FRAMEWORK Investing

Macquarie Infrastructure Corp. (MIC) Summary

This infrastructure company has a confusing structure but a tempting yield

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Key Takeaways

- **Market Capitalization:** $6.2 billion
- **Forward dividend yield of 7.1%**. OCP has been increasing since 2014, making the dividends look more secure.
- **Operates airport services (fueling, hangers), tank terminals, and several energy and power generation businesses.** The company is good at buying businesses in unique competitive niches, then extracting economic rents from them. (pp. 2-3)
- **The company's ownership structure is confusing and makes valuation difficult.** The company is managed by its parent – Macquarie Bank – and owners must pay Macquarie a management fee (which is relatively small) and a performance fee (which can be very large). (p. 2)
- **The company is dependent upon access to capital markets for growth.** MIC has paid out more dividends than it has generated in OCP in three out of the past five years. Its profitability appears to be drastically improving since 2014, but the firm relies on equity sales and, to a lesser extent, debt to maintain its investment program and to pay owners a dividend. (pp. 4-5)
- **Our low-confidence valuation range for MIC has an average value of $92 / share**. A firmer valuation would require more time and analytical work. (p. 6)

Overview

This firm shares a lot of characteristics of a REIT: Heavy reliance on capital markets, high payout ratios meaning that investments must be funded through new equity / debt issuance, and being in the position of a rent-taker for most of its businesses.

That said, there are important differences. The first is that this company is structured to pay its parent a performance bonus when the stock price appreciates more than a benchmark (a utilities index). This means that cash flows or virtual ones (since the performance bonus has been paid in shares – diluting out present owners) are not dependent solely on operational performance, but also on stock performance. The second is that most of its businesses involve the storage or provision of energy. See the Revenues section of this report for more information.

Having struggled with a discounted cash flow (DCF) model for this company, I pulled together a per-share dividend discount model (DDM) for it, and am at least able to derive a fair value range using the DDM. The company routinely makes large investments that represent well over 100% of the OCP it generates, making the DCF valuation unreliable, in my opinion.

This company's management strikes me as very competent, but the operational performance has been varied. The complexity of the ownership structure and performance payments, the variability of the results, and the reliance upon capital markets prompted a third-party research firm to place a "conviction sell" rating on the stock. We think a bearish investment stance on MIC is unwarranted.

Macquarie Infrastructure Corp.

