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For **Michael Dunning** at Inframation Group

Balfour Beatty Investments targets core market consolidation

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Balfour Beatty Investments rode the storm as the fortunes of its parent dipped. But performance at the group has improved, and as part of a broader strategy its investment arm is targeting new greenfield opportunities in the UK and US. CEO, Ian Rylatt talks to *InfraNews*.

During the UK's PFI boom years in the late 1990s and early 2000s, a "usual suspect" list of developers tended to bid on most new project tenders. One of these, Balfour Beatty Investments (known then as Balfour Beatty Capital), was front and centre on a seemingly endless flow of projects. Since then, the UK infrastructure market has altered radically. And so has Balfour Beatty Investments.

Since then, we have witnessed the global financial crisis, huge austerity programmes impacting mature infrastructure markets, and the UK's vote to leave the European Union.

That political and economic maelstrom has battered many infrastructure firms, including Balfour Beatty Investments' parent to the point that they too have had to make significant changes. In fact, much of Balfour Beatty Investments' present identity has been formed by the changes at Balfour Beatty over the past two or three years. During that period, Leo Quinn took over as chief executive of Balfour Beatty, the group returned to profit after two years of losses, and its share price nearly doubled.

Difficulties at Balfour Beatty

Much of Balfour Beatty's problems were tied to the slump in UK construction following the financial crisis and the decision by the then Conservative-led coalition government to drastically cut public spending. But the company had also overreached into new geographies and markets, making Balfour Beatty far too complex. Furthermore, poor management decisions impacted strategic direction and cost containment.

Also problematic were many of the legacy construction contracts that Balfour Beatty won during the recession, some of which had very low margins. Two thirds of those projects were in the UK with the rest in the Middle East and US.

Between 2012 and 2016, Balfour Beatty issued seven profit warnings; lost two chief executives, a chairman and a finance director; and called in KPMG to carry out an audit.

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In 2014, the company rejected a takeover attempt by Carillion and saw off a GBP 1bn offer for Balfour Beatty Investments by John Laing.

But since becoming chief executive in late 2014, Quinn has instigated a wide ranging transformation programme called Build to Last.

Central to the programme is a renewed focus on core activities. This has meant reining in projects in the Middle East and Australia to focus on the UK and US markets. It has also tightened up management practices, reduced costs, and improved bids for, and implementation of, projects.

"Leo [Quinn] has made the organisation much leaner, and returned the business to growth and profitability," says Ian Rylatt, CEO of Balfour Beatty Investments. "There's now far better cash management.

“The stronger our parent, the more potential opportunities there are for Balfour Beatty Investments to invest cash. Build to Last has been very good for Balfour Beatty Investments.”

In its FY16 results, Balfour Beatty finally returned a profit – GBP 67m – from its operations. And in the second half of 2016, the construction business returned an underlying profit.

Rylatt points out that Balfour Beatty Investments has been relatively insulated from its parent’s problems, apart from having less capital to invest. In fact, says Rylatt, the unit continued to invest during Balfour Beatty’s troubles and now has a portfolio worth some GBP 1.2bn.

Early PFI and disposals

Balfour Beatty Investments was among the first entrants to UK PFI during the mid 1990s. Projects included the Department of Health’s hospital building programme, the Building Schools for the Future (BSF) initiative, and the Department for Transport’s road schemes.

Prior to the problems at its parent company, Balfour Beatty Investments had embarked on a divestment programme, which involved packaging up and selling bundles of its operational PFI and PPP projects.

Its asset recycling process did coincide with Balfour Beatty’s reversal of fortunes, but Rylatt is keen to point out that this was not the catalyst.

“We had already started the divestment programme,” he says. “And that continued throughout the cycle, generating cash and profitability for the group. That enabled us to maintain balance sheet strength.”

Balfour Beatty Investments has, however, sold some assets as a result of Balfour Beatty’s simplification process. These were the US-based Parsons Brinckerhoff in 2014, and Balfour Beatty Infrastructure Partners (BBIP) – now renamed Basalt – in 2016.

The sale of Parsons Brinckerhoff, a professional services firm based in New York, netted Balfour Beatty GBP 820m.

