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The compelling story of listed Essential Infrastructure, and how it can help hedge inflation

Research & Insights

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Key points

- Global listed infrastructure offers access to assets with high barriers to entry, pricing power, and long-tail cash flows.
- The infrastructure asset class comes with inherent inflation hedging characteristics providing superior protection to investor returns.
- Australia now has very few listed infrastructure assets, compelling investors to seek opportunities in global ssential infrastructure.

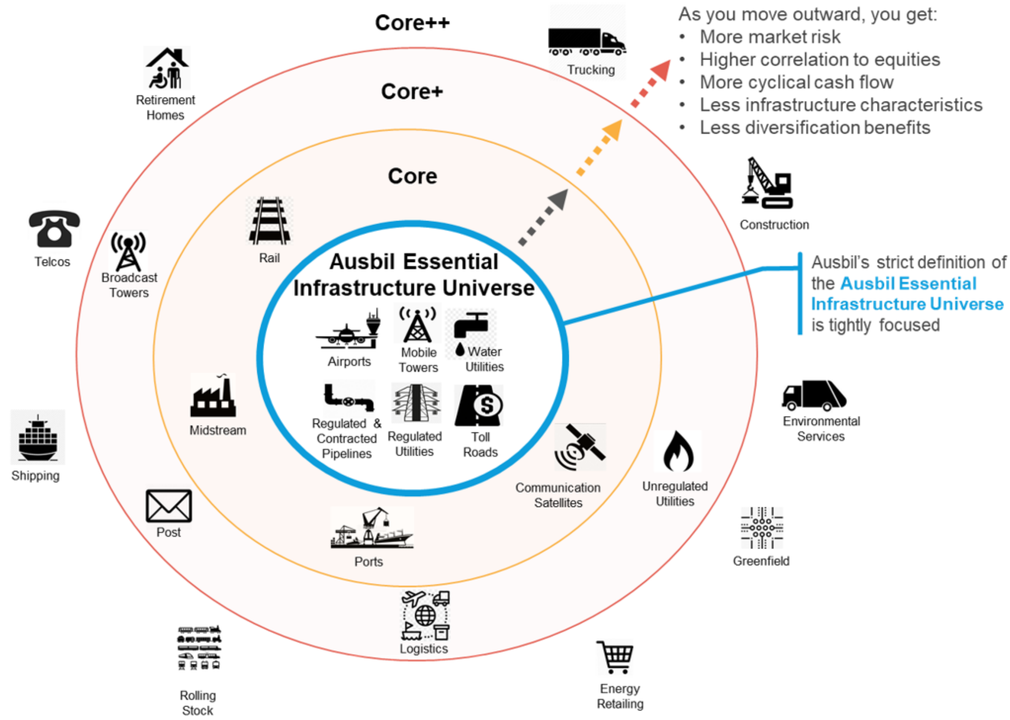
Infrastructure is a compelling asset class for the consistent and dependable yields it can generate. It generates this income from assets that enjoy significant barriers to entry and that are usually the providers of essential services like water, transport, telecommunications and energy transmission that continue to be utilised whatever the prevailing economic situation.

Ausbil's Global Essential Infrastructure team share their views on the sector, and talk about the powerful yield the asset class generates, how it performs in an inflationary environment, and why an active approach can be beneficial.

Q: What are the characteristics of Essential Infrastructure?

A: The Essential Infrastructure universe, under Ausbil's tight definition, comprises the assets that are essential for the basic functioning of a society, as illustrated in Figure 1. They are typically regulated or have a track record of very stable cash flows through the economic cycle. In our definition, Essential Infrastructure typically comprises monopolistic, regulated or long-term contracted assets, predominantly found in regulated utilities (electricity, gas and water), regulated or contracted pipelines, toll roads, airports and mobile phone towers.

Figure 1: Defining infrastructure: Caveat emptor, buyer beware



Source: Ausbil.

