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EXPERTS IN GLOBAL INVESTING

2020 INREVIEW

Covid-19 and global listed INFRASTRUCTURE

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The following discussion seeks to outline how we think about the investment case for infrastructure, the impact of the covid-19 crisis upon the different infrastructure sectors and the outlook for these sectors.

INVESTMENT CASE FOR INFRASTRUCTURE

Central to the investment case we make for infrastructure is that such assets generally produce reliable earnings because they provide services that are essential to the efficient functioning of communities and face limited, if any, competition. Because the services provided by infrastructure companies are essential, the prices charged can be increased with limited impact on demand. As a result, earnings are reliable and generally enjoy inherent protection against inflation. Over time, the predictable earnings derived from infrastructure assets are expected to deliver income and capital growth for investors.

Investors have generally defined infrastructure as essential assets—assets that provide services that are essential to the efficient functioning of communities. Where our strategy is different is that we apply a stricter definition in determining which companies and assets qualify as infrastructure and are eligible for investment in the strategy. We believe that a key reason investors invest in infrastructure is that they seek the reliable returns that are associated with the asset class. To ensure we achieve this key objective, we exclude infrastructure stocks whose earnings are materially exposed to competition, sovereign risk and changes in commodity prices. The aim of our approach is to limit our investment universe to stocks that provide investors with predictable inflation-linked returns over a business cycle.

The universe of infrastructure assets that we consider for the strategy mainly comprises two sectors:

- Regulated utilities, which includes energy and water utilities. We estimate that utilities comprise about 60% of the potential investment universe for the strategy. Utilities are typically regulated by a government-sponsored entity. Such regulation requires the utility to efficiently provide an essential service while allowing the utility to earn a fair rate of return on the capital it has invested.
- Transport infrastructure assets that provide mobility to people and goods to transport them around the communities we live in. Transport infrastructure assets include airports, ports, railroads, toll roads, communications assets and energy infrastructure (oil and gas pipelines). Regulation of infrastructure companies is generally less intensive than for utilities and allows companies to benefit from a greater number of people using their services. As populations grow and economies develop and become more interdependent, we expect aviation, shipping and vehicle traffic to increase, as will demand for communications and energy.

OUTLOOK FOR INVESTMENT IN INFRASTRUCTURE

We are confident that the underlying businesses we have included in our defined universe and in our investment strategy will prove resilient over the longer term. We regard the businesses that we invest in to be of high quality and, while short-term movements in share prices reflect issues of the day, we expect that share prices in the longer term will reflect the underlying cash flows leading to investment returns consistent with our expectations.

We are cautious about the path ahead and have positioned the infrastructure portfolios with a defensive mindset. We feel it is prudent to be cautious given that the uncertainty pertaining to health and economic scenarios means that the range of potential investment outcomes we face remains wide.

"… the health emergency has hit infrastructure businesses harder than utilities."

THE SECTOR-LEVEL IMPACT OF COVID-19

As noted above, our investment universe comprises regulated utilities (water, gas and electricity) and infrastructure companies (toll roads, airports, communications infrastructure, energy infrastructure and rail). Overall, the health emergency has hit infrastructure businesses harder than utilities.

REGULATED UTILITIES

Regulated utilities provide access to a range of services including the provision of water and wastewater services and energy. The transportation and distribution of water and energy are typically natural monopolies; that is to say, it is more efficient to have a single supplier of the service than multiple suppliers. Consequently, the supplier does not face competition.

As utilities provide a service essential to modern life and face no competitive threats their economic earnings potential is typically limited by regulation where a regulator sets the price that the utility can charge for its service rather than the utility setting the price. This regulator sets the price at a level that allows the utility to earn a 'fair' profit after taking into account expected demand for the service and the reasonable costs the utility is expected to incur in providing the service. Provided the expected demand forecast by the regulator is accurate and the utility can manage its operating costs in line with the amount allowed for by the regulator then the utility will make a 'fair' profit.

The lockout of physical commerce in response to covid-19 has hit utility volumes and utility operating costs. Data from the US Energy Information Administration shows that the volume of electricity demanded in the US fell about 5% in April 2020 and 7% in May 2020. The drop reflects the reduction in commercial and industrial electricity volumes as businesses closed due to quarantine requirements. This effect has been somewhat offset by an increase in household demand due to people working from home. The economic decline caused by the lockout of physical commerce is expected to lead to an increase in the number of businesses that will encounter solvency issues and an increase in unemployment. The natural consequence is an increase in the number of customers who will be unable to pay their bills, leading to an increase in bad debts. Due to this, the amount of revenue earned by utilities will likely decline.

The covid-19 economic crisis is likely to lead to pressure on short-term earnings unless the regulated utilities can take actions that will offset this. However, regulators generally allow losses incurred due to issues outside of the control of the regulated utility to be recovered by the utility over the near to medium term by socialising these costs across the customer base. For example, reflecting the depth of the economic crisis, the bulk of utilities we follow have elected to maintain water and energy services to customers who were unable to pay their bills. In return, regulators have typically announced that the expenses incurred by utilities as a result of such actions can be accrued and recovered from the broader customer base in the future. This means that utilities should continue to make 'fair' profits.

