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Global Essential Infrastructure: Understanding the opportunity

Research and Insights

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Global essential infrastructure in listed markets offers investors access to some of the highest quality, profitable infrastructure assets with comfortable leverage from around the world. Essential infrastructure offers investors the opportunity to benefit from businesses with high barriers to entry, significant pricing power, an innate hedge for inflation, and long stable cash flows. Tim Humphreys, Head of Global Listed Infrastructure, talks about the compelling investment opportunity in Essential Infrastructure.

Key points

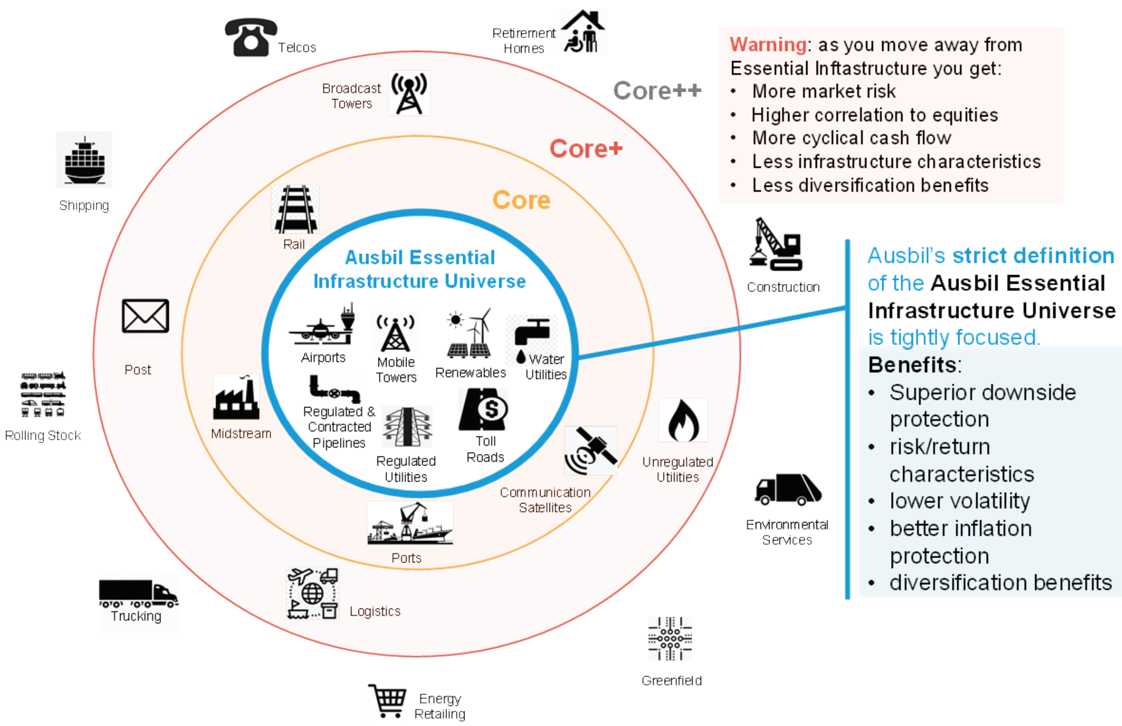
- Listed essential infrastructure offers investors access to some of the most sought-after assets in the world.
- Infrastructure assets deliver secure long-term cash flows for investors, often through structures such as multi-decade contracts or regulated revenue streams and the active avoidance of commodity and demand risk.
- The diversity in infrastructure means investors can access compelling underlying themes like sustainability and ESG, decarbonisation, population growth and movement, renewable energy, the electrification-of-things and the boom in global communications.
- Investing in infrastructure through the listed market benefits investors through superior transparency, more flexibility and diversification.
- The Ausbil Essential Infrastructure universe captures the 'essence' of what we know as infrastructure, but in listed form: the essential assets for the basic functioning of a society, such as regulated utilities (electricity, gas and water), regulated or contracted pipelines and renewables, toll roads, airports and mobile phone towers.

Q: What is essential infrastructure?

TH: Essential infrastructure refers to the assets that are 'essential' for the basic functioning of a society. Essential infrastructure is typically monopolistic, regulated or long-term contracted essential infrastructure assets and companies in sectors such as regulated utilities (such as electricity, gas and water), transport (for example, toll roads and airports), energy (like regulated or contracted pipelines and renewables) and communications (such as mobile phone towers).

As illustrated in Figure 1, the Ausbil Essential Infrastructure Universe is defined by assets within the inner circle of the diagram. Ausbil tightly defines Essential Infrastructure as a subset of Core infrastructure, focusing on infrastructure assets that are strictly long-term contracted / regulated.

