Contactus@
ausbil.com.au

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Research and Insights

Tim Humphreys on the once-in-a-decade opportunity in infrastructure from COVID-19

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Q: What has been the impact of COVID-19 on the global infrastructure sector?

The rapid, multi-sector, and indiscriminate sell-down in markets experienced in March 2020 as a result of COVID-19 was lightning fast. So too was the unprecedented macroeconomic stimulus response from central banks and governments globally, bringing stimulus levels to over 10% of world GDP.

The subsequent partial rebound of equities has been impressive, but it is fair to say that quality infrastructure remains on sale. We haven't seen this kind of valuation in infrastructure assets since the GFC, a real opportunity to shape our portfolio towards greater quality, at prices that position many of these assets to outperform in the decade to come.

It was no surprise, given the nature of COVID-19, for the transport and energy sectors to be hit. Clearly, we've seen traffic in airports drop to zero, and we've seen traffic on toll roads materially impacted all due to the lockdown. However, we are expecting this sell-down to be short term.

Across all sectors, we think that the short-term share price reaction is largely an overreaction compared to the true long-term impact on the value of these companies.

When we look out long term at these assets on multi-year cash flow valuations, the impact of this event is negligible on the long-term performance of most infrastructure assets, and does not materially change their values.

For long-term investors who have been looking to initiate or build a position in infrastructure, regardless of whether there are U or V-shaped recoveries, this is an opportunity to accumulate infrastructure companies with a significant margin of safety to their underlying value.

Q: Which sectors have been resilient and which sectors have been less resilient?

We have seen a bifurcation in performance across infrastructure sectors, with communications and utilities outperforming, and transport and energy underperforming.

The commonly accepted stability in utilities, and their revenue streams, played out as companies like water, gas and electricity utilities outperformed relative to both global equities and diversified infrastructure. This is largely due to the defensive nature of their revenues, some simply because they are diversified across large and captive markets, many because they also carry the feature of decoupled revenues.

For many gas, electricity and water utilities, the revenue line is decoupled from rises or falls in usage in order to maintain a stable and predictable revenue stream for the company. For example, in electricity, typically if usage falls below assumed levels, tariffs adjust upwards in future periods, such that the contracted revenue for the utility remains relatively unchanged.

This means that there is negligible or limited exposure to demand reductions, as we have seen with infrastructure revenue relatively unchanged for utilities and other regulated assets through COVID-19.

Utilities such as National Grid (electricity and gas; LON: NG) and Severn Trent (water; LON: SVT) are examples of utilities that outperformed broad infrastructure and global equities in the sell-down, largely due to the decoupled nature of their revenues. Other utilities like Atmos (gas; NYSE: ATO) and NextEra (electricity, gas and renewables; NYSE: NEE) also

Tim Humphreys
Head of Global Listed Infrastructure

Tim has over 20 years of financial markets experience working in Sydney and London with companies such as AMP Capital, AMP Capital Brookfield, RARE Infrastructure, Insight Investment and Rothschild Asset Management.

Prior to joining Ausbil, Tim was Head of Global Listed Infrastructure at AMP Capital. His primary role at AMP Capital was the management of global listed infrastructure funds which grew from $200m to $2bn during his tenure. Tim also sat on various Investment and Valuation committees for the AMP Capital Unlisted Infrastructure Funds.

Before joining AMP Capital, Tim was a senior analyst at boutiques AMP Capital Brookfield and RARE Infrastructure where he was responsible for a broad range of Infrastructure companies globally. Tim helped increase AUM at both companies significantly.

Earlier in his career he worked for 10 years as an equity analyst with Insight Investment and Rothschild Asset Management where he covered a broad range of sectors across Europe.

Tim is a founding member of Ausbil's global infrastructure team and his roles at Ausbil include strategy, portfolio construction and stock analysis.

Tim holds a Bachelor of Engineering (Civil and Structural Engineering) from The University of Sheffield (United Kingdom) and studied Engineering Science at Oxford University.

outperformed, though these are not decoupled, their utility revenues and cash flows proved very resilient to COVID-19 given their higher residential exposure (which benefitted from work-from-home), and additionally, in the case of NextEra, a strongly growing renewables business unaffected by COVID-19.

COVID-19, with its sudden shift to work-from-home, and high-tech usage in isolation, also saw communications like data and telecom towers outperform.

However, vanishing traffic from the world's toll roads, and the cessation of air travel, slowing in ports and across other transport hubs has seen the largest sector sell-downs, with transportation falling the most of all sectors.

