Infrastructure positioned to outperform in 2024

Global Listed Infrastructure – review and outlook

First Sentier Investors

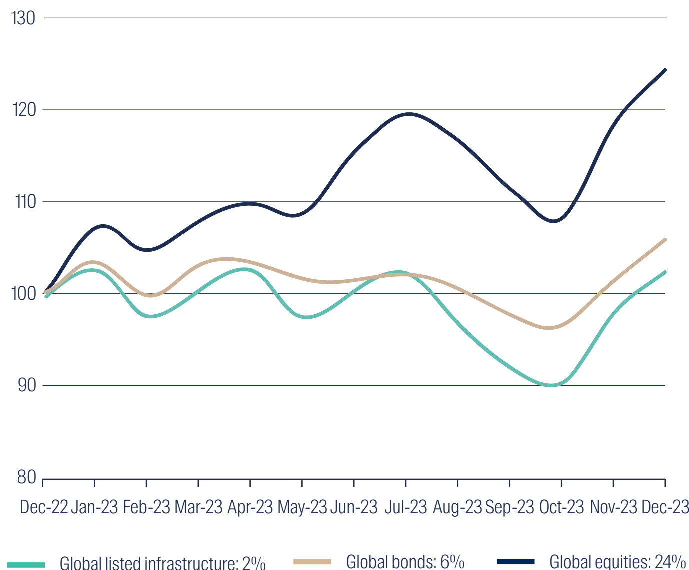
For financial advisers and qualified/professional/institutional investors only

February 2024

- Global listed infrastructure underperformed in 2023 owing to rising interest rates and a shift away from defensive assets. Relative valuations are now at compelling levels.
- Infrastructure assets are expected to see earnings growth in 2024 and beyond, aided by structural growth drivers, especially utilities which are benefiting from energy transition.
- Infrastructure capital expenditure should accelerate in 2024, despite a higher cost of capital.
- Political and regulatory risks remain elevated but reduced customer bill pressures should provide some relief

Global listed infrastructure (+2%) underperformed both global equities (+24%) and global bonds (+6%) in 2023[1]. Despite increased earnings and solid fundamentals, a sharp rise in real bond yields saw infrastructure valuations fall materially during the year. This paper provides analysis of the key drivers of performance in 2023 and offers an outlook for the year ahead. Additionally, while all investing carries risk, it explains why we believe that now is an opportune moment to consider investing in global listed infrastructure, highlighting the compelling reasons for doing so.

Global infrastructure, equities & bonds performance **CY 2023**

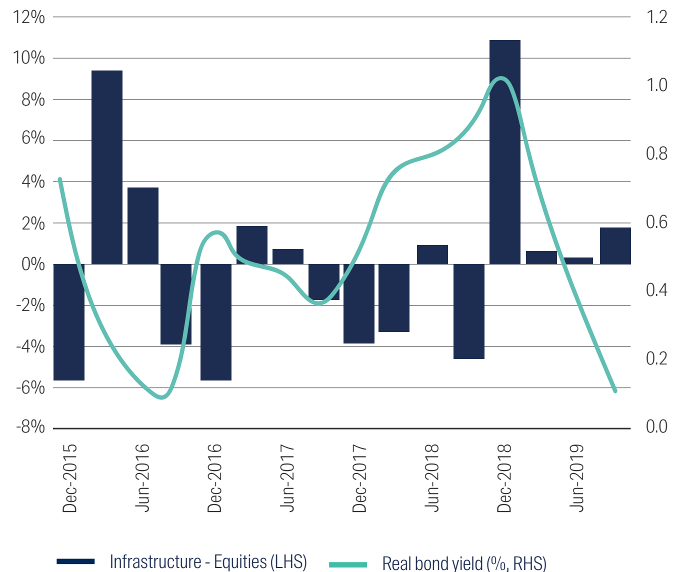


Global Listed Infrastructure: FTSE Global Core Infrastructure Index 50/50 Net TR (USD)
Global equities: MSCI World Net TR Index (USD)
Global Bonds: Bloomberg Global Aggregate TR Index Value Unhedged (USD)
Source: First Sentier Investors. Data to 31 December 2023

The recent period of global listed infrastructure underperformance is not unprecedented. In 2018, for example, infrastructure returns were adversely affected by a rise in real bond yields, but the asset class then bounced back as rates started to decline. With the likelihood of rates having now peaked in many markets, global listed infrastructure has the potential to outperform in the year ahead.

The relationship between real bond yields and the relative performance of global listed infrastructure and global equities, between 2016 and 2019, is illustrated in the following chart.

