Alphinity
INVESTMENT MANAGEMENT

Sector spotlight

March 2015

Each quarter, Alphinity Investment Management's portfolio managers share their expert views on the trends and themes emerging within their relevant sectors. This quarter, **Andrew Martin** shares his thoughts on the current trends and outlook for the **infrastructure sector**.

Who: Andrew Martin

Role: Principal and Portfolio Manager

Sector responsibilities: Financials, transport, infrastructure

Industry experience: 17 years

What are infrastructure assets?

Infrastructure typically refers to large capital assets that make up the basic physical structure of a country and are essential for the functioning and growth of an economy. These include roads, bridges, ports, rail, airports, communication and energy infrastructure. In a listed investment sense, there are some parallels with the utility sector which are typically monopoly-style, highly regulated assets involved in generation and distribution of essential services such as electricity, gas and water.

What are typical investment characteristics of infrastructure assets?

Infrastructure assets typically have a multi-decade life, and usually provide a stable, defensible income stream that may be indexed over time, providing some inflation hedge. Infrastructure assets generally have some flexibility around commercial pricing (as opposed to regulated returns seen in the utility sector), although are exposed to volume risk, for example, the number of cars on a toll road. Given the monopoly-like nature of these assets as well as high public reliance, there is often some regulatory and pricing oversight to ensure this position is not abused.

What are key differences to look for in infrastructure assets?

- **Risk to revenues:** for example, the number of cars on toll roads may be more stable than airline passengers;
- **Pricing power:** including regulatory oversight and any contracted indexation;
- **Capital structure:** i.e. how much debt is held;
- **Ownership structure:** for example major influencing shareholders, percentage of assets owned, and whether internally or externally managed;
- **Remaining life of asset:** many infrastructure assets are leased from the government – the longer the lease remaining the better and more certain the cash flows;
- **Competition:** is it a monopoly style asset?; and
- **Growth opportunities:** for example, new toll road opportunities such as NorthConnex in Sydney.

Alphinity
INVESTMENT MANAGEMENT

Why has infrastructure done so well since the GFC?

Infrastructure assets tend to provide a relatively consistent return over a long period of time, with reliable cash flows. Earnings are generally highly forecastable and very defensive in nature. Stable growth assets with a strongly defensive yield have become highly sought-after as global interest rates have fallen to record lows and growth has been hard to find, or proved illusory. These factors, combined with the investment volatility brought about by the GFC, have seen many pension funds globally conclude that infrastructure returns are a good match for their long term liabilities, creating more demand for these assets.

The infrastructure asset boom has been going on for some time in the unlisted sector as pension funds and infrastructure funds have moved to directly buy and manage physical assets rather than their managed listed equivalents. Those prices have been flowing into the listed equity space more recently, pushing the sector higher.

What is the outlook for infrastructure?

As long as the relative yields, plus the growth in those yields, remain attractive relative to bonds and other asset classes (when adjusted for risk), the sector will remain in favour. Whilst that gap has closed significantly, the global outlook for growth and interest rates has generally fallen, maintaining interest in the sector in a 'lower for longer' cycle (i.e. growth and interest rates are expected to stay low for some time).

Infrastructure may be 'expensive' relative to history but the certainty is materially higher relative to many other asset classes. Opportunities for growth also exist in the sector: as governments lower spending, opportunities for the private sector to invest increases. Conversely, in a period where yield curves steepen (by long-dated bond yields going up) and growth opportunities improve elsewhere, these stocks will suffer relatively. For example, if US interest rates rise due to an improvement in the US economy, there may be a steepening of its yield curve making bonds or US domestic cyclicals relatively more attractive, causing demand to wane for the infrastructure sector.

We have some sympathy for the 'lower for longer' theme, especially in Australia, but recognise the valuation risks, so for us it comes down to having a balanced approach between the micro and macro factors, and finding listed infrastructure assets that display relatively better valuation appeal as well as better growth opportunities than the market expects.

Interestingly, listed infrastructure asset prices still lag those seen in more recent unlisted transactions. For example, Indiana Toll Road in the US was recently acquired for a multiple of 32x Enterprise Value (EV) to Earnings before Interest, Taxes, Depreciation and Amortisation (EBITDA). Port of Newcastle was acquired for 27x EV/EBITDA. Whilst acquisition multiples are typically somewhat higher than listed multiples, these sit well above those of Australian-listed infrastructure stocks including toll road owner Transurban, Sydney and Auckland Airports and Macquarie Atlas Roads, (as well as 'infrastructure like' stocks such as rail company Aurizon and gas pipeline company APA).

For more information please contact our Investor Services team on 13 51 53 or visit alphinity.com.au

Disclaimer

The information contained in this publication is current as at March 2015 and is provided by Alphinity Investment Management Pty limited ABN 12 140 833 709, AFSL 356895 ('Alphinity'). The information is intended solely for investors in Alphinity's funds, holders of an Australian Financial Services License or other wholesale clients as defined in the Corporations Act 2001 (Cth). It should be regarded as general information only rather than advice. A reference to any security is not a recommendation to buy. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on such information, consider its appropriateness, having regard to their objectives, financial situation and needs.

18415/0715