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Investing in a low growth environment.

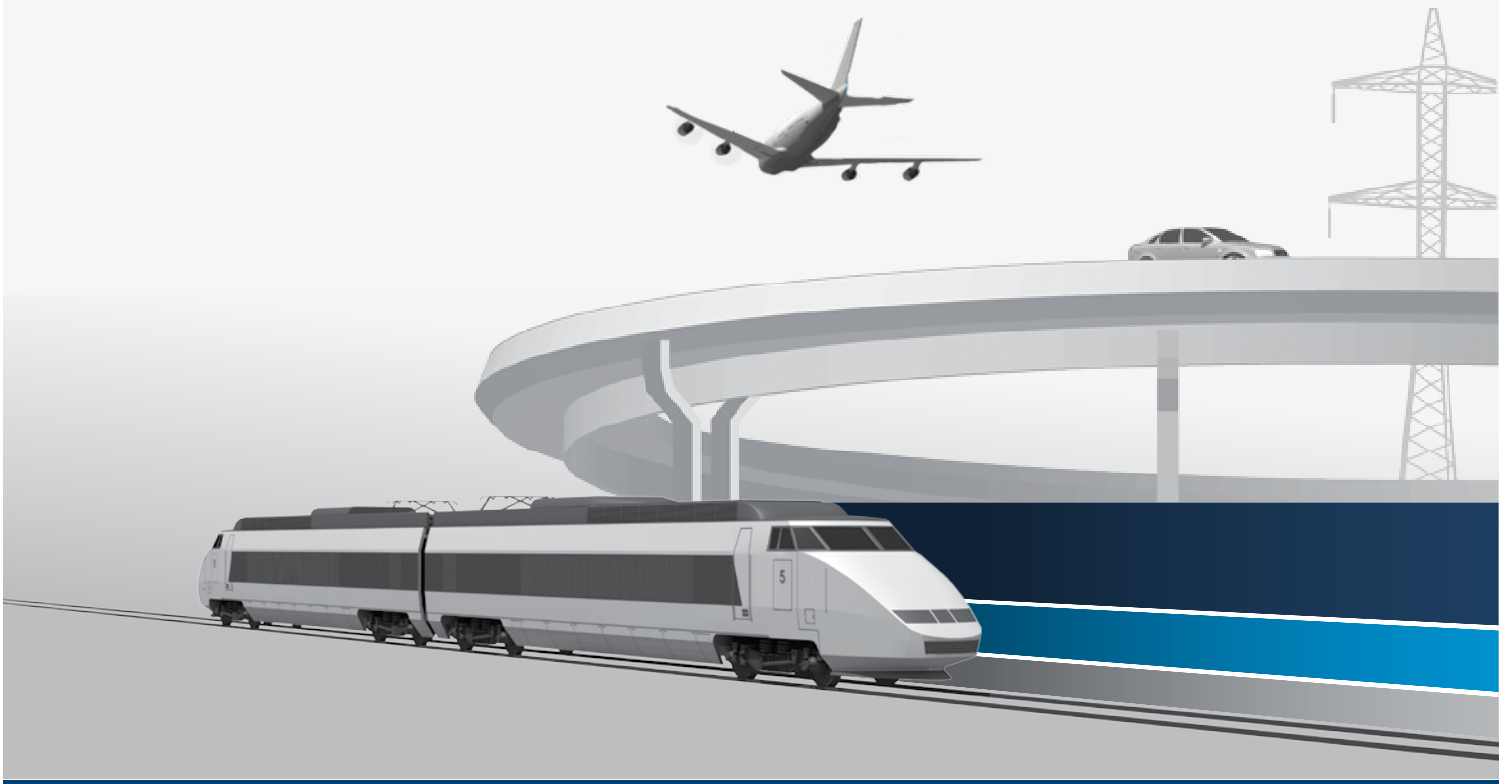
The Investment Report.

Global Listed Infrastructure Securities

Earnings growth supported by structural drivers

Global listed infrastructure consists of tangible assets that provide essential services. A combination of defensive earnings and structural drivers can support growth even during difficult economic environments.