Infrastructure outperforms as real yields fall



Source: Bloomberg, First Sentier Investors
Chart covers the period between December 2015 and September 2019.

1. All data in USD terms. Performance numbers reference the FTSE Global Core Infrastructure 50/50 Index, Net TR, the MSCI World Index, Net TR and the Bloomberg Global Aggregate TR Index, Value.

Year in review

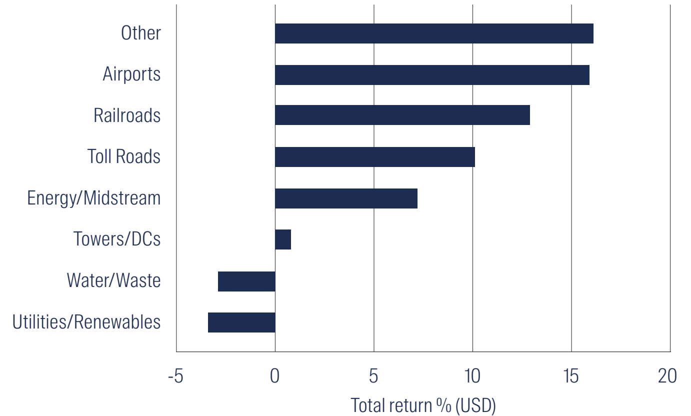
Having held up well in 2022, global listed infrastructure underperformed global equities during 2023. This appeared to be primarily a reflection of macro factors. Rising interest rates weighed on infrastructure valuations as central banks adopted a "higher-for-longer" narrative. This triggered a sharp rise in government bond yields, with the US 10-year real bond yield reaching multi-year highs. Meanwhile, inflation, which listed infrastructure assets can usually pass on to the end user, subsided. The asset class was also affected by a widespread shift towards higher beta sectors such as technology and themes such as artificial intelligence.

Transportation infrastructure such as Airports, Railroads and Toll Roads performed well in 2023. Airports in Europe and Latin America experienced gains as passenger volumes approached, and in some cases, exceeded pre-pandemic levels. Toll roads were supported by robust traffic volumes and the appeal of inflation-linked tolls. Passenger rail companies in Japan enjoyed the benefits of a return to office and strong leisure travel on their networks.

Elevated geopolitical tension underscored the importance of energy independence and security. Against this backdrop, the Energy Midstream[2] sector delivered another year of solid performance, bolstered by elevated commodity prices and strong demand for US Liquefied Natural Gas (LNG) exports. As a reliable and relatively cheap producer, additional long-term contracts for US LNG are likely in the coming years.

On the negative side utilities lagged, with renewables-focused utilities underperforming on concerns that higher borrowing costs may make it harder to fund renewables projects. Mobile Towers came under pressure in 2023, owing to concerns that telecom companies (towers' main customers) may slow investment in their networks. Tower companies typically have fixed escalators built into their contracts, but less ability to pass through higher interest costs.

Global infrastructure performance by sector **CY2023**

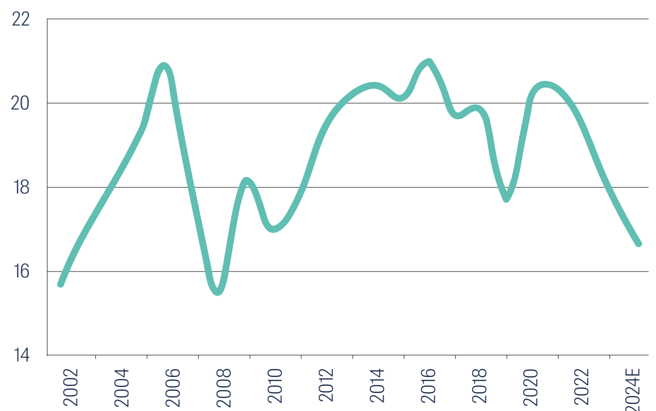


Source: Bloomberg and First Sentier Investors
Based on FGCI index weights. Data as at 31 December 2023

Infrastructure's inflation pass-through is working well, supporting earnings across the asset class. It can take time for this inflation pass-through to take effect. Toll road companies typically increase their prices every quarter, but US utilities need to wait until they re-negotiate with the regulator to pass through costs, which can take one to two years. This proved challenging for some companies, given the rapid rise in real bond yields in 2023.

We believe valuations are now compelling, with many global listed infrastructure companies trading at levels not seen since the global financial crisis.

