



A Franklin Templeton Company

Infrastructure Multiples Point to a Potential Rerating

13 May 2024

Key Takeaways

- ▶ Despite headwinds to defensive stocks, infrastructure's strong earnings growth, attractive valuations and predictable dividend stream make us quite constructive on the sector.
- ▶ Strong population and industrial activity growth in some regions are boosting toll road traffic, while corporate and Chinese air travel have yet to reach pre-pandemic levels, suggesting airports could see further liftoff.
- ▶ Regulated utilities are entering into an elevated capex cycle over the coming decades, and regulators, particularly in Europe, are improving their allowed returns to help utilities finance that growth.

Strong Earnings, Attractive Valuations

For most of 2023 and into 2024, infrastructure sectors have had a tough time keeping pace with the risk-on sentiment of the broader equity market rally. Rising interest rates and the more defensive characteristics of infrastructure have been headwinds, particularly when data in the U.S. continues to point to the strength of the economy. Notwithstanding this, we remain constructive on the outlook for listed infrastructure, given the strong growth outlook through the medium term, driven largely by secular factors, combined with attractive valuations.

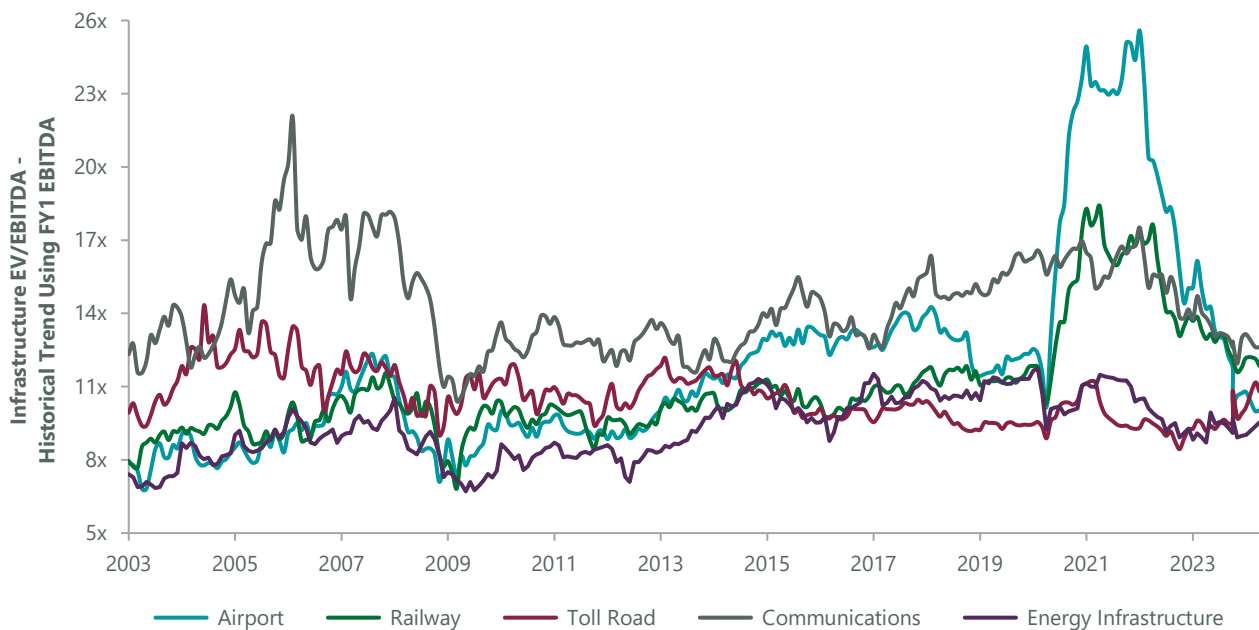
User-pays infrastructure such as airports, railways, toll roads and energy infrastructure multiples have now normalised to levels consistent with historical trading ranges (Exhibit 1), while growth prospects for regulated utilities, especially renewables, seem overly conservative.

Regional Dynamics Urge Selectivity in User-Pays Infrastructure

In toll roads, we continue to see strength across Europe and North America with traffic now at or above pre-pandemic levels. In some regions, such as Dallas–Fort Worth, in the U.S., strong population growth and industrial activity are driving traffic to levels well in excess of 2019; this benefits companies like Ferrovial, which has exposure to that service territory.

There is also strong traffic momentum in the airport sector, particularly those companies with higher exposure to leisure-based travel, such as Spanish airport operator Aena. Airport companies with more exposure to corporate travel and Chinese passengers, meanwhile, such as Frankfurt Airport and Aeroports de Paris, are still below pre-pandemic levels, so we expect further normalisation and recovery to come for those players. The return of the Asian passenger will be important for airports' retail business globally, given their high propensity to spend at airports compared to their average passenger.

Exhibit 1: User-Pays Infrastructure Consensus EV/EBITDA Multiples



As of 31 March 2024. Source: ClearBridge Investments, FactSet.