This paper highlights how the global listed infrastructure strategy is positioned in toll roads, mobile towers, renewable energy and transmission assets, which can continue to deliver earnings growth when broader economic growth is low.

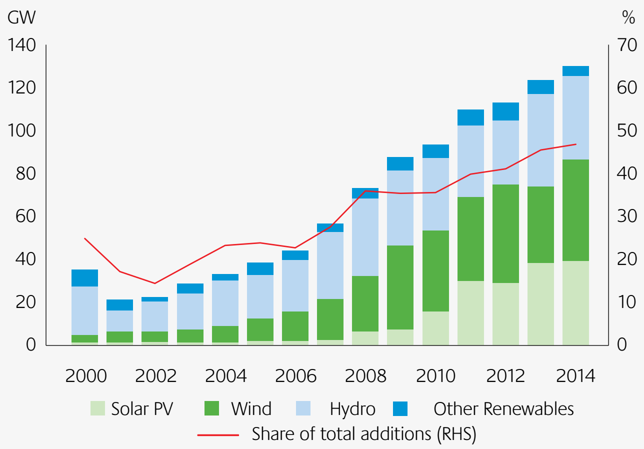


Utilities: renewables and transmission build-out

Utilities, a cornerstone of global listed infrastructure, have traditionally performed well during times of slower economic growth due to their stable cash flows and high dividend yields. As well as providing defence to a portfolio, many utilities are now deriving growth from the build-out of renewable energy; and the increasing need for transmission infrastructure.

The renewable energy space, in particular, is presenting some unique investment opportunities. Policy measures aimed at reducing carbon emissions are having a significant impact on how the electricity sector generates, transmits and distributes electricity. Wind and solar are rapidly taking market share from coal-fired and nuclear power stations. These two energy sources are estimated to expand their market share of the world's power capacity from just over 20% in 2012 to 29% in 2040. In contrast, coal-fired power stations are rapidly being closed. Coal's share of global power generation is forecast to decline from 40% in 2012 to 29% in 2040[1]. In the US, this large-scale capital investment in renewables is being led by big, publicly listed electric utilities including NextEra Energy, Xcel Energy and Iberdrola. The momentum behind growth in renewable energy is demonstrated in Chart 1.

Chart 1: Global renewables-based power capacity additions by type and share of total capacity additions



Source: IEA.

As electricity production evolves and becomes de-centralised, new transmission infrastructure will also need to be built, specifically to where wind and solar resources are strongest. Electric distribution grids will need to be upgraded, hardened and smartened to deal with two-way flow of distributed energy. Between 2016 and 2019, Californian utility PG&E proposes to invest almost US$1 billion in its 'Grid of Things'; a 21st-century power grid equipped to maximise the use of a growing array of advanced energy technologies from electric vehicles and rooftop solar to smart appliances and battery storage.

In order to support this investment, regulators are currently providing allowed rates of return to utilities of around 10%. We consider this very attractive, given these companies' low risk business models and the current low level of risk-free rates.

Toll roads: replacement investment cycle

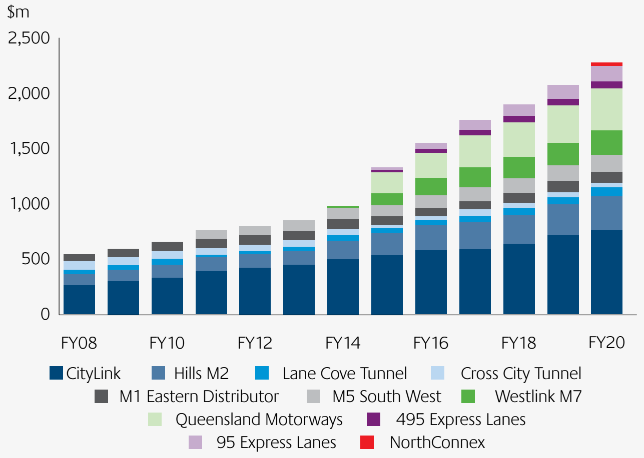
Governments have failed to invest in a wide range of infrastructure in recent decades. The growing need to improve road networks, combined with the inability of many governments to afford them, presents opportunities for the private sector.

