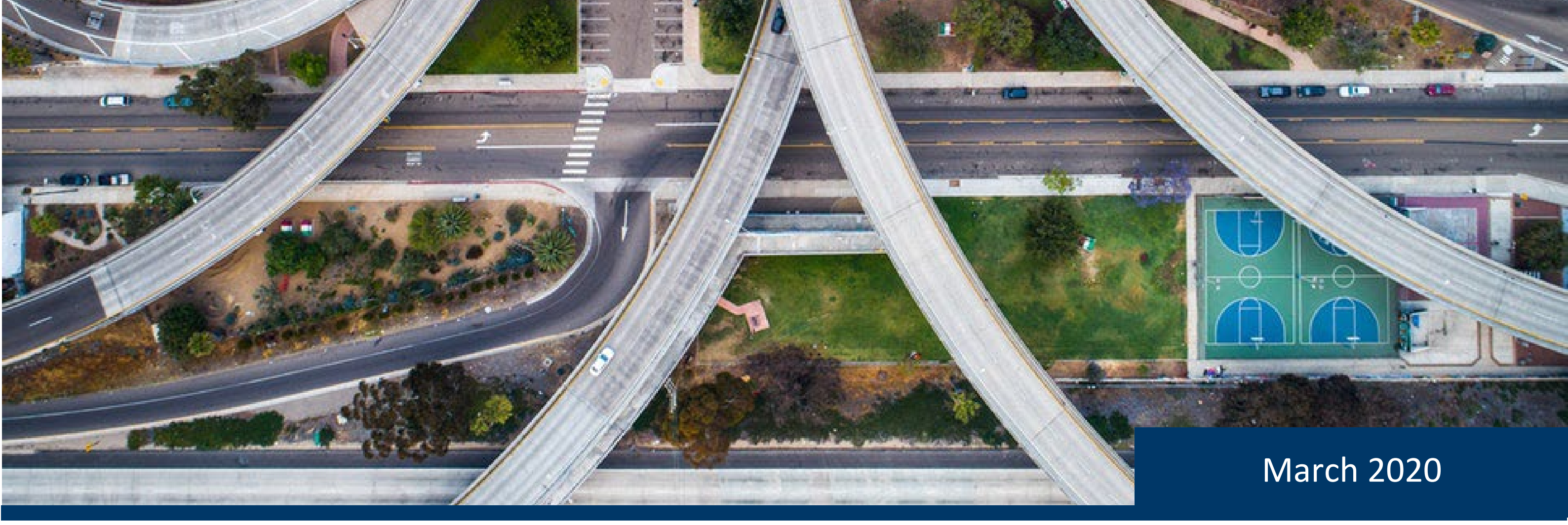


March 2020

# Understanding Infrastructure

Read RARE's specialist view on infrastructure and the key infrastructure characteristics we look for.

## Q. Firstly, what is Infrastructure?

Infrastructure is the physical assets that provide an essential service to society. Put simply, these are the services we use and interact with every single day. For instance, we use gas, water and electricity to carry out our daily activities and we also use infrastructure, such as rail and roads, to get from location to location.

Broadly, infrastructure can be categorised into two key buckets: regulated assets and user-pays assets.

With regulated assets, the regulator determines the revenues that a company should earn on their assets. If an asset earns too much, then the company is required to return some of its revenues to its customers by lowering prices. Conversely, if the asset earns too little, then the company is able to increase its prices. This mechanism leads to a relatively stable cash flow profile over time. Additionally, the regulator periodically takes into account inflation, which means price increases are often linked to inflation. As such, these assets also act as a good hedge for inflation.

With user-pays assets, a company's revenue is dependent on how many people use their assets. These physical assets, namely rail, airports, roads and telecommunications towers, move people, goods and services throughout an economy. Therefore as an economy grows, develops and prospers, these assets also typically grow. For instance, as more people use, and to some degree depend on mobile phone data, we see mobile communications towers adding additional capacity to the physical towers to meet this demand.

## Q. What is RARE's focus?

At RARE, we focus exclusively on global listed infrastructure. These are publically traded infrastructure securities such as the shares of electricity, water and airport companies. Listed infrastructure investors can enjoy the attractive characteristics of the infrastructure asset class which includes: long-term stable cash flows, lower correlation and beta to other asset classes and inflation protection while enjoying the added benefits of listed markets such as liquidity and lower fees.

Importantly, investing in the listed markets provides us with the flexibility to take advantage of market movements and to invest where we, as active managers, see value.

One point we feel strongly on is what exactly is meant by infrastructure. When we started RARE in 2006, we felt that the existing infrastructure indices were flawed in numerous ways. Based on what we see as the key characteristics of infrastructure, we have created proprietary investment universes, bespoke to the requirements of each of our three active strategies. This framework has remained unchanged since our firm inception.

