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Brookfield: Culture a Source of Competitive Advantage

This post by Jake Rosser has been excerpted from a letter of Coho Capital.

With all the financial and valuation tools at our disposal as investors, it is tempting to think of the act of investing as a precise science. Indeed, study after study confirms the efficacy of acquiring high return on capital companies at low valuation multiples. Such a formulaic approach might offer the illusion that investing is easy if one follows the fundamental laws of value investing. But investing is never easy. Data is backward looking and it is the future that will determine our returns. In our evolution as investors, one of the things we have discovered is that it is often the things that don't get measured that have a greater magnitude on investment returns than what is measured. That is to say, the numbers don't provide all the clues. It is often qualitative factors such as company culture, management's approach toward capital allocation, or customer service, that can yield critical insights into a company's sources of competitive advantage. In fact, an advantage premised upon qualitative factors can often be more enduring. For it is far harder to build and institutionalize these types of qualities than something like Six Sigma (GE). This realization has prompted us to pay close attention to leadership and company culture as a source of competitive advantage.

Brookfield Asset Management, a Toronto based asset manager of real estate and infrastructure, has the quantitative factors we like to see in an investment. It has an exemplary record of investment returns, having compounded capital at 19% a year under Outsider like CEO, Bruce Flatt. In addition, we can acquire shares on the cheap. From a qualitative perspective, we think Flatt and his lieutenants have created a distinct corporate culture focused on discipline, patience, reputation, and long-term results. These cultural attributes continue to define Brookfield despite its significant growth and expansion into new asset classes.

Brookfield manages $250 billion in assets in infrastructure, real estate, renewable power and private equity. The company's portfolio comprises an impressive array of assets including telecom towers, toll roads, container ports, gas pipelines, commercial real estate, and renewable power.

The assets held by Brookfield share several attributes, including modest ongoing capital investment, high barriers to entry, and cash flow generative economics with embedded growth. They also are long-duration in nature with the real estate business supported by long-term leases while the infrastructure and renewable power businesses benefit from long-term contracts.

Brookfield is one of the largest investors in each of its investment vehicles and is well-aligned with shareholders: "We promote long-ownership stability and orderly management succession and encourage our senior executives to devote most of their financial resources to investing in Brookfield. As a result, collectively our management partnership owns approximately 20% of Brookfield." (2015 annual report)

Unmatched Global Scope

> "The World is Flatt's: When it comes to global diversification and growth, Brookfield's collection of real assets is unrivaled. In real estate, Brookfield owns entire skylines in cities like Toronto, Sydney and Berlin, plus malls, apartments and self-storage. But infrastructure and renewable energy could become even bigger. Globally, the company

> already has 36 ports, 218 hyrdro-electric plants, thousands of kilometers of pipelines and rail networks, plus cell towers, wind farms and toll roads." —*Forbes*, May 2017

Brookfield's global reach is a significant advantage in opportunistically deploying capital in markets that offer the most favorable economics. Brookfield's offices span the globe with 100 offices spread across 30 countries. Brookfield's mixture of global resources with local on the ground capabilities provides the company key cultural and geographic advantages. Further, Brookfield's global footprint diversifies risks and allows the company to pick its spots.

And pick its spots, it does. Bruce Flatt and his team have shown a knack for timely acquisitions since recycling mining assets, near their peak in 2005, into infrastructure, at the time a nascent asset class. Brookfield purchased Australia's Babcock & Brown Infrastructure Group in 2009, near the height of the credit crisis. Brookfield opportunistically acquired the debt of the second largest mall operator in the US, General Growth Properties (GGP), during the company's bankruptcy in 2009, acquiring 35% of the company. More recently, Brookfield has been accumulating attractive assets in Brazil as the country undergoes a period of deep political and economic uncertainty. In April, Brookfield closed on a natural gas pipeline formerly owned by scandal-plagued Petrobras. That same month, Brookfield acquired a 70% ownership stake in Brazil's leading water distribution and treatment company. With minimal competition for Brazilian assets at present, Brookfield can practically name its price, as Mr. Platt eluded to in the company's annual report: "As we often do, we took a long-term view of the opportunity at a time when few others could, and therefore competition was limited."

The scale and diversity of Brookfield's assets give the company unique insights into the vagaries of the global economy. Just as railway loadings yield insights for Berkshire, so too does Brookfield's collection of ports, railways, toll-roads and renewable energy assets. The operational expertise acquired as a result is an invaluable resource when the inevitable market dislocations occur.