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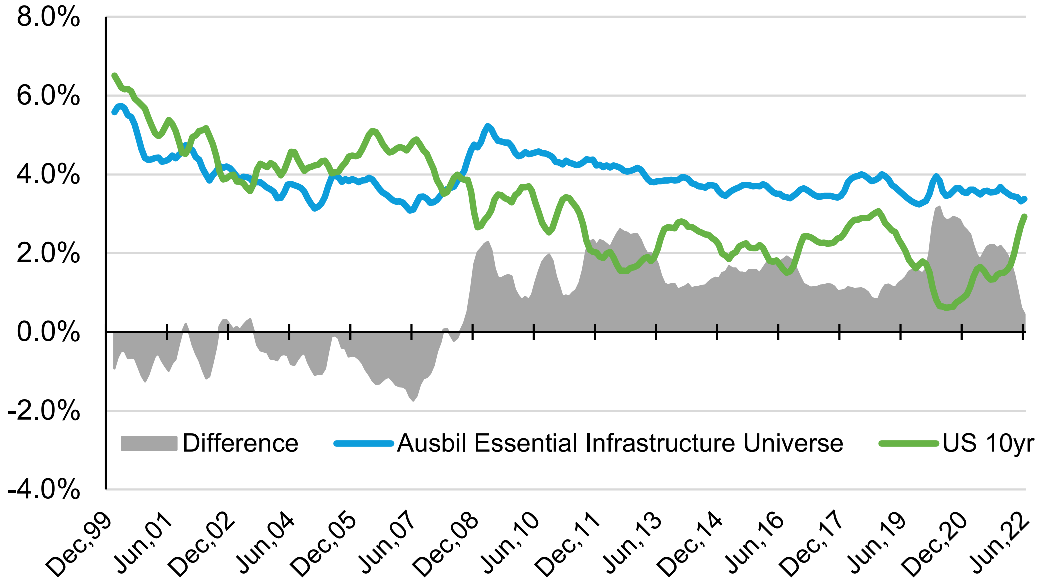
Under Ausbil's definition of infrastructure, the vast majority of an investment's cash flow must come from an Essential Infrastructure activity. Essential Infrastructure carries minimal greenfield risk, ideally has no immediate competitors (and low bypass risk), has non-cyclical cash flows, and have negligible or appropriately low demand risk.

Q: What type of return does infrastructure offer investors?

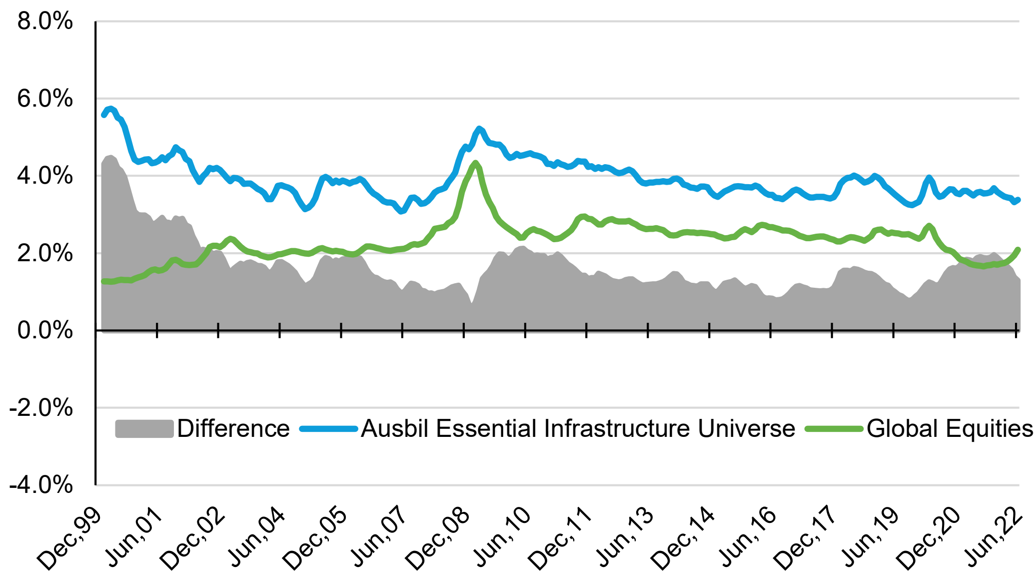
A: Essential Infrastructure offers a compelling mix of yield, relative stability and long capital growth in the returns it offers investors. On the income or yield side, listed global Essential Infrastructure assets demonstrate strong yield outperformance across most periods when compared to US government bonds also consistently offer a significantly higher yield than global equities, as illustrated in Chart 1.

