Building resilient returns for an uncertain future

By Matt **BUSHBY** and Fraser **HUGHES**

As the COVID-19 pandemic continues, the extraordinary measures aimed at mitigating its spread are testing business models and strategies. So what can be relied upon?

There is little clarity on the depth of the recession or what a staged recovery looks like, and predicting the daily economic habits which may change structurally is highly speculative. Investors are examining portfolios and re-evaluating their allocations, asking how each asset exposure fits this environment.

In this economic maelstrom, however, the fixed and essential function of the listed infrastructure sector make it a resilient long-term investment. Moreover, the stock market downturn opens an opportunity as many listed infrastructure companies are mispriced, as we discuss in Section 1.

The value of these companies is not materially impacted by short-term events, yet market pricing has moved dramatically in recent months.

On a longer horizon, there are characteristics governing the asset class which give it global growth opportunities and a predictability of revenue. We explore this in Section 2. Earlier in the journal we discuss the creation of a de novo infrastructure investment trust (IIT), as recommended in the recent G20/OECD report, aimed at allowing private capital to help strapped governments build and maintain essential infrastructure post-COVID and into the decades ahead.

All in all, there are key features of listed infrastructure which enhance its appeal at a time of uncertainty:

- The market appears to have mispriced both the earnings impact of the pandemic as well as the risk premium pinned to different infrastructure assets. This allows experienced specialist listed infrastructure managers to capitalize on emerging opportunities.
- Investors should retain flexibility in infrastructure capital deployment >

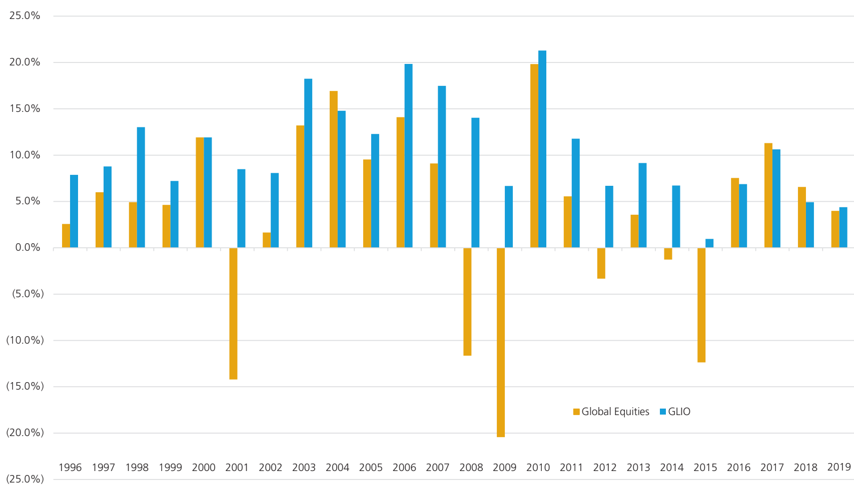
and the ability to manage exposure to different subsectors, as assumptions, including the structural changes to behaviour, economic conditions and sustainability considerations change going forward.

- Liquidity in listed infrastructure companies allows specialist managers to access these opportunities efficiently while managing overall portfolio risk.
- Available returns in 'core' unlisted infrastructure are trending lower; this reveals opportunities within listed infrastructure by contrast, and its complementary role within a blended infrastructure allocation.
- Many infrastructure companies, underpinned by regulation or long-term concession agreements, have a higher degree of earnings predictability compared with general equities and even REITs. This facilitates more accurate valuation assessment even during uncertainty.

"US utilities provide stable total returns of 10% per annum. Yet, they currently trade at a significant discount to the broader stock market and a record yield premium to bonds. We view this as a gift to long-term investors."

