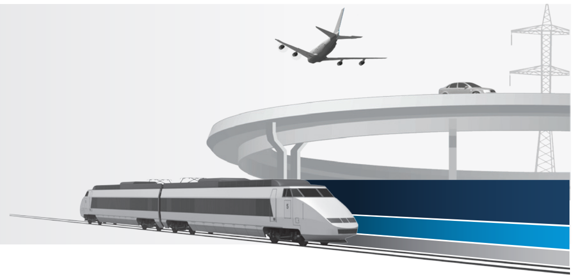
Glory Days

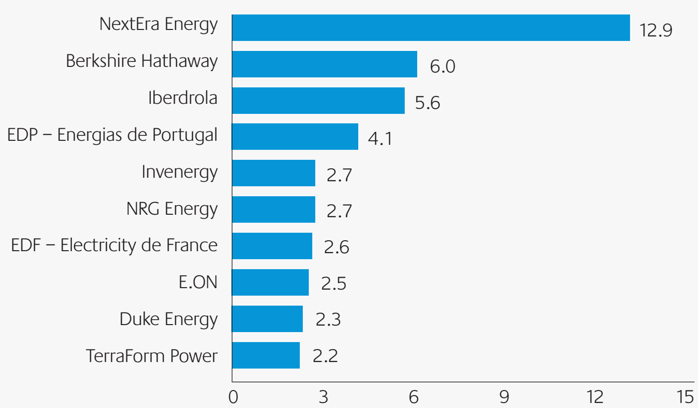


Andrew Greenup, Deputy Head of Global Listed Infrastructure | March 2017

The US economy has recovered from the 2015 'industrial recession', energy markets are resurgent and Trump has inspired consumer and corporate confidence – it feels like these are the glory days for US infrastructure.

Declining cost curves are changing the US energy landscape. The drive for energy independence has evolved into energy exports. The switch from coal to renewables is increasingly being driven by economics, not ideology. Government legislation may speed or slow this progress, but the outcome is inevitable.

Top 10 US wind owners, as at end-2016 (GW)



Source: Bloomberg, First State Investments.

Texas and New Mexico

First stop was the great state of Texas. As the second largest US state with 27 million people and accounting for 10% of national GDP, Texas is a large bastion of free markets, low taxes, small government and home to a variety of infrastructure companies. Key themes from my time in Texas are as follows:

Energy mojo. The Texan energy infrastructure sector has regained its mojo, but not its swagger. Balance sheets have been repaired and dividend distress has passed thanks to the recovery in oil and Natural Gas Liquids (NGL) prices and volumes. The continuing decline in cost curves for US energy producers sees the energy infrastructure sector, Enterprise Product Partners and Kinder Morgan in particular, well positioned to deploy growth capital expenditure (capex) at attractive risk adjusted returns.

Wind economics. Texas is home to the largest fleet of windfarms in the US given the very high (40-50%) capacity factors in West Texas. With wind cost curves continuing to decline and government subsidies legislated until 2021 we see no reason why wind won't continue to expand in Texas. Remember, Texas does not have a Renewable Portfolio Standard (RPS), hence power generation capex is driven by economics, not ideology. We expect utilities like NextEra Energy and Iberdrola to benefit from this trend.

Waste recovery. Meeting with several waste utilities in Houston, it appears to me this sector is enjoying the best operating environment in the last decade. Pricing growth is accelerating due to industry consolidation and CPI expansion, volumes are buoyant, commodity revenues from recycling are expanding and value accretive, bolt-on acquisitions remain aplenty.

Utility upgrades. El Paso is an isolated 1 million person city near the borders of Texas, New Mexico and Mexico. El Paso Electric is the local, regulated utility which is partway through the process of replacing its 60 year old power generation fleet with more efficient and cleaner Combined Cycle Gas Turbines (CCGT) and solar generation. Strong customer growth, a robust local economy and a large capex upgrade cycle should drive strong earnings growth and a higher dividend growth as the payout ratio expands.

El Paso Electric's Simple Cycle Gas Turbines

Source: First State Investments.

Ohio & Kentucky

From Texas I flew to Ohio and Kentucky. Cincinnati's Brent Spence Bridge over the Ohio River is ranked second on the Trump administration's infrastructure transportation project list, with a $2 billion replacement needed for this highly congested, 53 year old double decked bridge. I note the bridge is carrying double the traffic it was originally designed as the I-75 is the US' busiest truck route. This bridge will be a key test case to see if there is substance and federal money behind Trump's much vaunted $1 trillion infrastructure plan.

