KEYNOTE INTERVIEW

Closing the loop: Finding resilience in local markets



The local markets segment of transport boasts a rich vein of assets that are uncorrelated to the vagaries of global trade and GDP, believe Morgan Stanley Infrastructure Partners' Jaya Viswanadha, Tim Cooper and Daniel Sailors

The performance of many large transportation assets has been inextricably linked to global economic forces. Over the first half of this decade, this has often meant volatility and unpredictability for investors. This has particularly been the case with the movement of goods and people disrupted by the covid-19 pandemic, supply chain shifts and, more recently, a combination of tariffs and trade wars.

Yet, in the mid-market, there are many assets and businesses that are demonstrating resilience in the face of global uncertainty. These still offer opportunities to enter at attractive valuations and for value creation during ownership, argue Jaya Viswanadha, managing director focused on Americas investing for Morgan Stanley Infrastructure Partners; Daniel Sailors, also managing director for Americas investing; and Tim Cooper, co-head of Asia-Pacific at the firm.

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Q How have transport assets been impacted by all the economic uncertainty in recent years?

Jaya Viswanadha: Recent years have subjected transport assets to an extraordinary series of shocks – including the pandemic, severe global supply chain disruption, inflation spikes, rapid monetary tightening and shifting trade policy. This resulted in rerouted flows, uneven demand patterns and materially higher operating costs across the sector. Yet ultimately, people and goods continued to move, reinforcing that underlying demand for mobility is structurally resilient.

Daniel Sailors: Transport, in many ways, is a function of supply and demand. Within that, you have different parts of the market with varying degrees of elasticity. There are often consequences that are difficult to predict. You have businesses that benefited from supply chain disruptions during the pandemic, such as chassis leasing and warehousing. And you also have other parts of the supply chain that were materially negatively impacted. Ultimately, for large transportation assets in big markets, investors are really expressing a view on GDP. That's been challenging to do with conviction and has been highly volatile of late.

Q How can managers ensure resiliency and mitigate against unpredictable conditions?

Tim Cooper: Frequently, operating in the mid-market allows you to take a more nuanced view on things that are more economically predictable. We seek out businesses operating in closed loops that are likely to be stable throughout the economic cycle. If you combine a number of those assets across a portfolio and seek to execute on a bilateral basis, that allows you to opt out of buying large assets that are oftentimes highly correlated to GDP or simply leveraged bets on GDP growth. It facilitates, in a diversified way, adding value across the portfolio at a much more local level.

DS: We spend a lot of time identifying and orienting around markets and businesses that have a high resistance to change. If we overlay assets with a high criticality of service, then it reduces things like the elasticity of how price and volume can move. And if assets are closed loop in nature, it probably means that they're sitting inside a corporate or family business. That plays well to our team's particular strength in complex carve-out transactions.

JV: When a business is mission-critical and consistently reliable, there's more revenue durability even in disrupted conditions. On the revenue side, we look for a balanced portfolio of contracts and deep integration into customers' day to day operations. This increases relevance, raises switching costs and reduces demand volatility. Cost uncertainty can also be mitigated through the ability to pass through structural cost changes.

Q Can you give a couple of examples of 'closed loop transport' infrastructure?

TC: One of the investment funds we manage owns StraitNZ, an integrated ferry and logistics operator that connects the two islands of New Zealand. That business provides transportation services on a long-term contracted basis for consumer staples and other things that should remain stable throughout the economic cycle. In this instance, because of the location and the lack of close geopolitical connectivity, there should be very little likelihood of tariff impact. The asset largely operates as its own closed loop – none of what they do is related to export volumes.

DS: Another example is Pasha, which is involved in shipping goods from the US mainland to Hawaii. Some 95 percent of what's consumed in Hawaii is imported and there's very little warehouse capacity. You often have less than two weeks of critical goods inventory on the islands. The criticality of service generally allows us to have greater visibility into supply and demand. Given this, we believe both StraitNZ and Pasha uniquely operate in niche markets and are insulated from global trade.

Q What other characteristics are important?

DS: Resiliency and downside protection are paramount. We care deeply about having exposure to the right tail of a return profile. I would divide capital preservation into three buckets: contract, structure and market dynamics. Contract means having volumetric and price certainty from a creditworthy customer as one way to have downside protection and ballast. Structuring

Q How can managers access and execute 'closed loop transport' investments?

