Global Listed Infrastructure
The impact of inflation and interest rates

By Trent Koch, Portfolio Manager

Vaccine rollouts and government stimulus have led to expectations of higher economic growth, inflation and interest rates. This has put pressure on listed infrastructure returns with the asset class significantly underperforming global equities over the past 12 months. But with over 70% of the investible universe able to pass through the cost of inflation to consumers, are these fears overblown? Global Listed Infrastructure Portfolio Manager Trent Koch explains why inflation can be positive for many infrastructure assets and how market uncertainty has created a compelling investment case for the asset class.

Why are investors concerned about higher inflation today?

The COVID-19 pandemic caused the deepest global economic recession in nearly a century. Global growth slowed, unemployment increased and the transportation of people and goods were severely disrupted. In response, central banks and governments are now seeking to aggressively stimulate their economies. The likely results of this stimulus are increased global growth and higher inflation.

It's important to note that not all inflation is bad. Governments around the world often target a 2-3% inflation range and most countries have been trending well below that 'ideal' target band. Inflation is concerning when it is sustained and aggressive, because this can lead to economies becoming overheated. When economies overheat, central banks often raise interest rates in order to contain inflation.

Should rising interest rates worry investors in infrastructure?

The characteristics of infrastructure assets (stable, long-life; cash generative; low sensitivity to the economic cycle) makes them relatively sensitive to changes in interest rates, compared to global equities.

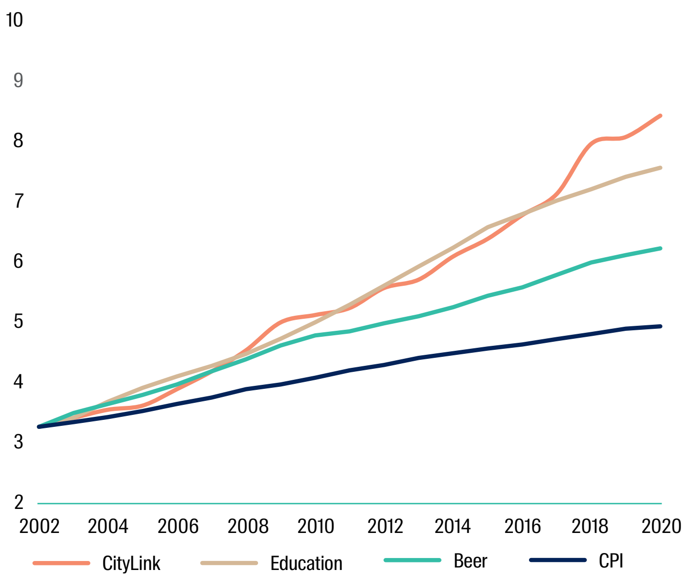
Importantly, the impact tends to vary depending on whether rising rates are being driven by higher inflation, or by real economic growth.

Inflation-driven

Where rising interest rates are a reflection of higher inflation, listed infrastructure fares relatively well. Infrastructure companies have a proven ability to pass through higher inflation to their customers (typically with a 6 -12 month lag). Most infrastructure assets have an explicit link to inflation through regulation, concession agreements or contracts. Those assets without an explicit link often have the pricing power to deliver a similar (or better) outcome, reflecting their strong strategic position.

Transurban is a good example of a stock with this pricing power. The company owns 21 toll roads in Australia and North America, most of which have the ability to increase tolls by inflation or better.

Toll increases compared to CPI components Australia

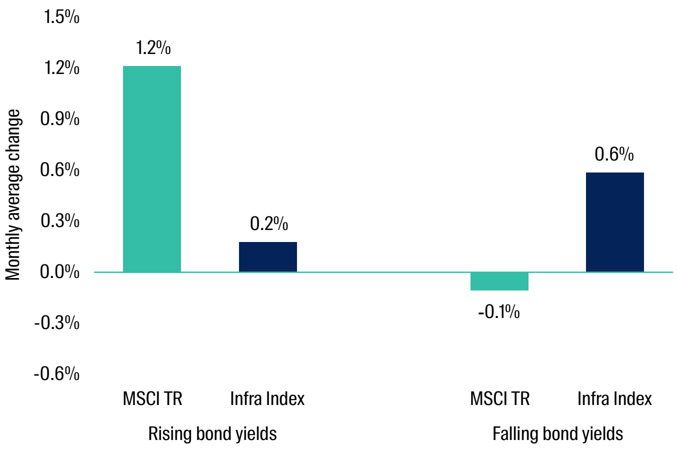


CPI component indices rebased to CityLink toll A$
Source: Bloomberg and First Sentier Investors
Data as at 31 December 2020

Real growth

Where rising interest rates reflect accelerating real economic growth, listed infrastructure tends to lag as investors shift from defensive to growth equities. Evidence of this is illustrated in the following chart.

