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INTERVIEW

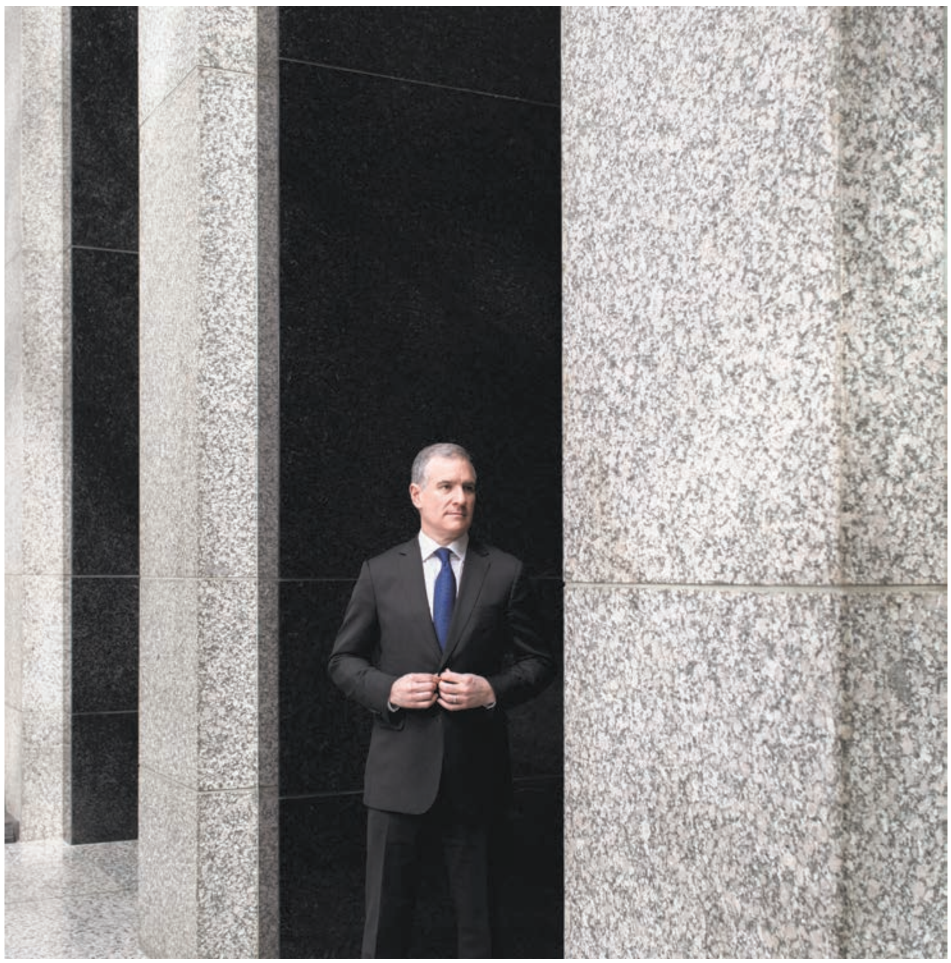
A Compelling Case for Alternative Assets

Brookfield's Sam Pollock sees long-term opportunities in infrastructure investing, especially in the developing world.

By BILL ALPERT

Brookfield Asset Management was founded in 1899 to finance streetcars and electric power in Brazil. Today, the Toronto-based firm has become a global player in alternative assets, managing about $250 billion in real estate, infrastructure, renewable-power projects, and private equity.

Sam Pollock has been a key member of the Brookfield team for 23 years. He served as chief investment officer of the parent company, whose shares (ticker: BAM) trade in Toronto and New York, and is now chief of Brookfield Infrastructure Partners (BIP), one of the firm's four publicly listed partnerships, which invests in highways, ports, and power lines. Its shares have returned nearly 20% on a compound annual basis since 2008. Pollock, now 51, is excited about the long-term prospects for infrastructure investing, and sees opportunities today in developing markets and the telecom sector.