Figure 1: Ausbil's strict definition of essential infrastructure



Source: Ausbil

To put a dollar figure on the total size of this essential infrastructure universe, it covers just over 100 companies across predominantly developed markets, totalling over US$2 trillion in total market capitalisation. This means the universe is large and very liquid such that it can absorb at least US$1bn in investment in just a few days. The listed essential infrastructure asset class is currently twice the size of private infrastructure, including private equity approaches to infrastructure, that sits at around US$1tr of which US$650bn has been deployed. Private infrastructure funds still hold around US$350bn in uncalled equity and capacity which is yet to be deployed into the asset class. As most private investment funds generally only get paid a management fee on cash that has been deployed, there is pressure to invest these funds as quickly as possible, risking 'definition creep' in what they secure. This can mean that new assets added to a portfolio can bring additional unwanted risks, many of which we do not believe reflect the true characteristics of infrastructure, such as commodity risk and consumer demand risk.

Recently, infrastructure has adopted terms typically associated with private equity (Core, Core+, Core++, Value-add and Opportunistic) to describe different assets on their basic risk and return characteristics. These categories have stuck, regardless of their suitability, and are also illustrated in Figure 1.

Moving out along the risk curve, Core+ infrastructure is defined as assets that bear some element of market risk and volatility. This means that investors can be giving up safer secular growth and taking on more volatile cyclical growth. For instance, Core+ includes infrastructure companies that have more cyclical business models with contract structures that are shorter in duration, and whilst they may have limited barriers to entry, market competition still exists. Core+ infrastructure assets typically include sectors such as broadcast towers, logistics, postal and unregulated utilities. Core+ infrastructure assets are likely to include material market and demand risk which reduces the security of cashflows and, in our opinion, moves them away from what we define as essential infrastructure.

Even further out along the risk curve is Core++ infrastructure, defined as assets with a higher associated degree of market risk and volatility in earnings. Core++ assets have higher levels of demand risk, and significant user-driven economics, often without holding a monopoly or significant barriers to entry. Core++ infrastructure can include construction, environmental services, greenfield infrastructure, energy retailing, retirement homes, rolling stock, shipping, telecommunications and trucking sectors. Revenues can contain significant portions of non-infrastructure generated cashflow. Any opportunistic or value-add assets in the infrastructure space are generally considered to have a Core++ risk profile, at a minimum.

These are the broadly accepted categories of infrastructure, with the inner-most category, the Ausbil essential infrastructure universe being an Ausbil house definition for infrastructure. However, it must be noted that infrastructure is a non-homogeneous asset class, and there are often regular and large exceptions to the accepted definitions, and some asset types or specific companies within an asset type may traverse the defined boundaries.

Q: Apart from what may seem obvious like airports and toll roads, why is infrastructure so important and is the world building enough of it?

TH: According to McKinsey Global Institute research (2016), the world invests some US$2.5 trillion in infrastructure a year, in sectors such as transportation, power, water and telecommunications. The problem, according to McKinsey, is that the world needs annual investment of around US$3.3 trillion through to 2030 just to support current projected global economic growth, effectively resulting in a cumulative US$49.1 trillion gap in infrastructure investment by 2030.

This underinvestment in a burgeoning and somewhat unstoppable demand for infrastructure, driven by economic growth and pure population growth, has become a significant opportunity in an asset class that is relatively young, and increasingly in focus for investors.

Q: What are the benefits of essential infrastructure assets from an investment perspective?

TH: From an investment perspective, the key investment characteristics of classic infrastructure are typically described as being:

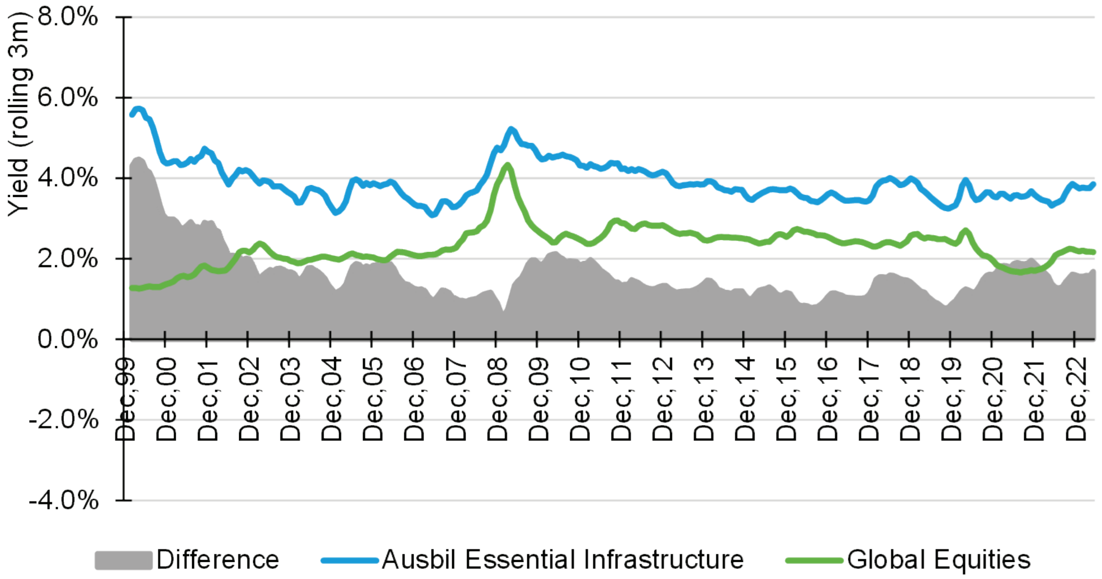
- high barriers to entry with monopolistic characteristics,
- earnings growth and stability through the economic cycle, with less volatile cashflows,
- more stable long-term returns,
- naturally hedged for inflation, and
- less correlated to equity markets.