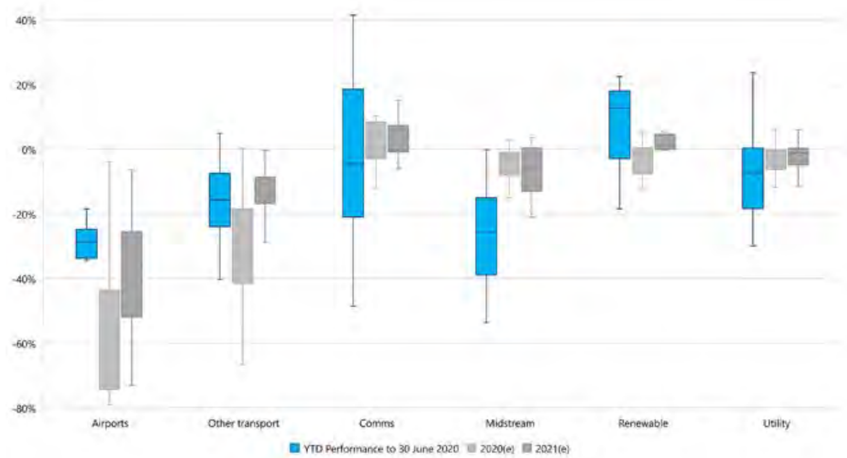
Steve Fleishman, Wolfe Research

Figure 1: Infrastructure cash flows more predictable than equities



Source: ClearBridge RARE internal calculations using Factset and GLIO data, as of December 31, 2019. GLIO Index constituents are equally weighted, trimmed mean 5% tails. Global equities as measured by the MSCI World Index.

Figure 2: Infrastructure earnings expectations show divergence



As of June 30, 2020. Performance data: GLIO Index, with constituents equally weighted. Earnings estimates 2020 & 2021

Misconceptions in the sell-off

Infrastructure assets are long-dated in nature, generating predictable cash flows (see Figure 1.) and ultimately shareholder returns over multi-decade periods. The value of these companies is not materially impacted by short-term events, yet market pricing has moved dramatically in recent months.

Examining the 12-month change in earnings before interest, tax, depreciation and amortization (EBITDA) growth for the GLIO Index-listed infrastructure companies and global equities is instructive here. Since 1996, listed infrastructure EBITDA has grown consistently year-on-year, approximately 9% CAGR. Global equities, represented here by MSCI World, has a 7% CAGR. Over the 24-year period, equities EBITDA declined in six of the years under analysis. The GLIO Index has remained consistently in positive territory.

Understanding and pricing the nuances for different regulatory regimes and cash flow profiles, as well as the among different passenger and volume segments for transport assets, reveals bargains for specialist listed infrastructure managers.

The travel and activity limits imposed to constrain the pandemic have clearly hit GDP-sensitive infrastructure sectors such as airports, toll roads and rail networks severely.

Subsequently there is a divergence of earnings expectations among and within the infrastructure sectors and across

Figure 3: Similar assets – measures undertaken by Oceania Airports.

Auckland Airport	Melbourne Airport	Brisbane Airport	Sydney Airport
Equity issuance of NZ$1.2 billion Dividend suspension until December 2021 Opex control & substantial capex reduction	Suspended dividends for fiscal 2020 & 2021 Opex controls Capex reduction fiscal 2020 and 2021, active management Liquidity support through additional bank lines	Dividend suspension for fiscal 2021 & 2022 **Monetization of cross currency swaps** Opex reduction; capex reduced / deferred Additional banking lines to support liquidity	Additional A$850 million in bank lines Opex cuts Capex controls, minimum plans Suspended dividends for 1H2020; suspension for 2H2020 also likely
Perth Airport	**Adelaide Airport**	**Christchurch Airport**	**Wellington Airport**
Opex reduction Capex reduction & growth plan deferred for now **Monetization of cross currency swaps** Suspended distributions for 2H2020 and fiscal 2021	**Monetization of cross currency swaps** Opex & capex controls Suspended dividends for fiscal 2021; moderated for fiscal 2022 Liquidity support through additional A$150 million bank lines	Some opex control Capex control for next two years Dividend suspension for 2HY2020, fiscal 2021 & 2022 Additional bank lines	Opex control & capex with flexibility No dividends for fiscal 2021 and 2022 Stand-by equity support

Source: From S&P Pacific Airports Update – June 18, 2020

"Resilient companies – companies that deliver enduring value – are built on a foundation of responsible business practices. At WEC Energy Group, thanks to our stable cash flows and our ongoing investment in essential infrastructure, we're providing investors with consistent returns and the environmental leadership they're looking for."

Gale Klappa, Executive Chairman, WEC Energy

Figure 4: Utilities and Equity Returns in early 2020 (prior to the May rally)

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

December 31, 2019 to April 30, 2020. GLIO Index constituents equally weighted. Domestic equity indexes: FTSE 100 Index (UK), S&P/ASX200 Index (Australia), Euro Stoxx 50 (Europe), S&P/TSX Composite Index (Canada), S&P 500 Index (US)

regions, and discrepancies in how the market has priced them.