DS: We're having a lot of conversations with corporates, over a long period of time, to help us close bilateral deals. For example, the introduction to Pasha came through a long-term business contact. The conversation with George Pasha and his management team transpired over more than two years, ultimately resulting in us becoming an investor.

When you're putting ideas to corporates, their response can be "not right now". But then suddenly it is right now. They want a clean solution and quick execution. You need a track record of giving a number, holding that number and executing. If you don't want to be competing on price, you need to get there on speed and terms.

The goal is a relationship as a trusted counterparty, and a problem-solver to a business or business owner. We need to be flexible around them. And if you really understand their core goals, then you can create structures that are more bespoke. When things are more bespoke, that's when people are less focused on price.

investments to sit higher in the capital structure can also create resiliency. And then market dynamics – as we discussed – means spending a lot of time on underwriting demand elasticity based on the ability for new supply to enter a market. Risk mitigation always comes first.

TC: I would add that at the back end of the pandemic, we saw inflation spike. If you were limited via some form of fixed or capped pricing on the revenue side of your business with an inability to pass through inflation, across several years, this could be damaging to your overall P&L. Having the ability to pass on inflation via contracts or pricing dynamics has always been fundamental, but the market was given a sharp reminder of this during the pandemic recovery years.

JV: There's no question that the scale and pace of technological change are accelerating. We seek to invest in businesses that are on the right side of these shifts – those positioned to be advantaged adopters of automation, autonomy and targeted applications of AI. When executed thoughtfully, these technologies not only improve efficiency – they can structurally expand margins and strengthen the long-term competitiveness of the business.

Q What kind of strategies add value to assets?

TC: There's no one-size-fits-all toolkit for adding value. A consistent framework to start with, however, is looking at individual portfolio exposures and working through what needs to happen in terms of business resiliency, contract structure, capital allocation and capital structure to move an asset from being core-plus to core.

We, as core-plus/value-add investors, are doing as much as possible to make it straightforward for a core investor to buy assets and run them in a sustainable manner. The outcome is very little effort over a long period of time – which is ultimately what permanent capital is looking for.

Again, let's turn to StraitNZ in New Zealand. We replaced and upsized the ships to give the company growth capacity over the next 10 years. We moved the customer side of the business to dynamic pricing, which is a much more sophisticated way of charging. We introduced take-or-pay pricing for freight customers to have contractual protection against volume downside. And we extended the leases in the ports on either side of the strait in New Zealand.

We believe a potential buyer could come in, understand the asset and run it easily for the next decade or more.

Q How do such assets fit into (or create) a portfolio for investors?

DS: Transport is just one industry vertical Morgan Stanley Infrastructure Partners invests in alongside energy, digital, and water and waste. We want to create a set of exposures across different sectors and different geographies that give us the opportunity to deliver alpha and not just exposure to the beta. This could mean a duopolistic ferry business in New Zealand, a heavily contracted toll road in Australia or a public-to-private transaction in partnership with the family founders of an Italian rail maintenance infrastructure business. Our job is to be better at identifying and providing exposure to businesses that have high resistance to change, as opposed to being the best at predicting change. We believe that gives investors a very non-consensus way to play the infrastructure space in a way that both reduces risk and has lower market correlation.

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> **JAYA VISWANADHA**

TC: We fight incredibly hard for alpha by doing deals on a bilateral basis. That means being sleeves up, out of the office and engaging broadly with market participants. We're maniacal on price and downside protection. But the demand for the end product, a high-quality, value-developed portfolio company, has never been higher. Right now, there's a very robust market for well-developed assets because of the macro uncertainty.

Q How big is the opportunity still to be tapped?

TC: In the world of hard rock mining, particularly in Australia, there's been a long-term strategy for owning the supply chain from pit to port. Now many mining companies in Australia, or oil and gas firms in North America, no longer feel that they need to own everything in their supply chain. There's a wealth of infrastructure becoming available for investment as part of that thematic – ports, airports, rail infrastructure, even toll roads – there are many assets in the supply chain that would meet our characteristics.

This is a subset of transportation, but it's incredibly fertile and in its early stages. Our goal is to be first to those assets, where we feel in five to 10 years you're looking at the next cell phone towers or data centre story. It's our job to get in front of that. ■

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