Essential infrastructure tries to distil these characteristics into a portfolio that really expresses the most desirable characteristics. This means that essential infrastructure should offer a compelling mix of yield, relative stability and long capital growth in the returns it offers investors.

Superior yield

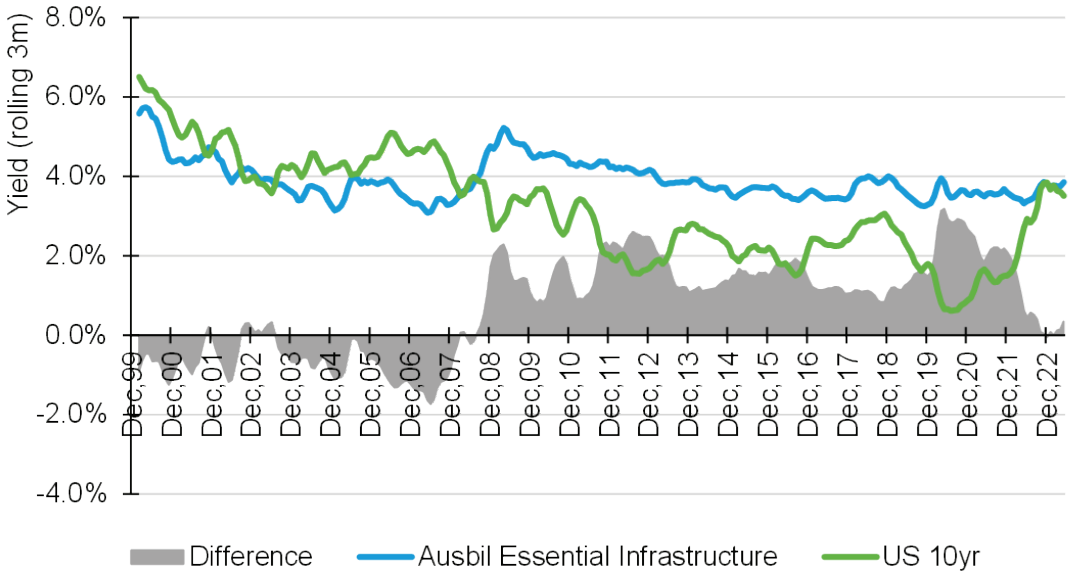
On the income or yield side, listed global essential infrastructure assets demonstrate strong yield outperformance across most periods when compared to US government bonds, and consistently offer a significantly higher yield than global equities, as illustrated in Chart 1.

Chart 1: The relative yield of infrastructure compared to global equities



Source: Ausbil, Bloomberg

Chart 2: The relative yield of essential infrastructure compared to 10-yr bonds



Source: Ausbil, Bloomberg

Since December 2000, listed essential infrastructure assets have 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 over the same period (Chart 1), and US 10-year treasuries of 3.2% pa (Chart 2). On average, the global essential infrastructure yield has exceeded global equities by 1.6% pa, and treasuries by 0.7% pa.

Perhaps one other compelling observation that can be made is the variability in returns, with global essential infrastructure offering more stable yields with lower variability as evidenced by a standard deviation in yields of +/- 0.5%, similar to the variability in global equity yields of +/- 0.5%, but lower than the variability in 10-year treasury yields of +/- 1.3%.

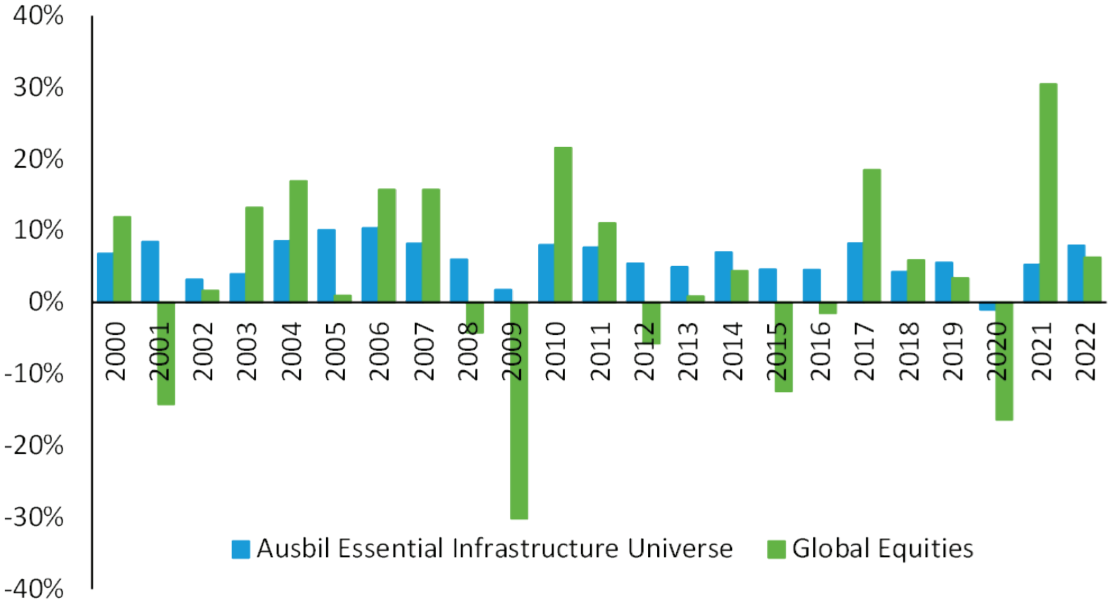
The yield of essential infrastructure has not only been consistently and notably higher than those of global listed equities and US bonds, but the yield of the asset class has also been more stable, and less volatile, an attractive characteristic for yield-dependent investors.

