

Essential infrastructure: The 2024 outlook for growth and opportunity

Research & Insights

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Ausbil Investment
Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200

Ausbil's Global Listed Infrastructure team shares their outlook for essential infrastructure for 2024, why inflation benefits infrastructure assets, and where they think growth and opportunity will be most compelling in the coming year.

10-minute read

Key points

- Opportunity: We believe infrastructure valuations do not currently reflect the cashflows generated from infrastructure assets, and that they are cheap in the current market. This is a significant opportunity for investors to benefit as they are re-rated on improved earnings.
- Current valuations do not reflect the fact that infrastructure is expected to see an uplift in profitability from inflation-driven revenue increases in a normalised, higher rate environment. Furthermore, current valuations do not reflect the longer-term benefits from secular growth themes such as the energy transition, repowering Europe, 4G to 5G transition on mobile phone technology, or the benefits of electrification and AI on power distribution and demand.
- Essential infrastructure is now offering upside potential last seen in the pandemic storm brought on by COVID-19.
- With valuations depressed but revenues rising on inflation - and driven by the compelling growth economics of the energy transition, 5G, electrification and AI - we believe that this is a compelling time to be increasing exposure to global essential infrastructure.
- The Ausbil Global Essential Infrastructure strategy achieved its 5-year milestone in December 2023, capping off a dynamic period, the heart of which was the global pandemic.

Q: In the current macro environment, and following the rapid normalisation of monetary policy over the last 18-months, how is infrastructure positioned?

TH: The rapid rise in bond yields globally has triggered a sell off in essential infrastructure, creating an exciting investment opportunity. As we stand at the end of calendar 2023, with US cash rates having risen from 2022 lows of 0% by ~550bps to 5.25-5.50%, and the yield on US 10-yr Treasuries having risen by ~300bps from around as high as 5.00%, the market has now returned to more normal levels for interest rates, though with higher inflation, as illustrated in Chart 1. In situations where inflation is driving higher bond yields, this is a positive backdrop for infrastructure assets as we argue below. However, during periods where real yields rise quickly and bond yields are not being driven by rising inflationary expectations, as has been witnessed during recent months, we can see disproportionate sell offs in longer duration asset classes like infrastructure.



Tim Humphreys

Head of Global Listed Infrastructure

Phone: +61 2 9259 0281
Email: tim.humphreys@ausbil.com.au



Jonathan Reyes

Co-Head of Global Listed Infrastructure

Phone: +61 2 9259 0286
Email: jon.reyes@ausbil.com.au



Natasha Thomas

Portfolio Manager - Energy and Communications

Phone: +61 2 9259 0283
Email: natasha.thomas@ausbil.com.au

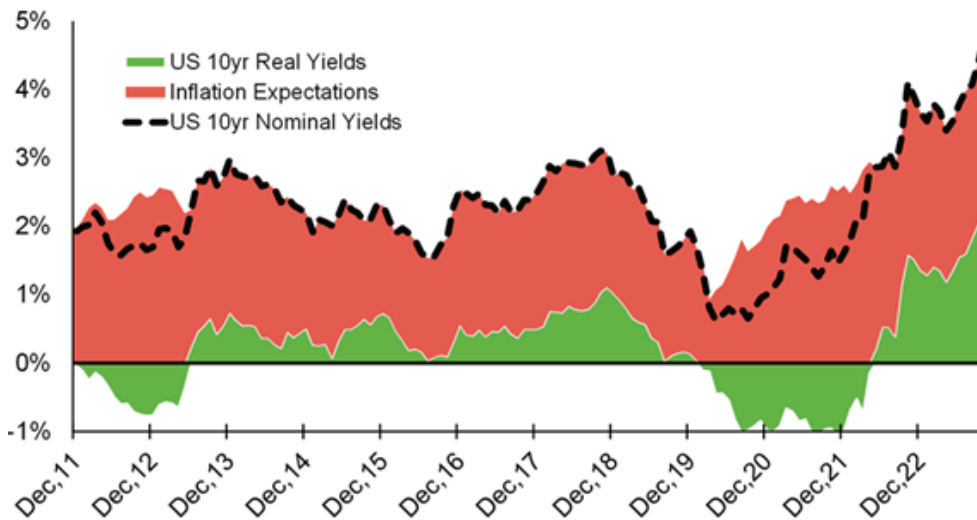


Paul Johnston

Portfolio Manager - Utilities

Phone: +61 2 9259 0284
Email: paul.johnston@ausbil.com.au

Chart 1: Infrastructure assets at valuation lows compared to the expected outlook for returns