Revenues per Share

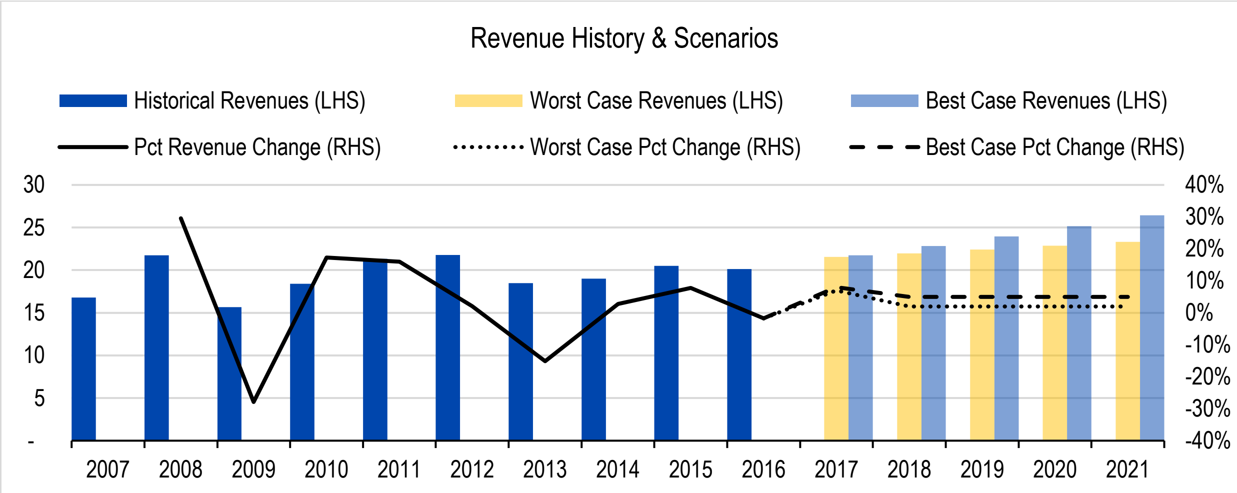
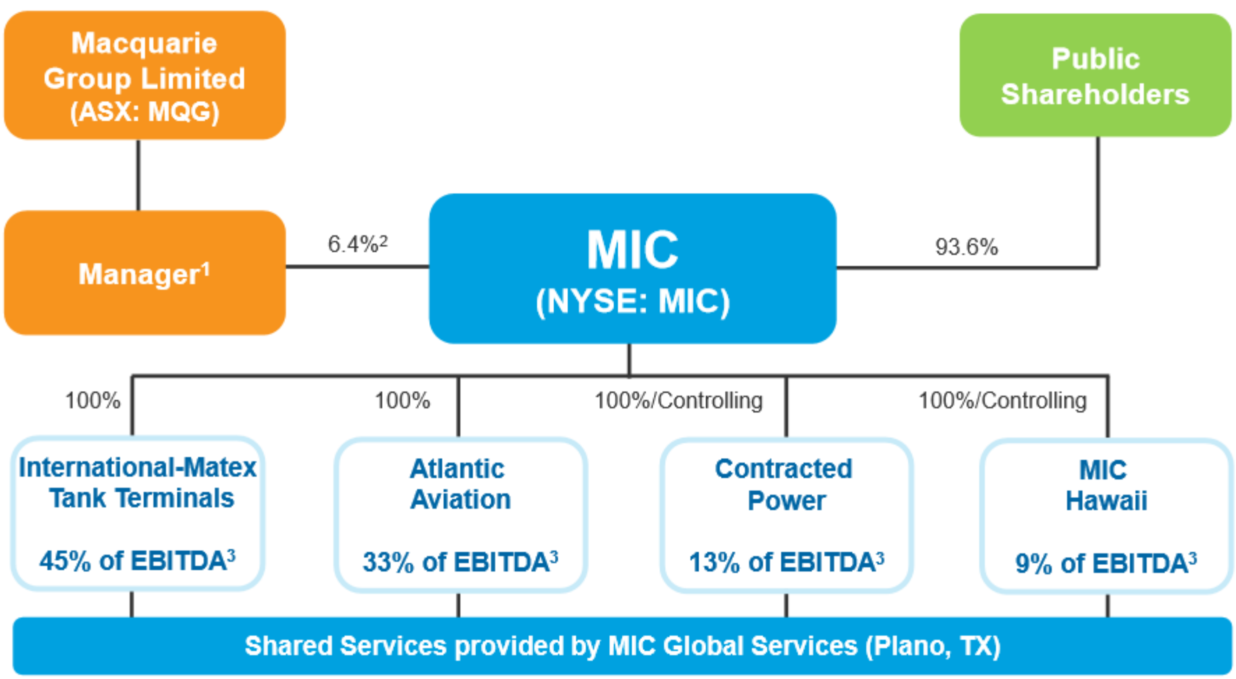


Figure 1. Source: Company Statements, Framework Investing Analysis

We have placed a simple range of future growth rates for MIC for this diagram. The best- and worst-case increases are based on the company's operational history but we have not made detailed projections based on MIC's business.

The firm has four businesses: IMTT – which operates liquid storage tanks in Bayonne, NJ, Atlantic Aviation – which operates hanger and other services for private jets and planes, Contracted Power – which operates solar, wind, and gas power generation facilities in the US, and MIC Hawaii – which provides transportation of gas and solar power to our 50th state.

Of these businesses, IMTT presently generates the lion's share of MIC's profits,



1. MIC is a party to a Management Services Agreement with Macquarie Infrastructure Management (USA) Inc. (Manager), subject to the oversight and supervision of MIC's Board of Directors. The Manager is a member of the Macquarie Group, a diversified international provider of financial, advisory and investment services.
2. As of July 31, 2017. Includes directors and officers ownership of an aggregate ~0.3%.
3. Proportionately combined EBITDA for the twelve months ended June 30, 2017, reflecting MIC's proportionate ownership interest in its Contracted Power and MIC Hawaii segments. Excludes $22.6 million of MIC Corporate expenses and $13.9 million of insurance proceeds at IMTT.

