First State Investments

Global Listed Infrastructure

Fund Manager Q & A

November 2014

Peter Meany

Head of Global Listed Infrastructure

- Peter Meany is the Head of Global Listed Infrastructure for First State Investments.
- Joined First State Investments in January 2007, Peter has more than 10 years of experience in the infrastructure and utilities sectors.
- Peter is responsible for the overall management of the Listed Infrastructure team and investment process.
- Peter holds a Bachelor Economics (Finance) from Macquarie University.

Introduction

Infrastructure describes the physical assets that provide basic services to modern society, including utilities, transport and communication assets. Their fundamental, essential nature gives them qualities that are beneficial to an investment portfolio.

Growth potential

Listed infrastructure exhibits growth characteristics, as well as offering relative stability. 'Income' infrastructure sectors such as utilities and energy pipelines pay a steadily growing dividend. 'Growth' infrastructure such as airports, railways and ports are positioned to benefit from strong volume growth, based on long-term structural drivers such as globalisation.

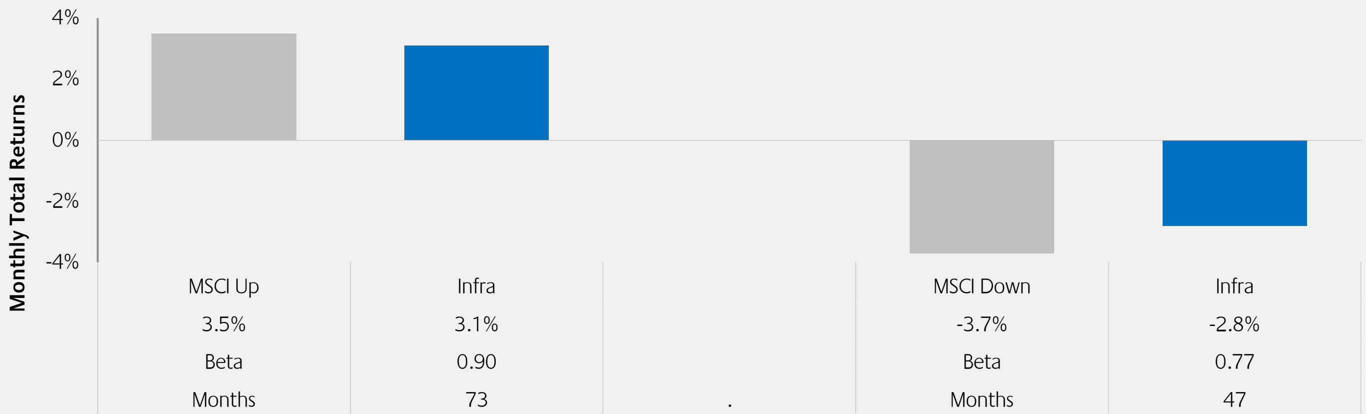
Inflation protection

Exposure to listed infrastructure assets can insulate investors from the impact of rising inflation. The monopolistic nature of many infrastructure assets gives them the ability to consistently increase the price of their services over time, often at contracted or regulated rates explicitly linked to inflation.

Attractive risk-adjusted returns

Over the past 10 years global listed infrastructure securities have delivered higher returns (more than 2% outperformance pa on average) than global equities, with a lower level of risk. The asset class has provided investors with most of the upside in rising equity markets, whilst offering protection from falling markets. This pattern of performance is driven by listed infrastructure assets' consistently strong pricing power, predictable cash flows, and relative immunity to economic cycles.

Global infrastructure in MSCI World up/down markets



MSCI Up	Infra		MSCI Down	Infra
3.5%	3.1%		-3.7%	-2.8%
Beta	0.90		Beta	0.77
Months	73	.	Months	47

Infra refers to UBS Global Infrastructure & Utilities 50-50 Net Total Return Index USD.
MSCI World Net Total Return USD. Monthly data for 10 years to 30 September 2014. Source: Bloomberg and First State Investments.

Growing investor interest in listed infrastructure has also led to questions about the potential risks that accompany these benefits. Some of the questions raised most often by clients, along with our responses, are set out below.