Performance in Rising/Falling Bond markets



Benchmark is FTSE Global Core Infrastructure 50-50 Net TR USD Index from 1 April 2015 (previously UBS Global 50-50 Infrastructure & Utilities Index Net TR, USD).
US 10-year Bond Yield
Source: First Sentier Investors
Monthly data from 31 Oct 2007 to 31 March 2021

The two halves of this chart show how global equities and listed infrastructure have performed during periods of rising and falling interest rates (represented here by US 10-Year Treasury yields) respectively.

The right hand side of the chart shows that in every discrete month since October 2007 in which US 10-year Treasury yields fell, global equities returned -0.1%, on average. The global listed infrastructure index performed better in this environment, rising by an average of +0.6% as infrastructure assets benefitted from the tailwind provided by lower rates.

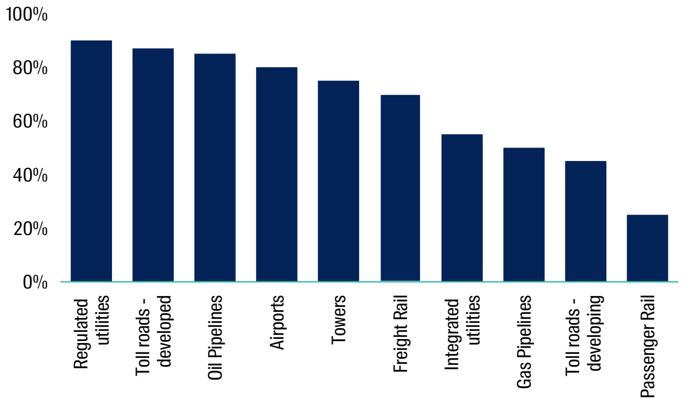
In contrast, when US 10-year Treasury yields rose, global equities delivered an average return of +1.2%. The global listed infrastructure index also on average delivered a positive return, but to a lesser extent, returning +0.2% on average in these months.

Are infrastructure assets vulnerable to higher inflation?

Some investors have taken the view that rising inflation will lead to higher interest rates. This has put pressure on listed infrastructure valuations. There are concerns that listed infrastructure companies may be forced to spend a higher proportion of their earnings on interest payments; and that profits could be eroded by rising inflation.

However, we estimate that more than 70% of the assets we invest in have the ability to pass inflation through to the end customer, insulating investors from its impact.

Degree of inflation protection by sector



Source: First Sentier Investors
Data as at 31 March 2021

What impact could higher inflation have on infrastructure assets?

The impact of inflation on listed infrastructure assets depends on a number of factors, including:

Type of asset

Regulated assets such as utilities are more likely to have government agreements in place that dictate how costs can be passed onto consumers. They tend to be less sensitive to both dips and peaks in economic activity, making them more defensive and well-positioned for a slowing economy. The benefit of including such assets in a portfolio was demonstrated in 2020, when usage remained stable (relative to roads, air and rail) and revenue did not contract significantly.

For example, UK water utilities earn a real return on regulated assets, with inflation essentially being a pass-through. US electric and gas utilities operate within regulatory frameworks which enable them to earn an allowed rate of return on money spent maintaining or improving their asset base. While this rate is fixed for each regulatory cycle (which tend to last between one and three years), the allowed rate of return of the next cycle can be adjusted upwards if needed, to reflect a higher inflation environment.

Agreements in place

Some contracts explicitly allow user costs to rise when inflation does. Others are more complex and look at a range of factors beyond inflation, such as operating and capital expenses. The nature of these contracts depends on the country, the type of asset and the regulations in place. Many toll roads, for example, have concession agreements that specify how prices can be increased, with an option to follow the Consumer Price Index (CPI) or an agreed percentage – whichever is higher.

Revenue drivers

In growth assets such as road transport, airports and rail, revenue is based on volume of users, and is therefore more sensitive to economic activity. If the contract allows inflation and other increased expenses to be passed on, then they are particularly well-positioned in a rising inflation environment.