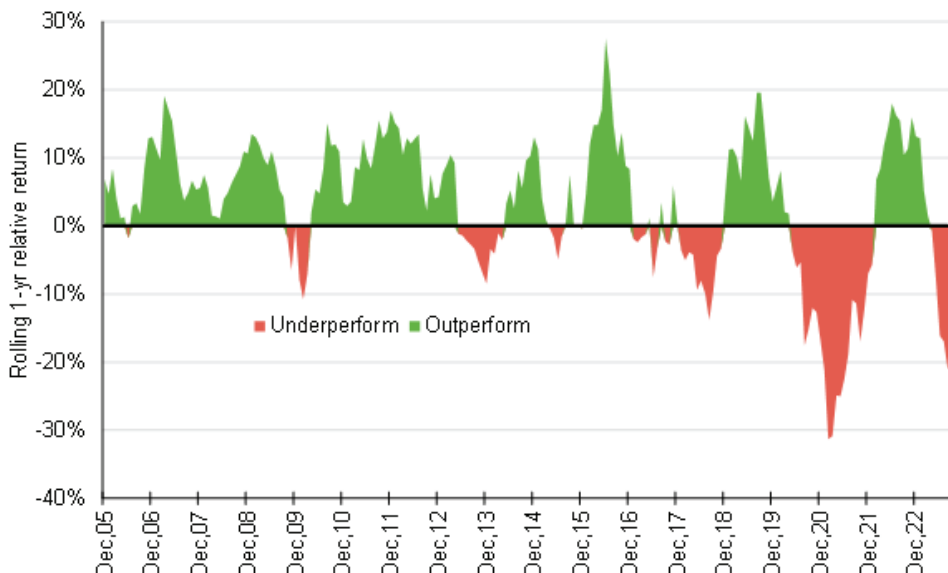


Source: Ausbil, Bloomberg. US 10yr real yields as represented by H15X10YR Index, Inflation expectations as represented by USGGBE10 Index as at October 2023.

Inflation expectations have actually come down over the past year, but nominal interest rates have continued to increase. This means that real yields are now 2-2.5%, a major reversal of the negative real yields experienced in 2020 and 2021 during the pandemic. This kick-up into positive normal territory represents the end of a long journey in emergency monetary policy that began in 2008 with the Global Financial Crisis, continued through the Sovereign Debt Crisis and Brexit, and finally through the COVID pandemic. With the rapid rise in rates from the start of 2022 to mid-2023, and the wind down of QE which has been underway since 2018, the normalisation of rates coincided with a significant rise in real yields towards their long run average of around 2-2.5%.

The most recent leg-up in real yields to 2% and above coincided with some rebasing in prices across global equity markets, with essential infrastructure disproportionately impacted. However, we believe that there is an exciting opportunity for infrastructure investors in these shorter-term moves. We believe essential infrastructure companies are trading around historical valuation lows, despite the positive outlook for revenues and cashflows partly driven by higher inflation levels that benefit infrastructure assets. This future cashflow growth has not yet been reflected in prices, as shown in Chart 2.

Chart 2: Essential infrastructure relative to global equities



Source: Source: Ausbil, Bloomberg. Total Return, USD from 31 Dec 2005 to 30 September 2023. Global Equities as represented by MSCI World Index, Ausbil Essential Infrastructure is represented by Ausbil Essential Infrastructure universe (100 companies) back test through 31/12/2018 and Actual portfolio 31/12/2018-31/09/2023.