Chart 1: The relative yield of essential infrastructure compared to 10-yr bonds



Source: Ausbil, Bloomberg.

Chart 2: The relative total performance of infrastructure compared to global equities



Source: Ausbil, Bloomberg.

Listed Essential Infrastructure assets have, since 2000, generated an average yield of 3.9% pa (on a rolling basis), compared to the yield generated by global equities (MSCI World) of 2.3% pa, and US 10-year treasuries of 3.2% pa. On average, therefore, the global Essential Infrastructure yield has exceeded global equities by 1.6% pa, and US treasuries by 0.7% pa.

Another important observation relates to the variability in returns. Global Essential Infrastructure has offered more stable yields with lower variability as evidenced by a standard deviation in yields of +/- 0.5%, while similar to the variability in global equity yields of +/- 0.5%, but noticeably lower than the variability in 10-year US treasury yields of +/- 1.3%.

Therefore, the yield of Essential Infrastructure has not only been consistently and notably higher than those of global equities and US bonds, but the yield of the asset class has been more stable, and less volatile.

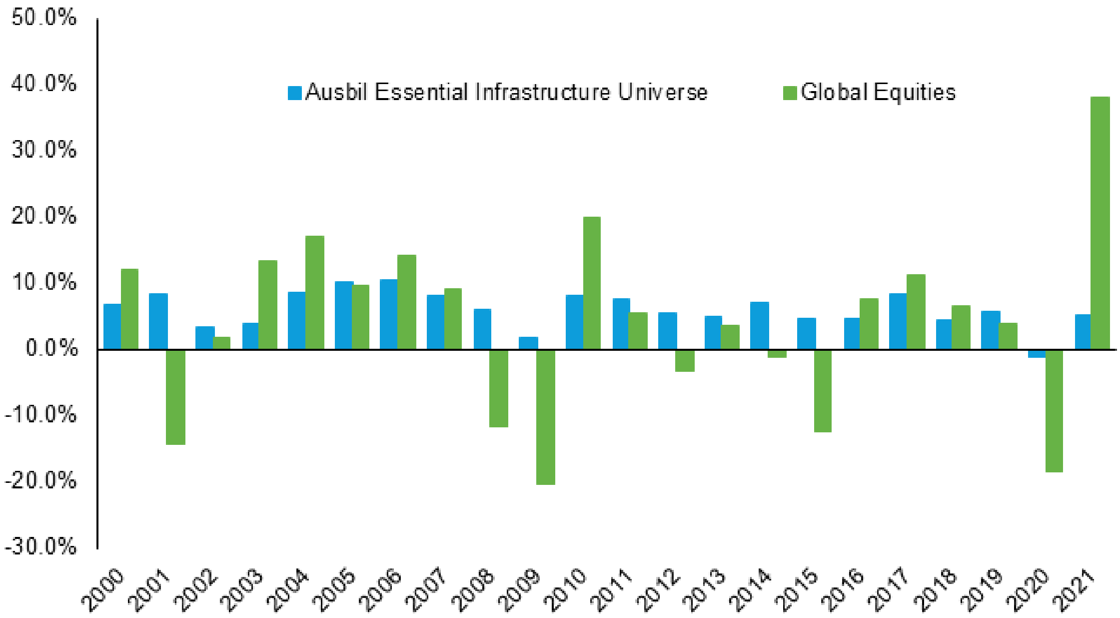
Q: Is the higher yield in infrastructure riskier than that of global equities?

A: The unique cash-flow nature of infrastructure is such that equity investors in this sector forego some elements of growth, compared to what is on offer in global equities, in return for a higher relative yield. With Essential Infrastructure, yields are typically backed by large, real assets that hold dominant or allowable monopolistic positions in their respective economies.

For most Essential Infrastructure assets there is little to no competition or substitution, and yields are underpinned by contracts and concessions or regulatory arrangements formulated and agreed with governments and regulators that allow revenue streams to recover operating and capital costs including inflation.

