

# Kairos Equity Yield

## Liquid infrastructure income investing

HAMLIN LOVELL

The daily-dealing Kairos Equity Yield (KEY) UCITS won *The Hedge Fund Journal's* 2016 award for 'Best Performer over 2 Years (2014 and 2015)', in the category of Long/Short Equity- Regulated Utility Sector Specialist. The fund, launched in June 2013, has just passed its third anniversary. Kairos, which, managing assets of €8.5 billion is one of THFJ's 'Europe 50' managers, has been pursuing utility oriented, and broader, European equity long/short strategies in other funds since its birth in 1999.

Lead manager Vittorio Villa has also been following the regulated company space closely over the same period, working in Luxembourg and Milan and now London. Villa has specialised in utilities for his whole career, having started as a sell side infrastructure analyst and worked for Credit Agricole Indosuez Cheuvreux and ING Barings before joining Kairos in 2006, just before Kairos hired a team to manage Italian funds and exploit the inefficiencies of this market.

Kairos co-founder, former proprietary trader Guido Brera, is Group CIO. Together with the risk team, Brera looks at KEY risk exposure, such as concentration of positions, country exposures, sector exposures, and may look closely at positions sized above 5%. The fund's risk constraints come from the UCITS rules, the prospectus and other internal guidelines that include liquidity stress tests. Assets of €480 million in KEY are consistent with some exposure to small caps (€250 million to €1 billion) and mid-caps (€1 billion to €5 billion). There are also limits on exposure to PIIGS (Portugal, Ireland, Italy, Greece, Spain) countries.

But within the multi-layered risk framework, Villa has the final say as portfolio manager. Analyst Oriana Bastianelli is fully dedicated to the product and she has more than 15 years' experience on the infrastructure/regulated businesses. Other PMs at Kairos, such as Federico Riggio (whose award-winning and unconstrained Kairos Pegasus strategy THFJ profiled in 2015) exchange ideas with Vittorio's team. A healthy dialogue exists throughout the equities team, who are now centralised in London.

Some 17 years' experience within Kairos (and more pre-Kairos) has built up a strong body of analytics and contacts around the utilities and infrastructure sector, which has seen wide divergence between the best and worst performing companies. Though high dividend stocks continue to enjoy a tailwind from declining interest rates, there have been pitfalls for the unwary. Some sub-sectors have faced headwinds, including lower electricity usage in Europe related to EU-level energy efficiency rules, and adverse local regulations such as those subsidising certain forms of power generation. For instance, Germany's Eon has lost two thirds of its value over five years and EDF has roughly halved in three years.



Vittorio Villa, Lead Manager, Kairos Equity Yield

### Outperformance and alpha generation

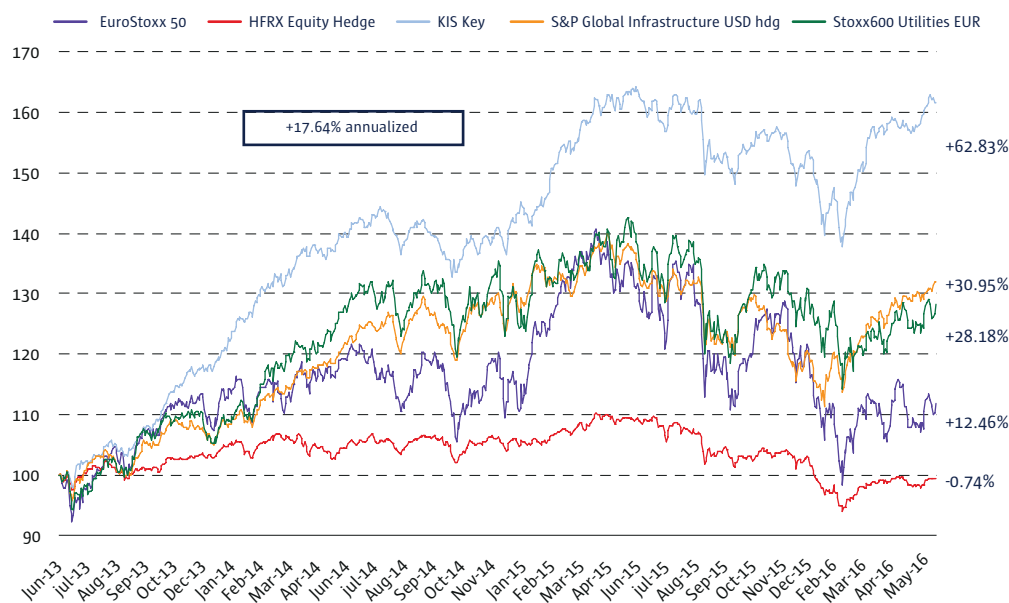
Kairos' fundamental stock selection and active management has helped KEY to deliver returns around double those of an index of European utility equities, as shown in Fig.1. KEY has also outpaced global infrastructure by a similar margin. This has been attained with a target net exposure between 50% and 80% (70% average over the period) which implies that the alpha generation was even greater than the

