Scope for Enhanced Infrastructure Returns Amid COVID-19 Uncertainty

Key Takeaways

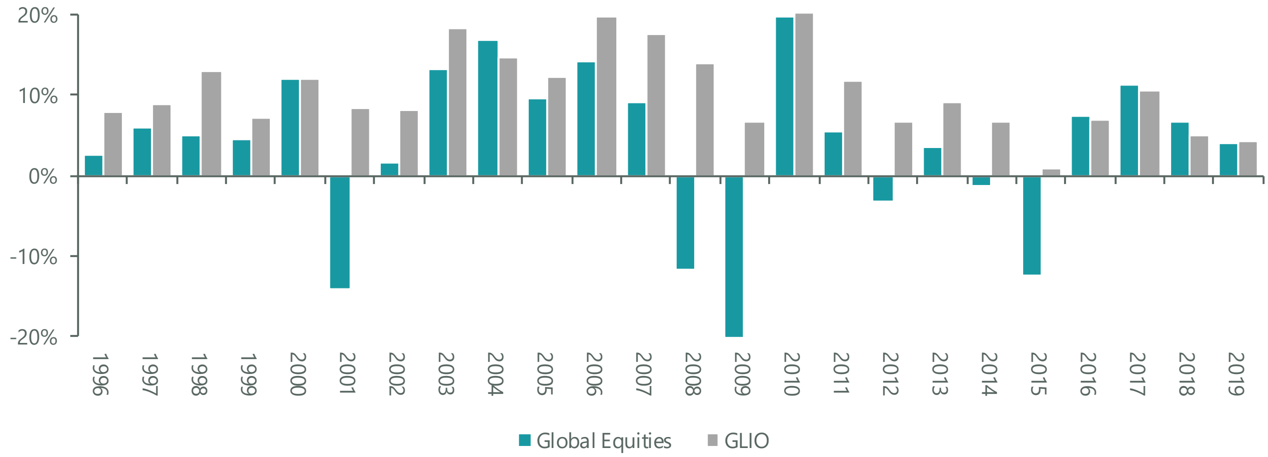
- The market has potentially mispriced both the earnings impact of the COVID-19 crisis and the market risk premium attached to infrastructure assets, allowing investors to manage risks and capitalise on emerging opportunities.
- Investors should retain flexibility in infrastructure capital deployment and the ability to manage exposure to different subsectors as assumptions, including the structural changes to behavior, economic conditions and sustainability considerations change going forward.
- Liquidity in listed markets allows specialist infrastructure managers the ability to access these opportunities while managing overall portfolio risk.

The premise of listed infrastructure investing is that while regulatory regimes and concession agreements are designed to produce outcomes over long periods of time, the majority of general equity investors have a shorter time horizon. This timing mismatch provides the opportunity for long-term investors to use liquidity to enhance infrastructure returns.

All manner of business models and investment strategies are being tested by the extraordinary measures which have been put in place to mitigate the spread of COVID-19. As the dust settles, investors will be examining their portfolios and re-evaluating the role of various allocations, asking how each asset exposure fits into their overall portfolio.

Across the equity market, significant uncertainty remains as to the profile and path of future earnings for most companies. That uncertainty extends to the length of the shutdowns and what a staged recovery looks like, the depth of the recession and what aspects of daily life may change structurally as a result of the pandemic.

Exhibit 1: Infrastructure Cash Flows More Predictable than Equities



As of Dec. 31, 2019. Source: Internal Calculations, GLIO. GLIO Index constituents equally weighted, trimmed mean 5% tails.
Global equities as measured by the Invesco MSCI World Index.

In this context, listed infrastructure is an ideal exposure. Infrastructure and utility companies are essential assets, typically monopolies or oligopolies, which are underpinned by regulation or long-term concession agreements. These characteristics lead to a more predictable future earnings path than general equities (and REITs), which makes it easier for the market to value these companies. It is also less risky to take a position in those names as their required return, or the cost of capital, is lower than that of other segments of the market.

Examining the 12-month change in earnings before interest, tax, depreciation and amortisation (EBITDA) for listed infrastructure companies and global equities, we find infrastructure and utility companies have displayed a much tighter range of cash flow outcomes than equity markets as a whole (Exhibit 1).