Figure 2. Source: Macquarie Infrastructure Corporation Investor Relations Presentation. Note the complex ownership arrangement mentioned in the Overview.

The above diagram shows the percentage of the business by EBITDA – a rough measure of profitability. Several of MIC's business account for fuel sales as a pass-through, so when fuel prices are up, MIC's revenues from those segments look relatively better. To analyze the demand environment, we find it more helpful to look at the change in gross margin for those businesses (Atlantic Aviation, MIC Hawaii, and Contracted Power).

Each of these businesses have distinctive competitive advantages. IMTT is sited in across the NY Harbor in Bayonne, NJ – an irreplaceable piece of real estate that makes it ideal for transporters of petrochemical and foods oils, all of which are stored there. Capacity utilization of these assets is very high and accounting depreciation on the assets is much higher than actual (i.e., the economic life of those assets is much longer than the accounting life).

Atlantic Aviation buys up hanger and airport services businesses (FBOs) owned by smaller operators and operates them at commercial airports which tend to serve corporate jets and private pilots rather than commercial jets. These businesses have long-term relationships with the airports on which they operate and are often local monopolies.

One of the most interesting pieces of Contracted Power is a gas-fired generation facility collocated with IMTT in Bayonne and connected to Manhattan with an underwater cable. Energy produced at this and other locations (which are wind and solar installations) is sold through to utilities under long-term contract.

MIC Hawaii is also a local monopoly, albeit one that is not growing.

In general, MIC management seems skillful in selecting infrastructure projects that have monopolistic qualities or are otherwise irreplaceable. This is attractive from an income perspective, though less so from a growth perspective. For growth, the company must find and purchase new assets at a good price or they must figure out how to develop present locations in such a way as to extract further revenues and profits from them.

Owners' Cash Profits per Share

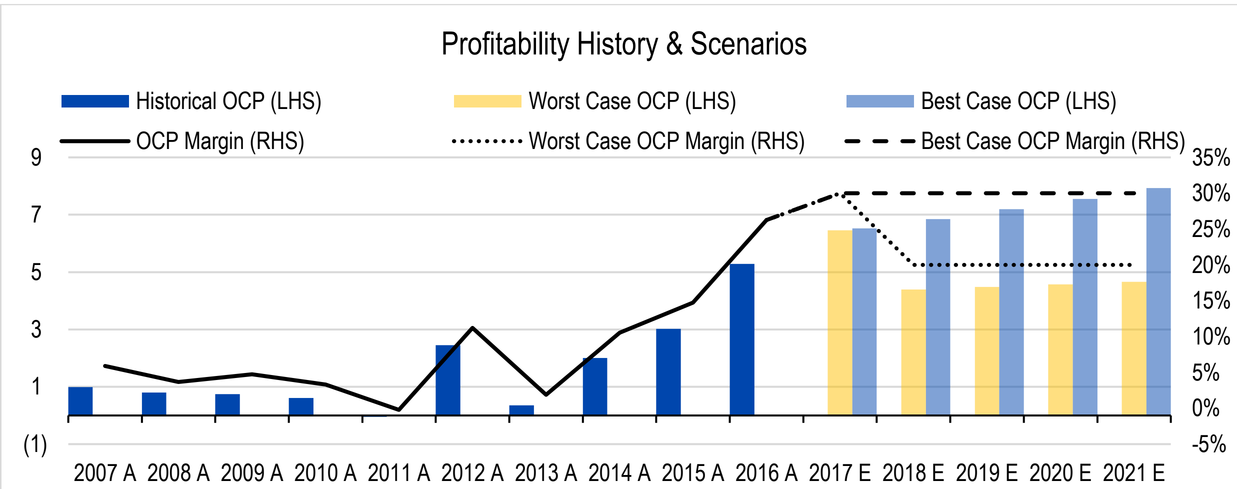


Figure 3. Source: Company Statements, Framework Investing Analysis

Note the big uptick in profitability in the 2014-2016 period (the 2012 result is an artifact of the data related to what was, at that time, its joint venture in the IMTT business. MIC bought out its IMTT JV partner in 2014). The reasons for this improvement are related to perverse incentives at its IMTT joint venture partner; when MIC bought out its JV partner's shares in IMTT, the strength of that business finally could shine through. In 2015-2016, the Contract Power subsidiary increased its proportion of gas-powered generation in Bayonne, and this also contributed to a bettering of profit.