"Infrastructure plays are critical, scarce assets with high replacement costs and location factors that give them barriers to entry." —Sam Pollock *Philip Cheung for Barron's*

Barron's: What does Brookfield mean by alternative assets?

Pollock: Alternatives for us are generally "hard" assets, private investments. They are long-lived and tend to have very high barriers to entry. They're supported by long-term leases in the case of our real estate business, or long-term contracts in our infrastructure businesses. That provides low volatility. These are also highly cash-generative businesses, providing a steady dividend that grows in value over time. Given these characteristics, they tick many boxes for private investors who are trying to invest for the long term to match their liabilities or, in the case of sovereign wealth funds, protect capital for a rainy day.

There are a number of alternative asset managers in the market today. What distinguishes Brookfield?

We have evolved in the past 15 years or so from an investment company into an asset manager. What makes us unique and, in some people's eyes, complex, is that we have a significant balance sheet of capital that allows us to invest alongside our cli-

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ents. We think that's a good thing because it aligns our interest with theirs. They know we're the largest investor in all the strategies we provide.

While some managers cater only to institutional investors, Brookfield allows public investors to tap into your expertise. Explain how you do that, please.

We have four publicly listed partnerships: Brookfield Infrastructure Partners, the infrastructure vehicle; Brookfield Renewable Partners [BEP], our renewable-power vehicle; Brookfield Property Partners [BPY], which invests in real estate; and Brookfield Business Partners [BBU], our private-equity vehicle.

How can a public investor be sure you're not favoring yourselves or the private investors?

We don't assign an asset to this pocket or that pocket. Everything goes into one pocket, and our public companies are treated in the same way as our private investors. We have three flagship funds: the real estate opportunity fund; a private fund that combines renewable power and infrastructure; and a private-equity fund. All investments go through the funds. Our public companies basically subscribe for a percentage of each new fund, based on what we think they can absorb on their balance sheets over the life of the fund.

How did Brookfield get into infrastructure investing?

We sold our mining assets in 2005 and were looking to invest the proceeds. We were already doing a lot of real estate deals, and wanted to find something similar to real estate. Infrastructure was a nice fit. Starting in about 2007, I went into infrastructure full time to build that business up.

It looks like you've been successful. Brookfield Infrastructure returned 49% last year. What drove the gain?

The company's solid results and several large acquisitions in Australia and Brazil. Brookfield Infrastructure units have posted a total return of 19% a year, compounded, since inception in 2008, and we've done it with relatively low risk. We made some timely acquisitions, such as the purchase of Australia's Babcock & Brown Infrastructure Group in 2009, after the financial crisis.

What is the long-term outlook for infrastructure investing?

This is an attractive and growing asset class. Even after 10 years, we're still in the early innings of capital formation in this sector. There are a tremendous number of infrastructure carve-outs coming from industrial companies and governments that are capital constrained. Governments can't fund the buildout and rehabilitation of critical infrastructure. Energy and resource companies are carving out their asset-intensive businesses.

In general, infrastructure plays are critical, scarce assets that have high replacement costs and location factors that give them barriers to entry. Because of the high barriers, they generally generate high margins. Our business has cash-flow margins of about 60%, and our cash flows tend to be inflation-protected.

Your accounting has been criticized, including by Barron's, for using International Financial Reporting Standards that produce valuations at odds with your properties' co-owners. How does IFRS differ from generally accepted accounting principles governing U.S. businesses?

As a Canadian company, Brookfield uses IFRS. A key distinction between IFRS and U.S. GAAP is the option to revalue a company's PP&E, or property, plant, and equipment, to account for changes in "fair value." It is more relevant to companies like ours, with long-lived assets that appreciate in value over time. Revaluation gives investors a better sense of the balance sheet, on a long-term basis, than a historical cost method of accounting.

Having said that, there are drawbacks, mostly for our infrastructure business. IFRS doesn't allow you to revalue intangible assets, and that includes concessions. We have a fair amount of concessions, which are contracts to operate a government asset, such as a toll road. When we make improvements, the value isn't fully reflected in the cash flows.