Global infrastructure **Price/Earnings x**



Source: Bloomberg and First Sentier Investors
Simple avg of 250 stocks in universe. Data as at 31 December 2023

2. Oil & gas storage & transportation

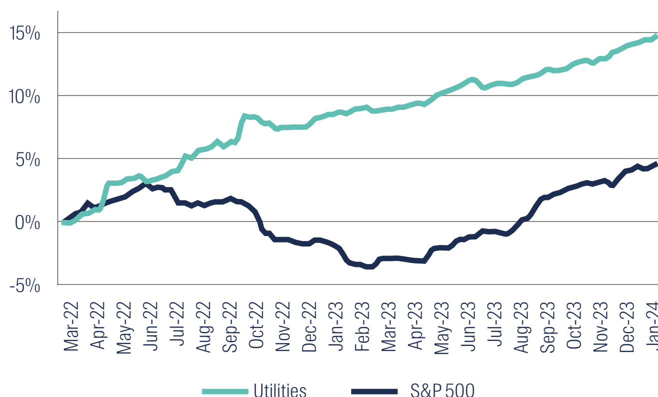
Outlook

The early part of 2024 may present challenges for broader markets, including slower economic growth, operating expenditure inflation and higher interest costs. We believe a recession is still a possibility, with markets overly optimistic and recent global equity returns largely driven by the "Magnificent Seven[3]" tech stocks. Overdependence on such a narrow set of stocks can be risky, leaving markets vulnerable to a downturn if their fortunes were to falter. In our view, infrastructure provides a significant and cheap diversifier within a portfolio.

Despite these potential headwinds, we continue to see positive earnings revisions for infrastructure companies. For example, utilities have the ability to pass through inflation, while the transition to lower carbon sources of energy generation is presenting them with opportunities for rate base and earnings growth. Overall, we anticipate upside earnings risk for listed infrastructure.

The following chart illustrates how US utility earnings have held up since early 2022, compared to the broader US market.

Earnings resilience **2022/23**



Source: Bloomberg
Data as at 31 December 2023.

Infrastructure capital expenditure growth is likely to gain momentum in 2024, even in the face of a higher cost of capital environment. We anticipate that corporations will increase equity raisings while reducing buybacks to fund this acceleration in capital expenditure. This strategic shift should lead to greater investment in growth opportunities.

Political and regulatory risk are likely to remain elevated, given the US presidential election year and elections expected in more than 40 countries, including the UK, India and Mexico. For utility stocks, reduced customer bill pressures should provide some relief to this political risk. One area that we remain watchful of is the 2022 Inflation Reduction Act (IRA). The IRA is a United States federal measure passed by the Democrats which provides long-term tax incentives for clean energy projects, and which is expected to be supportive of regulated US utilities' earnings growth over the years ahead.

The IRA is not subject to annual renewal (which previous clean energy subsidies were), or to voting to increase the US debt ceiling. However if the Republican Party (the GOP) were to win majorities in the US House of Representatives and the US Senate, as well as the Presidency, it would be in a position to reverse this legislation.

Even if it were able to, the GOP's appetite to do so is likely to be low. The majority of the US' renewable energy projects, which are set to benefit from the IRA, are located in GOP states (for example Texas, Oklahoma, Arizona, Kansas, Missouri, Iowa etc.). There could be some risk to funding for projects with more marginal economics e.g. offshore wind and hydrogen, but overall the risk to the IRA appears to be small.

Mergers and acquisitions (M&A) activity levels could accelerate in 2024 as private market funds buy discounted listed infrastructure assets, and as listed infrastructure companies sell non-core assets to fund higher growth capital investment needs. This could lead to consolidation and increased competitiveness within industries.

In our opinion, balance sheets remain under-geared in Asia, while those in North America and Europe are fairly geared. We expect leverage to remain a focus in 2024, with the market penalising companies that need to borrow or raise equity to fund growth. It is worth noting that debt maturity remains strong at over 12 years on average for the holdings in our global strategy today[4].

We take a closer look at the sector outlook for the asset class in the section below.