The unique cash-flow nature of infrastructure is such that equity investors in this sector forego some elements of growth, mostly cyclical, compared to what is on offer in global equities. However, in return, investors gain exposure to longer-term secular growth themes along with 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 markets' real assets.

For most essential infrastructure assets there is little to no competition or substitution, and yields are underpinned by long-term contracts and concessions. These are agreed with regulators, governments and customers, and generally allow for steady increases in revenue streams to cover operating and capital costs, and inflation rises.

This stability in revenue and earnings is the cornerstone of essential infrastructure, and can be seen in Chart 3, which shows the year-on-year EBITDA growth for essential infrastructure companies compared to that of global equities.

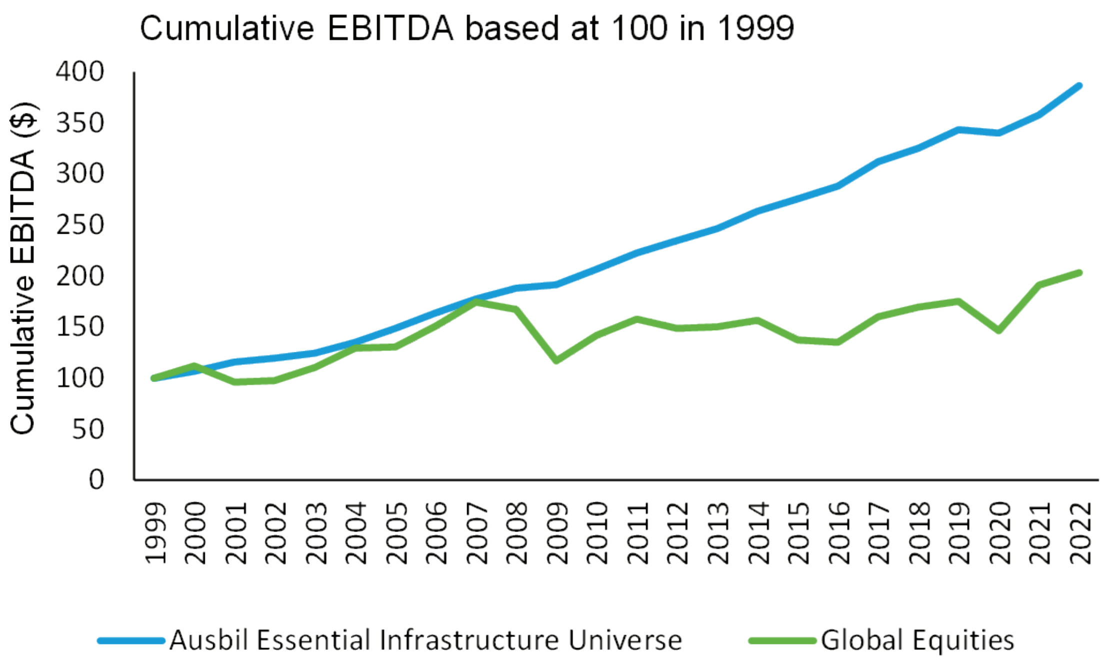
Chart 3: Infrastructure earnings (EBITDA) growth across the cycle compared to global equities (2000 – 2022)



Source: Ausbil, Bloomberg

One of the strong themes that can be seen in infrastructure earnings growth is that it is consistently positive across the cycle. Chart 3 demonstrates this stability and secular growth compared to the cyclical 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 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 – 2022)