This stability in revenue and earnings can be seen in the EBITDA growth for Essential Infrastructure assets compared to that for global equities, as illustrated in Chart 3.

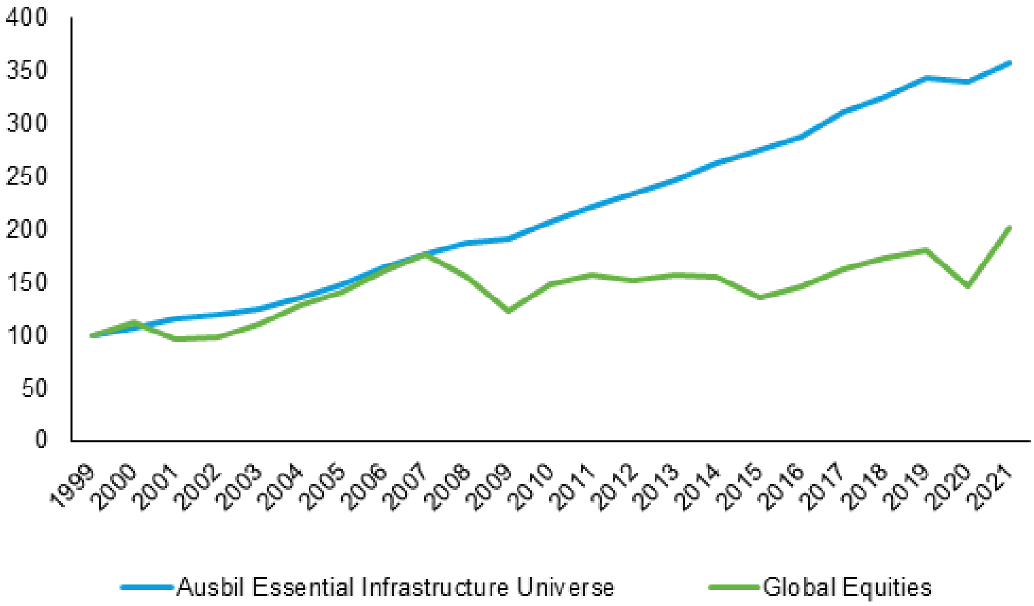
Chart 3: Infrastructure earnings (EBITDA) growth across the cycle compared to global equities (2000 – 2021)



Source: Ausbil, Bloomberg.

One of the strong themes that can be seen in infrastructure earnings growth is that it is consistently positive through economic cycles. Chart 4 demonstrates this stability compared to the boom-and-bust pattern that can be seen in the earnings growth of general equities. While global equities can enjoy periods of superior earnings growth, a lot of the benefit is given away in market drawdowns or when the earnings cycle goes into major contraction. By contrast, the steady positive earnings growth shown in Essential Infrastructure compounds over the long-term to significantly outperform the far more volatile earnings growth of general equities, as illustrated in Chart 4.

Chart 4: The compounding benefit of infrastructure's steady EBITDA (earnings) growth outperforms global equities (1999 – 2021)



Source: Ausbil, Bloomberg.

Comparing the key elements of risk between Essential Infrastructure and global equities, we believe infrastructure shows lower risk on average over time, as illustrated in Table 1.

Table 1: Relative risks of Essential Infrastructure compared to global equities

Risks	Essential Infrastructure	Global Equities
Climate Change Risk	Given infrastructure assets provide essential services maintaining a 'social licence' is critical to their success. ESG therefore is typically a strong focus of infrastructure management teams. While some infrastructure sectors are involved in activities like fossil-fuel based power generation and/or operating and maintaining oil and gas pipelines that carry climate change related risk, this means there is typically a much greater focus on addressing and mitigating these long-term risks to ensure the sustainability of their operations.	A far more diverse universe by type of business, potentially producing relatively higher ESG and climate change risk overall.
Commodity Risk	Essential Infrastructure is relatively shielded from commodity risk given the nature of contracted and regulated revenue agreements in place. Ausbil actively avoids direct sensitivity to commodity prices in the Essential Infrastructure assets we invest in.	Most listed businesses in global equities are relatively more exposed to changes in patronage, input costs and/or commodity prices than Essential Infrastructure. While hedging is available, most companies are significantly more exposed to movements in commodity prices than Essential Infrastructure.
Credit Risk	Despite often having higher gearing levels than general equities, debt financing of infrastructure is generally considered less risky as it is typically supported by very high-quality credit and sovereign counterparties, and contracted/regulated revenue streams. This is reflected in generally lower credit margins for similar tenor of debt for infrastructure assets. Note unlisted infrastructure assets generally have higher gearing levels than Essential Infrastructure, potentially diluting its superior characteristics to global equities in this regard.	General equities, at a gross level, would stand as having a lower credit quality than infrastructure assets (despite generally having lower gearing), largely due to operating risk, commodity and input risk exposure, and exposure to variable end demand.