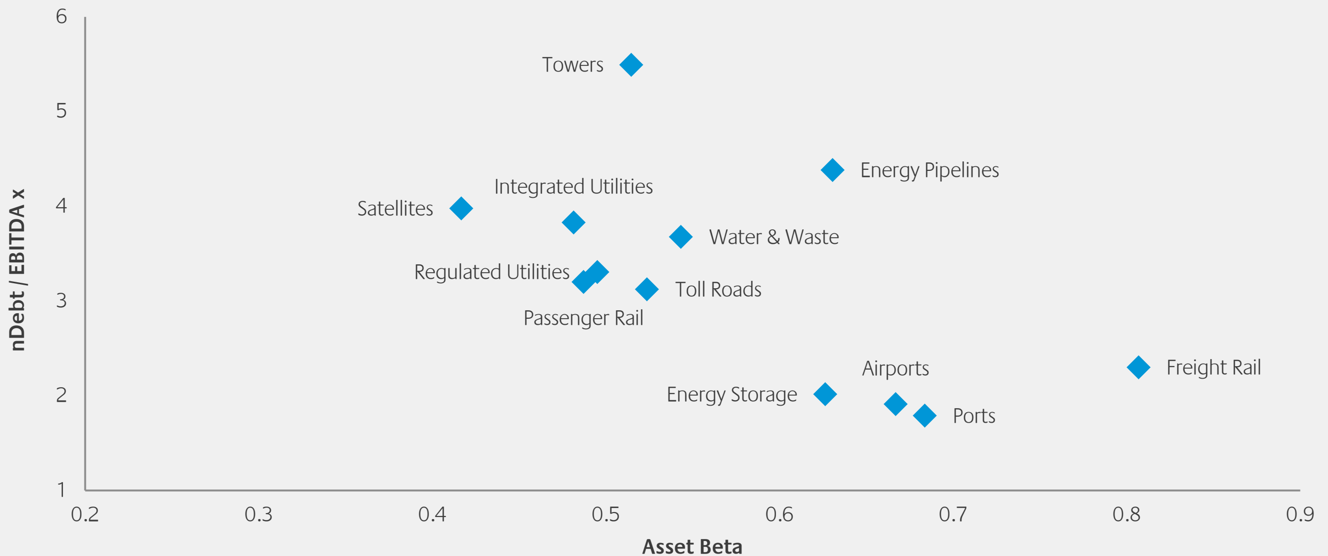
Q1: How vulnerable is listed infrastructure to a rise in bond yields?

A1: Global interest rates and bond yields have fallen to historically low levels since 2008. This has benefitted 'income' infrastructure sectors such as energy pipelines and regulated utilities, as the yield they offer has become increasingly appealing compared to alternative income-generating asset classes. Sectors with leveraged balance sheets, such as towers and energy pipelines, have also benefitted from the lower cost of debt. Rising interest rates and bond yields could represent a headwind for these sectors' valuations.

However the broad range of listed infrastructure asset types provides ample scope to invest in sectors that are much less sensitive to interest rates; for example freight rail, airports, toll roads and ports. These sorts of assets benefit from rising volumes in a growing economy. This enables active managers to shelter from the impact of rising interest rates by increasing exposure to these sectors.

The wide dispersion of sensitivity to interest rates (leverage) and economic growth (beta) that exists within the asset class is illustrated in the chart below. For example, freight rail companies are relatively sensitive to rising economic growth rates – as they benefit from better haulage volume growth and margin expansion – while their low levels of debt make them relatively insensitive to rising bond yields.

Global infrastructure GDP sensitivity and leverage



Source: First State Investments as at 31 August 2014.

Q2: Are current listed infrastructure valuations too high?

A2: Listed Infrastructure has delivered above-average returns of between 12% and 15% in recent years, as equity risk premiums recovered from the financial crisis. These returns should not be extrapolated into the medium term given some sectors, like energy pipelines and airports, are now trading towards the top end of long-term multiples. On the other hand, 'growth' sectors like toll roads and freight rail continue to offer an attractive return profile. We believe the market continues to under-estimate the recovery in volumes, the strength of pricing power and the operating leverage from fixed costs. Valuations for the sector overall remain broadly in line with long-term averages.