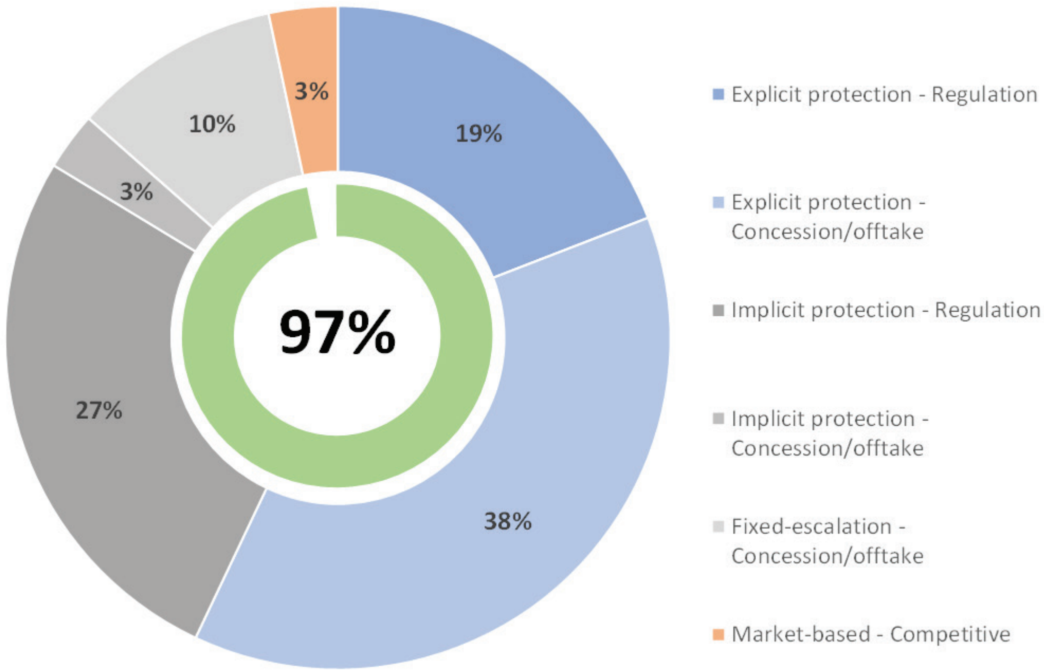
Source: Ausbil, Bloomberg

Inflation hedge

Turning to inflation, essential infrastructure should demonstrate a high degree of inflation protection, because in a tight definition of essential infrastructure, inflation protection is one of the key characteristics.

Figure 2 illustrates the high-level of inflation protection built into the Ausbil essential infrastructure portfolio. Some 97% of our essential infrastructure portfolio has a direct means by which to pass through inflation to users through price adjustments. It is important to note that there can be a lag of up to 2 or 3-years before the full impact of inflation is reflected in revenues. For example, toll roads increase their tolls based on the previous year's inflation number, so they do not start to get a revenue uplift until around 12-months after inflation starts to rise. This means that companies are set to benefit over the next few years, regardless of where inflation goes from here, as the full positive impact of recent inflation feeds through.

Figure 2: The proportion of inflation hedging by type across Ausbil's essential infrastructure portfolio



Source: Ausbil Global Essential Infrastructure Fund as of 30 April 2023.

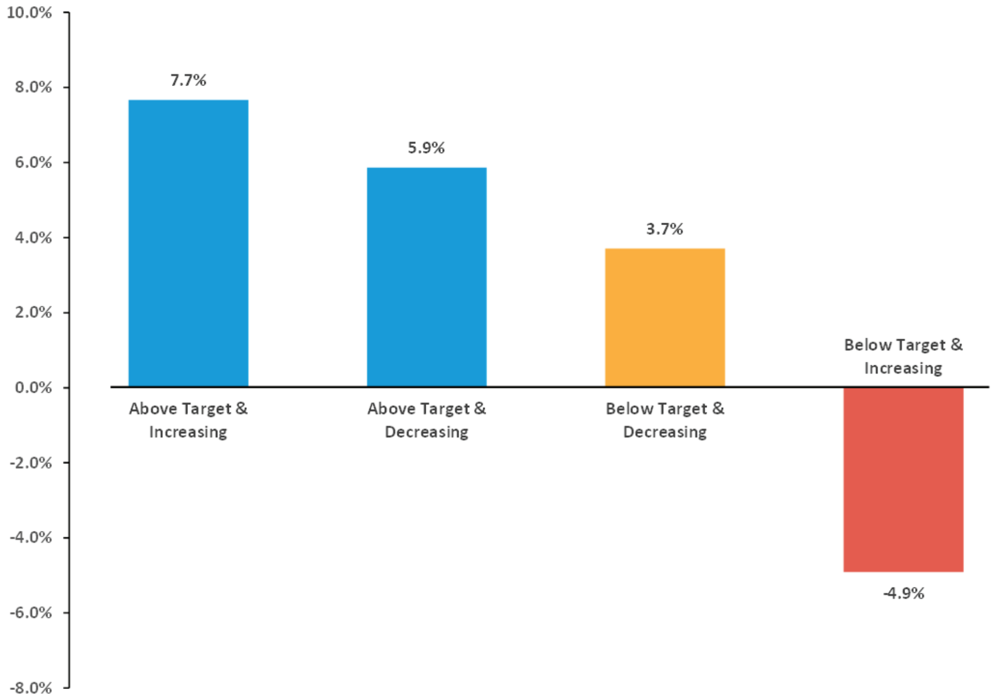
At an absolute level, essential infrastructure has historically performed best under a moderate inflation backdrop. This has been the case as the moderate inflation typically translates into healthy cashflow growth through contracted or regulated CPI escalators (adjustment clauses in contracts that allow for CPI to pass through the charging structure for users), whilst not causing significant changes to nominal base yields.