Earnings Expectations Vary and are Not Well-Priced by the Market

GDP-sensitive infrastructure sectors such as airports, toll roads and rail networks have clearly been impacted more severely by the restrictions of movement as a result of COVID-19. Exhibit 2 shows market expectations of different 2020 and 2021 infrastructure earnings measures (EBITDA, EPS or DPS) depending on what we believe investors are focusing on in each particular region and sector as well as the year-to-date performance as of June 15, 2020.

There is divergence among sectors and regions, both in terms of future expectations and how the market has priced those expectations. These differences create opportunities for specialist listed infrastructure investors who understand, and more importantly, who can price the nuances within regulatory regimes or cash flow profiles among different passenger/volume segments for transport assets.

While fairly limited in the case of utilities in different regions, the short-term range of potential outcomes for transport assets is still broad as the length of lockdowns and the staged recovery path will vary by asset type and location. Despite this, while on average utilities have performed better than most transport assets, the range of returns has still been broad.

Infrastructure assets are long dated in nature, generating cash flows and ultimately value for shareholders over multi-decade periods. The value of these companies is not materially impacted by short-term events, yet market pricing has moved dramatically.

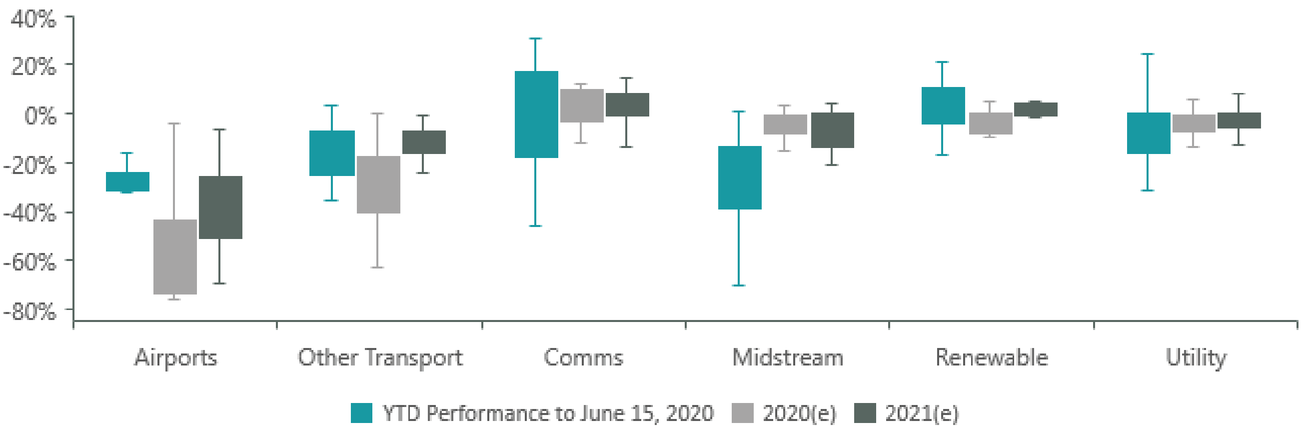
Case Study – Valuation Is Driven by the Long-Dated Nature of Cash Flows

By way of example, consider a simple, long-dated European transport company like Getlink and a single-state regulated U.S. utility, with revenue decoupling, like Edison International, for each of which market consensus expectations since December 31, 2019 have decreased (Exhibit 3):

Under a full lockdown, we believe that realistic (but simplified) operational scenarios for these assets are:

- Getlink: 5% utilisation for cars/Eurostar, and 30% for trucks/freight
- Edison International: Only maintenance capex allowed (i.e., no growth capex), due to social distancing restrictions, and 5% revenue impairment due to rising bad debts.

Exhibit 2: Infrastructure Earnings Expectations Show Divergence



As of June 15, 2020. Performance data: GLIO Index, with constituents equally weighted. Earnings estimate consensus: FactSet.

In both cases, there is no reduction in fixed costs for the period of the lockdown. We estimate the earnings impacts under these simplified scenarios are -80% for Getlink and -5% for Edison International.

We have modelled these operational impacts under base case and downside case lockdown and recovery periods and calculated the earnings measure impacts for these cases (Exhibits 4 and 5).

Assuming prices reflected fair value prior to the pandemic (which we believe was not the case for Edison International) the impact on underlying valuation versus the share price movement as of June 15, 2020, is shown in Exhibits 6 and 7.