Utilities (~50% of our global strategy)

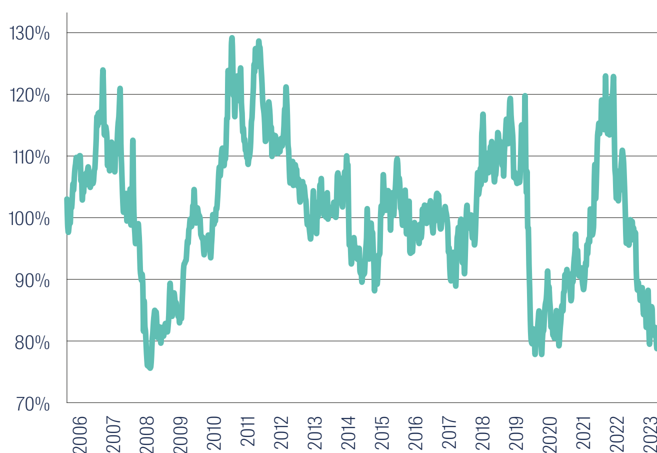
After a difficult 2023, utilities and renewables stocks face a more constructive outlook in 2024. We believe earnings risks are poised slightly to the upside. Capital expenditure growth should accelerate, reflecting the need for increased resiliency spend and higher electricity usage growth from data centres, industrial on-shoring and electric vehicles. Customer bill pressures are declining, balance sheets are in better shape going into 2024 and we could see a re-emergence of M&A activity. However we also expect to see increased equity issuance to help fund higher capital expenditure.

3. The seven largest US tech stocks: Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia, Tesla.

4. As at 31 December 2023

Renewable energy investment is expected to rebound after a trifecta of bad news in 2023, including cost increases stemming from China sanctions and COVID-19, Inflation Reduction Act (IRA) delays and a sharp increase in the cost of capital. These factors, combined with a potentially favourable interest rate environment and the sector trading at a large discount to its historic relative trading earnings multiple, set the scene for a constructive year.

US utilities valuations relative to S&P 500



Source: Bloomberg, First Sentier Investors
Data as at 31 December 2023.

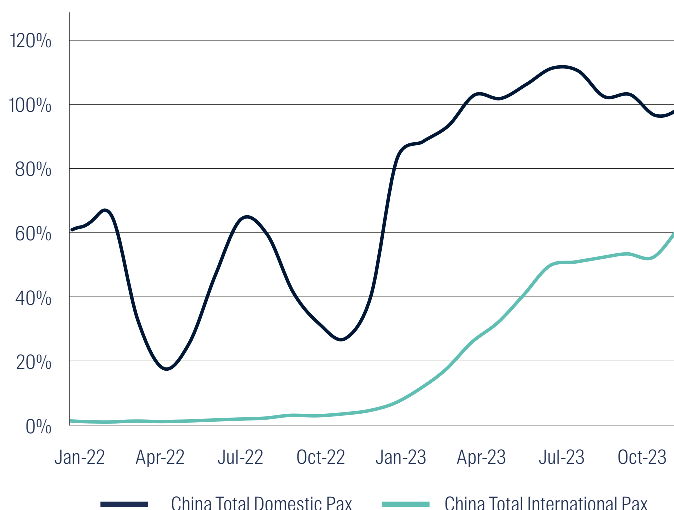
Overall, the IRA has increased the earnings growth potential and visibility of US utilities, which represent around 40% of our global strategy. Integrated and regulated utilities operating in US states with strong renewable resources (solar in the south, wind in the mid-west) and good or improving regulation should be key beneficiaries.

Transportation (~30% global strategy)

Toll roads have benefited from the modal shift from passenger rail to cars since COVID-19, with inflation escalators in tolling having little impact on demand from road users. Strong operating leverage further supported positive earnings growth during the year. Improvements to road networks during the COVID-19 period lead us to believe that there will be strong traffic growth beyond 2019 levels, as congestion returns to major cities and road users make use of these enhanced assets. We maintain an overweight position in the sector and remain positive looking ahead into 2024.

In 2023, airports experienced a significant increase in passenger traffic as the COVID-19 recovery gathered pace, approaching pre-pandemic levels. Leisure-orientated airports outperformed, owing to pent-up travel demand[5]. In 2024, we anticipate a recovery in retail spending by Chinese travellers and a gradual improvement in business traffic. However, cost-of-living pressures may constrain leisure travel, resulting in slower growth than in 2023. Therefore, we remain selective within the sector, but have identified what we believe to be attractive mispricing opportunities for 2024.

COVID Recovery by Traveller Type (vs 2019 comp.)



Source: Company Reports, First Sentier Investors

The freight railroad sector saw an improvement in performance in 2023 as volumes turned positive towards the end of the year. We anticipate this trend to continue into 2024, driven by improved service and a reduction in inventory destocking. Despite the challenges faced, the sector's pricing power remains strong, and as costs stabilize, we expect to see margin improvement in the second half of 2024. This combination of volume growth and margin improvement has the potential to lead to a positive re-rating of valuations for North American railroads in 2024.

