ClearBridge
A Franklin Templeton Company

# Global Infrastructure Value Strategy

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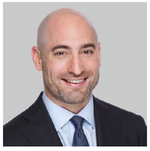

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## Key Takeaways

- Infrastructure assets trailed global equities in the first quarter amid a robust rally for equities, although March saw a reversal as cyclical strength and a slight sentiment shift for utilities helped infrastructure outperform.
- European utilities are heading into what we believe will be an elevated capex cycle over the next decade to support the energy transition and upgrade aging infrastructure.
- We have been increasing exposure to U.S. rails, which over the past two years have been in a freight recession as retailers were left with bloated inventory as consumers balanced their goods/services spending after exiting COVID-19 lockdowns.

## Market Overview

Infrastructure assets trailed global equities in the first quarter amid a robust rally for equities, in many ways a continuation of the bull market that began in late 2023 as softening inflation and resilient economic growth spurred risk-on sentiment. Defensive asset classes such as infrastructure outperformed equities in March, however, as cyclical sectors such as energy infrastructure did well and utilities began to get some credit for some of their long-term drivers, such as surging demand for electricity from AI-powering data centres.

Strong economic and jobs data and the return of the ISM Manufacturing PMI to expansionary territory led to higher energy prices and further solidified the soft landing narrative, helping midstream energy performance in the portfolio for the quarter. GDP-sensitive toll roads and rail also saw positive results. On the flip side, economic strength and the pushing back of potential interest rate cuts weighed on yield-sensitive sectors such as towers and long-duration renewable energy businesses.

On a regional basis, the U.S. and Canada was the top contributor for quarter, with U.S. electric utility Constellation Energy and U.S. rail operator CSX the lead performers. Constellation Energy is primarily a nuclear generation company and is the largest producer of carbon-free electricity in the U.S., serving states including New York, Illinois, Maryland, Pennsylvania and New Jersey. The company's combined generation capacity is more than 32 GW and 90% of annual output is carbon free. Constellation has been a beneficiary of AI and subsequent power demand as its 24/7 base load nuclear generation can get premium contracts.

Midstream remains a strong free cash flow story after deleveraging efforts throughout 2021–2023 and the lowering of capex plans.

CSX runs the second-largest listed U.S.-centric railroad in terms of market cap, owning over 20,000 miles of track and operating across 23 states mostly on the East Coast. CSX was an outperformer as quarterly results demonstrated best-in-class adjusted operating margins combined with continued volume recovery, which has surpassed expectations.

Portuguese renewables utility Energias de Portugal (EDP) and U.S. communications company American Tower were among the largest detractors. EDP is an integrated utility based in the Iberian Peninsula, operating electricity distribution, generation and energy supply businesses. It has a growing exposure to global renewables through its 83% owned subsidiary EDPR, which primarily consists of onshore wind farms. EDP also operates electricity distribution and generation businesses in Brazil. EDP's share price was negatively impacted by a focus on lower power prices, along with El Nino impacts across the U.S.

American Tower is a leading independent owner, operator and developer of wireless and broadcast communications infrastructure. The company has 41,000 sites in the U.S. and a further 139,000 sites across 19 countries, predominantly emerging markets (75,000 in India, 40,000 in Latin America and 18,000 in Africa). Shares underperformed as the market favoured more cyclical sectors, while tower stocks, being notably sensitive to interest rates, experienced further declines due to the uptick in bond yields.

### Portfolio Positioning

European utilities are heading into what we believe will be an elevated capex cycle over the next decade to support the energy transition and upgrade aging infrastructure. This is further supported by policy such as the REPowerEU, which incentivises investments. In the U.K., for example, over the next five years, the sector is proposing to invest £96 billion, or nearly double what was invested in the past five years. With higher capex and higher allowed returns, we think this translates to better earnings and dividends for our companies, while valuations are looking attractive.

We have been increasing exposure to U.S. rails, which over the past two years have been in a freight recession as retailers were left with bloated inventory as consumers balanced their goods/services spending after exiting COVID-19 lockdowns. However, with increasing evidence of a more normalised inventory-sales ratio following two years of destocking, and a strong consumer still spending, we believe this will trigger a restocking cycle, meaning rail volumes have likely bottomed and will inflect higher.

In European transportation, while earlier in 2023 we preferred toll roads over airports given uncertainty around airport traffic in the context of a potential recession, as of late 2023 evidence points to strong airport traffic, and we have adjusted exposure to reflect that in recent months. The coming year looks like another dynamic airport traffic year, so we remain positive on the sector.

U.S. utilities have been an unloved sector of late in the context of the bull market that has evolved as recession fears have subsided. We remain constructive on longer-term fundamentals, which are supported by the energy transition driving mid-single-digit rate base growth. Selectivity will be important here, as we now have the added theme of manufacturing reshoring (mostly in Southeastern states) and data centre growth (in Virginia, for example) driving long-term sales.

Other sectors where we are maintaining exposure are midstream energy, which remains a strong free cash flow story after deleveraging efforts throughout 2021–2023 and the lowering of capex plans, and communication towers, which are still seeing some pressure from higher interest rates, but expectations are that these will abate sooner rather than later, and we are sizing our exposure appropriately.

## Outlook

We remain generally balanced between more defensive regulated utilities and more GDP-sensitive infrastructure names. This served us well in 2023 in the face of uncertainty around growth and a possible recession. Given the strength of the data we are seeing for our infrastructure companies (e.g., freight volumes, traffic volumes), as well as broader economic data generally, the outlook for more GDP sensitive areas is improving.

## Portfolio Highlights

We believe an absolute return, inflation-linked benchmark is the most appropriate primary measure against which to evaluate the long-term performance of our infrastructure strategies. The approach ensures the focus of portfolio construction remains on delivering consistent absolute real returns over the long term.

On an absolute basis, the Strategy saw positive contributions from four of the eight sectors in which it was invested in the first quarter, with the electric sector the standout positive contributor and energy infrastructure, rail and toll roads the other positive contributors. The main detractors were renewables and communications.

Relative to the S&P Global Infrastructure Index and on a U.S. dollar basis, the Strategy underperformed in the first quarter, driven primarily by overweights to the rail and renewables sectors and stock selection in the energy infrastructure and airports sectors. Conversely, stock selection in the rail, renewables and toll roads sectors proved beneficial.

On an individual stock basis, the top contributors to absolute returns in the quarter were Constellation Energy, Ferrovial, CSX, Gibson Energy and Aeroports De Paris. The main detractors were EDP, American Tower, PG&E, Fraport and Severn Trent.

During the quarter we initiated a position in Brazilian electric utility Equatorial Energia. We also exited our positions in Australian toll road operator Transurban and U.S. electric utility PPL Corporation.