Short-term impacts from COVID-19 mitigation efforts do not materially impact valuations. Longer term, there is a range of potential outcomes when it comes to when and how economies emerge from COVID-19 lockdowns and what (if any) structural changes may occur in behavior as a result of the pandemic. Liquidity is valuable in this environment as it is likely that a significant portion of the share price movement results from future earnings uncertainty and a change in the perception of the riskiness of the underlying asset, essentially the market risk premium attached to the assets.

Exhibit 3: COVID-19-Related Revised Expected Future Cash Flows, Getlink and Edison International

Type of Business	**Getlink** Long-Dated Transport Assets Connecting France and the U.K.	**Edison International** Single-State U.S. Utility
EBIDTA/EPS 2020 (Consensus)	-40%	-3%
EBIDTA/EPS 2021 (Consensus)	-20%	-1%

As of June 15, 2020. Source: FactSet.

Prior to the pandemic, U.S. utilities earnings yield for many years had been trading at a premium of ~250 basis points relative to the consensus forecasts of the two-year forward 10-year Treasury yield. That margin increased to over 400 bps through the recent crisis. As the Edison International example above demonstrates, the earnings of the utilities are not materially impacted; rather, it is the perception of the riskiness of the underlying asset that has increased as reflected in a more significant valuation compression than fundamentals warrant.

Liquidity enables specialist listed infrastructure managers to navigate this changing landscape using a deep understanding of regulation and concession agreements. This allows an assessment of why the market has potentially mispriced both the earnings impact of the crisis and the market risk premium attached to the assets, which allows an investor to manage risks and capitalise on opportunities as they emerge.

Liquidity Can Enhance Infrastructure Outcomes

Clearly, there are opportunities for investors to capitalise on mispricing in the listed infrastructure markets and as Exhibit 2 demonstrates there has been a broad range of outcomes across different sectors this year. There is anecdotal evidence of intra-period write-downs of a number of private market asset valuations (typically in the order of 5%–10%) depending on the subsector and even of some assets revalued

Exhibit 4: Earnings Impact of COVID-19 Mitigation Efforts by Quarter

Shorter Lockdown	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22
GET	–	-80%	-40%	-5%	-5%	-5%	-5%	-5%	Pre-pandemic Levels
EIX	–	-5%	-2.5%	Resumption of Pre-pandemic Levels					

Longer Lockdown	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22
GET	–	-80%	-40%	-40%	-25%	-10%	-10%	-10%	Pre-pandemic Levels
EIX	–	-5%	-2.5%	-2.5%	Resumption of Pre-pandemic Levels				

As of June 15. Source: Internal Calculations.

higher. High-quality, core infrastructure assets can be accessed via listed markets at discounts of 10%–30% depending on the asset type and location.

Liquidity in listed markets allows specialist infrastructure managers to access these opportunities while managing overall portfolio risk as assumptions, including the structural changes to behavior, economic conditions and sustainability considerations evolve.

Exhibit 5: Earnings Impact of COVID-19 Mitigation Efforts (Summary)

Shorter Lockdown	GET	EIX
2020	-31%	-2%
2021	-5%	–

Longer Lockdown	GET	EIX
2020	-41%	-3%
2021	-14%	–

As of June 15. Source: Internal Calculations.

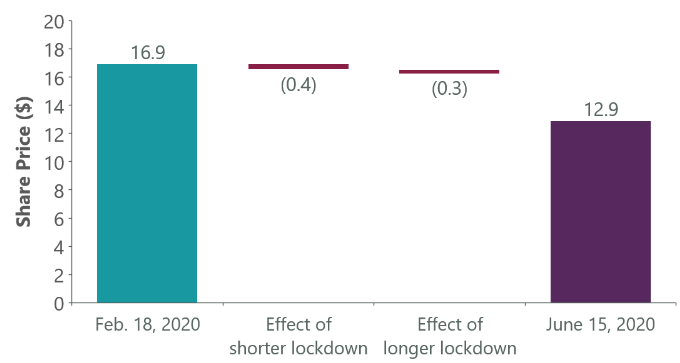
For investors not assuming a "V" shaped recovery, it is important to maintain exposure to utilities within infrastructure portfolios as these companies provide predictable and visible earnings and therefore more defensive returns and attractive income.