Note that our future projections are higher than historical OCP margins in the best-case scenario and higher than all historical results save one (2016) in the worst-case scenario. We are reticent to project better-than-historical results as being the "normalized" values, but MIC's 2017 mid-term results are also strong – in the 28% OCP Margin range – and we believe our assumption that MIC's baseline profitability has taken a step up is reasonable.

Amazingly, while revenues per share have only grown at a 1.9% average rate over the past 10 years, OCP has grown at an average rate of 39.3% per year, thanks to the pick-up since 2014.

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Investment Spending

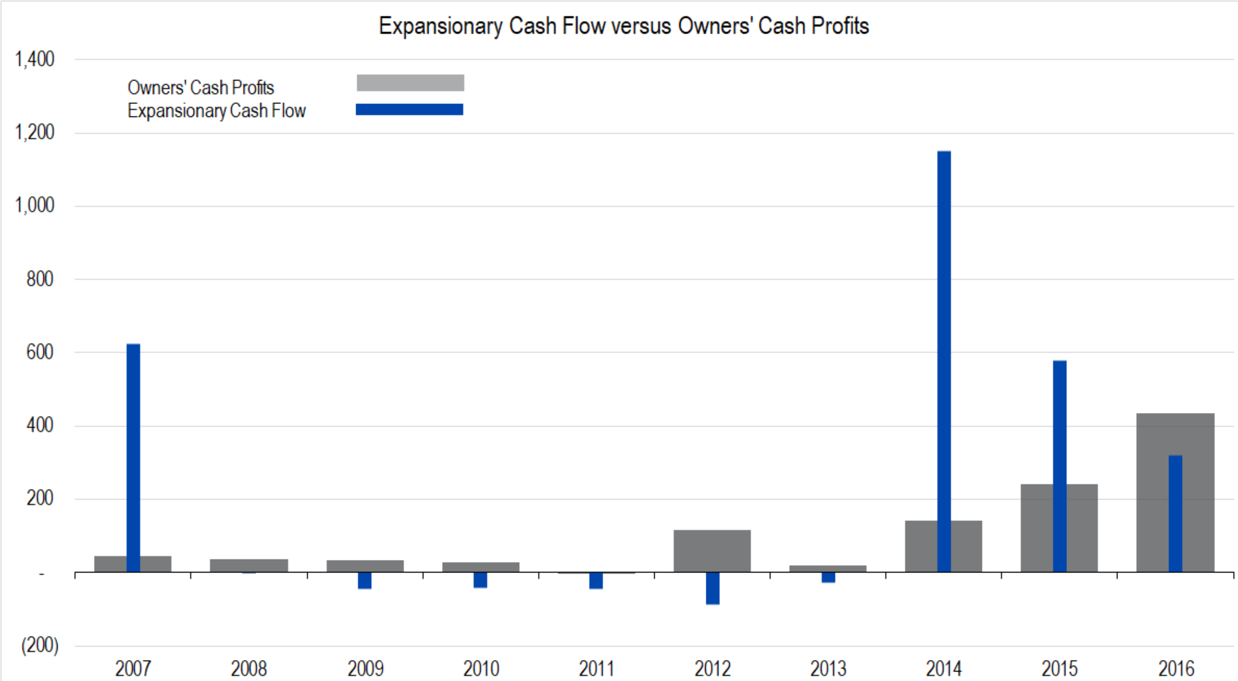

Figure 4. Source: Company Statements, Framework Investing Analysis

Note that for this section, we are not showing per-share values, but absolute ones. We will revert to per-share calculations in the next section.