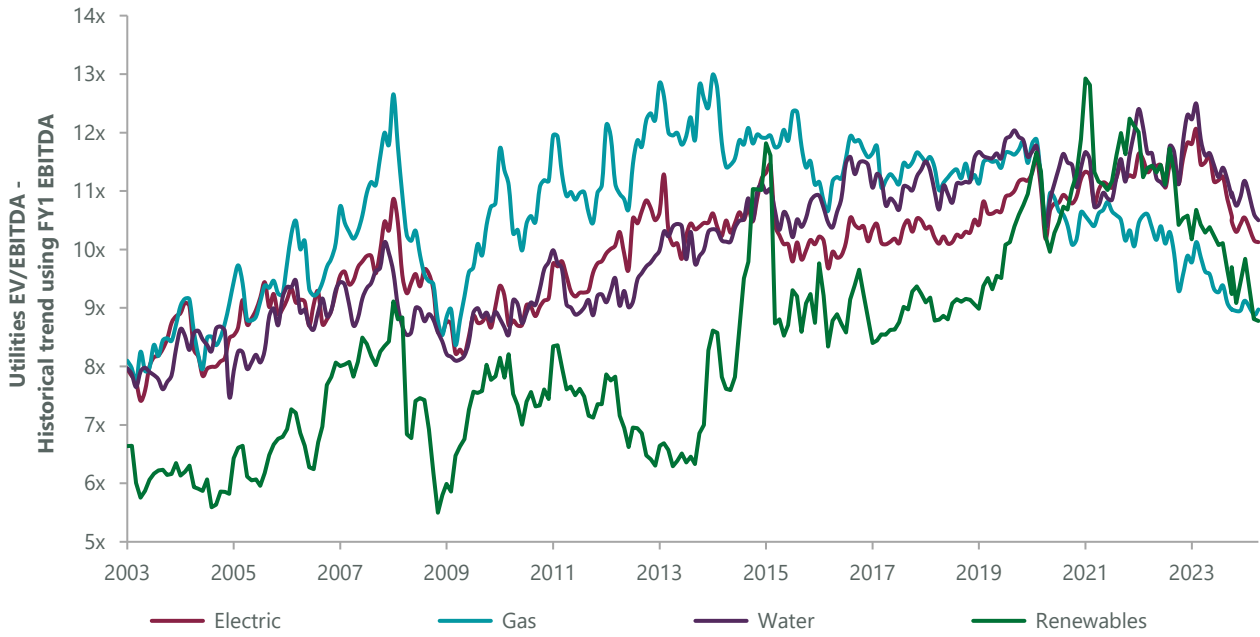
Cash flow generation for energy infrastructure and pipeline companies continues to grow modestly, despite the recent volatility in commodity prices. Midstream Infrastructure companies such as Pembina and Gibson Energy have revenue streams that are largely fixed fee-based and not tied to commodity prices, and they are remunerated by their oil and gas producer clients for the volume of molecules handled through their gathering, processing, fractionation and storage facilities. Given the expected production growth profile in coming years, these companies continue to expand their infrastructure asset base to support customer growth, while earning an attractive return for the capital invested, particularly for the brownfield expansion projects that leverage their existing footprint.

The communications sector has derated in recent quarters, largely due the inability of wireless communication tower companies to pass on the impact of rising interest rates in their long-term leasing structure. However, we believe that as we approach an environment of peaking interest rates, and if the Fed does indeed begin an easing cycle toward the back end of 2024, that will become a tailwind for the sector. In the meantime, companies such as American Tower and Crown Castle continue to grow revenues year on year as their telco customers roll out more 5G technology on their tower infrastructure.

Regulated Utilities Continue Inflation Pass-Through, Get Little Credit for Growth

On the regulated side, rising interest rates have been a headwind for the share price performance and multiples of utilities in recent months (Exhibit 2). That is despite their ability to pass on higher rates to customers through their allowed returns, which are negotiated with regulators. Fundamentally, we see the sector entering an elevated capex cycle over the coming decades, particularly electricity networks companies, which are building out infrastructure to support the energy transition. We have seen regulators, particularly in Europe, improve their allowed returns to help utilities finance that growth. An example is German power utility EON, which recently upgraded its five-year investment plan by 33% to €42 billion, as the regulator boosted the allowed weighted average cost of capital for new assets from 5.07% to 7.09% in recognition of the need to accelerate energy-transition-related investments to achieve decarbonisation targets. Ultimately, we see higher investments, higher asset base growth and higher returns, which should translate to sustainably higher earnings and dividends for shareholders through the medium term.

Exhibit 2: Utilities Consensus EV/EBITDA Multiples



As of 31 March 2024. Source: ClearBridge Investments, FactSet.

Support continues to be strong across the U.S. and Europe for renewables, but recent weakness in the power pricing environment combined with rising interest rates have impacted investor sentiment for the sector. Many renewable companies are now trading at levels that only give credit for the existing assets that are in operation and factor in no value for future growth, which we believe to be very conservative. Therefore, we view the sector as being very attractive from a valuation perspective, especially given growth driven by long-term secular themes such as the energy transition, digitisation and demographics.

While we continue to monitor short-term macro crosswinds, both user-pays infrastructure and regulated utilities provide stable, predictable cash flows through the medium term with a high degree of inflation protection through their contracts and regulation. Importantly, they provide essential services, which means cash flows are likely to remain resilient through a recessionary environment. This ultimately provides for predictability of dividends to shareholders. A good portion of infrastructure returns is underpinned by that predictable dividend stream, while the capital component is underpinned by secular growth drivers that predictably drive earnings growth over the medium term — something to remember, as not every market is risk-on.

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