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GLOBAL LISTED INFRASTRUCTURE UPDATE

20th March 2020

It is now one month since the market weakness began, and so we wanted to provide our clients an update on the portfolio during this volatile period. Within this update note we consider:

1. The performance of the sector since the start of the market weakness, on February 19th,
2. The different performance of the various infrastructure subsectors,
3. Adjustments to the portfolio that we have made as a result of these movements; and
4. Our conclusions on the outlook for the sector at this time.

We are separately providing a thought piece on the infrastructure sub-sector that has been most impacted by COVID-19, being airports, and the opportunities that we currently see in this sector.

Infrastructure sector and portfolio performance

From February 19th to the close on Thursday March 19th the FTSE Global Core Infrastructure 50/50 Index dropped 29.7% in local currency terms[1]. This compared to a 29.3% drop in global equities[2]. This lack of defensiveness during a period of such weakness is both surprising and disappointing, and is clearly very unusual from a historical perspective. We believe that the reasons for this have been due to both:

1. Some specific impacts from the two primary causes of this market weakness being
   (a) The rapid spread of the COVID-19 and
   (b) The sharp fall in oil prices –having on certain infrastructure assets, as discussed below; and
2. The generally indiscriminate selling that has been occurring in the market (which we think can be attributed to, among other factors, large fund flow movements in passive investments).

Our performance for the various portfolios we manage during this period has generally been inline or modestly ahead of the FTSE Global Core Infrastructure 50/50 Index (more so for currency hedged portfolios) whilst also further ahead of certain other main infrastructure indices (especially the S&P Global Infrastructure Index).

Following is a brief summary of the movements that we have seen in some key sectors (the % movements noted relate to an average of the stocks on our Focus List[3], and our view as to the appropriateness of these moves. At this time the sector has seen a material derating making us more positive on the outlook generally and so the following comments are specific to our viewpoints of the relative movements between the sectors. We then conclude with a broader comment on our view of the outlook for listed infrastructure and our portfolio.

[1] Source: Bloomberg
[2] Source: Bloomberg
[3] The GLI Focus List is a proprietary list of global infrastructure companies that we believe will provide the strongest possible combinations of inflation protection and low volatility of cash flows to equity.

Regulated North American Utilities (Focus List stocks -22.4% on average)

In the current environment we would have expected the North American regulated utilities to be some of the strong performers. Bond yields have dropped to record lows over the last month, and considering that Allowed Return on Equity ("ROEs") are not directly linked to bond yields the North American utilities are, in our view, typically the most interest rate sensitive regulated utilities. And similarly to regulated utilities globally, there is very little economic sensitivity as volume risk is ultimately assumed by the customers.

Considering these factors we have been surprised that the sector has not been more defensive during this period, and so have used the weakness to add to our positions. As a result of this buying, and also stock outperformance, our holdings in North American regulated utilities have increased from 25% at the start of the year to now 35% (approximately).

Regulated UK Utilities (Focus List stocks -17.0% on average)

We would also have expected the UK regulated names to be strong performers in this market. The assets are not as interest rate sensitive – as the Allowed ROEs are more directly linked to bond yields – although pleasingly the ROEs for the UK water companies were all recently locked-in for the next 5 years. From an economic sensitivity perspective these stocks are even more defensive than the US utilities, considering that 3 of the 6 listed market opportunities are regulated water businesses.

Similar to the US regulated utilities, these stocks initially did not perform as defensively as we would have expected, although more recently have acted increasingly so. It should be noted that the prior 3 months had been relatively strong for these stocks, compared to the FTSE Global Core Infrastructure 50/50 Index – following the election of Boris Johnson and the finalisation of the water regulatory reset – and so we did not materially change our holdings.

Our portfolio position has increased from approximately 13% to 14% during this year.

North American Pipelines (Focus List stocks -45.5% on average)

The pipelines that are on our Focus List do not have any material direct commodity price exposure. However the drop that we have seen in the oil price has been dramatic, and so considering that these assets operate in the energy sector has had a specific impact on them.

