Global Listed Infrastructure: "Be first and be lonely." Ginni Rometty

Travel Diary

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Rebecca Sherlock
Senior Analyst
Global Listed Infrastructure

- Rebecca is responsible for the coverage of the Utilities and Water & Waste sectors, which involves meeting with management, producing detailed financial models, undertaking qualitative reviews, and the presentation of stock ideas to the team.
- Prior to joining FSI in April 2008, Rebecca worked for Ernst & Young's Transaction Advisory Team in Australia, advising both Government and Corporate on Public-Private Partnerships. Prior to Ernst & Young Rebecca worked for Grant Thornton (UK) advising the Public Sector on PFI Projects.
- Rebecca holds a Bachelor of Science in Mathematics (First Class) from Sheffield University and is also a Chartered Accountant with the Institute of Chartered Accountants in England and Wales.

Jessica Johnson
Analyst,
Global Listed Infrastructure

- Jessica is responsible for coverage of the Utilities and Ports sectors. This involves meeting with management, producing detailed financial models, undertaking qualitative reviews, and the presentation of stock ideas to the team.
- Jessica initially joined First State Investments in February 2010 on the university graduate program.
- Jesscia holds a Bachelor of Commerce (Hons) from the University of Queensland.

Key points

- The combination of regulated earnings and natural gas is currently very much in vogue. This is a positive for National Grid as it looks to sell a majority stake in its UK gas distribution network.
- Renewable energy sources continue to find ways to improve competitiveness. This bodes well for companies such as NextEra Energy that have been at the forefront of wind and solar development.
- California remains a positive regulatory jurisdiction. Both utility regulators and consumer advocacy groups recognise the need to attract investment into the state to meet ambitious renewables goals.
- Railroads that can most quickly adapt their business models to reflect the changing United States (US) economy will cope best with volume reductions. Union Pacific is focused on improving productivity and pricing in order to offset the impact of soft volumes.

Over the last few weeks we have been on the road, touring assets and meeting with infrastructure management teams, regulators, industry competitors, investors and brokers. Between us, we have visited the US (New York, Nebraska, Massachusetts, Florida, California, Texas), Canada (Toronto) and Dubai.

"Many receive advice, only the wise profit from it." Harper Lee

This year financial markets have been rife with corporate activity as companies leverage up their balance sheets or use their scrip to gain market share. The utility world has been no different, with regulated assets commanding premiums of up to 60% above their regulated asset base. To put it simply, regulated companies are like London properties – it's a seller's market.

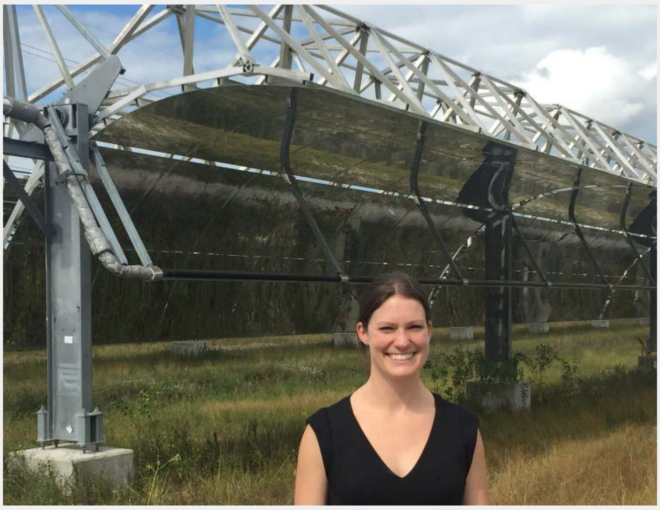
The Fund is well positioned to take advantage of this theme through its holdings in smaller regulated utilities with high quality assets such as ITC Holdings, Alliant Energy and NiSource. The Fund also has a large holding in National Grid, which has recently decided to sell a majority stake in its UK gas distribution assets. These assets have a regulated asset base of c.£8.5bn. We anticipate keen interest from pension funds, direct infrastructure funds and private equity given the ability of these assets to produce predictable, stable cashflows over the long term.

"Keep your face to the sunshine and you cannot see the shadows" Helen Keller

NextEra Energy's Martin Next Generation Clean Energy Center is a 3.8 gigawatt hybrid gas/solar power plant in Florida. This facility includes one of the state's few utility-scale solar plants. The entire site covers 11,000 acres of land and has a total of 190,000 mirrors, in effect a huge sea of mirrors.