raw outperformance. The fund has a gross exposure target of 60-150%, average of c. 140% attained over the period.

KEY targets high single to low double digit returns, mainly from dividends and capital gains. The past three years have surpassed the target with annualised returns of 17.64%. The strategy has been firing on all cylinders. Performance attribution has not only come

**Fig.1 Performance since inception: 17.64% annualised return %**

Source: Kairos on Bloomberg daily data. From inception (June 10, 2013) to May 31, 2016. Past performance should not be taken as a guide to future returns.

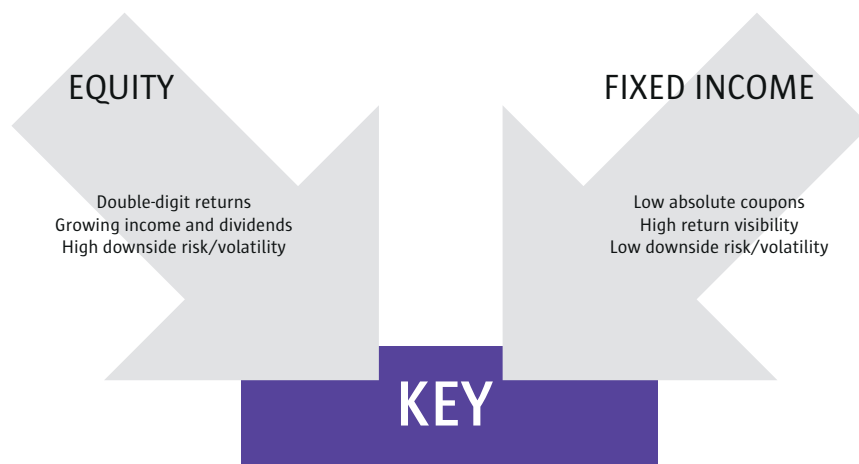


involve concessions or long term contracts, with some element of fixed costs, and gaming is an example. KEY invests in publicly listed equities and thus avoids the multi-year lock ups that can apply to direct investments into infrastructure (though the huge appetite of pension funds for high quality infrastructure assets is one potential exit route for some holdings).

Villa expects at least 80% of the book to be in Europe and all holdings to have some link to Europe as it is the market that Kairos know best. The US exposure is mainly European companies with a US listing, such as gaming concessions group IGT, rather than US companies. Kairos can hedge currency exposures, but has been leaving roughly half of its USD exposure unhedged, making a marginal contribution to returns. For some positions that use derivatives such as CFDs, the currency exposure is in effect only on the P&L of the position. There is no direct emerging markets exposure. On a look through basis, there is some marginal indirect emerging markets exposure, such as a Chilean utility owned by Spain's Endesa and some minor exposures to Brazil and Turkey.

**Fig.2 An hybrid asset class between equity and bond**

Source: Kairos



'Equity-like' returns with 'bond-like' risks

KEY runs a concentrated book of 30-40 positions, actively selecting countries, sectors and companies. KEY's main sectors have been utilities, transport and logistics, telecoms, IT and gaming. The largest country exposures have been Italy, Spain, Switzerland and Austria. The fund has some PIIGS (Portugal, Ireland, Italy, Greece and Spain) exposure with Italy and Spain together around 25%. Villa has a constructive outlook on how Draghi's expansion of QE programmes is helping peripheral Europe. Villa also views the agreement on Greek government bonds (GGBs) as positive (but KEY only has about 2% in Greece).