Yet another twist in the COVID-19 story has been that of oil. As the world entered the inevitable COVID-19 recession, April witnessed negative oil prices in the futures market for the first time in history. This negative loop adversely impacted sentiment in energy and energy infrastructure when, in fact, most investable oil and gas pipelines have revenues that are largely independent of price and volume through take-or-pay contracts, or other similar contracting mechanisms. Pipelines with very high revenue and cash flow certainty, and low counter-party risk, is the only energy infrastructure we define as investable for the purpose of essential infrastructure.

Q: Transport has been particularly hard hit by the crisis. What is the outlook?

The COVID-19 demand-side shock, and the impact of lockdown measures on population behaviour meant that we saw patronage assets like the transport, toll roads and airports sectors take an unprecedented hit, with services coming to a screeching halt. The sell-down in these sectors was severe and deep.

For airports, there have been a number of major events that have disrupted air travel significantly which are helpful to contextualise COVID-19. For example, in the aftermath of September 11, where air travel was halted suddenly in a matter of hours, air travel quickly returned to trend again even with the overarching concerns about terrorism that played out for many years to follow. While Avian Bird Flu and SARS impacted airline operations, they were eventually subdued as major risks to travel and the industry returned to trend relatively quickly.

While global airport shares have bounced hard off their March lows, we believe a cautious approach to airport investing is still warranted, though interesting investment opportunities are emerging. The challenge with airports is that there still remains a wide range of possible outcomes in terms of the recovery of air travel even as countries look to progressively open-up to domestic and international air travel. The worst case, but still plausible scenario, is of a very slow recovery and some structural change to air travel could have a more material impact on value, balance sheets and gearing. For example, we believe that there is potential for a permanent and structural reduction in corporate air travel resulting from COVID-19. Given the wide range of potential scenarios, balance sheet strength is very important in terms assessing an airport investment.

Airports were hit hard, even the high-quality hubs such as ADP (EPA: ADP) that owns Charles de Gaulle Airport in Paris, and Aena (BME: AENA) which owns all of the airports in Spain. In the local region, Auckland International Airport (ASX: AIA) undertook a substantial capital raising given liquidity constraints, highlighting that even the highest quality airports were not immune. AIA shares have traded up strongly since the capital raising, and when COVID-19 subsides, and air travel trends become clearer, airports like AIA and Sydney International Airport (ASX: SYD) will benefit greatly.

Similarly to airports, the patronage of toll roads collapsed during the COVID-19 lockdowns, significantly impacting these assets. For example, traffic on Transurban's (ASX: TCL) assets fell 57% at the peak of the crisis, and Atlantia's (BIT: ATL) traffic fell ~80-85% across its European assets. Atlas Arteria (ASX: ALX) that owns the APRR toll road in France temporarily lost almost all of its traffic as the country was placed into lockdown. While commercial vehicle traffic proved far more resilient, light vehicle traffic almost entirely vanished in some cases.

Overall, toll roads saw traffic severely impacted for some time, but because they can still operate with social distancing, as lockdowns have been lifted, we have witnessed in many cases a sharp recovery in traffic back to levels not too dissimilar to pre-COVID levels. Moreover, given recent trends, there is a case for toll road traffic to overshoot previous levels if people remain cautious about how they travel to work from a social distancing perspective.

There are other opportunities in toll roads as they are likely a focus for government stimulus (as we have just seen with the Australian Government announcing that it will expedite 15 infrastructure projects worth $72 billion), and also the potential divestment of additional infrastructure assets that are held by governments which still own 80% of the world's infrastructure assets. For example, Atlas Arteria have just completed a capital raising to give them flexibility to pursue 'shovel-ready' road projects as part of a potential Government stimulus program. There is likely to be the potential to expand existing assets, and invest in

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new infrastructure opportunities that become available as governments eventually seek to pay down some of their stimulus debt.

In contrast to airports, and given the sharp road traffic recovery we are witnessing in most instances, the range of potential outcomes for toll roads is far narrower. Toll road valuations are unlikely to be materially affected by COVID-19, in our view. We generally approach toll road valuations conservatively with traffic constrained to capacity assumptions usually prior to the concession ending. This, in turn, means any temporary traffic disruption, even severe ones like those triggered by COVID-19, will have a more muted valuation impact. Nonetheless, similar to airports, not all toll roads are the same, and require detailed due diligence, with balance sheet and liquidity considerations of paramount importance.