It is unlikely that another plant like this will be built, given the technological advances and cost reductions being achieved in photovoltaic panels. A photovoltaic panel can use both direct and indirect sun rays, whereas these mirrors can only use direct rays. That gives photovoltaic panels a significant advantage in places like Florida, where there is significant cloud cover. It was only the economics at the time that led to this design being implemented at Plant Martin; technology has moved forward since then. The costs of renewable energy continue to fall as technology progresses. Turbines are getting taller, blades are getting longer and solar panels are being installed and stacked in more effective ways. The experience of companies at the forefront of renewable development, such as NextEra Energy, will give them a significant advantage over utilities that are just starting to invest in this space.[1]

Asset tour: NextEra's Plant Martin Solar Thermal generating plant



Source: First State Investments.

"California, still a magical vanity fair" Eileen Granfors

On the US West Coast, meetings with the CPUC[2] and consumer advocacy group TURN[3] gave us confidence that California is still a positive regulatory jurisdiction. Comments in both meetings indicated an awareness of the state's need for private investment.

Governor Jerry Brown has announced a Renewable Portfolio Standard goal of 50% by 2030 (i.e. an obligation for California's utilities to procure at least half of their energy from renewable sources by that date). This is the highest in the US and will result in significant investment by the state's three main listed utilities – PG&E, Southern California Edison and San Diego Gas & Electric. These utilities have submitted their long-awaited Distribution Resource Plans (DRPs); initial comments from the CPUC have been positive. Their plans set out how the utilities plan to merge rooftop solar, energy storage, electric vehicles and other distributed energy resources into their daily grid operations. These DRPs have the potential to significantly increase the capital investment of these companies by as much as 20% on their base capex plans over 2018-2020.

Some concern was evident from the regulators about the potential for 'rate shock' to customers. This is to be expected, given the context of large scale, state-wide investment which will ultimately be paid for by utility customers. However, lower natural gas prices have had an offsetting effect, and will help utilities to moderate any potential price rises for customers.

As in all sunshine states, rooftop solar was high on the agenda. Customers that do not have solar panels are currently shouldering a higher allocation of the costs associated with maintaining the distribution network, thereby subsidising solar customers. California has recently adopted a minimum bill approach as a first step to address this misallocation of costs. The CPUC sees this as a first step in evolving rate design to more accurately reflect usage of the grid. Although we have seen load growth decline due to energy efficiency and growth in distributed generation (such as rooftop solar), California is decoupled i.e. utility revenues are not linked to the amount of energy the utility sells. As a result, distributed generation does not have a financial impact on Californian utilities. This is another reason to view California positively.

The portfolio holds a large position in PG&E, the Californian electric and gas utility. We remain positive on the company post this trip.

"I didn't get there by wishing for it or hoping for it, but by working for it" Estee Lauder

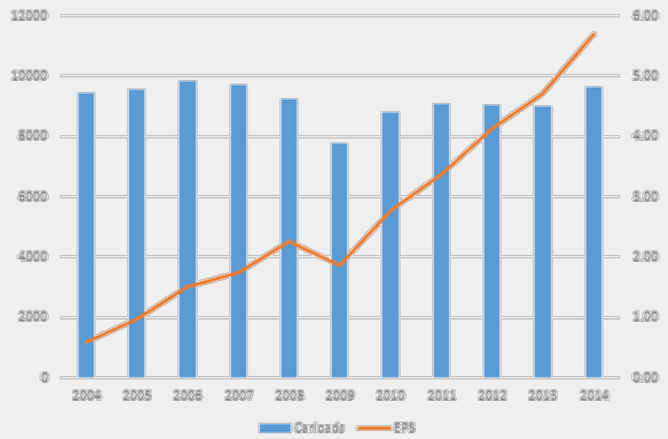
US railroad volumes remain challenged by (1) lower coal volumes as coal fired electricity generation plants continue to shut down (2) lower industrial volumes as the strong US dollar

[1] Plant Martin is included within NextEra Energy's regulated asset base, meaning that NextEra is remunerated on the capital deployed.
[2] California Public Utility Commission
[3] The Utility Reform Network who is the consumer advocacy group in California for energy and phone services.

and weaker global growth weigh on manufacturing and (3) lower agricultural volumes as farmers store grain in the expectation that prices will rise from current levels. Automotive and domestic intermodal volumes have been stronger, supported by consumers taking advantage of cheap borrowing and low fuel costs.

In a tough volume environment, freight rail operators need to adjust and focus on the things that they can control. For example, Union Pacific, the largest Class 1 railway company, has re-sized its headcount, increased its productivity and focused on service performance in order to improve cost performance. In 3Q 2015, Union Pacific posted their best operating ratio yet – 60.3%. This compares to an operating ratio of 69.1% in 3Q 2011 and demonstrates a consistent focus on cost management and price increases. The company are firm believers that 'reducing prices does not generate more volume'.

