What key opportunities and in which industries do you see in each of the above mentioned countries?

The Islamic Infrastructure Fund indeed covers the countries of Central Asia. In general, we are attracted by Central Asia because we are one of only a handful of dedicated infrastructure fund managers that can invest there. Also, the need for infrastructure investment in the CIS countries is vast. Investment is urgently required to address; deficient quality and, in some sectors, under-supply of critically needed infrastructure; significant capital and operating inefficiencies; deteriorating asset bases following decades of under-investment in maintenance and replacement; and environmental protection.

The differences between the countries in Central Asia in terms of macro-economic and legal and regulatory environment and political stability are considerable. Of all the Central Asian countries we cover, we prefer by far Kazakhstan and Azerbaijan. We have focused our efforts mainly on these two countries because they are investment grade, pursue prudent economic and fiscal policies, and generally offer a welcoming legal, regulatory and political environment for private capital. Also, both countries have made tremendous strides in opening up the infrastructure sectors for foreign direct investment.

As in most countries where we operate, policies and regulation for private investment in infrastructure are still evolving and sometimes fall somewhat short of creating the predictable, stable and conducive environment needed but we found that governments in Kazakhstan and Azerbaijan are receptive and able to adjust to create the necessary conditions for infrastructure investment. In both countries, the motivation to attract the private sector for areas in infrastructure provision that traditionally were the realm of the public sector is perhaps less to attract capital but also to attract international infrastructure management know how and to transfer risk.

You have a wide personal experience of work in Europe and Asia. Are there any particularities of work in the CIS region?

Comparing the CIS region with our markets in Asia, what stands out is that there is less of an investment backlog in the sub-sectors such as power that are critical to economic growth. Infrastructure in Central Asia is available and accessible. The issue is more one of efficiency, effectiveness and compliance with international standards particularly in environmental protection. While infrastructure, such as roads, ports, airports, power and heat generation plants, are there and functioning they often are old and woefully inadequate and relying on outdated, inefficient and polluting technologies.

A second point is that the CIS countries have a well-educated population. In our markets in Asia we often see very capable, well-educated people at the top levels of the central government and public administration but with an almost absent layer of middle management. In the CIS that is different. There, professionals and civil servants at all levels are generally well educated and responsive to the need of change or to changing conditions. It means that as investors we can easily explain and implement our active ownership approach. We are very impressed by the management of the companies we are invested in or are considering to invest in.

What are the major factors of success in infrastructure projects?

Some of these factors have been mentioned before. In the first place, as in any sector, you need to buy well. That means that as a fund manager you have to have the capability (and spine) to turn down opportunities that are attractive but whose prices have become frosty as a result of too much capital looking for too few opportunities. This happened in the LBO markets in the 2005 – 2007 period and that is happening now in infrastructure as many LPs are seeing infrastructure as one of the safest havens within the different alternative asset classes.

Success in investing in infrastructure lies with the ability to effectively assess and manage risk. Legal and regulatory risk is inherent in our business and we monitor, on a regular basis, the stability of the economy and infrastructure investment politics and policies in CapAsia's markets. Having local offices in our key markets helps us to gain instant and direct information in this respect. Some of our senior management as well as our shareholders have good relationships with the government which helps in assessing and monitoring legal and regulatory risk.

We have encountered in the past, several instances, where regulatory decisions had detrimental impact on the profitability of our assets. However, our credible and experienced partners negotiated with the government and minimized any impact, if any on our portfolio performance. This is also why we are very selective choosing partners and sponsors.

A further success factor in infrastructure is the capability to design and implement active ownership approaches and thus create value in a portfolio company. Our active ownership approach focuses on corporate governance strengthening, revenue growth, EBITDA margin improvement and capital structure optimisation.

What is the role of local authorities in the projects that you invest in? Does the relationship with government represent one of the key success factors?

Governments and national and local authorities are key factors in the success or failure of an infrastructure investment. They can create and maintain the environment that will make investments in infrastructure successful and enduring. However, they can also wreck havoc to such investments. Government and local authorities set and apply the rules of the game. They award concessions for specific infrastructure services provision, they issue development and construction permits, they often set or regulate tariffs for user charges and they or their utility companies are often also the main client of the output of an infrastructure asset such as a water treatment plant or a power generation plant. In short, they represent political risk.