Value range by sector

Source: First State Investments as at 31 August 2014.

From current levels, we estimate that listed infrastructure has the potential to deliver medium-term returns of between 8% and 10% pa. This estimation is based on a yield of between 3% and 4%, and earnings growth of between 5% and 6%.

These yield and growth outcomes are well supported by tangible assets providing essential services in contracted or regulated business models. Leverage and payout ratios are lower than normal, which provides opportunities for well-managed companies to deliver shareholder returns which surprise on the upside.

Q3: Has the popularity of other alternative equity strategies – such as minimum volatility or high yield-focused portfolios – resulted in a crowded trade?

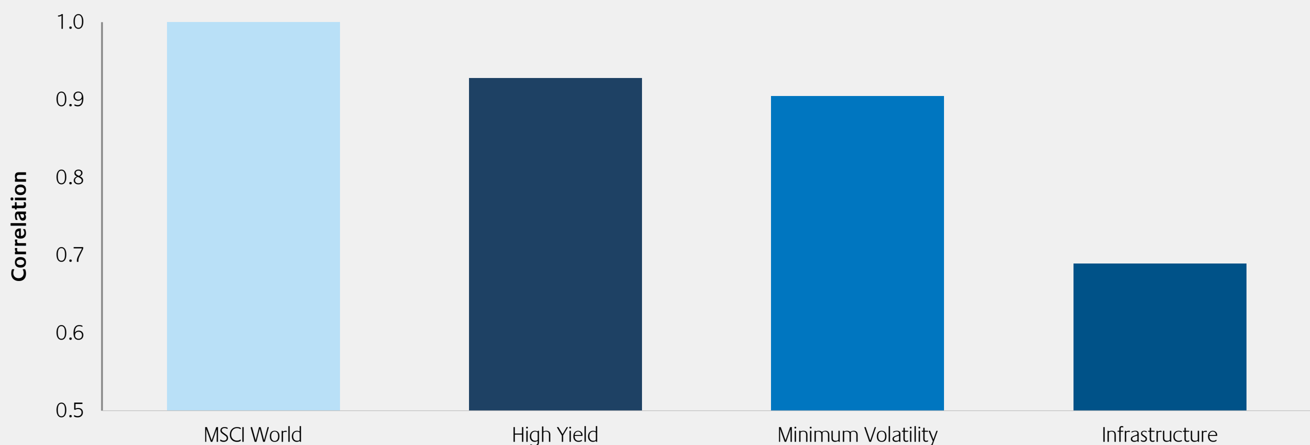
A3: The credit crisis and low bond yields have resulted in strong demand for alternative equity strategies which reduce volatility and provide an alternative source of income. Minimum volatility strategies and high yield strategies share some common characteristics with listed infrastructure. The growing popularity of these strategies has raised some concerns regarding the overlap of holdings and the resulting increase in portfolio concentration risks.

The charts below illustrate that listed infrastructure, minimum volatility and high yield equity strategies have differing return, risk and correlation profiles.

Global listed infrastructure relative risk/return

MSCI World, Minimum Volatility, High Yield - Net Total Return USD.
Infrastructure refers to UBS Developed Infrastructure & Utilities Index. Monthly data for 20 years to August 2014.
Source: Bloomberg and First State Investments.

Global listed infrastructure correlation



MSCI World, Minimum Volatility, High Yield - Net Total Return USD
Infrastructure refers to UBS Developed Infrastructure & Utilities Index. Monthly data for 20 years to August 2014.
Source: Bloomberg and First State Investments.

High yield strategies have greater volatility and a higher correlation with the MSCI World index. In addition to this, prominent high yield equity sectors – such as tobacco and fast food – face structural challenges. Minimum volatility strategies also have a relatively high correlation with the MSCI World, and lower total returns over the long run. Listed infrastructure has delivered higher returns with lower volatility, and lower correlation with global equities. Further analysis of index weights suggests the Listed Infrastructure overlap of holdings could be around 5% for MSCI World and 15% for minimum volatility. This overlap could be significantly lower for an actively managed, high conviction portfolio.