Foreign Exchange Risk	The long-term contracts in infrastructure can easily be hedged or swapped to protect assets from the risk of adverse movements in foreign currency. Debt is often raised in the same currency as the infrastructure asset cash flows creating a natural FX hedge.	On average, global equities demonstrate greater elasticity in demand and variability in patronage such that hedging foreign exchange risk is relatively harder.
Inflation Risk	Most infrastructure assets have pricing structures that incorporate ratchet clauses for increases in inflation, captured through tolls, availability pricing, or price determinations by regulators. This means that the asset class is very well hedged for inflation providing greater protection to investor returns.	General equities on average tend to suffer from high inflation, except for companies with pricing power and inelastic demand across the cycle. On average, general equities are more exposed to inflation than Essential Infrastructure.
Interest Rate Risk	Interest rates impact infrastructure more with respect to revaluing cash flows relative to general equites, but demand for essential infrastructure tends to remain as rates rise. Some infrastructure assets like regulated utilities are periodically compensated for changes in the cost of equity and debt. The duration of debt held by infrastructure companies tends to be longer than global equities, which reduces refinancing risk. The weighted average debt maturity of Ausbil's Essential Infrastructure portfolio is close to 11 years, for example.	General equities vary in the impact of interest rates. Those leveraged to discretionary spending can be impacted by the effect of interest rates on consumer spending. Higher growth companies with long duration cashflows can be impacted through the effect on discount rates. Generally, rising interest rates can be detrimental to growth companies, and those with long-term cashflows like REITS. Debt would also tend to be shorter duration. For example, the average debt maturity for S&P/ASX 200 companies is around 7.5 years. These factors increase refinancing and interest rate risk.

Source: Ausbil.

Q: Where are we in the big picture on inflation and interest rates, and how does infrastructure perform in inflationary environments?

A: Without talking too much on the COVID demand and supply shock, or on the war in Ukraine that precipitated an energy shock, the world economy has witnessed the long-term low in interest rates, and they have begun to rise. Since the early 1990s, rates had been on a long downward cycle. With the onset of COVID in 2020 and emergency monetary policy, these rates fell to near zero in Australia and the US, and negative in Europe – all negative in real terms. As the unprecedented COVID stimulus drove the world back into growth so too did it bring back inflation and interest rate rises, further exacerbated by the invasion of Ukraine.

Essential Infrastructure has historically performed best under a moderate inflation backdrop. This has been the case as inflation translates into healthy cash flow growth through CPI escalators or regulatory uplifts, while not causing significant changes to nominal base yields. Interest rates, globally, are rising, and have risen quickly in 2021 and 2022 with monetary policy normalisation, and the shock to energy prices from the war in Ukraine. However, the economic backdrop of reasonable (albeit slowing) economic growth and elevated inflation is a supportive environment for the asset class.

Persistent inflationary scenarios that test the upper bounds of central bank targets are less beneficial for infrastructure, and any other real assets or equities with duration in their cash flows. However, the effect of higher interest rates and inflation on future cash flows impacts all asset classes.

Importantly, we think that active management can lead to better outcomes when managing inflation impacts on a portfolio. Infrastructure sectors are heterogeneous, and offer the opportunity for active allocation towards sectors that hedge well for inflation, and away from those that offer relatively inferior inflation protection. For example, while the Regulated Utilities sector overall offers strong inflation protection characteristics, the nature and type of economic regulation that applies dictates the level of inflation protection. Similarly, Transportation infrastructure tends to lag in high inflationary environments as these companies typically have long duration in cash flows, and relatively high gearing which makes it more sensitive to increasing bond rates. Active management is a prerequisite to achieving these inflation protection characteristics and exploit any mispricing between sectors.