The company invested heavily in 2014 to buy out the IMTT partner. As you can see from the diagram below, funding for this transaction was mainly done using equity (green section) rather than debt (gray section).

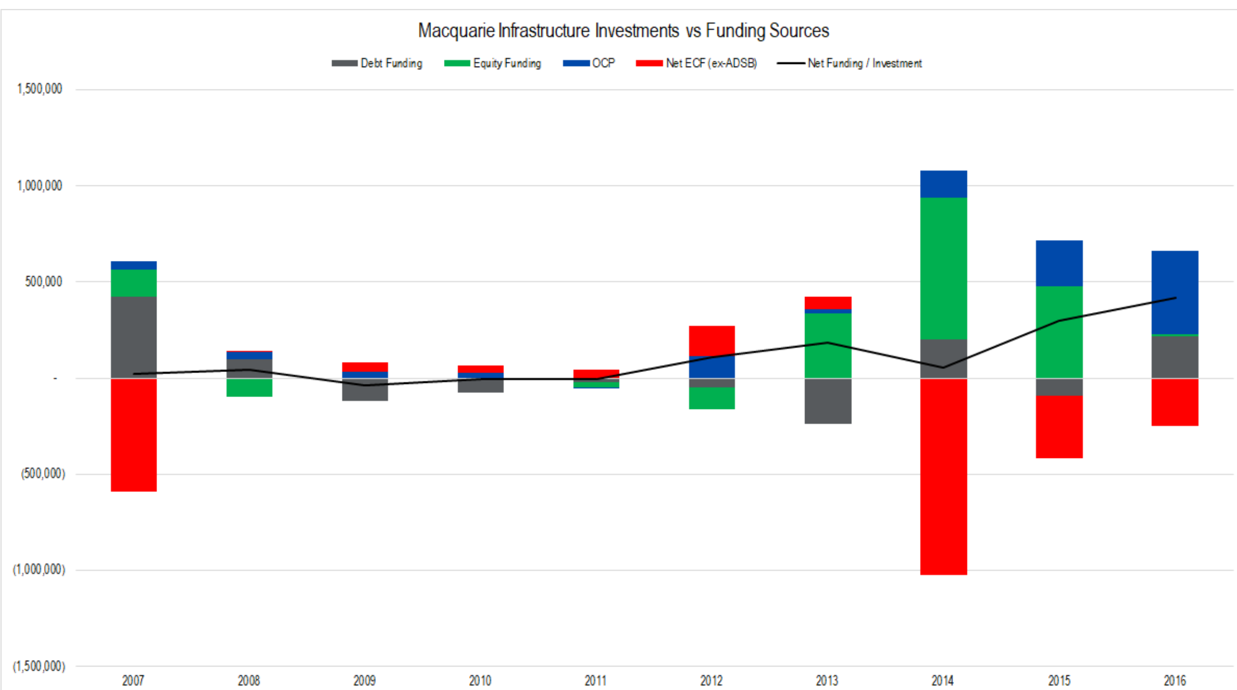

Figure 5. Source: Company Statements, Framework Investing Analysis. Red sections show net Expansionary Cash Flow (investments), not counting the implied value of share issuance. MIC issued convertible bonds in 2014.