Inflation rate

For assets with an agreed price rise in their contracts, the actual inflation level matters. For example, some mobile towers include price escalators in their contracts at a set amount, e.g. 3%. If inflation is lower than this, the asset owner benefits from the price increase. Conversely, an inflation rate higher than this will disadvantage the owner.

How does your portfolio change depending on inflation expectations?

Part of our job as active managers is to take interest rate expectations into account when positioning portfolios. We are able to shelter portfolios from the impact of rising rates by tilting away from "income" infrastructure sectors such as utilities; and increasing holdings in "growth" infrastructure sectors such as roads and railways.

While macroeconomic conditions play a part, the impact of inflation also depends on particular companies and their assets. As bottom-up investors, we look at the dynamics of the asset and the sector, including barriers to entry, pricing power and structural growth opportunities.

What are your thoughts on leverage for infrastructure companies today?

It is understandable that investors are becoming concerned about debt levels with potential interest rate hikes on the horizon.

Screening
Whether you are looking at a toll road, a tower or an airport, if you take that defensive asset and put too much leverage against that balance sheet, it is no longer defensive. So assets with too much leverage are removed from our investible universe. We take a universe of roughly 250 companies and screen that down to ~125 core infrastructure assets that we consider to be investible. Part of that screening process addresses leverage, but we also eliminate assets based on other factors. These include our view on management quality, the capital structure and corporate governance frameworks.

Strong balance sheets
When analysing company leverage (and hence sensitivity to changes in interest rates) we focus on a range of measures including Net Debt to EBITDA, forward interest coverage ratio and refinancing risk. The strategy's current weighted average Net Debt to EBITDA ratio is ~4.0x; a level we are comfortable with given the predictable nature of the cash flows being generated by our holdings' underlying assets.

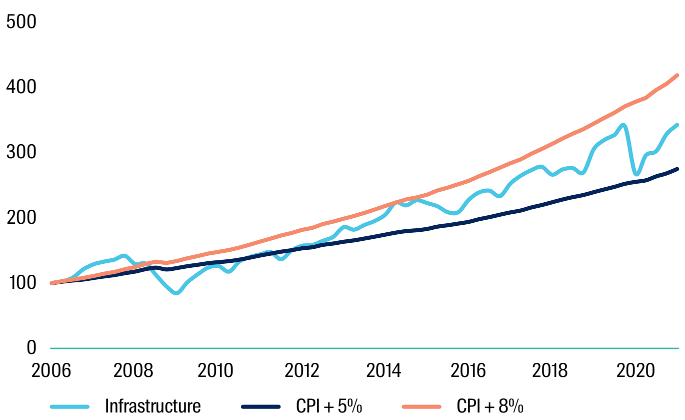
Further, many infrastructure companies have taken steps to take advantage of current low interest rates. We have seen significant refinancing of existing debt to lock in reduced rates, lengthen maturities, spread refinancing risks, and diversify funding sources. The weighted average debt maturity on our top 10 holdings is currently over 10 years[1]. That means debt has been locked in at very low levels for the next decade.

It's important that infrastructure companies maintain appropriate debt structures so that when inflation does increase, they have the ability to increase prices and see that flow through to the bottom line. It's one thing to be able to pass on the costs of inflation to the end customer, but if debt costs are rising by as much or more, the asset will be in a weak financial position.

How has listed infrastructure performed relative to inflation over time?

Global listed infrastructure has proved capable of delivering returns well in excess of inflation. For the 15 years to March 2021, listed infrastructure has delivered total returns of 8.5% pa, equivalent to CPI plus 6.6%.

Listed Infrastructure Performance

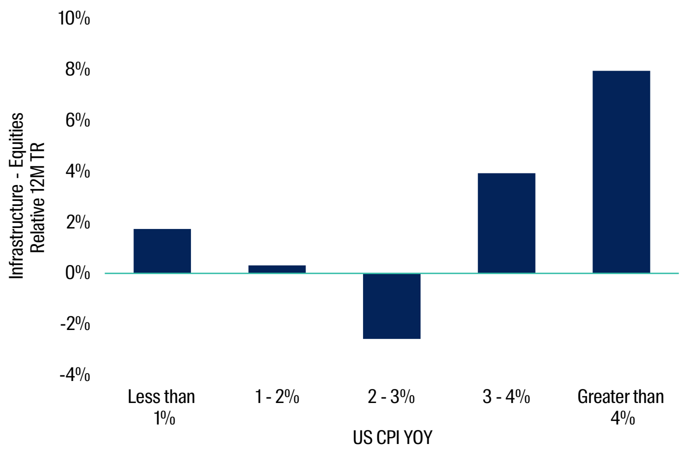


Infrastructure FTSE Global Core Infra 50/50 Net TR Index (USD)
CPI US CPI Urban Consumers SA
Source: Bloomberg and First Sentier Investors
Quarterly time series from 2006-2021