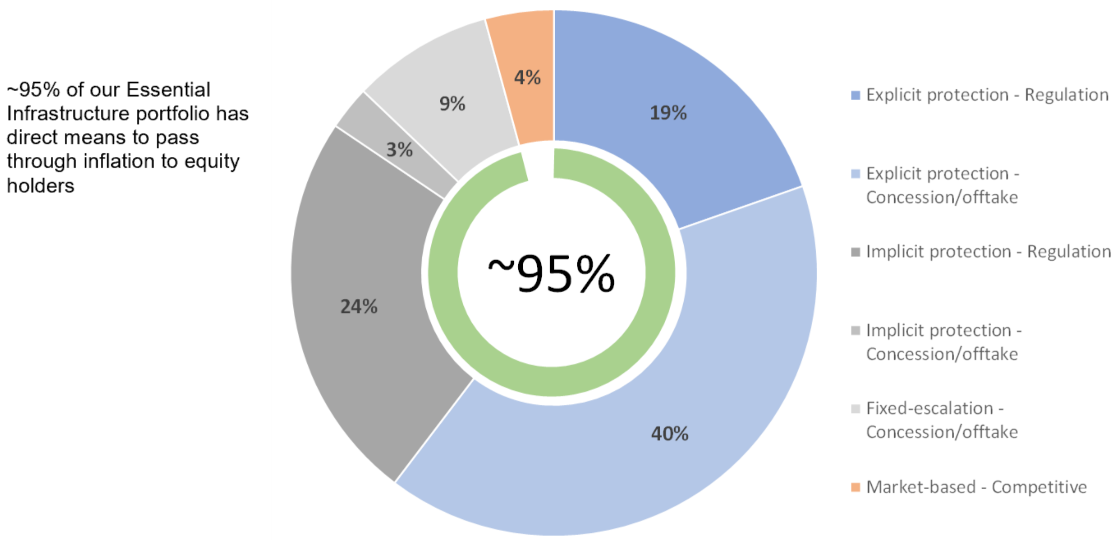
Q: How would you describe the inflation protection characteristics of Essential Infrastructure?

A: As described earlier, Infrastructure as an asset class has strong inflation protection characteristics due to the nature of the assets and the regulation and contracts that exist. For investors, this means that infrastructure will offer superior protection to investor returns during high inflation periods compared to other asset classes. Ausbil's Essential Infrastructure takes that inflation protection characteristics even further due to the narrower definition versus broader approaches to the asset class.

Chart 5 below illustrates the inflation protection characteristics of Ausbil's Essential Infrastructure Fund. On a weighted average basis, around 95% of the Fund displays strong inflation protection with only a small percentage directly exposed to competitive markets where lesser inflation protection exists.

Breaking this down, ~60% of the Fund has explicit inflation protection – typically where there is a very direct link between actual inflation outcomes and cash flows providing best in class protection to investor returns. Implicit inflation protection represents a further ~27% of the Fund where there is an indirect link between inflation outcomes and cash flows offering strong inflation protection. Fixed-escalation means that there are fixed percentage increases in prices and/or revenues irrespective of inflation outcomes. These are confined to the mobile tower companies and still provide sound inflation protection qualities given their cost structures largely mirror this fixed escalation in revenues. Whether an Essential Infrastructure company provides explicit or implicit inflation protection is determined by its characteristics – the nature of the regulation that might apply or contract/concession that exists. We discuss this in more detail in the next question.

Chart 5: Inflation protection characteristics of Essential Infrastructure



Source: Ausbil Global Essential Infrastructure Fund as of 31 March 2022.

Q: How does inflation impact the key infrastructure sectors from a risk-benefit perspective?

A: Infrastructure offers significant opportunity for active investors to allocate across sectors and take advantage of the asset classes inherent inflation hedging. Table 2 illustrates the potential benefits and risks of inflation across the key Essential Infrastructure sectors.

Table 2: Where are the inflation risks and benefits across essential infrastructure sectors?