Having followed the utility sector since 1998, Kairos has deep experience at assessing disparate regulatory regimes in Europe. "We have a strong network, we know the companies, regulators and politicians and we gather intelligence," says Villa.

Kairos tends to avoid 'low visibility' situations with opaque or capricious regulators. Utilities can sometimes be seen as a soft target for politicians with special taxes having been introduced by some governments, such as the UK's "windfall tax", the Italian government's "Robin Hood" tax, and the French government's volte face over its predecessor's promises to toll road companies.

**Interest rate sensitivity and inflation protection**

Utilities can be perceived as 'bond proxies' riding on the bond market rally that has, as of early June, resulted in over \$10 trillion of debt now having negative yields (according to Fitch Ratings).

from long positions. Shorts, hedges, relative value trades, and an opportunistic call option writing strategy, have also made contributions.

**European regulated utilities**

The investment universe for KEY is comprised of predominantly European companies that are regulated, and semi-regulated, utilities, which tend to be monopolies or semi-monopolies where

regulators or government agencies dictate returns on assets. For example, electricity power grids in Italy are permitted a 6% real pre-tax return on their regulated asset base – and this generates a far more stable and predictable earnings pattern than downstream utilities grappling with the vagaries of commodity, gas and electricity prices. Regulated industries include energy, gas, airports, motorways, and telecoms. In contrast, semi-regulated industries

Assets where yield makes up a significant part of returns naturally have some interest rate sensitivity but important distinctions should be made. Dividend income can grow over time and is not fixed in the same way as coupons on fixed income corporate bonds.

Kairos argues that its universe of equities can be seen as a hybrid between equities and bonds, as illustrated below. KEY aims to synthesise the best aspects of both asset classes by using security selection, trading, hedging and derivative strategies to generate a higher return to risk ratio.

Some companies in the space may be closer to inflation-linked bond proxies than nominal bond proxies. Regulated utilities can offer a high degree of inflation protection, and there is an attractive asymmetry in that inflation-related price changes are usually floored at zero, meaning that deflation need not result in any price cut - and nor do regulated asset bases (RABs) decrease under deflation. "This has been tested in Italy and Spain," says Villa, where bouts of mild deflation have not resulted in price cuts nor reductions in RABs. Kairos has also identified telecom assets such as telecom towers that receive revenues over very long term contracts, making them akin to inflation linked bonds.

Whether companies' cash-flows are nominally fixed or inflation-linked, the companies and industries KEY invests in are far from homogeneous, with some companies exhibiting much greater interest rate sensitivity than others. Explains Villa: "The duration of assets varies substantially. The longest term concessions such as motorways or airports can have a 30 year duration with Eurotunnel at 70 years".

In contrast the regulatory regime for energy networks in Southern Europe changes every two to three years, and Villa therefore views it as more like a variable coupon short term bond. Hence KEY has huge flexibility over its asset duration. Kairos estimates the weighted average asset duration of KEY's book at between eight and 11 years, and stress tests suggest that an overnight 1% spike in interest rates could cost 4% given current net exposure around 80%.

If rates crept up slowly, Kairos might do one or more of: rotate back towards shorter duration assets, reduce net exposure or hedge. Kairos does have the flexibility to short duration-sensitive assets in order to hedge interest rate risk. For instance, an Italian motorway concession was shorted as a partial hedge for exposure there. But Kairos's base case macro view is that rates will stay lower for longer. Villa points out: "There is a strong tailwind from Draghi and in June the ECB started buying

corporate bonds – with debt issued by many of our holdings included in the eligible list". In 2008 Kairos opportunistically hired a European fixed income team with a focus on corporate bonds and KEY benefits from this additional insight into the capital structure of companies for which debt can be very important.