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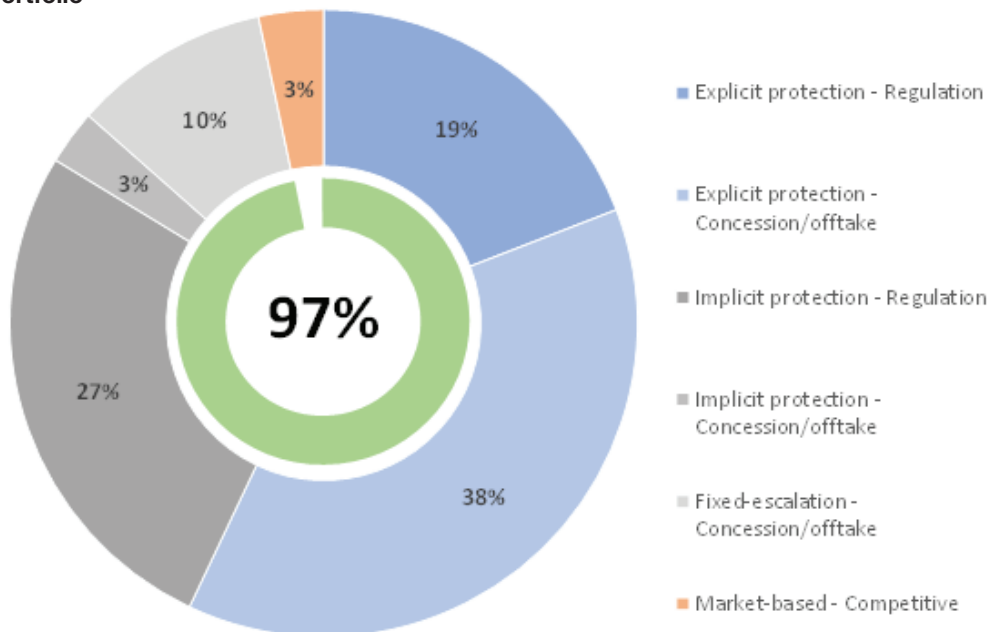
Over the last 12-months, essential infrastructure has underperformed global equities by some 20%, which represents a move of more than two standard deviations. A move of such size has only recently been matched by the experience during the pandemic lockdowns of 2020 and 2021, which were especially hard on infrastructure such as toll roads and airports. As we saw in the pandemic, such moves are often good opportunities for investors, and in the current situation the rebasing in values for inflation has meant that infrastructure investors can buy inflation-adjusted future cashflow at even more of a discount.

Q: Why is inflation good for infrastructure cash flows?

JR: Turning to inflation, essential infrastructure demonstrates a high degree of inflation protection largely due to the design of the contracts and regulatory policy that supports their licence to operate in various jurisdictions and activities. In very simple terms, infrastructure assets are usually allowed to increase their revenues by inflation, and some, like water utilities that are allowed to earn a defined rate of return, can inflate the value of their asset bases by inflation that increases their allowable cash flows.

Chart 3 illustrates the high-level of inflation protection that is 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, certain toll roads are able to 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.

Chart 3: The proportion of inflation hedging by type across Ausbil's Essential Infrastructure portfolio