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Dividends per Share

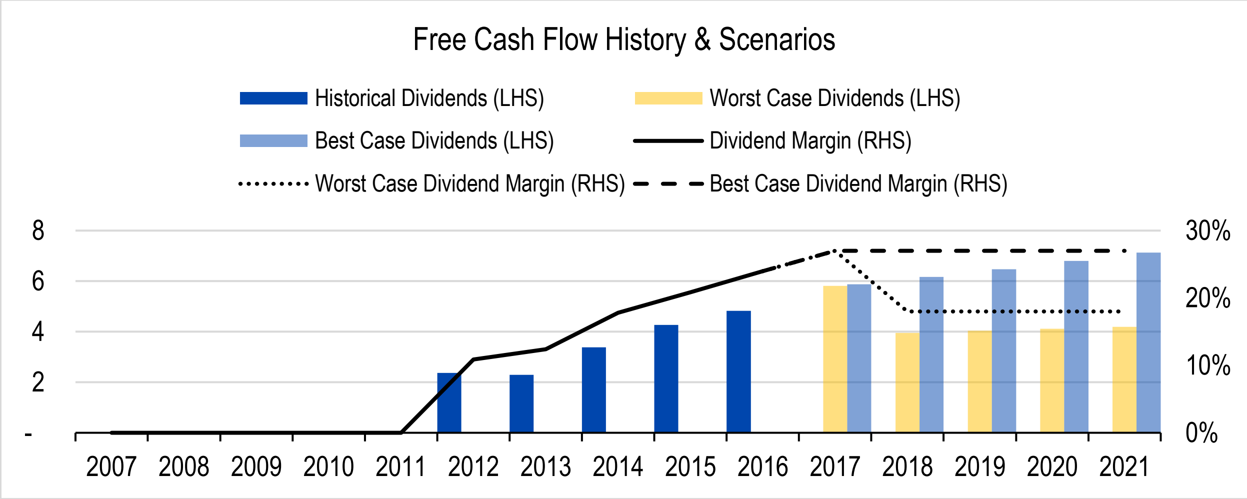

Figure 6. Source: Company Statements, Framework Investing Analysis. Our 2017 dividend assumptions are a bit higher than management is presently guiding towards, but our worst-case assumptions from 2018 forward imply a significant dividend cut. Overall, we believe our best- and worst-case ranges, in aggregate, will contain MIC's actual dividend payout over the next five years.

One criticism of the third-party research firm mentioned in the Overview that put a "strong sell" rating on the stock is that the firm's leverage, combined with its sensitivity to volatile end markets and its commitment to high dividend payments was foolhardy. The company would not be able to cover dividends during a downturn.

We believe the underlying businesses are more resilient to economic downturns than the third-party research firm claimed, and we note that, while the firm must have had to borrow money or issue equity to pay dividends in the past, recent high profitability levels allow it a much more comfortable cushion to pay its high yield.