The deal also spurred Balfour Beatty Investments’ decision to sell its only Australian asset – a 50% stake in the Wollongong student accommodation PPP – to InfraRed.

“When we sold Parsons Brinckerhoff, we were consolidating in our core markets,” says Rylatt. “Our interest in Australia had been from Parsons Brinckerhoff. Australia is a long way away and it is difficult to run a business that isn’t large enough to be self-sustaining.

“One project wasn't a business. It was an investment.”

Rylatt adds that construction on the Wollongong project had not yet been completed when it was sold. But even so, Balfour Beatty Investments realised a “good return.”

The sale of BBIP was also linked to the group’s simplification process, says Rylatt.

BBIP gave Balfour Beatty Investments significantly more access to brownfield opportunities, despite the investment arm's core focus on greenfield deals.

“They were sound investments, but deals like the Wightlink ferry business were unrelated to our core activities,” says Rylatt. “BBIP was also a cash drag when we could have been investing in greenfield projects.”

Selected divestments						
Asset Name	**Sector**	**Country**	**Realised Value**	**Equity Holding (%)**	**Date of Realisation**	**Acquirer**
Sunderland Street Lighting and Highway Signs	Street Lighting	UK	GBP 33m	80.00%	Dec-16	Equitix
Borough of South Tyneside - Street Lighting & Traffic Signs PFI Scheme						
Coventry Street Lighting PFI						
Eastern Shire Counties Partnership (Cambridgeshire)						
Eastern Shire Counties Partnership (Northamptonshire)						
BSF Islington	Education	UK	GBP 73m	80/90%	Jul-16	INPP
BSF Southwark						
BSF Blackburn with Darwen & Bolton						
BSF Oldham						
BSF Hertfordshire						
BSF Ealing						
BSF Derby City						
Source:www.infra-deals.com						

Core activities now

"About 70% of what we do is related to the wider group," says Rylatt. "The other 30% isn't related but in areas where we still think we can create value for our shareholders."

Rylatt points out that three main areas fall into that 30%. The first is working with local contractors in the Canadian PPP market, an area Rylatt says Balfour Beatty's construction arm has no interest in entering.

"In Canada we bring our development history, skills and capabilities from what we do in the UK and US and bolt that onto the capability of a local partner," says Rylatt.

The second non-core area is US student accommodation. "Half of what we've done has been with

Balfour Beatty's construction business in the US," says Rylatt. "The other half has been with other contractors.

The third area is multi-family housing in the US.

Recent Investments					
Asset Name	Sector	Country	Equity Holding	Equity Holding (%)	Date of Investment
University of Sussex Student Accommodation (Falmer Campus)	Accommodation	UK	GBP 20.8m	80%	Mar-17
Humber Gateway Offshore Wind Transmission Link	Energy Transmission	UK	GBP 12.5m	59.50%	Sep-16
Irish Primary Care Bundle	Healthcare	Ireland	EUR 201.51m	40%	May-16
DCC Data Centre (Borden Data Centre) P3	Data Centre	Canada	CAD 5.4m	50%	May-16
Glasgow Kennedy Street Student Accommodation	Accommodation	UK	GBP 11m	100%	Apr-16
Gloucestershire Waste PFI (2016)	Waste	UK	GBP 20.8m	50.50%	Jan-16
Source:www.infra-deals.com					

The UK market

Balfour Beatty Investment has adapted its focus in line with dramatic changes since the days of PFI, but remains optimistic about the UK.

"There is a strong drive from the UK government to invest in infrastructure," says Rylatt. "And we have a healthy order book. There will be opportunities with HS2, and Crossrail 2, and we are currently working on Thames Tideway. We are also doing a lot in the education sector."

Noting that "90% of what we used to do was PFI," Rylatt says that since then "we've had to slim down the organisation. PFI was very labour intensive, and at its peak we employed around 340 people in the UK. We're now down to 190."

This does not point to fewer opportunities, but types of opportunities that require fewer people, and changing procurement processes, Rylatt says.

Of those new procurement processes, student accommodation has become a central focus. This includes projects procured by universities, and Balfour Beatty Investments building their own student accommodation.