Due to this regulatory arrangement, regulated utilities might face some short-term declines in earnings but we do not expect significant changes to their long-term earnings outlooks.

Notwithstanding the current crisis, the bulk of the regulated utilities that are in the infrastructure investment portfolio have noted that they do not expect earnings to suffer material declines. Indeed, almost all of the utilities in the portfolio have reaffirmed their earnings guidance for 2020.

In an environment where our base case is that economic growth will be difficult to come by and interest rates are likely to remain at historically low levels, we believe regulated utilities remain attractive investment propositions.

INFRASTRUCTURE

Infrastructure assets enable the transport and distribution of people, goods and data across the community. The infrastructure sector includes the following segments: airports, toll roads, rail, communications infrastructure and energy infrastructure. The covid-19 crisis has affected the different segments of the infrastructure sector in different ways, as the following shows.

AIRPORTS

Airports generate revenues through three major businesses. The aeronautical business charges passengers and airlines for using facilities such as runways and terminals. The commercial business generates revenue from the commerce that takes place at an airport's retail shops, car parks and the food and beverage outlets. Finally, the property business earns rental income from the businesses that rent office or industrial space from the airport.

The International Air Transport Association (IATA) has noted that by the first week of April, governments in 75% of the markets it tracks had banned entry while an additional 19% had imposed travel restrictions or compulsory quarantine requirements for international arrivals. As a result of the closing of the majority of international and domestic borders the level of aviation activity was essentially reduced to zero in most aviation markets from April to June. With no passenger throughput the revenues for most airports collapsed.

In response to the crisis, airports were quick to ensure they had sufficient available cash to pay their expenses by raising debt and suspending dividends. The large listed airports in our universe were able to raise significant amounts of debt. For example, Sydney Airport announced on April 20 that it had raised an additional A$850 million, Aena of Spain raised more than 1.9 billion euros in April and May while ADP of France raised 2.5 billion euros in April. The ability to quickly raise significant amounts of debt reflected the powerful earnings track record of airports and the expectation from debt providers that when the crisis is over airports will again generate reliable earnings.

The aviation industry has faced many demand shocks in recent times. Events such as the failure of airlines (for example, the failure of Ansett in Australia), the September 11 terrorist attacks on the US in 2001, the economic fallout from the global financial crisis in 2008, and the SARS disease crisis of 2002 to 2004 led to material reductions in aviation activity. After each shock, aeronautical activity rebounded strongly such that the number of passengers travelling quickly rose above previous levels. The desire to travel meant that the demand for long-distance mobility won out.

"… the impact of the covid-19 crisis on the aviation sector is unlike anything the industry has previously experienced."

Despite this track record, the impact of the covid-19 crisis on the aviation sector is unlike anything the industry has previously experienced. We expect that travel volumes will progressively return as the desire to travel reasserts itself but that the time period over which it takes to return to previous levels will be much longer than experienced in previous shocks. We have started to see the green shoots of aviation markets reopening—IATA has reported that from late May flight levels in South Korea, China, and Vietnam have risen to a point now just 22% to 28% lower than a year earlier while searches for air travel on Google increased by 25% by the end of May compared with the April low, albeit they remain 60% lower than at the start of the year. Despite these positive developments, much uncertainty remains around the near-term outlook for aviation and we remain cautious about the investment prospects for airports compared with other infrastructure sectors.

TOLL ROADS

Toll roads enable efficient transport of people and goods across and between communities. Progressive population growth in the community leads to demand for new toll roads because the existing routes—the untolled alternatives—are essentially running at capacity and the government does not want to pay for new infrastructure. The value proposition toll roads offer consumers is they reduce the time taken to complete a trip compared with the free alternative and they also improve the certainty of travel times.

> **"... we expect traffic to return to more normal levels over the medium term."**

The combination of government-mandated quarantines and the lockout of physical commerce has led to significant reductions in traffic on all roads. Italy's Atlantia owns interests in toll roads located in Spain, France, Italy and South America and has released data that shows that at the height of the crisis in Europe average daily traffic on its toll roads in Spain, France and Italy declined by more than 80% compared with a year earlier. While the covid-19 crisis has made movement around and between communities more problematic in the short term, we expect traffic to return to more normal levels over the medium term. Indeed, traffic is ultimately a function of population and economic development in the communities the toll roads serve. By the middle of June, average daily traffic for Atlantia's roads in Italy and France, where the lockdown conditions had been loosened, was down by 26% to 28%; that is to say, the level of average daily traffic had recovered from being more than 80% down to about 30% down. For Atlantia's roads in Spain, average daily traffic had fallen by approximately 50%, which reflected the stricter lockdown conditions still applying in Spain.

While toll roads will face a hit to earnings in the short term, we are confident that traffic and consequent earnings will return to more normal levels over the medium term. Indeed, given the natural reluctance of people to travel on public transport in the absence of a vaccine it might be that traffic levels return to pre-covid-19 levels relatively quickly.