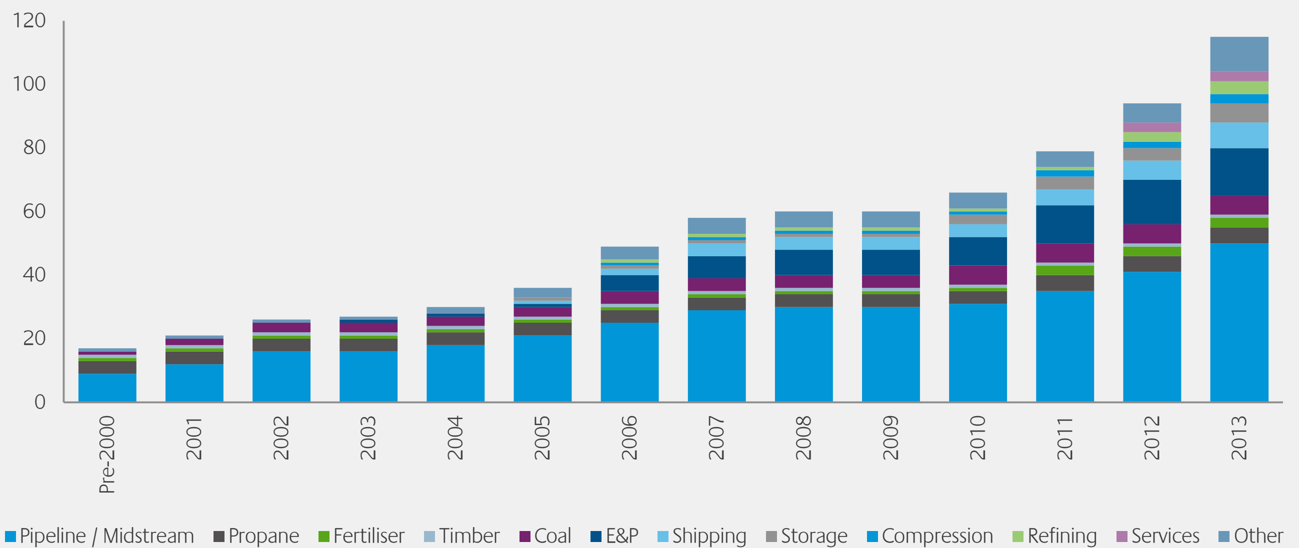
Q4: Which listed infrastructure sectors merit the most cautious approach?

A4: Shale gas has created a massive infrastructure investment boom for US energy pipelines. Companies are scrambling to build pipelines to connect shale gas reserves with export markets and the population centres where the energy is needed. Bullish long-term growth assumptions have led to huge optimism – and corresponding valuation multiples.

Demand for energy pipeline stocks has been further driven by their ability to drop down pipeline assets into Master Limited Partnerships (MLPs) - tax-efficient vehicles which distribute a high proportion of earnings to shareholders. However MLPs are structured in a way that encourages distribution growth ahead of other important factors, such as the quality of underlying earnings. This focus has seen pipeline construction projects receive multiple competing bids, with bidding companies forced to accept more commodity, volume or operational risk in the pursuit of growth.

The surge of interest has also led to the acceptance of a wider range of assets into MLP structures. While MLPs have historically tended to primarily hold defensive assets such as oil and gas pipelines, traditional, contracted pipeline companies now represent less than 50% of the MLP sector by number. As a result of this strong momentum the US MLP sector has almost doubled in size in the last few years to over US$830 billion. Its combined market capitalisation is now 20% larger than the entire US REIT sector.

MLP IPOs by sector and year



Source: Latham & Watkins, First State Investments as at 31 December 2013.