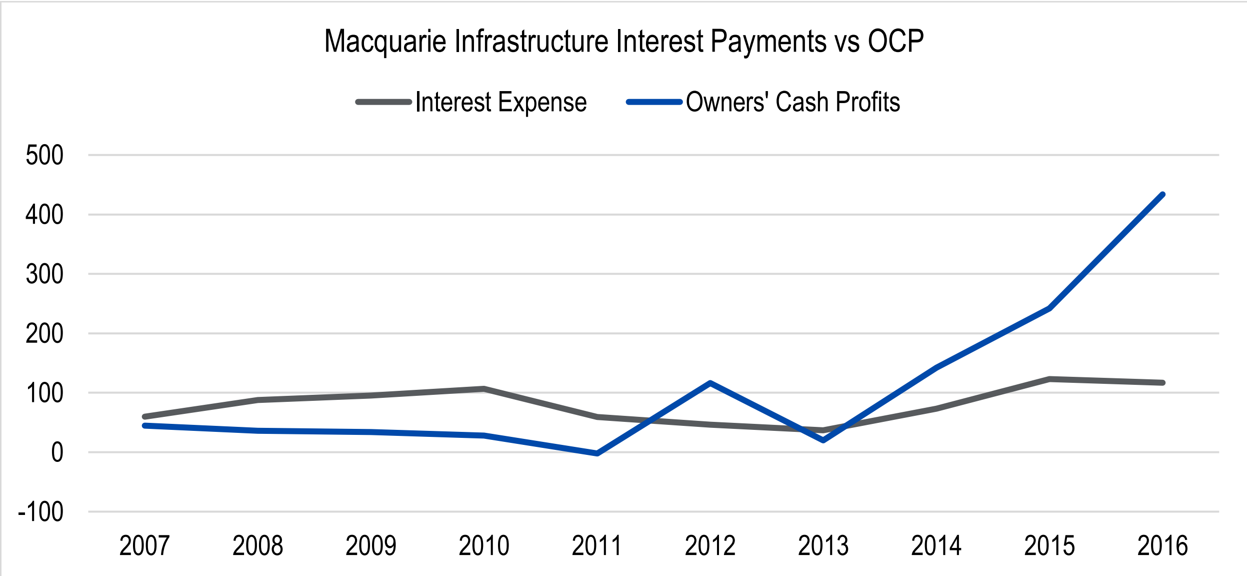

Figure 7. Source: Company Statements, Framework Investing Analysis. Note that OCP is a post-interest number. In other words, the fact that the blue line above is lower than the gray line does not mean that the firm had to tap capital markets to pay interest in the past. The notable rise in OCP over interest expense in 2016 suggests that the firm will have an easier time paying dividends.

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DDM-Based Fair Value Range

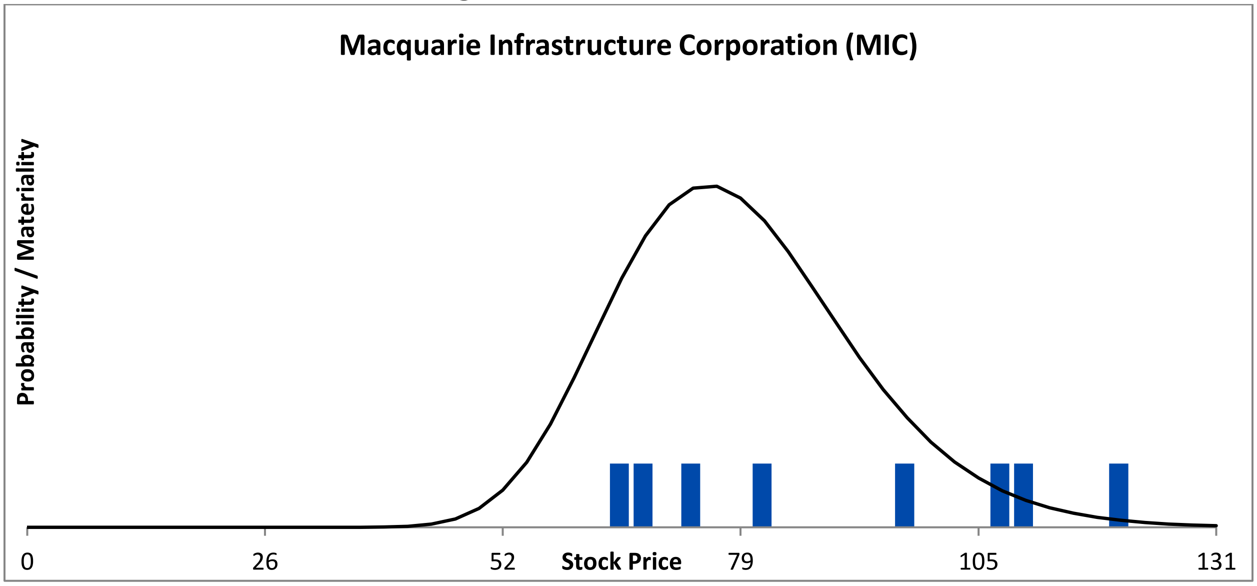

Figure 8. Source: Framework Investing Analysis, CBOE (pricing)

The four lower valuation scenarios have an average value of $74 per share and extend from $66 to $81 per share. The four higher valuation scenarios have an average value of $109 per share and extend from $97 to $121 per share. The average of the eight scenarios is $92 per share.

At the present payout, the lower valuation cluster average implies a dividend yield of 7% per share, the upper valuation cluster implies a dividend yield of 5% per share, and the average of the entire range implies a dividend yield of 6%.

It's worth pointing out that we have assumed a flat investment rate that generates the projected dividend payouts on the previous page assume there is no dilution from payments made to the Macquarie management company. This assumption will likely be wrong. If performance is good, the stock may well outperform its benchmark, which would trigger a large payment to the management company. This payment may be paid in stocks, but we treat this dilution as though it had an immediate cash cost. Assuming that the company's stock would appreciate quickly were operational scenarios to be relatively good, that suggests our higher valuation cluster would probably be pushed down as payouts to the management company exceed our expectations.