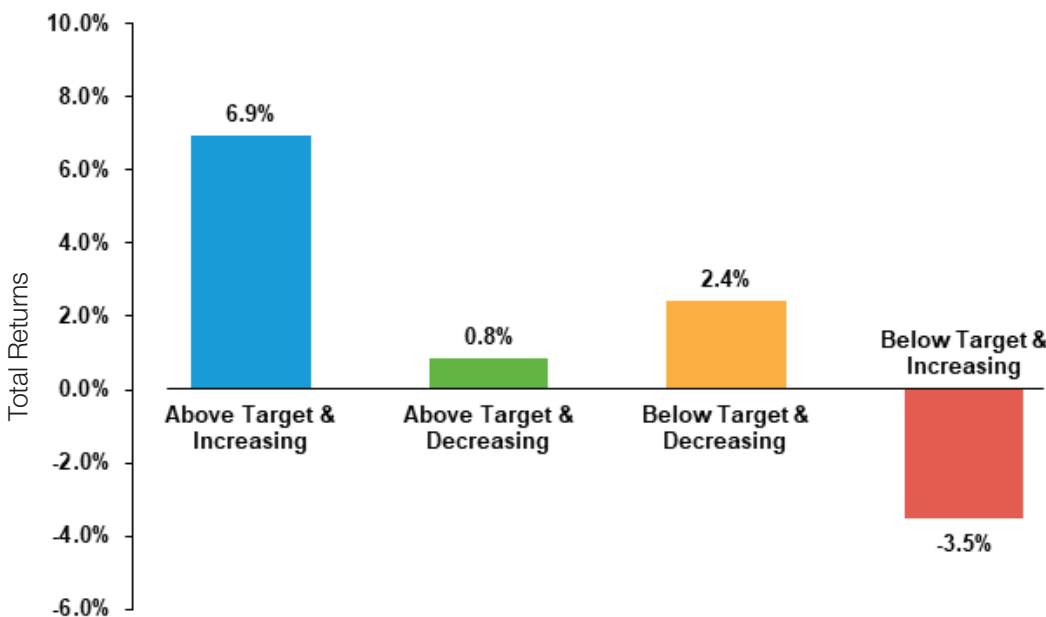
Source: Ausbil Global Essential Infrastructure Fund as of 30 April 2023.

Q: In terms of outlook, under what inflationary conditions does infrastructure do well?

TH: 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.

Chart 4: How Essential Infrastructure performs in different inflationary environments

Average Annualised Relative Performance:
Essential Infrastructure Universe vs. Global Equities during inflation regimes



Source: Past performance is not a reliable indicator of future performance. Source: Ausbil, Bloomberg from 31 December 2005 to 30 June 2023. Ausbil Global Essential Infrastructure Universe vs MSCI World Index. All data is Total Return, USD. Average monthly total returns during inflation regimes, annualised. Inflation Regimes calculated as the U.S. CPI relative to 2% FED target.

Chart 4 shows how essential infrastructure performs relative to global equities across various inflation scenarios. 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), essential 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), essential infrastructure underperforms global equities. Unsurprisingly, in scenario four, whilst essential infrastructure has risen on an absolute basis, it still underperforms global equities.

Q: You mentioned that the inflation outlook was actually beneficial for infrastructure returns. Can you elaborate?

JR: As discussed, a higher inflationary environment will benefit Essential Infrastructure’s inflation-linked cashflows as the companies are able to adjust pricing in tandem with the rising cost of goods and services. One key factor that is often not fully appreciated by the market is the compounding effect of higher inflation over time. As companies are allowed to increase their pricing to keep pace with inflation, the incremental increases in tolls or fees collected from customers will compound over the years and decades to come. This compounding effect bolsters essential infrastructure company’s ability to fund future projects, distribute dividends, and preserve their value in real terms.

Q: What do you think are the key drivers of growth for listed infrastructure in the coming year?

TH: The infrastructure market is complex and often very asset and geography specific when looking at the drivers of growth. While we have seen that inflation is set to benefit uplift in future cash flows for infrastructure, there are also some major growth drivers in the overall total return equation which offer compelling opportunities in the asset class. The team describes these opportunities below, the thematic and the outlook they see for 2024 in communications, regulated utilities, transport and energy infrastructure.

Q: Natasha, can you describe the opportunities in 2024 for the communications sector?

NT: As some of the longest-standing companies in the essential infrastructure sector, mobile phone tower firms have demonstrated relatively lacklustre performance in the past 12-18 months. This can be attributed firstly to the rise in interest rates and subsequently to the prevailing sentiment of 'higher for longer'. Notably, publicly traded tower companies continue to trade at a significant discount compared to their private market counterparts. This discount is despite the underlying strength of these businesses, with the recent devaluation in the public mobile phone tower sector being primarily driven by macroeconomic conditions. Looking forward, the primary driving force behind the global demand for mobile phone tower companies remains the relentless surge in mobile data consumption.