We believe that the energy pipeline sector today is attracting too much capital, and that this is supporting inflated valuations, aggressive M&A activity, and potentially unsustainable growth expectations. We have concerns over increasingly tight distribution coverage ratios, and the commodity exposure that some pipeline companies are taking on in their earnings. Even accounting for the sector's strong growth prospects, valuations appear full by historic standards. We struggle to find mispricing, and are currently underweight energy pipelines, with no exposure to MLPs.

Q5: What are the infrastructure investment opportunities in emerging markets?

A5: We seek to invest in companies that operate in environments characterised by stable regulation, a transparent, independent legal system and minimal political interference. To date, most companies matching these criteria have been based in developed rather than emerging markets.

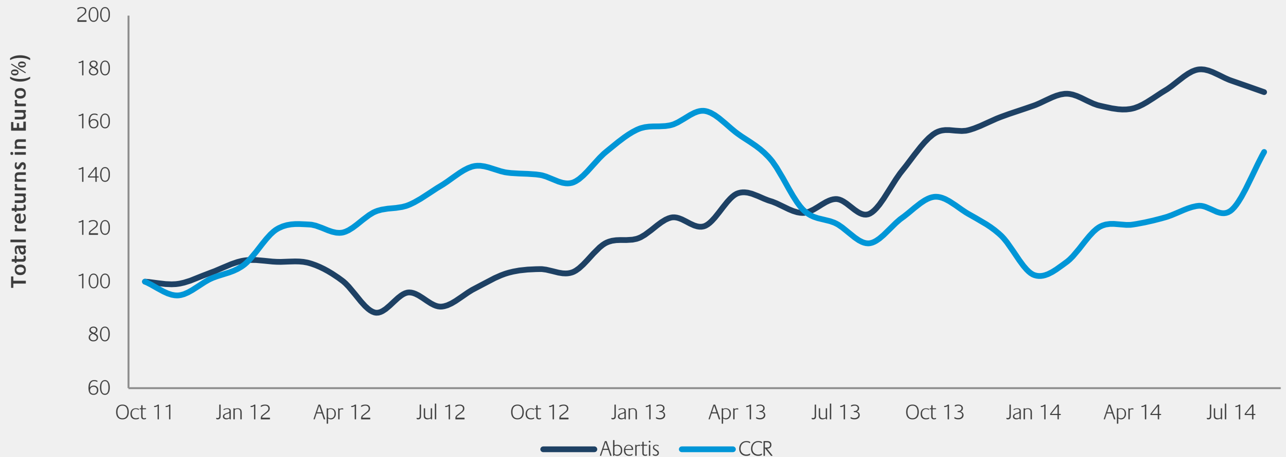
This year, significant valuation differentials have appeared between emerging markets companies and comparable companies in developed markets, to a point which suggests that investors are now being compensated for those risks.

In 2011, sovereign debt concerns led to depressed growth expectations and low valuation multiples for European infrastructure stocks. As sentiment improved, earnings growth expectations were revised upwards at the same time as valuation multiples, benefitting volume-sensitive European stocks such as toll road operators Atlantia, Abertis and Vinci.

The current pessimism surrounding emerging markets infrastructure stocks suggests similar mispricing may have arisen. Accordingly, we have built positions in emerging markets toll roads CCR (Brazil) and Jiangsu Expressway (China). CCR is run by a well-regarded management team. Its high quality assets are trading at a discount to intrinsic value due to the economic and social challenges facing Brazil. Jiangsu is a highly cash generative firm which is trading at an attractive valuation. It is well-placed to benefit from structural growth trends, including growing car penetration in China.

Over the same period, we reduced our holdings in European toll road operator Abertis, following a strong rally in its share price as investor sentiment towards European markets rose and traffic volume trends on its roads improved.

Abertis (Spain) vs CCR (Brazil)



Source: Bloomberg, First State Investments as at 31 August 2014.

These transactions are consistent with our contrarian and active approach to investing within a global opportunity set. Our strategy currently has a total of 6% direct and 15% look-through exposure to emerging markets. We continue to monitor our entire investment universe, with a view to pursuing our conviction-based investment approach.

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