By way of illustration, Figure 3 shows how essential infrastructure performs relative to global equities across various inflation scenarios, including:

1. inflation above the Federal Reserve (Fed) Funds target range, and increasing;
2. inflation above the Fed Funds target range, but decreasing;
3. inflation below the Fed Funds target range, and decreasing; and
4. inflation below the Fed Funds target range, but increasing.

What we find is that in the first two scenarios, as long as inflation is above the Fed's target of 2%, infrastructure has historically outperformed global equities. Under scenario three, where there are concerns over an economic slowdown or recession and investors rush to defensive cashflows and high quality (both hallmarks of essential infrastructure), listed infrastructure outperforms. In scenario four, where inflation has bottomed and is starting to increase (a classic cyclical turning point signal that leads investors to sell defensives and buy cyclicals), listed infrastructure underperforms global equities. Unsurprisingly, in scenario 4, whilst essential infrastructure has risen on an absolute basis, it still underperforms global equities.

Chart 5: How essential infrastructure performs versus global equities in various inflationary environments



Source: Ausbil, Bloomberg.

Importantly, we think that active management can lead to better outcomes when managing inflation impacts on the portfolio. Infrastructure sectors are heterogeneous, and offer the opportunity for active allocation towards sectors that hedge well for inflation, and those that thrive in inflationary environments. For example, transportation 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. Energy infrastructure (oil and gas pipelines), by contrast, has historically performed strongly as high inflation leads to higher commodity prices and therefore increased exploration, drilling and capex activity, which ultimately leads to higher volumes carried by pipeline infrastructure.

Diversification benefits

From the perspective of diversification, while the Ausbil essential infrastructure universe is highly correlated to the general index (FTSE 50/50 Developed Core Infrastructure Index), it is significantly less correlated to global equities (0.59), US corporate high yield (0.67) and global bonds (0.42), as shown in Figure 3.

Figure 3: Lower correlations with other asset classes

	Ausbil Essential Infra (Linked)	FTSE Dev Core Infra 50/50	Global Equities	US Corp High Yield	Global Bonds
Ausbil Essential Infra (Linked)	1.00				
FTSE Dev Core Infra 50/50	0.95	1.00			
Global Equities	0.59	0.66	1.00		
US Corp High Yield	0.67	0.68	0.83	1.00	
Global Bonds	0.42	0.27	0.44	0.59	1.00

Source: Ausbil, Bloomberg Rolling 12 month correlation coefficients from 31 October 2011 to 30 April 2023. Global Equities as MSCI World Index, US Corp High Yield as Bloomberg Barclays US Corporate High Yield, Global Bonds as Bloomberg Barclays Global Aggregate Bond Index, FTSE Dev Core Infra 50/50 as FDCICUN Index, Ausbil Essential Infrastructure is represented by Ausbil Essential Infrastructure universe (100 companies) back testing through 31/12/2018 and Actual portfolio 31/12/2018-30/04/2023.

Q: What differentiates Ausbil's Global Essential Infrastructure strategy?

TH: Ausbil's Global Essential Infrastructure strategy is a style-agnostic, high-conviction, concentrated portfolio of high-quality global essential infrastructure stocks. Ausbil's unique approach means that the team only invests in companies that are 'essential' for the basic functioning of society and have a track record of delivering the characteristics of infrastructure. This definition is much stricter than peers and assets are predominantly regulated or under long-term contracts. This proprietary and tight definition seeks to best express the most desirable characteristics of infrastructure, namely inflation protection, downside protection, income and secular growth.

Quality is also a key differentiator for Ausbil. We conduct an extensive quality assessment on all of the companies in our universe in order to understand how their quality sits today, and how it can change, for better or for worse in the future. Importantly, this is done through the lens of infrastructure specialists, looking at such things as regulation and management. Quality for us is just as important as valuation, and we think that this is an important differentiator to other managers.

As long-term investors, Ausbil assesses listed infrastructure investments as if we were acquiring the entire company and its infrastructure assets to own them for many years. Unlike typical equity investors who look at short-term earnings-based multiples, we evaluate the total lifecycle cashflows for each company and its assets, and our valuations are based on the difference between our expected rate of return and the cost of capital. This approach is similar to private equity and differentiated from our peers. In addition, each company undergoes detailed due diligence from both a quality and ESG perspective.

Q: Do you apply ESG (Environment, Social, Governance) considerations in your essential infrastructure investing?

TH: We integrate ESG into our investment process for a number of reasons. Firstly, we believe the consideration of forward thinking ESG factors is crucial when assessing the long-term overall sustainability of the types of companies and assets in which we are invested. Secondly, we believe that adding ESG considerations vastly increases the understanding of potential risks, helping further refine our investment thesis on companies. Thirdly, we are seeking to build portfolios with better sustainability scores given that we believe markets will increasingly punish those with poorer ESG characteristics. Finally, ESG helps with identifying existential issues with the future of assets, for example, those that are more impacted by events like global warming or the secular fall in the demand for fossil fuels. In short, we believe ESG adds an irreplaceable layer of risk assessment that can improve our long-term risk-adjusted returns.