Our portfolio is focussed on gas pipelines more so than oil pipelines but we are very aware of the potential for second derivative impacts through the credit quality of the shippers on the pipeline, as well as the impacts on future volumes as a result of these credit pressures. For example, whilst most of the shippers on the pipelines are the users of oil or gas which tend to have strong credit profiles, there are some E&P producers that have weaker credits, and which are being directly impacted by the oil price weakness.

The timing has also been unfortunate for the pipelines as they have continued to progress their deleveraging process, but at this time remain on average more levered than the broader infrastructure sector.

Initially during the market weakness the sector was not as weak as others, and so considering the above factors we took the opportunity to reduce our pipeline exposure. More recently the stocks have been further priced down, and so we currently see the risk/reward more evenly balanced.

Currently the portfolio holds approximately 14% in North American pipelines, relative to 19% at the start of the year.

European Concessions (Focus List stocks -46.3% on average)

These companies on our FL include 4 airports, 3 toll roads and the railway owner Getlink. Similar to the pipelines there has been a very specific impact from the current market weakness – but in this case as a result of the effects of COVID-19. This has been most noticeable on the airports with a collapse in travel demand, travel restrictions and cancellation of flights en masse. From that perspective our portfolio is well positioned, currently only holding 5% in airports globally and below the weight in the FTSE Global Core Infrastructure 50/50 Index.

Notwithstanding the clear short-term impact on transportation infrastructure assets, we are of the view that this weakness has created some very attractive opportunities. We are confident that these assets will retain their pricing power (and indeed for airports the regulated aeronautical side will see higher future charges to users in the event that traffic reduces), and we believe that the long-term traffic trajectory will incur minimal impact.

Weighing these factors, our view is that some of the European transportation concessions are currently being mis-valued. We are very mindful of the likelihood that COVID-19 will continue to trigger further short-term announcements that impact these assets, and so have been very selective in adding to such positions, but from a longer-term perspective believe that there are currently some compelling valuations.

The portfolio currently holds 13% in European concessions, from 17% at the start of the year, as a result of the price weakness in this sector.

Other Sectors

The other sectors that we invest in have generally performed relatively well during this period.

Japanese regulated utilities and Australian regulated utilities have been very defensive as we would expect they should have been.

The telecommunication tower companies have also performed relatively well during this period. This sector has very little economic sensitivity, although has higher financial leverage, and so has performed better than we might expect.

One beneficiary of the recent events has been our storage terminal business Vopak, which is a top 5 holding. Due to the sharp drop in the oil price the curve for this commodity has moved sharply into contango, which makes oil storage more valuable. As a result the stock has well outperformed the sector during this period.

Summary

Markets are currently extremely volatile and so the opportunities are changing quickly. It has been disappointing that the sector has not out-performed global equities during this period of market weakness, although more understandable when considering the specific factors that have caused the weakness, and the impact that they are having on certain infrastructure sectors such as airports and pipelines.

During such periods of economic and financial market disruption the importance of a strong balance sheet increases. The position changes that we have made over the last month have included a focus on the credit quality of the portfolio, and so we are confident in the debt positions across our portfolio companies.

We do not have a special insight into the duration of the impact from COVID-19, and are assuming that this disruption will likely be for an extended period. We are confident that most transportation infrastructure assets will see a return of traffic once the disruption subsides, although it is important to understand the difference time periods over which this will occur between the asset types.

Notwithstanding the uncertainty, we are positive on the outlook for the sector at current valuations. Infrastructure assets generally provide essential services with strong strategic positions, low cash flow volatility and natural inflation linkage, and notwithstanding the current disruptions we expect that such assets will continue to be keenly sought by investors in what remains a low yield environment. In our opinion this low yield environment looks even more likely to persist given the economic downturn underway and associated central bank actions, notwithstanding the very recent increases in some sovereign government bond yields.