The performance of global listed infrastructure during periods of higher inflation provides further evidence of the benefits that can be provided by this asset class. The chart below compares the relative performance of infrastructure to global equities, when inflation is in a given band.

For example, when inflation is between 3% and 4% pa, global listed infrastructure has outperformed global equities by around 4% pa on average. Importantly, this outperformance increases to almost 8% pa when inflation is above 4% pa.

Infrastructure Performance During Periods of Inflation



Infrastructure FTSE Global Core Infra 50/50 Net TR Index (USD) from Dec-05, prev Macquarie
Equities MSCI Daily TR Gross World USD
CPI US CPI Urban Consumers SA
Source: Bloomberg and First Sentier Investors
Quarterly time series from 2006-2021

[1] As at 30 April 2021

Why is listed infrastructure a strong potential opportunity now?

2020 was clearly an unprecedented period in many ways, and it was a challenging year for global listed infrastructure. For just the second time in the last 15 years, listed infrastructure underperformed both global equities and bonds (global equities +15%, bonds +9%, listed infrastructure -4%). We now feel that concerns around potential increases in interest rates have already been priced in.

We think our investment universe of utilities, toll roads, airports, railroads and towers are well positioned today on a relative value basis. And whilst we have maintained a cautious view of the airports sector, we believe toll roads and railroads are well positioned for a strong COVID-19 recovery as global economies reopen.

Conclusion

Investing in a portfolio of global listed infrastructure assets provides investors with exposure to assets including toll roads, airports, railroads, utilities, pipelines and mobile towers. These sectors share common characteristics like high barriers to entry and pricing power. We estimate over 70% of the assets we invest in have the ability to pass through inflation to the end customer.

Investor concerns around rising inflation and higher interest rates have been largely priced in providing investors with a compelling case to invest in an asset class that we expect to provide inflation protected income and strong capital growth for many years to come.

Appendix: What does inflation protection look like by asset type?

We break down our 'investment universe' into four broad categories – Utilities, Transport, Communications and Energy Infrastructure. The table below provides a summary of inflation protection by asset type.

Category	Typical strategy allocation[2]	Inflation protection
Utilities	50%	**North American utilities** – Regulated return on investment methodology with allowed returns moving with interest rates which implicitly incorporate inflation. Utilities file for a rate case requesting costs such as inflation be passed through to the end customer. Allowed ROEs have been in the 8-10% range historically despite falling interest rates. **European utilities** – As a general rule regulation provides protection against inflation. Key difference is if Weighted Average Cost of Capital (WACC) is determined in real (adjusted for inflation) or nominal terms (fixed returns). **UK / Australia utilities** – WACC is set in real terms with Regulated Asset Base (RAB), Capital Expenditure (Capex) and Operating Expenditure (Opex) estimated and approved by a regulator in real terms using inflation forecasts. Returns are then adjusted each year for actual inflation.
Transport	30%	**Toll roads** – Concession agreements for a defined period which specifies how inflation will be treated. Agreements are often 30 years plus with explicit links to inflation. **Airports** – Depends on the regulatory model of the airport. The majority of airports are dual-till where aeronautical revenues are regulated with explicit links to inflation. Non-aeronautical revenues are typically commercial agreements so depends on the contract. **Railroads** – Freight rail rates are largely unregulated but strong pricing power allows them to pass through many uncontrollable costs. Passenger rail revenue depends on contract in place.
Communications	10%	**Mobile towers** – US tower operators have contracted price escalators of ~3% per annum. Contracts are typically 5-15 years in length. European tower operators have contracts that are mostly linked to inflation.
Energy Infrastructure	10%	Depends on the nature of the commercial agreement. **Oil pipelines** – Typically have long-term contracts with annual price escalators embedded in their terms. **Gas pipelines** – Most contracts are take-or-pay but with fixed pricing hence more exposed to inflation.

[2] These allocations are indicative only and may vary over time.

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