Australia's Transurban, which operates Australian and US toll road concessions, provides a good example of this. It is the dominant operator in Australia's largest cities, giving it considerable economies of scale that can be used to its advantage when bidding for toll road concession projects that connect to its existing network. The company has a track record of successfully negotiating with governments to secure new projects, and of gaining concession life extensions in exchange for additional capex spending commitments.

Traffic volumes have become a less important driver of earnings growth in recent years as new projects and road widenings have become more significant, decoupling the company's earnings from broader economic growth rates. This strategy enables the company to pay a distribution yield of ~4.5% which is forecast to grow at over 10% pa between now and 2020. Chart 2 illustrates how Transurban's concessions and earnings have evolved and are forecast to continue to grow.

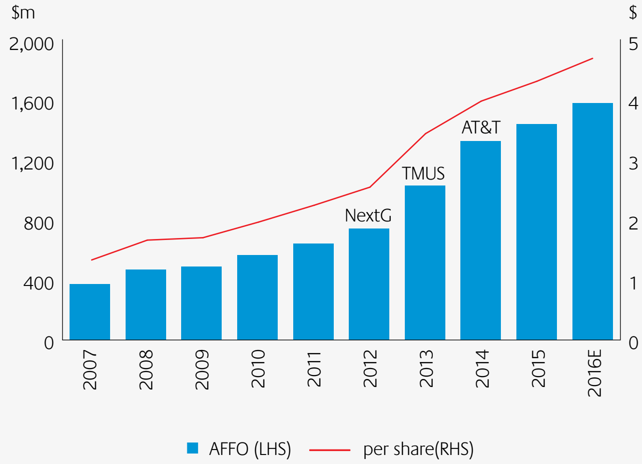
1 US Energy Information Agency: International Energy Outlook 2016.

Chart 2: Proportionate EBITDA



Source: Transurban, CFSGAM.

Chart 3: Crown Castle – adjusted funds from operations



Source: Company, CFSGAM.

Towers: ever-growing appetite for mobile data

Cash-generative mobile tower companies such as American Tower and Crown Castle continue to benefit as structural growth in demand for mobile data places telecom companies under ongoing pressure to improve network quality and capacity.

The appetite for mobile data has surged in recent years, increasing globally by 74% during 2015 alone. This growth is being underpinned by the increasing popularity of data-intensive activity such as audio and video streaming services and by consumers' growing expectations that a high-speed data connection will be available, even in the absence of Wi-Fi.

This demand enables tower companies to use fixed price escalators to automatically raise customer prices, typically by around 3% pa. Rising prices, combined with organic growth in tower sites and acquisitions, have enabled Crown Castle to deliver the steady earnings growth shown in Chart 3, through a period of turbulent world markets and muted economic growth rates.

This growth looks set to continue. Progress continues to be made in the wireless sphere; just as 3G gave way to 4G, providing a boost to mobile towers, the next wave of technology – 5G – is expected to start rolling out in the early 2020s. Emerging markets present additional opportunities. American Tower has recently invested in a portfolio of towers in India, where a majority of customers have yet to negotiate the transition from 2G to 3G technology.

Implications at portfolio level

Our largest overweight position today is the toll road sector. Revenues are robust, with consistently high operating margins of between 60% and 80%. We believe that the market does not yet fully appreciate these companies' ability to grow earnings through contracted toll increases, additional growth projects, concession extensions and organic traffic volume growth.

Mobile towers represent another overweight position. We like their high free cash flow, the long-term visibility of contracted revenues and the robust growth in mobile data demand that is underpinning earnings growth for this sector.

Our largest underweight position is in US Utilities. Some companies in this sector face challenging regulatory environments, are trading at full valuation multiples, or derive significant portions of their revenue from conventional energy generation, which now faces a vicious cycle of declining market share, reduced revenues and rising costs.

Our main holdings in this sector are made up of companies that are at the forefront of renewable build-out such as NextEra Energy and Xcel Energy; an area of the market that is experiencing a virtuous cycle of falling costs, improving productivity and growing market share. We also have exposure to companies which are participating in the build-out of much needed transmission infrastructure such as Eversource Energy and Dominion Resources.