In just the last two years, mobile network data traffic has nearly doubled, reaching an astonishing 126 exabytes of data per month. Looking ahead to the next five years, the projected growth in data traffic per device remains highly compelling. We are still in the early stages of the 5G investment cycle worldwide, and we maintain a strong belief that a sustained period of investment lies ahead, similarly to the past cycles seen with the shift to 2G, 3G and 4G technologies.

This ongoing growth will be fuelled by a variety of factors, whether it is the emergence of data-hungry applications or the increasing use of artificial intelligence. Mobile phone carriers across the globe will continue to make substantial investments in their networks to enhance coverage and expand capacity to meet the ever-increasing consumer demand. Consequently, this leads to heightened leasing activity and increased revenue opportunities for the mobile phone tower companies.

Q: Paul, how is 2024 looking for regulated utilities?

PJ: Utility regulation varies materially from country to country, and indeed from state to state in North America. As a result, the outlook for utilities can vary and depends upon the regulatory constructs in each jurisdiction. For example, some utilities can mechanically pass on the increased cost of capital (debt and equity) periodically to customers, whilst others cannot and therefore may potentially take a hit to their profitability and valuation. Also, utilities with a higher proportion of holding company debt (that is debt not directly associated with a regulated asset or subsidiary) are generally less protected from higher interest rates. Similarly, some utilities are explicitly protected from the impact of inflation (for example, in the UK or Italy), whereas others have to ask their regulator for an increase in the prices they charge their customers to cover for the impacts of inflation on their costs.

We very much focus on those utilities that are well-regulated from an investor standpoint, and we particularly look for those companies with protection from inflation and interest rates combined with stronger balance sheets. With this in mind and given the discount that these companies are currently trading on, we believe that the outlook for our preferred regulated utilities is very attractive.

Interestingly, electric utilities are well poised to see an increase in demand for electricity, after many years of decline. The journey to Net Zero really means the electrification of everything, including transport, industry and commerce, and this will lead to an increased demand for electricity over the coming years. More recently, however, an extra layer of demand growth from the rapid emergence of artificial intelligence (AI) is becoming more apparent. Recently, we met with the CEO of an electric utility in the US who reported that Microsoft are proposing to build a data centre in their state in order to house some of their burgeoning AI capabilities. The required power for this data centre is estimated at around 1GW (gigawatt). To put this in perspective, 1GW is about the same output from a large nuclear reactor, and this is just for Phase 1 of the project, with subsequent phases to follow.

Q: Jon, what is transport offering infrastructure investors in 2024?

JR: The transportation sector has not been immune to the rapid movement in the macro market and has been negatively impacted by the sharp rise in real yields. However, our base view is that the large adjustment to new rate levels is largely behind us, and we are now moving to a more fundamentally driven market. With travel patterns normalising from the impact of COVID-19, the transportation sector is a great example of fundamentals leading the way forward in the equity recovery, back to pre-pandemic levels. Valuations remain supportive for much of the sector, and the traffic expectations priced-in by the market remain undemanding despite the increasing concern around current consumer purchasing power.

For airports, a full return of Chinese travellers is expected to be a tailwind in 2024, especially given that many airports are still at, or around, 2019 levels without contribution from this important and fast growing market segment. As the pandemic disruptions fade, we think that the market will again value up the long-term cash flow generation offered by these assets. For toll roads, the strong inflation capture will show through as tolls have been structurally raised for decades to come in many cases. The higher tolls combined with market valuations that has historically attracted private equity interest in the sector has us optimistic as we head into 2024 for the sector.

Q: Natasha, how are you seeing the energy infrastructure market in 2024?