Q: What does this mean for energy?

Energy infrastructure is split between those long-haul pipelines (where we invest), with very long contracts that, for all intents and purposes, look like a regulated utility; and midstream companies (where we don't invest) that are closer to the well head, and have a lot more sensitivity to volume and to price. Both types of company have been sold down together, creating a fantastic opportunity to acquire infrastructure assets, like high-quality long-haul pipelines, at a significant margin of safety to their true underlying value. The Canadian company, Enbridge (TSE: ENB) is one such company.

Historically, oil was more valuable in the US, and gas produced in oil wells, such as in the Permian basin, was burnt off at the well head. Now, with oil production dropping, gas production volumes have also fallen and prices have risen, bringing the gas sector back to life. For infrastructure investors, gas has become more of an interesting sector as a result.

For example, Williams Companies (NYSE: WMB) has a main pipeline in the US, Transco, which takes gas from the Gulf Coast up to the North East where there is huge demand for gas. That company had been written down in the market over the last 12-months, yet their pipelines in the North East show markedly improved economics since COVID-19.

Q: The crisis has accelerated the trend in the direction of working remotely. What is the impact on communications?

Communications infrastructure largely outperformed from both the underlying stability of its cash flows, and sentiment buying of technology and technology-related companies in the wake of COVID-19.

Driving the performance of communications is the growth in mobile data. More data was created in the last three years than in the prior history of the world. The transition from 4G to 5G requires higher volume and denser networks of mobile phone towers. This drives the mobile phone operators' needs to secure long-term contracts on more mobile phone towers in a mutually reinforcing network effect.

Mobile phone tower companies have been very strong. In the US, companies like SBA Communications (NASDAQ: SBAC) and the Spanish company, Cellnex (BME: CLNX), have strong and resilient business models that have outperformed during COVID-19.

Q: Investors like infrastructure because of its lower volatility and higher free cash flow characteristics. What are the income characteristics of your strategy and how does it compare to other sources of income?

For us, everything that matters for investing in infrastructure ultimately converges on cash flow. The more confident a company is about their cash flow, the more they are going to pay out in dividends. With infrastructure companies, not only do we have confidence that the long-term cash flows are there, you also have growth embedded in these revenue streams, offering defensive growth characteristics. A secular growth story like mobile phone towers, and growth in demand for data, is a case in point. Essential infrastructure is always going to be an asset class that has a compelling yield story when compared to the general market, with many assets demonstrating a defensive growth profile that is sought by long-term investors.

When you think about the change in the macro environment over the last decade, but even more recently with COVID-19, and how supportive that change has been for the infrastructure asset class, it is just extraordinary. We have seen interest rates move to even lower levels, for even longer, and global growth expectations ratchet down. A relatively low growth, low interest rate, and low inflationary environment is very supportive for infrastructure investing given its long-term cash flows, growth profile and competitive yields. At the same time, quality infrastructure companies have been smacked down by 20% or more in some instances, and you are getting a dividend yield of around 4%. This is a compelling opportunity for any investor looking for a defensive investment, with secular growth opportunities and an attractive dividend yield component.

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A short notice on the COVID-19 public health event, and how it can impact investments

Given the currently evolving issues around the Coronavirus (or Covid-19) globally, which has officially been designated a pandemic by the World Health Organisation, we wish to notify that, as with many firms, business may be disrupted. A public health crisis, pandemic, epidemic or outbreak of a contagious disease, such as the recent outbreak of Coronavirus (or Covid-19) in Australia, Italy, China, South Korea, the United States and other countries, could have an adverse impact on global, national and local economies, which in turn could negatively impact investment returns in any of Ausbil Investment Management Limited’s registered managed investment schemes (the Funds). Disruptions to commercial activity relating to the imposition of quarantines or travel restrictions (or more generally, an inability on behalf of authorities to contain this pandemic) may adversely impact any investment, including by delaying or causing supply chain disruptions or by causing staffing shortages. The outbreak of Coronavirus has contributed to, and may continue to contribute to, volatility in financial markets. The impact of a public health crisis such as the Coronavirus (or any future pandemic, epidemic or outbreak of a contagious disease) is difficult to predict, which presents material uncertainty and risk with respect to any investment or fund performance.

For further information please contact:

Mark Knight
Head of Distribution
02 9259 0226
0438 307 841
mark.knight@ausbil.com.au

Ausbil Investment Management Limited
ACN 076 316 473
AFSL 229722
Level 25
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200
Fax 61 2 9259 0222