These allocations have proven their more defensive nature versus general equities time and time again. While impacted in the selloff, these companies generally provided investors protection when measured against their own domestic equity market.

Relative performance by utilities varied by market, which is partly a function of the relative valuation of the sector within each market going into the pandemic, as evidenced by U.S. utilities falling more than those in other countries. It is also a function of local market structure and other local factors, including the asset profile of underlying companies, local regulatory specifics as well as liquidity needs of local investors. In this context, global diversification is critical to managing overall portfolio risk and easy to achieve with a listed infrastructure portfolio.

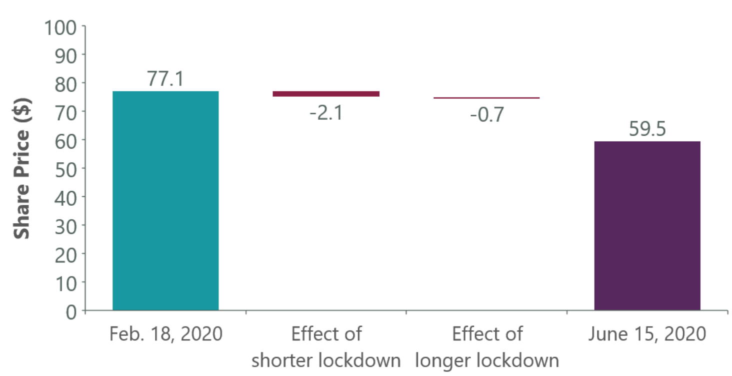
Getlink rose around 50% from its low in mid-March to June 15. As the example demonstrates, long-term infrastructure valuations are not particularly sensitive to shorter-term events. Liquid investors were able to capitalise on this opportunity where the skew to potential outcomes was significantly to the upside; however, a greater divergence of short-term earnings expectations exposes investors to greater sentiment-driven volatility.

Exhibit 6: Valuation Impact of COVID-19 Mitigation Efforts: Getlink



As of June 15, 2020. Source: Internal Calculations.

Exhibit 7: Valuation Impact of COVID-19 Mitigation Efforts: Edison International



As of June 15, 2020. Source: Internal Calculations.

A benchmark-unaware approach is an advantage in navigating the current environment. Investors in the listed market are able to protect capital and generate attractive income from the more defensive parts of infrastructure — the utilities — while uncertainty is heightened. They can then reduce exposure to the more defensive names and redeploy that capital into GDP-exposed infrastructure names as the investment risk-reward profile becomes more attractive. As signs of a recovery or limited further downside emerges, capital should be deployed to volume-sensitive infrastructure such as rail, toll roads and airports, where earnings, and dividends, are related to throughput or usage.

Exhibit 8: Utilities and Equity Returns in Early 2020 (Prior to May Rally)

	Domestic Equities	GLIO Utilities	Outperformance
UK	-20.8%	-2.7%	+18.1%
Australia	-16.0%	+0.9%	+16.9%
Europe	-20.5%	-4.4%	+16.1%
Canada	-12.4%	-0.8%	+11.6%
U.S.	-9.3%	-11.8%	-2.5%

Dec. 31, 2019, to April 30, 2020. GLIO Index utility constituents (all electricity, gas water) equally weighted. Domestic equity indexes: FTSE 100 (U.K.), S&P/ASX200 (Australia), Euro Stoxx 50 (Europe), S&P/TSX Composite (Canada), S&P 500 (U.S.).

Conclusion

While a general equity manager could broadly undertake the approach of pivoting from defensive to more GDP-sensitive areas of infrastructure, in a benchmark-relative context the overall exposure to infrastructure and utilities (and often the depth of coverage) would generally be low.

A manager of specialised infrastructure portfolios like RARE benefits from a focus on and an understanding of the future earnings profile of infrastructure companies, which is critical for assessing mispricing in the market. Analysing the efficacy of revenue decoupling (from volume) mechanisms or cross-checking analysis from one market versus another that is slightly behind the curve in terms of reopening and applying that to different regulatory regimes, for example, could yield important insights. We believe specialisation is more likely to yield the best return outcomes for the lowest risk to investors.

About the Author

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- 21 years of investment industry experience
- Joined RARE Infrastructure in 2012
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