NT: There is no question that the global shift towards cleaner and more sustainable energy sources is an ongoing trend, which presents significant opportunities for energy infrastructure companies worldwide. While the aspiration to achieve carbon reduction targets solely through renewable energy sources is commendable, we find it improbable because of the substantial investment still necessary between now and 2050, not only in renewable energy itself, but also in the electricity grids themselves. This is where energy infrastructure companies play a crucial role.

Our focus lies on identifying energy infrastructure companies with established regulation or fee-based contracts that are contributing to the energy transition. Examples include facilitating the transportation of natural gas through pipelines and exporting liquefied natural gas (LNG), primarily from North America to Europe and Asia. Despite being a fossil fuel, natural gas emits significantly less carbon dioxide than coal and oil when burned in power plants or used in transportation, making it a cleaner fuel. We anticipate that natural gas will continue to be a vital component of the fuel mix throughout the energy transition, not only for playing a role in grid stability but also for its place in achieving energy security.

Additionally, we are seeing increased investment opportunities that leverage existing energy infrastructure to support the energy transition, such as initiatives related to carbon capture and sequestration, hydrogen hubs, and renewable natural gas.

Q: What are the key risks that you are thinking about?

TH: A lot of the key risks relate to the prevailing macro-economic environment. If inflation starts to rise again, and we see central banks continue to hike interest rates further, then that would be a headwind for all long-dated asset classes, including infrastructure. Additionally, if real bond yields surge even higher this will be a further headwind the asset class. We believe that we are near the plateau for rates and real bond yields, but we are still considering the range of possible outcomes in how we position for this risk.

In addition, if economic activity starts to accelerate but inflation is under control, then investors may look to reduce positions in defensive asset classes in order to increase positions in asset classes that will benefit more from a cyclical upswing. We have seen this effect to a certain extent this year, as investors have chased technology and AI, and have used defensive assets to fund these positions.

Company-wise, we have been through reporting season, and most companies have either met guidance or increased guidance for the full year. Two issues on which we are focused are the debt books that infrastructure companies have, and the impact of re-financing maturing debt at current levels; and the impact of inflation on companies with meaningful capital expenditure plans, or with large labour forces where wage inflation could be a risk, such as airports.

Q: If you could sum up what excites you in infrastructure in 2024, what would you say?

TH: We see the compelling value proposition for essential infrastructure over the next 12 months as being a combination of three things. Firstly, the short-term underperformance relative to global equities has led to a significant valuation upside opportunity. Secondly, the benefits of recent inflation are yet to feed through into revenues and cashflow, and with inflation set to remain above trend for the next few years, this benefit will take several years to be fully reflected in higher profits. Finally, the long-term secular growth drivers such as the energy transition, repowering Europe, mobile phone technology transition from 4G to 5G, and the impacts of AI have never looked better. To us as infrastructure investors, this is both compelling and exciting, and we are positioned in essential infrastructure to benefit from this over the next twelve months.

Contact Us

Institutional



Mark Knight

Chief Executive Officer
Phone 0438 307 841
Email mark.knight@ausbil.com.au



Adrian Amores

Head of Global Institutional Distribution
Phone 0435 962 052
Email adrian.amores@ausbil.com.au



Fawaz Rashid

Senior Manager, Global Institutional Distribution
Phone 0401 830 483
Email fawaz.rashid@ausbil.com.au

Wholesale



Hik Chadirchi

Head of Wholesale Distribution
Phone 0424 160 728
Email hik.chadirchi@ausbil.com.au



Andrea McGarry

Business Development Manager, QLD & NT,
Wholesale Clients
Phone 0411 465 426
Email andrea.mcgarry@ausbil.com.au



Dimitri Giannaras

Business Development Manager, NSW & ACT,
Wholesale Clients
Phone 0431 576 815
Email dimitri.giannaras@ausbil.com.au



Marko Matosevic

Business Development Manager, VIC, TAS & WA,
Wholesale Clients
Phone 0431 340 553
Email marko.matosevic@ausbil.com.au



William Orr

Business Development Manager NSW,
Wholesale Clients
Phone 0402 620 188
Email william.orr@ausbil.com.au

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