Land Securities Trillium's acquisition of SMIF

Simon Ellis

05/02/2007

As institutional investors and investments banks step up their pursuit of stable government-backed infrastructure returns, consolidation in PPP's secondary market seems an inevitable consequence

Late last year the identity of the two bidders for Laing and its large portfolio of secondary assets - Henderson and Allianz - conformed largely to expectations.

But the £927 million (US$1.82bn) acquisition of the Secondary Market Infrastructure Fund (SMIF) - completed today by Land Securities Trillium (LST) - goes against the flow.

Rather than an international financial giant looking to find a home for pension fund flows, LST is a UK-focused property management company described by its chief executive as occupying a space 'between a service operator and a traditional landlord'.

The company's existing business model involved managing and systematically upgrading 25 million square feet of outsourced office space for clients including the Department of Work and Pensions and BT.

So what drew LST to compete against the financial community for what was originally a fund set up to exploit long-term PPP revenues?

Rationale and bidding

SMIF was established in 2001 by Babcock & Brown and Abbey National and acquired 24 assets before management backed by Star Capital launched an LBO for the firm in December 2003.

Over the next two-and-a-half years the firm signed a major portfolio purchase with Jarvis, signed a primary and secondary investment partnership with facilities manger GSL and launched SMIF Asset Management Limited (SAML) to run its growing holdings.

By June 2006, having expanded the portfolio to 64 projects and their investor base to include Bank of Scotland and AMP, SMIF's owners contracted Rothschilds to hold an auction for the fund.

Bill Doughty, SMIF's former chief executive explains: 'Like all things with rapid growth and rapid investment, you get to a point where you begin to stretch the capital base of the business.

'But towards the early part of 2006 I think it was very clear that for the benefits of the business and for the benefit of the investors, whose interests are paramount in that analysis, we decided that it was the time to seek a new home for SMIF.'

The competition drew the attention of 31 companies, which in September 2006 were reduced to a shortlist of:

- Land Securities Trillium
- Macquarie
- Ontario Teachers' Pension Plan
- HSBC Infrastructure Fund
- 3i with Societe Generale and Barclays

According to Doughty, the bidding was 'very tight' but LST offered a unique opportunity in terms of future growth and offered a strong synergy in asset management.

The deal includes the transfer of SMIF's 89-strong team. The fund's 'core people' including original partners Doughty, Barry Williams and Ian Gethin are expected to stay for the long term in a senior capacity.

The new full corporate structure will be revealed in the next two weeks but will be 'fully integrated' rather than SMIF forming a separate division of the new group.

'The good thing is, we decided on Land Securities Trillium', Doughty explains, 'and the management was very involved in the decision, because they ticked the boxes as far as the desire to continue to increase their presence in the market.'

He adds: '[LST] had something that no one else had which was the ability to marry up their service management capability which is pretty important when you are doing business with the public sector.'

LST chief executive Ian Ellis agrees that SMIF's decision to add the SAML asset management division in early 2005 presented an added synergy,

'When we first looked at SMIF it was not an automatic thought that this is a fund management business and we should bid for it,

'It was only when we looked at the document and thought it is much more than a fund management business, it actually does have an operational arm which is where we perceive there is a big gap in the PPP market.'

It is a gap LST is already beginning to exploit. In 2004 the company identified the £30 billion (US$59bn) Building Schools for the Future (BSF) and the rationalisation of the MoD's estate as key areas for future growth.

In January 2006, LST made its first steps into the PPP primary market through the launch of a 50:50 JV with the Mill Group for the Investors in the Community (IIC) scheme. The JV is on the shortlist for Kent BSF and down to the last two for Islington BSF.

But it is the entry into the defence space that has really paid off as LST - along with defence technology specialist Qinetiq - won preferred bidder for both stages of the Defence Training Review PPP, which has an estimated capital value of £16 billion.

Ian Ellis says, 'The front-end is moving forward but it became apparent there is a large secondary market where people had already won deals and were operating them.