### Runway for multiple expansion

Indeed, for Kairos the bond-like features of many firms in the space are the strongest asset allocation argument for rerating. One sign of the disconnect between corporate bond and equity valuations is that many companies now offer a higher dividend yield on equity than the coupon yield on their bonds (which has even turned negative for some corporates in places such as Switzerland).

Kairos sees potential for substantial multiple expansion on bond-like equities, and thinks that more firms with predictable cash-flows could attract premium ratings. Though some 'quality' companies, in sectors such as consumer staples, have already attained above average valuations, Kairos is seeking out some laggards that still trade at discounts to the wider market.

"Gaming concessions are still perceived as cyclical and ascribed a low multiple but in reality this is like a regulated utility with 10-20 year concessions," argues Villa. KEY owns Opap, Playtech and IGT and "the last of these has rerated to a higher valuation multiple after winning renewal of the Italian lottery concession," says Villa, who also sees scope for M&A in the sector. Yet the implied cost of equity on some gaming names remains in the mid-teens, according to Villa. Hence Kairos sees huge potential for further multiple expansion, if the equity risk premium compresses to 4-5%.

Villa also thinks that some airports are quasi-bonds that also offer secular growth trajectories, and could see more multiple expansion: he points out that London City airport recently sold for a gargantuan multiple of 30 times EBITDA. Some of KEY's investments in airports have been rerated. Flughafen Wien has been a popular Kairos holding for some years, also making appearances in Riggio's fund. Back in November 2014, an Australian infrastructure fund made a public offer for 30% of the firm at €82, and in April 2016 they bought a further 10% at €100 per share. Kairos has tactically traded around the position, taking some profits after the first offer, rebuilding the position, and then slicing it again. Flughafen Zurich has also performed well, doubling in the past three years partly due to its latest capital structure strategy. The airport's erstwhile un-levered balance sheet allowed it to consistently increase ordinary dividends, and the company is expected

to distribute special dividends every year to 2019 unless large M&A opportunities will arise.

### Italian consolidation

If re-rating is one theme, then the rationalization of Italian industry is another. Italian Prime Minister, Matteo Renzi, is seeking to reform restrictive practices and encourage more industrial efficiency across a number of sectors including banks. Italian municipal utilities appear to be extraordinarily fragmented with "300-600 unlisted municipal utilities often losing money and offering low quality service," observes Villa. Italy's government is happy to promote consolidation that is seeing medium sized players acquiring smaller ones. Villa thinks the synergies from consolidation are easy to attain simply by reducing headcounts and KEY owns Iren and Acea. Italian telecom towers, such as Rai Way and Ei Towers, have also benefited from consolidation.

### Short and relative value books

KEY's short book can make an incremental contribution to returns, such as 0.7% in 2014, though it is only sized up to 10% of the fund. It includes both single stocks and sector hedges. Alpha shorts include firms with aggressive accounting, specific events, or industry headwinds. A Finnish utility, Fortum, was shorted ahead of it spinning off its regulated assets, with the main thesis being falling electricity prices. A Spanish utility, Endesa, was shorted as its parent company, Enel, was doing a placing to increase free float. Fraport (Frankfurt airport) was shorted as a sector hedge for the fund's substantial exposure to airports in the form of Zurich, Vienna and Spanish operator Aena. Relative value spreads are also a relatively small sleeve at up to 10%, but they contributed 5.7% to returns in 2014.

### Opportunistic yield enhancement

Kairos will sometimes use derivatives for yield enhancement. Covered call writing is both a hedge to reduce downside and a source of income. When implied volatility is attractive, the fund may sell call options on a covered basis, against long positions. "We aim to cash in premium of at least 2% over one or two quarters by selling the call," explains Villa.

This is an opportunistic strategy so in 2014 it contributed 2.5%, but in 2015 it only made 0.1%. "In 2015 a very strong first half for equities reduced implied volatility so it was not worthwhile to sell the calls," Villa recalls. Then, in the second half of 2015, the market correction made stocks more appealing to buy on a fundamental basis, and Kairos did not want to cap the upside by selling calls. In contrast 2014 was a relatively directionless year where it made sense to pick up some premium. Investors can choose to have KEY dividend income paid out twice yearly, or roll it up inside the fund. **THFJ**