Political risk exists at two levels: you have general risk and then you have more specific political risk. At a general level it is about political succession, as that impacts the continuity of policy, for example, if the government changes and the new government decides it doesn't want private participation in infrastructure. The more specific risk is where you have arbitrary, unilateral decision-making on the part of governments which affects the stability of the legal and regulatory environment on the basis of which we invest. If we invest, we assume there is certainty and predictability in the regulatory environment. However, you can have an arbitrary, unilateral decision that can annul your assumptions. That can take the form of a government not honouring a performance obligation; it can also be related to government intervention, or the lack of it. Infrastructure projects are essentially regulated by the relevant local authorities.

It is important for CapAsia and our investee companies to maintain a good relationship with the relevant public authorities, to be an effective lobbyist when these authorities contemplate regulatory or legal change and, generally, ensure that agreements signed with the authorities are honoured and risks mitigated.

Where and how do you find new projects for your funds?

Most of the leads we originate are proprietary, i.e. found by the CapAsia team through contacts either with infrastructure and utility companies or with financial advisors. A key role in our origination is played by our own local offices which we have in our main markets and which are staffed by investments professionals from the country itself.

Also, as a multi-country fund manager—in theory, we can invest in twenty different countries although in practice we focus on eight—we have the luxury of being able to be selective. We don't cover all sectors in all countries where we are active but concentrate our efforts typically on two or three sectors in each country. These sectors differ from country to country as a function of need, policies, legal and regulatory environment and market players.

We apply a rigorous, top-down and bottom-up, research approach to understand the underlying trends and dynamics of sectors on which we focus. We then source opportunities within these sectors from our existing networks with local investment advisory, legal and accounting firms. We also expand and widen our network with the major players in each of our target sectors, talk to relevant banks and deal advisors, as well as leveraging on our working relationship with ADB and IDB effectively. In addition, we maintain good relationships with government authorities, suppliers, industry consultants to be on top of developments in the specific sectors. Further, CapAsia also leverage on the networks and contacts of CIMB which has a strong presence in most Southeast Asian markets.

Do you see any changes on the market (like decreasing valuation of companies, lack of debt financing, growing caution of market players, etc.) as the result of the new crisis wave expectations?

Actually for the better part of two years, the global macro-economic environment has steadily deteriorated largely due to the events in the Euro-zone. Our investment countries have been largely shielded from excessive volatility but the overall macro-economic trend in these countries is one of consolidation at best. Several trends can be discerned in these countries including slower economic growth as a result of stagnating European and American export markets, tightening of credit as Western banks have started shrinking balance sheets, falling local stock markets and depreciation of currencies.

Without much doubt, debt in our markets will become more scarce and will have more demanding conditions attached to it. We have seen European banks not only discontinuing new lending activity in Asia but even exiting these markets altogether. But also local banks are becoming more cautious. This will compromise the borrowing ability especially of the mid-market companies we target. Also, fund managers relying on leverage to finance buy-outs will have greater difficulty in finding debt at suitable terms.

Further, despite a recent surge of interest in infrastructure funds from institutional investors, fund raising will become more challenging and far fewer funds than currently on the road will close. This may mean that less capital will be available to fund the growth, acquisitions and expansion of companies. If so, it would offer great opportunities to those funds that do have dry powder and asset prices could come down. My view is that the coming two years could be exceptional for profitable investments with ample opportunities and more realistic entry pricing.

Having said that, it is difficult to see where the crisis is heading. It is clear that, if the European and US debt crisis remains unresolved, a deep recession in these countries could follow. That will affect the global economy and all bets would be off.

What are you mid-term and long-term plans on the market? Do you expect to close any new deals/funds in the nearest future?

At the portfolio investment level and as mentioned before, we are at the final stages for two new IIF investments and plan to close them early in 2012. In addition, we have a wide range of opportunities following behind, many of which look promising. Our goal is to have IIF substantially invested by year-end. In parallel, we have launched our second Southeast Asia infrastructure fund, CAIF III, for which we hope to have an initial close before mid-year 2012. We already have an active pipeline for CAIF III and expect to make our first investments soon after initial closing.

We will stick to those markets that we know best and where we believe that we are a leader. We will resist the temptation to branch out beyond our home markets of Central, South and Southeast Asia. We are all excited about the mid-market infrastructure market opportunity in non-BRIC Emerging Asia and the strong interest of LPs in both Asia and infrastructure. With the launch of CAIF III and other new fund initiatives we are pursuing, we aim to have over USD 1 billion in assets under management within the coming two to three years.