"We are three quarters of the way through building student accommodation in Glasgow, and when finished we'll let that out to students ourselves," says Rylatt.

Balfour Beatty Investments has also been active in availability-based OFTO (Offshore

Transmission) programme, winning four projects – Gwynt y Mor, Humber Gateway, Thanet and Greater Gabbard (now sold).

They have recently pre-qualified for round five of the initiative.

Rylatt hopes that the proposed CATO (onshore transmission) programme will result in new investment opportunities.

> If we get a pipeline of ad hoc, one-off projects that would be very difficult for the market to respond to...

“There’s a significant need for infrastructure reinforcement in the UK electricity supply and transmission market,” says Rylatt. “If it’s privately financed, and through Balfour Beatty’s transmission and distribution business we feel we have a competitive edge in that market.”

Rylatt adds that Balfour Beatty Investments is moving into property development schemes, “without being out and out property developers.” For example, Balfour Beatty Investments won the tender for the East Wick and Sweetwater Regeneration Project in London. The company also qualified for the Transport for London Property Framework, which it hopes will result in deals.

The company is also waiting for news on the proposed PF2 initiative. But Rylatt echoes some of the market’s frustration over the government’s lack of clarity.

“What are the schemes? What’s the nature of the pipeline? What will the bid costs be? What’s the nature of the opportunity? Everyone is looking at it closely because you need a pipeline of work to be able to justify recruiting a team to deliver it.

“If we get a pipeline of ad hoc, one-off projects that would be very difficult for the market to respond to, it would be very disappointing.”

Despite the huge infrastructure push by the Labour government in the 1990s and early 2000s, Rylatt believes that much of the UK’s social infrastructure still needs renewing.

“There’s no doubt that a lot of schools need redeveloping,” he says. “And assets that were 50 years old when PFI began are now 70 years old. There’s definitely a need for further investment. But it is whether that is centrally or locally led.”

Rylatt adds that when the government stopped issuing PFI credits, it effectively curtailed the incentive for local authorities to use PFI as a procurement tool.

“The government not only has to look at PF2 and how it is procured, and the nature of risk transfer,” says Rylatt. “But it has to look at what the underlying drivers are to make it a successful procurement programme. The risk transfer in PFI’s latter years went too far.”

But at the same time, Rylatt believes that the PFI model has been unfairly represented.

“A weakness of PFI is that it is complicated and isn’t easily communicated,” he says. “PFI became a victim of its own success and it was easy to make it a political football.”

“PFI delivered hundreds of major hospitals and thousands of schools, replacing ageing estates which were simply no longer fit for purpose. It also brought a very strict discipline to cost and risk management.”

Because there is no benchmark demonstrating the value of PFI relative to traditional procurement, it is difficult to demonstrate the true costs of these tools.

“In an information void it is very easy to draw a comparison with very transparent PFI information on whole life cost against unknown information in public procurement,” says Rylatt.

“I am very saddened by a lot of the reporting around PFI.”

Despite Rylatt’s praise for the PFI model, he does not believe it is suitable for all types of projects. He cites the Thames Tideway model as a more suitable structure for large projects, since the government effectively provided a range of guarantees to private investors in case problems occurred during construction.

Rylatt believes that PFI-type models are best suited to projects with capital values that fall between GBP 100m and GBP 400m.

Brexit

Key to the UK market’s development is how it eventually uncouples from the European Union, and the government’s efforts at damage limitation.

At the moment, says Rylatt, Balfour Beatty is assessing the possible immediate impact of Brexit, and making contingency plans for what he describes as the “slow burn” effects.

A major issue facing Balfour Beatty and other UK construction firms is the potential for serious skills shortages. Other problems include import tariffs on goods, which would impact the ability to invest in UK projects.

Furthermore, if British universities become less attractive to foreign students, due to movement restrictions or research funding cuts, demand for new student accommodation may fall.

“If universities put investment on hold, then that would slow down the market,” says Rylatt. “But we are sitting on a big portfolio and that will continue to generate capital. It would be our ability to grow the business and recycle capital that would slow down.”