Union Pacific Carloads vs EPS



Source: UNP and First State Investments.

"Everything in a modern container port is enormous, overwhelming, crushing" Rose George

DP World's recent 2015 Analyst Day was held in Dubai and included an asset tour of Jebel Ali Port and the Jebel Ali Free Zone Area (JAFZA). Jebel Ali Port in Dubai is one of the top ten ports in the world; it has three operating terminals with a capacity of 19 million TEUs[4], and a fourth terminal in development. This represents almost 50% of the capacity of regional ports serving the GCC.[5]

DP World has recently acquired the 57 km^2 Free Trade Zone next to Jebel Ali Port. 20% of Dubai's GDP comes from the port and the JAFZA, underpinning strong government support for continued growth in the area. The government has also given approval for DP World to develop land to the south of the current JAFZA to serve new customers, which will result in a 20% expansion of its current footprint. This will be positive for container volumes, as more manufacturing is brought into the JAFZA.

Volumes will also be supported by upcoming events such as the World Expo in Dubai in 2020, the scheduled completion of the Etihad Rail network by 2020, and the FIFA World Cup in Qatar in 2022. As a result, the port is preparing for higher levels of construction, tourism and infrastructure in the region. By 2020, the number of hotel rooms is expected to have doubled from the current 80,000. Offsetting this is the low oil price dampening regional economies, like Saudi Arabia, which has seen a negative effect on volumes in Dubai.

The recent lifting of Iranian sanctions is also affecting volumes. In the short term, this is having a negative effect as some volumes bypass Jebel Ali and go straight to Iran. The expectation is that in the medium to long term, as US sanctions are eased, volumes will increase at Jebel Ali because of its available capacity and economies of scale. This supports DP World's argument that they 'are planning for the future' as they announce capacity expansions and the construction of Terminal 4 before the capacity is actually needed. The challenge of this significant investment is that it keeps a lid on DP World's ROE[6] , which has never exceeded 8%.

Jebel Ali Port is now under the same management as the JAFZA. It is located next to an airport that is undergoing significant capacity upgrades, with plans for it to be connected to the Etihad Rail network once it is completed. Land, air and sea all brought together into one interconnecting hub – infrastructure at its finest!

Although we consider Jebel Ali a world class port asset, we believe DP World's current valuation fully reflects these expectations for growth. The Fund gains exposure to similar growth themes through its holding in China Merchants Holdings (International). Both ports aim to deliver volume growth of around 5%, but DP World trades on a 16x PE[7] ratio while China Merchants trades on 11x PE.

The photo below shows two of the 78 quay cranes at the port and gives some idea of the scale of this port.

Source: First State Investments.

[4] Twenty-foot equivalent units
[5] Gulf Cooperation Council is a regional organisation for the Arab States of the Gulf with six members including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.
[6] Return on equity
[7] Price to earnings

Conclusion

The move to a low carbon economy is happening in many different ways. Renewable energy is becoming competitive without subsidies, promoting further build out; coal is uneconomical, promoting faster shut down of generating plants; transmission lines are being built to bring hydro power into the US; and demand side management tools are taking shape in forward thinking states like California.

The freight rail industry is adapting to a softer volume environment. Management teams are focusing on cost reductions and operational efficiencies. Companies that can adapt quickly and focus on productivity and price, such as Union Pacific, will fare better in this environment.

Highlights

- Meeting ex-Senator and Governor of Nebraska, Ben Nelson. Nebraska remains the only state to have not privatised its electricity and gas systems.
- Asset tour of Jebel Ali Port, the ninth largest container terminal in the world. 80% of goods coming into the United Arab Emirates come through this port.
- California's DRPs are in the very early stages but could result in significant upside to utility capital investment. We also see increased investment from the Clean Power Plan and state Renewable Portfolio Standards, as California moves towards its 50% renewable target by 2030. Companies are already talking about how they will integrate electric vehicles and connect more renewable energy to the grid.

Lowlights

- Hearing a broker talking about being "long term" and trying to get next quarter EPS right.
- Nearly getting mugged on Florida's tri-rail – mass transit is not Florida's core competence.

Favourite quotes

- "No free money, money comes from somewhere" Consumer advocacy group on utility investment.
- "Not all states were born equal" Canadian company on which US states they find attractive for M&A.
- "I hope it's the bottom, but every time I think it's the bottom it goes lower" A very depressed Master Limited Partnership investor.
- "We are willing to settle with our biggest adversaries if that is the best outcome for ratepayers" Consumer advocacy group.
- "We are for sale, tell everyone; we are actually offended no one has made a bid for us" A mid-cap US utility.