In general, we do not have great confidence in this valuation range – recall that our revenue projections were based on an estimate of historical results and our profitability projections were better than the company's prior history. That said, we may make a small allocation to this stock in our income-focused portfolio and do more work to firm up our valuation assumptions.

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Price and PS Ratio

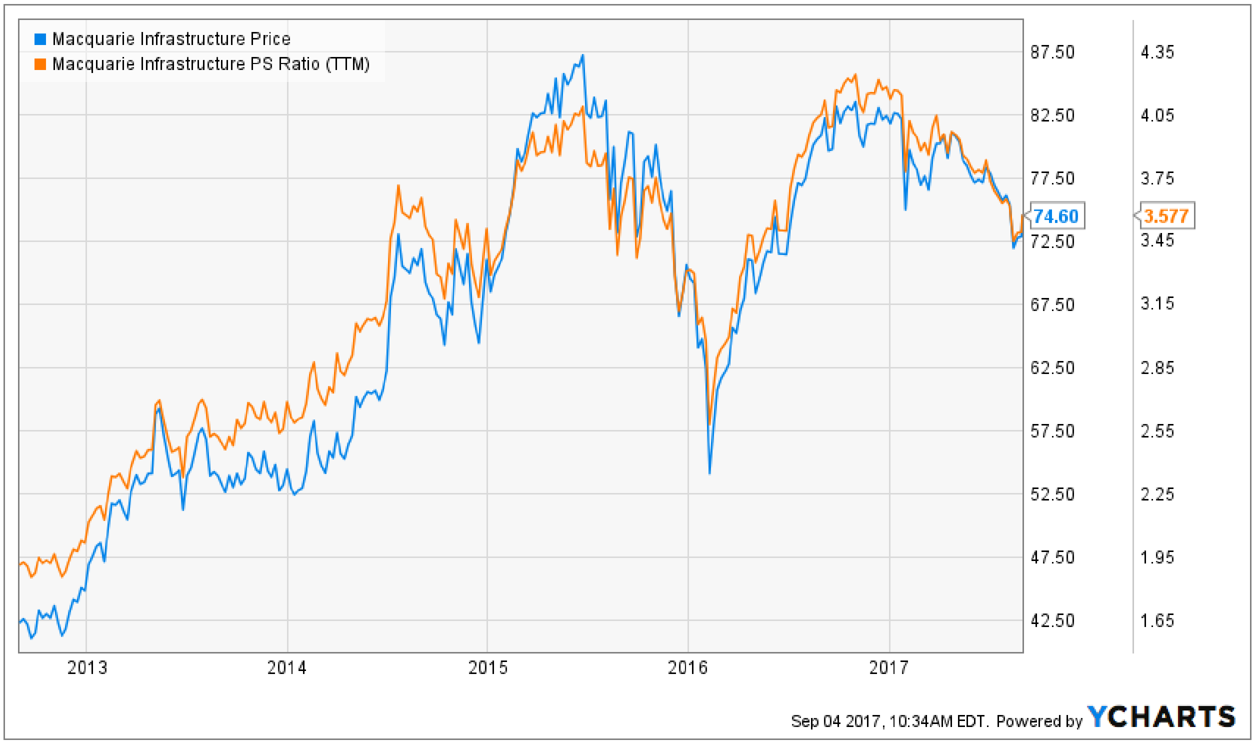

Figure 9

The company is down sightly from the price at which it was trading last year. The sudden drop in early 2017 represents that market reaction to the third-party research report.

Options

No LEAPS are available – the longest-tenor options expire in April 2018 – but the bid-ask spread is not terribly wide by option standards and even the furthest tenor options had a few contracts' worth of volume on Friday. Considering the uncertainty behind our valuation and the high dividend yield, we personally prefer an unlevered investment strategy in the underlying itself. We will mitigate market risk by keeping the allocation small and mitigate valuation risk by firming up our understanding of the company's operational value drivers.

Next Steps

- Understand revenue growth picture better. How quickly can MIC's revenues grow from making improvements to its current properties and franchises?
- Understand the root cause of the large increase in profitability over the past three and a half years, and sharpen our estimates for a normalized profitability range.