IFRS works against you when you revalue PP&E. You are increasing your depreciation and amortization charges. That reduces your net income, which is a negative for people who don't realize that some of the depreciation just reflects the fact that you've revalued the business.

Brookfield Asset's stock has also performed well, compounding by 15% a year in the past five years. What are the best ways for a public investor to measure the company's success?

All they have to measure are: How are we doing at raising capital and earning fees from that? And, how are we doing at investing that capital? Fee-bearing capital—the capital we manage on behalf of investors who pay us a fee—totals about $115 billion. It has been growing at a compound annual rate of around 11% a year over the past five years. Fee-related earnings have been compounding by 37% annually in the same span.

You're good at gathering assets. Are you also good at investing them?

Net of fees, our opportunistic real estate funds have earned returns of 18%, while infrastructure has earned 12%. The operating measures we focus on are FFO, or funds from operations, and AFFO, adjusted funds from operations. Funds from operations basically are net income, with depreciation and noncash items, or nonrecurring costs such as hedging, added back. Hedging is probably the biggest thing—and deferred taxes, which make some noise. AFFO is FFO adjusted for maintenance capital spending. That gives you your true cash flow. Assets need to be maintained, so adjusting for this recurring cost is very important.

While investors look at AFFO and FFO to measure how well we are doing, what they really care about is our dividend payout. Our targeted payout ratio is 60% to 70%. Brookfield Infrastructure provides a dividend yield of 4.3%. Since inception, we have grown the dividend on average by 12% per year. We have grown FFO per unit by 19% a year and AFFO, by 23%.

Where do you see opportunity in today's market, and what do you recommend avoiding?

Sticking with infrastructure, we are enthusiastic about a number of the emerging markets, in particular Brazil and India. Brazil has been a value story. It is a country with great long-term fundamentals, but because of the noise around corruption cases and the recent recession, investors have generally avoided it. We have been able to invest in some extremely high-quality assets at good value, including toll roads and gas transmission. It is still a place that people should focus on. India has a fabulous macro story. It is probably going to be the fastest-growing country in the next couple of years, maybe longer. The political situation is as stable as it has ever been, and we see an environment that is extremely favorable for foreign investors. India has opened its market to allow foreign investors to own assets outright, which is something that wasn't the case a number of years ago.

Do you favor any particular sector?

We currently like the telecommunications-infrastructure sector. There is a solid demand story supporting large capital investment in 5G and other rollouts. Because of that, a number of operating companies are effectively securitizing their businesses: They are separating their opco, or operating-company, business from their asset- heavy business. This is happening in wireless towers, telecom fiber, and those sorts of things. The process is under way, and it is an interesting place to look.

Are some assets or countries either unattractive or fully valued?

There are a lot of strong competitors in the U.S., and that market is more mature. Our focus is probably in Europe, India, and South America.

How do you avoid the political headaches that have hurt some utilities in Brazil?

It is best to focus on business-to-business utility assets. These would be transmission assets, pipeline assets, and such, where customers are businesses. It is fine to have some businesses that are consumer-facing, but you want to have a diversified portfolio so that you aren't too affected by one regulator or political environment.

Are there any countries that are unattractive for privatization?

We focus on countries that we know well. In South America, we focus on Brazil and Chile, Colombia, and Peru. There are other places where you could invest capital, but they don't have respect for law and private capital. The same situation exists in Asia. We tend to stick mostly to Organization for Economic Cooperation and Development, or OECD, countries, and a few countries like India and parts of South America where we've been operating for some time.

Do you expect public and private investors to boost their allocation to infrastructure, and hard assets generally?

The appetite for infrastructure is as strong as it has ever been. We're seeing allocations grow in North America and Europe, where people have been investing in infrastructure for about 10 years but continue to increase their allocation. We see a lot of capital coming from Asia, where they either haven't been investing in infrastructure or alternatives, or they have done so modestly. I suspect that in the next couple of years, more than half our capital will come from Asia for our infrastructure strategy.

Thanks, Sam.