Ausbil applies ESG principles and assessments in our essential infrastructure approach, including the following:

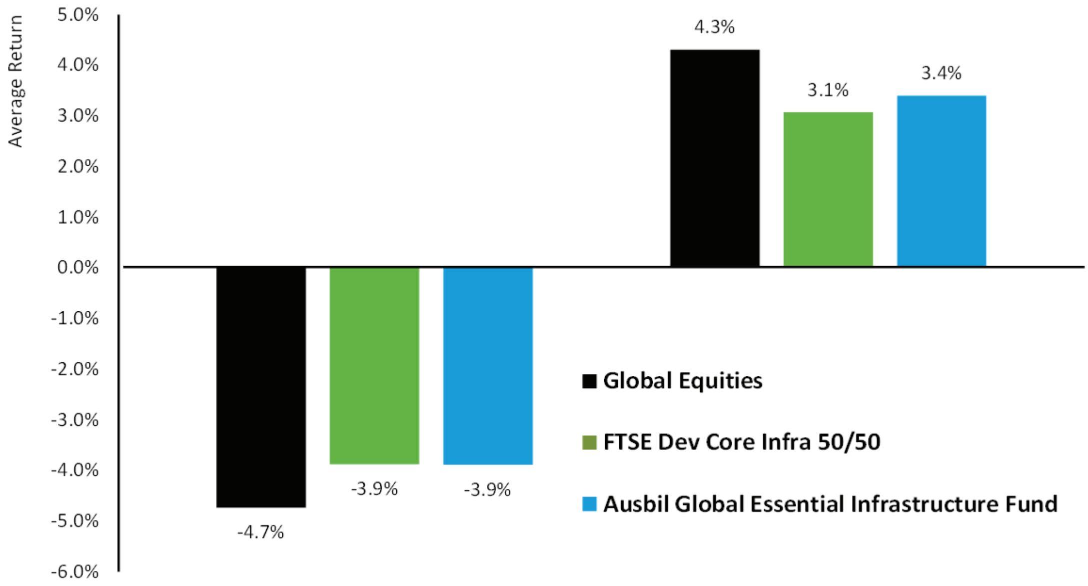
- We apply negative screens to exclude companies involved in controversial activities, including thermal coal.
- Quantitative analysis of E, S and G factors is undertaken in order to derive individual company ESG scores on which we can rank our investment prospects on ESG factors.
- We generate an industry ESG score based on each sector's sustainability characteristics, and when combined with the individual company ESG scores, this derives an overall sustainability score for each company.
- We actively engage with portfolio company management on key ESG factors, for example, management of indigenous affairs, formulation of climate goals, social impact, environmental impact, in order to understand ESG-related risks and encourage improvement.
- We take an active approach to voting the shares we are responsible for in order to improve ESG outcomes.

Q: How does essential infrastructure perform over time?

TH: Infrastructure performs relatively well over time compared to global equities, given its defensive characteristics combined with secular, rather than cyclical, growth. Chart 6 shows the return capture performance for the Ausbil Essential Infrastructure strategy since inception in December 2018 compared to global equities (MSCI World) and global listed infrastructure (FTSE Developed Core 50/50 Infrastructure Index). While global equities delivered an average of 4.3% in up months, the FTSE 50/50 still delivered 3.1% and the essential infrastructure universe delivered 3.4%, representing an 'upside capture' of around 80%.

For us, downside protection is more important than upside capture, and pleasingly, the downside capture of essential infrastructure has been around 83% of the downside that global equities has suffered during down months. COVID lockdowns significantly impacted global infrastructure, listed and unlisted, in 2020 and 2021, however, downside capture was still superior to that of global equities. Importantly, it is the asymmetry of the upside and downside capture that is important, and we seek to can control the downside, and capture most of the upside in rising markets, so that over the long term we increase the potential to outperform.