These gaps create opportunities; understanding and pricing the nuances for different regulatory regimes and cash-flow profiles, as well as the among different passenger and volume segments for transport assets, reveals bargains for specialist listed infrastructure managers.

Market expectations for 2020 and 2021 infrastructure earnings are seen in Figure 2, where we have mapped consensus EBITDA or EPS forecasts depending on what we believe investor focus is in each region and sector, versus the corresponding year-to-date performance as of June 30, 2020.

Looking at consensus earnings, utilities and renewables show a tight range for 2020 into 2021 as might be expected. This is generally reflected in the median company holding up better than transport-related sectors, however, there has been a surprisingly wide range of outcomes. In communication infrastructure, towers are ahead YTD and earnings growth is forecast, while satellites have struggled. >

We look at energy transportation (or midstream) in a separate article, but the double whammy of the oil-price shock hit share prices hard in the first quarter. While the sector has recovered some share-price losses, the sector's relatively narrow range of consensus earnings for 2020 and 2021 could highlight either opportunities for investors or reflect longer term headwinds from an increased focus on sustainability considerations, depending on an investor's timeframe.

Obviously, airport earnings will fall in 2020 and are forecast to partially recover in 2021, but estimates over the period vary widely. Broadly, other transport such as railroads, roads and marine ports are hit to a lesser extent as airports, but there are nuances within this group too.

Subsequently, high-quality, pure infrastructure assets can be accessed via listed markets at discounts of 10-30% depending on the asset type and location.
Generally regulated utilities and renewables' uncertainty is fairly limited because of the essential nature of the service provided. Performance has outpaced most transport assets which are sensitive to the length of lockdowns, staged recoveries, asset types and locations.

Nevertheless, as a case in point, prior to the pandemic, US 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 has increased to over 400 bps through the recent crisis, and this presents an opportunity given the sector's defensive nature.

Notwithstanding the clear difference between transport and utilities, the range of share price returns has actually been wider in utilities compared to transport. This may be reflective of the 'generalists' in the sector, and the number of large utility companies quoted in headline generalist indices like the S&P 500, FTSE 100, CAC40, etc.

On a long-term investment horizon, we are broadly confident that short-term impacts from COVID-19 will not materially affect valuations. In the short to mid-term, there is a wide range of potential outcomes regarding when and how economies emerge from lockdowns and what structural changes may occur in economic behaviour as a result.

As a result, liquidity is valuable in this environment as a likely significant portion of the short-term share price movement results from earnings uncertainty rather than a change in the underlying asset. Specialist listed infrastructure managers have experience to take advantage of the current disconnects using their understanding of regulation and concession agreements.

Regarding private market assets, there is anecdotal evidence of intra-period write-downs of a number of valuations. Some Australian Super funds wrote down private market real estate and infrastructure investments between 5% and 10% in the first quarter, depending on the sub-sector. Oddly, there have even been stories of some assets re-valued up!

EDHECInfra, who issue the most up-to-date unlisted benchmark series, valued the first quarter down 6.4%, with unlisted airports down 10.2%.

Regulation underpins long-term returns. Whether an infrastructure investment is held in listed or unlisted form, the key driver of asset-level risk and returns is regulation.

It is helpful to remember that irrespective of valuation methods, the underlying assets and issues faced by management remain the same. Figure 3. highlights the similar measures taken by Oceania airports in 2020. Sydney and Auckland Airports being the two listed airports of the eight.

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 defensive returns and attractive income.

These allocations have continually proven their resilience versus general equities, and this was repeated during the most recent sell off.

Utilities' relative performance is partly a function of the regional valuation of the sector before the pandemic, as evidenced by US utilities falling more than peers in other countries. It is also a function of local market structure (for example an equally weighted S&P500 was down -16% over the same period highlighting the strong contribution from a small number of sectors and individual companies). In this context global diversification is critical to managing overall portfolio risk and easy to achieve with a listed infrastructure portfolio.

An approach which ignores benchmarks can also reap additional rewards in this environment.

While a general equity manager could broadly pivot from defensive to more GDP-sensitive areas of infrastructure in a benchmark context, the overall exposure and likely depth of coverage would be lower.

A specialist infrastructure manager, however, benefits day-to-day from deeper understanding of the future earnings profile of infrastructure assets they own. Ultimately a fundamental knowledge of key drivers such as contract structures and regulation are critical in ascertaining whether the broader market has mispriced a company.