'We thought we would also think about getting involved in that market because it is the long-term relationship that we like. So that is where our business role and philosophy met SMIF.'

Financing

LST will pay £527 million (US$1.36bn) in equity as well as taking on £400 million (US$786.2m) of SMIF's debt.

The debt expanded significantly from the £184 million (US$361.6m) originally agreed as a result SMIF's subsequent securing of several additional assets in the interim period.

SMIF's existing debt, which consists of a combination of term loans and working capital facilities from Espirito Santo Investment, WestLB and HVB will be retired and transferred to LST's corporate lines.

LST estimates that SMIF's assets will yield an initial equity return of 5 per cent , with a stabilised yield on completion of certain projects of around 5.4 per cent.

SMIF's impact on the business is expected to be earnings neutral in its first full year, with profits before tax rising to around £40 million (US$103.2m) by year five.

The secondary market

Bill Doughty believes the secondary market will continue to offer opportunities as smaller construction companies and contractors attempt to lighten their balance sheets and larger players offer more substantial portfolios.

Doughty says: 'I am already aware that this year a number of opportunities in the UK are coming forward which would really enforce this market and its growth. Added to that there is the fact that right next door to us there is an increasing European opportunity as well.'

In December, the firm made its first move into Europe through the acquisition of a 100 per cent stake in one of the first European PPP projects to reach the secondary market, Bilfinger Berger's British Embassy in Berlin PFI.

However, the attractiveness of its stable government-backed assets have made the secondary market a fiercely competitive space with existing rivals Henderson, I², Innisfree joined by asset management giants such as Allianz.

Doughty accepts that competition is strong but believes the field is not unlimited: 'In any market that has this kind of attractions, there will be some sort of pressure on the cost of assets both primary and secondary.

'But I don't think there are going to be a significant amount of new entrants because those parties which have been successful so far have done so because they have created scale and the benefits of scale will naturally fall to them.'

With spoils on the horizon such as AMEC's 12-project PFI portfolio valued at up to £480 million (US$943.5 million), scale could indeed be a crucial factor.

Conclusion - Going long

Like any acquisition, LST's purchase of SMIF was undoubtedly motivated by building the scale to compete in a market attracting increasing international attention.

With UK construction and asset management companies seemingly irresistible themselves at the moment, the deal could be seen to add crucial weight to LST as a defensive measure.

But both sides also claim that it is the level of service and length of commitment that will set them apart as reliable long-term counterparties in what is becoming an increasingly liquid secondary market.

'We perceive that the partnering part of the deal is falling down,' Ian Ellis explains. 'And that is what we are good at, so we saw it is a space we should move into.

'We could make a compelling case to say we will be your partner for 25 years, we have an operating business, this is the team that will look after your assets and look after your relationship.'

For Bill Doughty, investors who neglect the asset management side will suffer in the long run: 'To ignore [asset management] is to ignore the fact that you only have the right to receive a very high quality earning stream from a government counter-party if you deliver on the partnership promise.

'I think that sometimes the secondary market is wrongly understood as being purely about financial engineering, but it is actually about management across the piece.'

The project at a glance

Project Name	Land Securities Trillium Acquisition of Secondary Market Infrastructure Fund (SMIF)
Location	SMIF offices in London, Bath and Falkirk. Stakes in projects in the UK and Europe.
Description	Acquisition by Land Securities Trillium of SMIF's portfolio of 79 PPP equity stakes and 89-person financial, asset mangement and support team.
Total Project Value	£927 million (US$1.82bn)
Total equity	£527 million (US$1.36bn)
Total senior debt	£400 million (US$786.2m)
Debt:equity ratio	43:57
Legal Adviser to LST	Berwin Leighton Paisner
Legal adviser to SMIF	Lovells
Legal adviser to Star Capital, AMP and Bank of Scotland	Norton Rose
Date of financial close	05/02/2006