Sector	Risks	Benefits
Transportation (Airports and Toll Roads)	Increased borrowing costs associated with higher nominal yields is the largest risk together with higher discount rates. The net result of higher revenue versus higher borrowing costs and discount rates tend to offset each other and is therefore relatively neutral overall to long-term valuation. However, a potential short-term risk is that bond yields tend to move with inflationary expectations whereas tolls typically are adjusted on a trailing CPI basis. This can introduce a timing mismatch impacting valuations as discount rates are moving up faster than fundamentals.	For Transportation infrastructure, the offset to increased inflation is higher revenue and EBITDA through a direct linkage in rising tolls (CPI escalated) or regulated/contracted returns. For Airports, they are ~50% regulated and the higher CPI figures feed into the regulatory determinations with higher passenger tariffs protecting investors from higher inflation.
Regulated Utilities	The principal risks from inflation in utilities depends on how they are regulated but there can also be an affordability impact that needs to be considered. By-and-large, utilities earn revenue on pre-agreed tariff plans approved by their regulator, and these typically include price adjustments for inflation that can be passed on to end users. Although this varies, there can be a timing mismatch in terms of when higher borrowing costs, discount rates and operational and capital costs in particular are reflected in tariffs depending on the regulatory cycle. Also given the essential aspect of the services they provide, sharply rising inflation and costs and therefore prices, can lead to an increased focus on affordability which needs to be monitored closely.	These companies have tariffs that are directly or indirectly linked to inflation via regulation providing investors with strong inflation protection. In Europe and the UK, for example, Regulated Utilities have tariffs linked to inflation, and higher debt and equity return requirements lead to higher tariffs in time. The regulated asset base is typically annually indexed for outturn CPI and capital expenditure. All these factors mean Regulated Utilities generally shield investor returns from high inflation.
Renewable Energy	Rising operating costs and interest rates are unable to be passed through into tariffs for existing operating assets and capital cost inflation can impact individual project returns where the input costs cannot be adequately hedged. Furthermore, rises in the cost of capital can impact valuations for renewable energy companies given they generally have higher growth profiles.	Renewable energy companies typically have power purchase agreements or other supply arrangements that specifically allow for the pass through of inflation. Also, for uncommitted growth projects, Renewable energy companies should be able to embed higher assumptions for capital, operating and financing costs in new offtake pricing and/or auctions mitigating the inflationary impact.
Communications Infrastructure	Mobile Towers are relatively long-duration infrastructure assets and as such higher inflation and cost of capital assumptions negatively impacts valuations. US tower companies have benefited from fixed 3% annual escalators versus much lower inflation over the last 20 years.	The operating margins of Mobile Tower companies are largely protected by built in escalators in the contracts with their customers. In the US, the escalators are typically fixed at an average of around 3%, which covers the fixed annual increase in the cost of ground leases under their towers, by far their largest operating cost. In international markets the escalators tend to be based on local inflation rates, mirroring the expected increase in their costs.
Energy Infrastructure	The energy infrastructure companies that fit Ausbil's definition of Essential Infrastructure are typically regulated or have long-term contracts in place. The risks for the regulated pipeline companies are similar to that of the regulated utilities in that there can be a timing mis-match to recover inflationary cost increases. Where long-term contracts are in place, there is usually some level of inflation protection built-in.	In an inflationary world, particularly one with commodity-related geo-political risk, then we are likely to see commodity prices rise, but also differentials in prices between regions increase. This will likely increase the movement of commodities both within countries and around the world, which plays into the long-term demand for these services, and also potential expansion opportunities

Q: What does all this mean for investors?

A: For investors seeking superior investment returns, the characteristics of Essential Infrastructure offer relatively higher yield than global equities. In addition, listed Essential Infrastructure offers the potential for attractive capital growth over the long-term underpinned by secular investment opportunities over coming decades relating to, for example, the decarbonisation of economies and the rise of 5G and future mobile technologies. With this superior yield comes less volatility, and relatively lower risk in terms of asset backing and inflation risk compared to global equities. Given these assets are essential to the workings of their respective economies, generally display monopolistic characteristics, and are highly regulated, their overall risk is relatively lower, a prerequisite for those seeking consistent investment yield through an economic cycle.

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