Figure 5: Global infrastructure assets

Investable Market USD (billions)	North America		Europe		Asia Pacific		Developing		Totals	
	Unlisted	**Listed**	**Unlisted**	**Listed**	**Unlisted**	**Listed**	**Unlisted**	**Listed**	**Unlisted**	**Listed**
Community & Social	26	–	39	–	18	–	20	–	102	–
Regulated Assets	183	2,121	111	631	43	177	101	535	437	3,464
User Pays Assets	122	657	179	303	65	201	205	202	571	1,364
Competitive Assets	421	–	403	–	111	–	444	–	1,379	–
Total (Infrastructure)	751	2,778	731	934	237	379	770	737	2,490	4,827

As of April 30, 2020. Source: ClearBridge RARE internal calculations FactSet, Preqin. Privately held assets that have not been transacted in the past 10 years are not considered "investable" due to their unavailability to private buyers

Global growth opportunities – recap

The infrastructure opportunity set is large. Depending on how broadly infrastructure is defined, there are $50–$75tn of infrastructure assets globally.

Most infrastructure assets remain under public (government) ownership and are therefore not accessible to private investors. In the USA alone, the value of public sector assets is in the $30-$40tn range, although the exact number is unknown as the country does not have a balance sheet.

This aside, we estimate that, on a narrow definition, roughly $7tn in global infrastructure assets are privately owned, of which listed infrastructure accounts for 70%, or $5tn, of asset value (approximately $2.5tn in equity value).

There is also sound evidence that the investable universes for listed and unlisted infrastructure are complements rather than substitutes as large regional and business operations differences are evident.

First, they offer diverse subsector exposures (Figure 5):

- Community and social assets, such as schools, universities, hospitals and government facilities that help deliver social services.[1]
- Regulated assets, such as water, electricity and gas transmission and distribution, for which a regulator determines the revenue a company should earn on its assets.
- "User pays" assets, such as rail, airports, roads and telecommunications towers, which move people, goods and services throughout an economy and where pricing, volume and revenue are determined by how many people use the assets.
- Competitive assets, such as telecommunication and utility retailers.[2]

Some assets, such as community, social and competitive assets, are more commonly available in the private, unlisted market. The listed infrastructure market, however, provides much more depth in regulated utilities and "user pays" assets – high-quality core infrastructure assets that are more liquid. These are the assets that make up the GLIO Index.

Second, our assessment of the infrastructure asset class shows there are also meaningful differences in risk exposures for the listed and unlisted universes, which can lead to different observed performance (Figure 5). This suggests these universes are not substitutes; rather, they are complementary.

Different subsector and risk exposures allow investors in both listed and unlisted infrastructure the opportunity to improve portfolio construction efficiency and control unintended portfolio biases or risks.

Regulation underpins long-term returns. Whether an infrastructure investment is held in listed or unlisted form, the key driver of asset-level risk and returns is regulation. The returns "allowed" by the regulator are a critical driver of long-term asset-level returns and the operating conditions or constraints imposed by the regulator are key ongoing risks to be managed or mitigated.

Regulated case studies

As examples of how deep regional and sectoral knowledge can reveal opportunities, we would highlight the US utility sector where compounded company-reported return on equity (ROE) has exceeded regulator-allowed ROE by approximately 30 basis points per annum since 2001. This shows companies outpacing regulators' operating assumptions and agreed business cases, as is normal for many regulated utilities in the USA. The >

"The UK listed water companies have a good track record of performance and none more so than United Utilities. The sustainable improvements we have delivered in operational performance, supported by a strong balance sheet and effective investment, gives us every confidence in delivering value across the 2020-2025 regulatory period."

Steve Mogford, CEO, United Utilities

1 Not covered by the GLIO Index
2 Not covered by the GLIO Index

Liquidity is valuable in this environment, as a significant portion of the short-term share price movement likely results from earnings uncertainty, rather than a change in the underlying asset.

investment case can be found in full here.[3]

Our second case study is the UK water industry, where a change in policy aimed at rewarding better-run companies took place in the 2016–2020 regulatory period. British regulators are now agreeing on a series of operational and customer-engagement benchmarks with companies and attaching financial penalties or incentives to the outcomes. This is an opportunity for active infrastructure investors to allocate to the better performers.[4]

3 *https://www.rareinfrastructure.com/insights/the-listed-infrastructure-opportunity/*

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