RAIL COMPANIES

Rail companies are integral to the movement of goods across an economy. From agriculture to automotive parts to chemicals and coal, railroads serve practically every industry. In simple terms, rail companies charge shippers based on the volume of goods transported and the distance those goods are transported. A key risk faced by rail companies is the potential fluctuation in the volume of goods transported due to changing economic conditions. For example, the volumes transported by US rail company CSX declined by 15% in 2009 following the onset of the recession in the US.

The quarantining of communities and the shutting down of physical commerce have proved to be significant blows for rail companies. For example, the volumes transported by CSX declined by 21.5% in the second quarter of 2020 (the 12 weeks ended 13 June 2020) compared with the same period a year earlier, according to the Association of American Railroads. However, the US rail businesses are diversified across industries and we expect volume losses due to interruptions to supply and economic decline to be recouped as the US economy recovers. While conditions for rail remain poor and there remains much uncertainty surrounding the US economic outlook, the rail companies have seen improvement in volumes in June. Data from the Association of American Railroads shows that CSX volumes in week 24 of 2020 declined by 17.7% compared with the same week a year earlier, an improvement compared with week 19 of this year when freight volumes had declined by 26.2%.

While railroads will face a hit to earnings in the short term, we are confident that as the US economy recovers, rail will enjoy rising freight volumes. This will lead to a recovery in the earnings of rail companies.

COMMUNICATIONS INFRASTRUCTURE

Communications infrastructure refers to the structures, technology and connections that enable the transmission and routing of data. Communications infrastructure companies effectively charge rent, typically under long-term agreements, for the use of the infrastructure assets they have built. Key customers are telecommunications carriers and large enterprises. By sharing assets among multiple customers, communications infrastructure owners provide customers with a low-cost service while generating attractive returns.

The proliferation of smartphones and the rise of streamed media among other factors have led to an explosion in demand for data and fast connection speeds. This is expected to continue. US communications technology equipment giant Cisco has projected that global IP traffic will grow 200% between 2017 and 2022 while US wireless data traffic will grow 400%. Meeting this increased demand will require greater usage of existing infrastructure, which is often constructed with spare capacity, and investment in new infrastructure. Both will benefit communications infrastructure companies.

Communications infrastructure companies have been largely unaffected by the covid-19 crisis. Many customers have experienced increased network demand due to an increase in the number of people working from home. Further, in the US and most other countries, communications were deemed an essential service and investments in infrastructure exempt from quarantine orders. While increased near-term demand is unlikely to provide an immediate boost to revenues for communications infrastructure companies due to the nature of the contracts, investments by customers in response to more permanent shifts in behaviour are likely to support demand for their assets over time.

For consumers, social isolation and working from home have demonstrated the importance of high-quality broadband networks. As Jessica Rosenworcel, Commissioner of the US Federal Communications Commission, recently noted: "This pandemic has demonstrated conclusively that broadband is no longer nice-to-have. It's a need to have."

We expect the earnings of communications infrastructure companies to be highly defensive in response to this crisis and the outlook to remain positive as demand for data grows and network investment required to meet this demand is made.

ENERGY INFRASTRUCTURE

The energy-infrastructure companies in the strategy generate earnings by storing oil, gas and chemicals or transporting oil and gas across their pipeline networks. Energy-infrastructure companies are essential to the distribution of energy in communities and earn revenues based on long-term contracts with minimal direct exposure to commodity prices. As the bulk of revenues are derived under long-term contracts, a change in oil prices, such as the significant decrease in oil prices that occurred during the covid-19 crisis, typically only has a minor impact upon revenues and earnings. For example, Enbridge, a Canadian-domiciled energy-infrastructure company, has noted that less than 5% of earnings are linked to commodity prices.

The customers of energy-infrastructure companies are typically energy producers and these companies face reduced revenues and earnings due to a decline in energy prices. If these customers have solvency issues then this could lead to an increase in bad debts, but access to energy-infrastructure services is essential to the ability of energy companies to earn revenues; that is to say, the use of energy-infrastructure services is non-discretionary if energy companies want to get their product to their customers. Typically, the overwhelming bulk of customers are investment-grade credit quality. For example, Enbridge has noted that more than 95% of customers are investment-grade credit quality while APA Group, an Australian gas pipeline company, has noted that 93% of revenues are derived from investment-grade customers.

The shutdown of many businesses and any consequent slowdown in the economy could lead to a reduction in the volumes transported across energy networks. While the revenues energy-infrastructure companies earn from transporting oil and gas can change with movements in volumes, underwritten 'take or pay volumes' usually account for the majority of revenues so we assess their exposure to volume decreases as low.

"An investment in listed infrastructure can be expected to reward patient investors."

In terms of our outlook, we believe that infrastructure assets, with their reliable earnings that are protected to a degree from inflation, are an attractive long-term investment proposition. The predictable nature of their earnings compared with those offered by other asset classes means that infrastructure assets offer diversification benefits. In uncertain times, the reliable financial performance of infrastructure stocks makes them particularly attractive. An investment in listed infrastructure can be expected to reward patient investors.

Please keep safe and best wishes,

Gerald Stack
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Gerald

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