## Q. What are the key infrastructure characteristics RARE looks for when determining if a company is a suitable investment?

The way we think of infrastructure investing is simple – the companies we invest in must meet three key criteria. Firstly the asset that the company owns must be a hard, physical asset. Secondly, this hard asset must provide an essential service to society or an economy. And lastly, there must be robust frameworks in place to ensure that we, the equity holders of the companies we invest in, get paid. This framework can be regulatory in nature or based on long-term concessional contracts. Both structures provide visibility over the company's ability to generate cash flow.

So when constructing our investable universe, the key characteristics we look for in a company come down to the stability of cash flows as well as the level of predictability of these cash flows. In assessing this we will also look at the political and legal framework the company operates in and their pricing power.

Across our three investment universes, the companies held are either regulated utilities or owners of long-term concessional assets. By their very nature, these types of companies provide us with a high-level of confidence that they will have cash flow generation well into the future.

The image below summarises what types of Infrastructure assets we focus on and which ones we exclude.

## Q. What doesn't RARE consider to be an infrastructure asset?

In constructing our investment universe, there are two main types of infrastructure assets that we avoid.

The first type is competitive assets that attract a higher risk relative to regulated and user-pays assets. Within the electricity sector, for instance, we are able to invest in the companies that own the electricity, transmission and distribution, however we exclude from our investable universe the companies that are exposed to wholesale energy prices. These companies generate electricity and then sell it back to the electrical grid. As such, they are subject to the forces of supply and demand which in turn reduces the predictability and reliability of their cash flows. This lack of cash flow predictability, among other things, increases their relative riskiness.

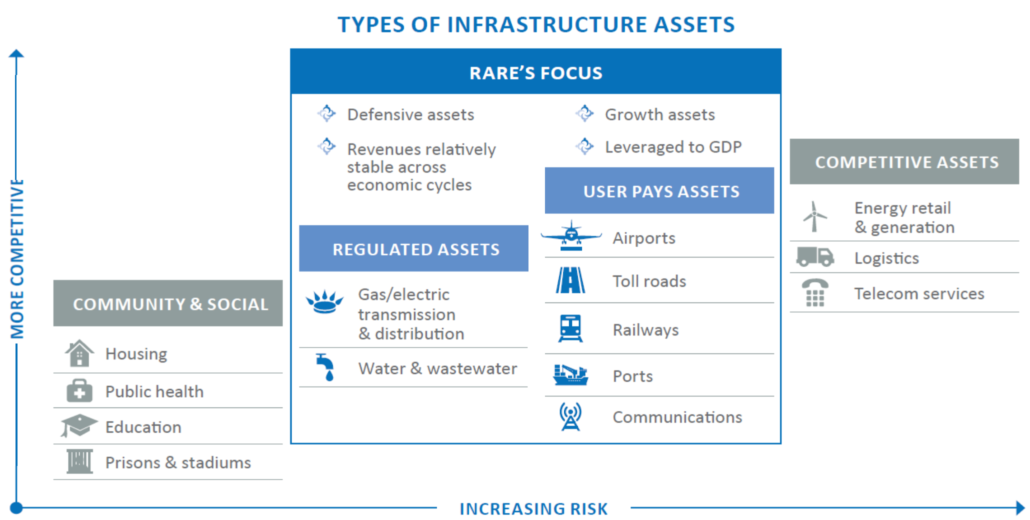
Airport services such as refuelling and baggage handling for instance, are also excluded from our investable universe. This is because the companies that provide these services do not own the hard assets and have merely won a contract to provide these services. As there are no barriers to entry, such as regulation or long-term concessional agreements, there are limited safeguards in place to prevent another service provider from undercutting them on cost at contract renewal. This lack of framework increases the relative riskiness of these types of securities.

The second type is community and social assets, which includes housing, public health, education and prisons. Firstly, these assets tend to be unlisted. As such, there are limited opportunities in the listed market. While these assets are not competitive in nature, we exclude them from our investable universe as they often include property exposure and or servicing and operating businesses. Generally their business models include availability based payments, often inflation linked, for a defined contract term. During this period, contracts are unable to be re-priced.

As a result, they have neither the protection of regulated assets in terms of the ability to reprice the contracts, say for changes in bond yields, or pass through of operating costs; nor the upside of infrastructure assets in terms of the benefit of volume improvements, namely exposure to economic growth. As a result, community and social assets tend to act as long duration assets with significant real bond yield exposure.

Understanding these risks is at the core of RARE's ethos and our name – '**R**isk-**A**djusted **R**eturns to **E**quity' – illustrates our belief that investing is not just about the best returns but is also about managing risk in portfolios.

### The Infrastructure/Risk Continuum




Source: RARE

**Important information**