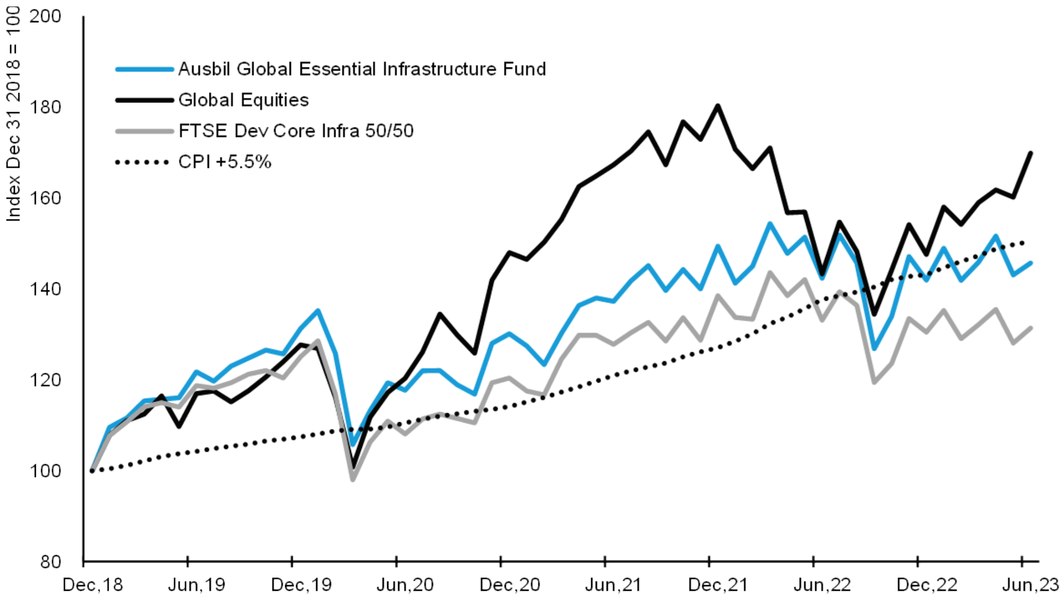
Chart 6: Asymmetric returns, equity-like upside with half the downside



Capture ratios vs MSCI World Index, Source: Ausbil, Bloomberg, FTSE. Total Return, USD from December 2018 to June 2023. Global Equities as represented by MSCI World Index, FTSE Dev Core Infra 50/50 as FDCICUN Index, Ausbil Essential Infrastructure is represented by actual gross portfolio returns 31/12/2018-30/06/2023. All data is Total Return, USD. Due to rounding the figures may not add up. Past performance is not a reliable indicator of future performance.

Unsurprisingly, given this asymmetry of upside and downside capture, over time, the compound relative outperformance of Ausbil's essential infrastructure universe compared to global equities, and the FTSE 50/50 infrastructure index, shows significant outperformance for Ausbil's Essential Infrastructure strategy compared to the general infrastructure index, as illustrated in Chart 7.

Chart 7: Long-term compound relative performance of Essential Infrastructure



Source: Source: Ausbil, Bloomberg, FTSE. Total Return, USD from December 2018 to June 2023. Global Equities as represented by MSCI World Index, FTSE Dev Core Infra 50/50 as FDCICUN Index, Ausbil Essential Infrastructure is represented by actual gross portfolio returns 31/12/2018-30/06/2023. All data is Total Return, USD. Due to rounding the figures may not add up. Past performance is not a reliable indicator of future performance.

Q: What does this mean for investors?

TH: In conclusion, the main point to make on infrastructure investing is, *caveat emptor*, or buyer beware. Not all infrastructure is the same. Definitions of unlisted infrastructure are being continuously stretched as the asset class grows and higher allocations are made. As a result, index definitions crawl out along the risk curve, and increasingly include assets that are not, by definition, essential or even core infrastructure. As we have seen, this has significant consequences on the risk and return characteristics of a portfolio.

Our belief is that investors allocate to infrastructure in order to access a unique combination of characteristics. This includes downside protection, inflation protection, low cyclicality, low commodity risk, lower correlations with other asset classes, and access to long-term secular growth. These are the characteristics that we focus on when we build our portfolio because we believe this is what investors are seeking.

In our view, it is crucial that investors seeking the true investment benefits of the infrastructure asset class look to essential infrastructure to replicate these benefits. By having a very tight definition, only those companies and assets that are able to demonstrate true infrastructure investment characteristics are included.

From this foundation springs the overall long-term characteristics of a basket of essential infrastructure stocks, such as lower downside capture, lower maximum drawdown, persistent high risk-adjusted returns and diversification benefits.

Q: What is the outlook for global essential infrastructure in 2023?

TH: As we approach the midpoint of 2023, two prominent factors continue to dominate the market landscape: inflation and interest rates. While inflation has been gradually decreasing in most countries, it has not been declining at the pace desired by central banks. Consequently, central banks have been raising interest rates in their pursuit of achieving price stability. We think inflation and interest rates will remain higher for longer, and we do not see any interest rate cuts by the Fed until at least 2024.

Essential infrastructure is well positioned to navigate this current environment. When evaluating essential infrastructure stocks, one of the characteristics we prioritise is cash flow protection against inflation. This can be achieved through regulatory mechanisms (like with utilities), or contractual escalators (like with energy infrastructure). Moreover, when interest rates reach their peak, it is likely to be favourable for infrastructure assets, particularly those with longer durations that have underperformed across the rate-rising cycle.

Historical data suggests that infrastructure tends to outperform broader equities once interest rates reach their peak because the secular growth prospects for infrastructure remain relatively stable in a high interest rate environment. This consistent growth trajectory is a significant advantage of essential infrastructure, making it an appealing investment choice in the years to come when compared to other sectors. It is therefore unsurprising to hear that a lot of investors that we talk to are revising upwards their allocations to listed infrastructure to around 10%, and even 15% in some cases.

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