Rylatt points out that if business were to slow down because of Brexit or any other reason, Balfour Beatty Investments would increase investments in its other core market — the US.

The US market

The centrepiece of BBI’s US investments is the military housing sector, which is worth GBP 121m (the group’s remaining equity investment and accrued returns from its underlying projects).

The firm is the largest provider of US military housing, operating 47 large bases. Rylatt says it is undertaking what he refers to as variation work on existing projects.

At present, he says, there is no new military housing being procured. But this may change, he adds, noting that the most promising area is single occupancy.

“We are doing a lot of pilot schemes with the Department of Defence on what that could look like,” says Rylatt. “It’s a huge opportunity.”

Rylatt believes that Donald Trump’s support for increased military spending should also translate into investment in military accommodation.

Elsewhere in the US, Balfour Beatty Investments is focused on the burgeoning student accommodation market and on multi-family housing. It recently won two housing projects in the US — one in Alabama and another in Georgia.

Balfour Beatty Communities Military Housing Investments

Asset Name	Sector	Country	Equity Holding	Equity Holding	Date of Investment
Air Force ACC III Housing Project	Accommodation	USA	-	100%	Jun-14
Air Force Northern Group Project	Accommodation	USA	USD 22m	100%	Aug-13

Source:www.infra-deals.com

Performance

Rylatt is confident that US opportunities will complement those it expects to develop in the UK.

He credits the unit’s strong performance during its parent’s downturn to three factors. The attractiveness of PFI and the growth of the secondary market played a part – but active portfolio management was crucial. “This has driven some very attractive pricing, when we have disposed of assets,” says Rylatt.
Balfour Beatty Investments has also driven efficiencies from the assets it has owned and operated.

"Our asset management has exceeded expectations," he says.

"Those two things have been the reason why we have divested certain assets," adds Rylatt. "But selling assets is also about client relationships, market relationships and strategic priorities going forward."

So what are these strategic priorities?

"I fully support what Leo [Quinn] is doing by simplifying the organisation," says Rylatt. "It's been fantastic for the company. The challenge is how we go about maintaining that simplified, leaner structure.

"It's clear that Balfour Beatty's focus is the UK and US markets where the outlook is positive. We won't be seeking to go back to the multi-country approach we had before. Why would we, we are already operating in the two crown jewels in terms of where infrastructure investment is, and where it is going to go."

Promoted from within

Rylatt's Balfour Beatty career has almost perfectly synchronised with the company's involvement in PFI. He joined the company 18 years ago, after spending a number of post graduate years at Rolls Royce. There, he worked in sales finance of aero engines and aircraft, spending time in the US selling to American Airlines and Continental.

Back in the UK, Rylatt was seconded to NEI, which had recently been acquired by Rolls Royce, and became involved in developing independent power projects in the UK, Middle East and Africa. As part of this he helped establish Rolls Royce Power Ventures.

At that point, he moved to Balfour Beatty Capital Ventures (which later became Balfour Beatty Capital and then Balfour Beatty Investments).

After a couple of years, Rylatt was charged with running Balfour Beatty Investment's project finance and infrastructure investment teams. Two years on, he was asked to head up Balfour Beatty Investment's UK business. He eventually took over from Anthony Rabin, who went on to lead the company's international activities.

A core part of his remit is to retain staff in what has become a highly competitive environment for infrastructure investing expertise. But this is not always easy, as Rylatt explains:

"Part of the challenge with the growth of the secondary market infrastructure funds is that they are trying to hire my staff," he says. "We have lost staff. But in some ways that's quite flattering.

Balfour Beatty Investments employs around 1500 people, with some 200 in the UK and another 100 in the US. The remainder are at Balfour Beatty Communities, Balfour Beatty Investments' US military housing business, working in facilities management.

"We tend to hire junior people from banks and law firms and train them up to be experts in their field," says Rylatt. "It's very rare that we hire senior members of staff from the outside. So we tend to promote from within."

That recruitment strategy is central to the company's approach to risk management, says Rylatt. In this way, employees learn to apply the specific capabilities of the Balfour Beatty Group to originating, developing and managing investments.