Asset Management

As impressive as Brookfield's collection of real assets is, the crown jewel of the business is the company's asset management division. Around a decade ago, Brookfield realized that the economics of owning hard assets could be increased by managing assets for other investors as well. Rather than just manage assets for its own portfolio, Brookfield now earns a fee stream for managing the capital of others. Fee related earnings and carried interest totaled $843 million over the last 12 months and have grown at a compound annual growth rate (CAGR) of 37% over the past five years. Demand remains strong for Brookfield's investment management services due to strong results. The company currently manages over $113 billion in outside capital and we expect this number to rise materially in ensuing years.

Brookfield's asset management business is comprised of four publicly traded partnerships: Brookfield Property Partners (BEP), Brookfield Renewable Partners (BEP), Brookfield Infrastructure Partners (BIP) and Brookfield Business Partners (BBU). The four publicly traded investment vehicles provide Brookfield with a perpetual flow of cash, which should grow above the rate of inflation. Brookfield earns a 1.25% annual management fee based upon the value of the listed entities and generates a performance fee of 15-25% depending on the level of the dividend payout. The arrangement is attractive with Brookfield poised to extract significant future value from its partnerships even without contributing any additional capital. But there is a tactical advantage as well, since approximately half of the capital invested in Brookfield's publicly traded partnerships is permanent. This provides the company stable funding during market upheavals and enables a long-term investment horizon.

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Early Innings in Infrastructure Investing

After years of chronic under-investment in areas such as power grids, water distribution, ports and transportation there is substantial scope to increase funding for infrastructure. The need is particularly acute in emerging markets where growing populations, coupled with tighter integration within the global economy, are straining existing assets. A study by McKinsey suggests annual spending of $3.3 trillion dollars a year is needed just to maintain existing rates of economic growth with $57 trillion needed by 2030 to account for economic growth.

Given the sums involved we expect governments to increasingly turn to institutional investors to close funding gaps. It is a good match. Institutional investors are wary of fixed income after a 30-year bull market in bonds and are looking for a new asset class with a similar risk profile. Infrastructure offers high visibility due to long-term fixed cash flows and typically provides strong protection against inflation due to contractual escalators in pricing. Investors are also fond of infrastructure investing due to its high barriers to entry and focus on essential services.

The case for infrastructure investing is compelling. The inputs are in place for a multi-decade ramp in spending and perhaps no one is better equipped to benefit from the opportunity than Brookfield. Brookfield has a formidable head-start in the sector and possesses the finest infrastructure investment business in the world. It's ability to conduct operations across the globe and sterling reputation leave it well-positioned to capture a substantial share of the economics. Further, Brookfield's network of relationships with 450 sovereign wealth funds, pension funds and endowments provides it ready access to capital. Last year, Brookfield raised $14 billion in capital earmarked for infrastructure investment, nearly a quarter of all the funds Wall Street committed to infrastructure last year.

Valuation

For the last twelve months, Brookfield's funds from operations (FFO – FFO is akin to a price/earnings equivalent for the REIT industry. Although Brookfield is not a REIT, its holdings of real assets make REITS a suitable comp) were $3.15 per share for an FFO multiple of 12.4x. This compares to an average REIT multiple of 18x. We think this is an average price for an exceptional business. The FFO measure is imperfect, and much like Berkshire prefers book value (also imperfect) as the best measure of its business, Brookfield believes FFO best captures the progress of its business.

Another way to think about valuation is to add the International Financial Reporting Standards (IFRS) equity value attributable to Brookfield and separately value the asset management business. As of the first quarter, 2017, Brookfield had $31 billion of its own assets invested across Brookfield vehicles. The asset management business generated $691 million in fee related earnings. If we apply a 15x multiple on Brookfield's fee related earnings we arrive at a value of $10.4 billion. Together, with Brookfield's investments of $31 billion, we arrive at a total valuation of $41.4 billion. This compares to a current valuation of $34.3 billion.

Bruce Flatt has built a winning culture at Brookfield focused on the long-term and partnering with shareholders. We believe Brookfield will be the partner of choice for an exponential increase in infrastructure investment opportunities. We also believe the scalability and negligible capital needs of the asset management business are poised to deliver attractive economics.

When asked in a *Globe and Mail* interview if he had any hobbies, Flatt answered "collecting shares" of his company. It is that kind of singular devotion that has enabled Flatt and his team to turn Brookfield Asset Management into a wealth creation machine. We are glad to be along for the ride.