I note only 100 miles down the Ohio River at Louisville, December 2016 saw the opening of the $1.1 billion Lewis & Clark Bridge. This successful project was a public private partnership funded by a 35 year concession to toll traffic on the bridge. We believe a project like this is evidence that private sector infrastructure capital can provide win-win solutions in the US for governments and the communities they serve.

Lewis & Clark Bridge across the Ohio River

Source: Courier-Journal.

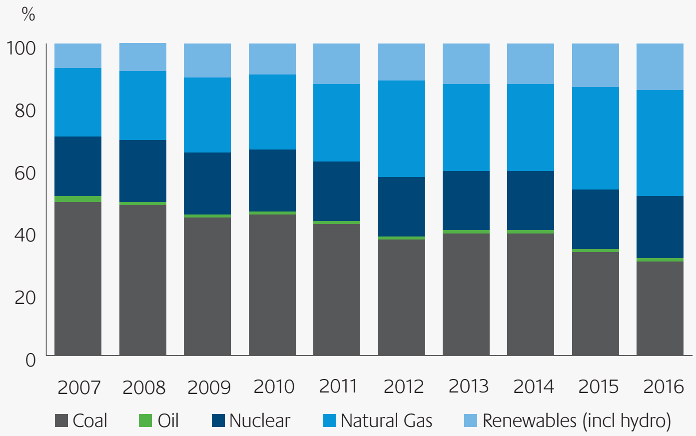
New York

Goodbye buckeyes and bourbon, hello New York City for a Master Limited Partnership (MLP), clean technology and utility conference. My takeaways from this conference were as follows:

Energy exports. Growth capex for the US energy infrastructure market seems to have been reset at more realistic and sustainable levels post the massive boom and bust cycle it experienced over the last five years. The largest opportunities for growth capex are in the export of US energy – Liquefied Natural Gas (LNG), NGLs and refined petroleum products. The build-out of takeaway capacity from the Marcellus / Utica shale gas fields is happening but at a slower pace than expected due to (1) producer reluctance to sign long term contracts and (2) permitting bottlenecks. Other key infrastructure needs include NGL midstream gathering pipelines and processing plants, as well as oil pipelines to take away newly ramped up oil production in the Permian. There appear to be limited new opportunities in refined products pipelines at current commodity prices.

Coal vs Renewables. I did not meet a single utility executive, not one, that believed the Trump administration was going to adversely impact the expansion of renewables or reverse the decline in coal. These views reflected State and corporate support for renewables and the economics of falling renewables cost curves. Reassuring for NextEra Energy, Xcel Energy and Iberdrola.

US electricity generation by fuel type (%)



Source: Bloomberg, First State Investments.

Every management team I met was highly sceptical of Trump's ability to deliver serious corporate tax reform by 2018, if at all. However, management were much more optimistic about near term reduction in federal regulations which will have the benefit of reducing the cost and timing of new infrastructure projects.

Utility scale solar PV has seen costs decline from $2.65m/MW in 2011 to $1.14m/MW in 2016. This continuous cost decline sees solar participating in more RPS auctions as well as enjoying strong demand for renewable energy from corporates. I was also interested to find out that NextEra Energy, the world's largest renewables operator, was spending $100 million on battery research.

Energy efficiency is materially reducing electricity consumption. From its peak in 2014, electricity demand has fallen 1.2% while real GDP has expanded by 4.2%. This is why we retain a preference for electric utilities (including PG&E Corp & Eversource Energy) where revenues are decoupled from volumes.

Massachusetts

Last but not least I caught the Acela Express train to Boston. A few points of interest were as follows.

Tower growth. Mobile tower giant, American Tower, is now truly a global company with 70% of its towers and 35% of its EBITDA from outside the US. This gives the company the highest growth profile (both organic and M&A) compared to its peers; but this growth has the highest currency, sovereign and operating risk. In the US, the company is forecasting a modest acceleration in new leasing activity in 2017 with no change in the 3% pricing environment.

Offshore wind. Massachusetts has set a mandate of 1,600mw of offshore wind by 2027. This is the first serious attempt in the US at offshore wind and hence will be an important test case. Fortunately, Europe has been at the bleeding edge of this technology which should reduce development risks for the likes of Eversource Energy and National Grid.

Conclusion

US infrastructure companies are enjoying glory days, volumes are strong from a robust economy, the energy sector has recovered, and pricing is positive and improving as CPI accelerates. Risks to near term earnings forecasts for US infrastructure companies are on the upside.

However, let's remember investing is a popularity contest and you never want to buy an asset when it is most popular. Hence, we tend to be nervous when markets are euphoric and price in significant amounts of optimism, while ignoring or not pricing in material risks. It should come as no surprise then that our strategy is underweight the US for the first time in two years.

Andrew Greenup

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