Communications (~10% global strategy)

The mobile tower sector faced challenges in 2023 owing to higher interest rates and slower domestic leasing activity. Their main customers (telecom operators) continued to roll out 5G but at a slower pace than previously expected. With leverage for tower companies higher than other sectors, balance sheets have been a focus. Over the year ahead, we expect the 5G rollout to continue, leading to incremental demand for tower leasing and improved valuations.

Data centre leasing activity remains mixed, with early signs of Artificial Intelligence (AI)-related demand offset by customer footprint optimization. Although there have been modest

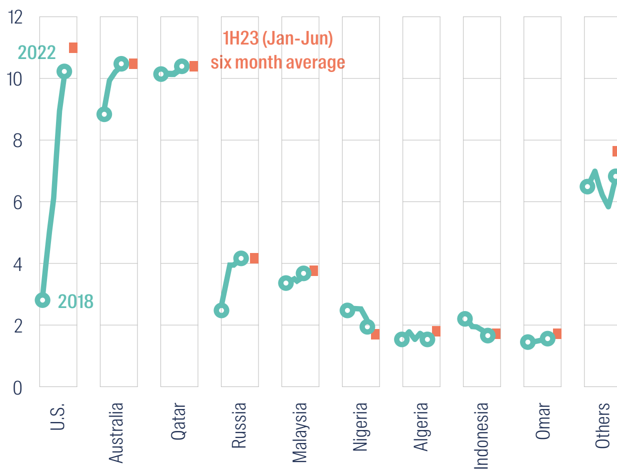
5. Source: First Sentier Investors; company data.

additions to supply, robust demand has swung pricing in favour of the data centre operators.

Energy Midstream (~10% global strategy)
Buoyant energy prices, increased natural gas exports and disciplined capital expenditure saw the North American energy midstream sector produce strong free cash flow (FCF) in 2023, further enhancing already-robust balance sheets. In the absence of substantial new investment opportunities, we expect the sector to use its FCF for increased dividends, buybacks and selective M&A in 2024.

The energy crisis that followed Russia's 2022 invasion of Ukraine reminded the world that only when energy is affordable and secure can it be truly sustainable. Natural gas is expected to play a crucial role as a transition fuel in various parts of the world, especially in developing countries. Within the US, extreme weather events, the closure of coal fired power plants and delays in the buildout of new renewable generation means natural gas has increasingly been called upon to provide stability and reliability to the electric grid. This domestic demand, combined with rising LNG export levels, is underpinning the financial health of the energy midstream sector.

Global liquefied natural gas exports by exporting country (Jan 2018-Jun 2023) Billion cubic feet per day



Source: EIA. Data as at 30 June 2023

Why now?

The following six reasons outline why we believe listed infrastructure is well positioned to outperform in the year ahead:

- **Interest rates** – may have now peaked, as many central banks have paused their tightening cycles. Rising interest rates have been an asset class headwind which could turn into a tailwind very quickly.

- **Valuations** – listed infrastructure has delivered broadly flat returns over the past two years, despite resilient earnings growth. We believe valuations are now at appealing levels.

- **Macro risks** – despite rising bond yields, slowing consumer spending and wars in Europe and the Middle East, broader equity markets traded close to all-time highs in 2023. Listed infrastructure, which is less sensitive to the global economy, could now serve as a defensive diversification tool.

- **Renewables outlook** – supply chains are easing and construction costs decreasing. In the US, IRA benefits have taken time to execute but are expected to support earnings upgrades for US utilities over the medium term.

- **Private markets** – demand for infrastructure assets in private / unlisted markets remains strong, and valuations are well above listed markets. This provides an element of downside protection for investors.

- **Earnings growth** – we expect the asset class to deliver EBITDA, EPS and DPS[6] growth of between 6% and 7% per annum over the next two years, despite a potentially challenging economic backdrop.

Conclusion

In 2023, global listed infrastructure underperformed global equities due to rising interest rates and a shift away from defensive assets. However, earnings growth for critical infrastructure assets is expected to be underpinned by structural growth drivers in 2024 and beyond, particularly for utilities that are deriving earnings growth by investing in the energy transition.

Infrastructure's inflation pass-through is working well and supporting earnings across the asset class. Valuations are now appealing, and earnings have proved resilient.

We believe the mix of inflation-linked income (a yield of between 3% and 4%) and structural growth (expected earnings growth of between 6% and 7%) offered by the asset class will prove attractive to investors in the years ahead.

The First Sentier Global Listed Infrastructure team remains focused on bottom-up stock picking, seeking mispriced, good quality companies trading at attractive relative valuations.

6. Earnings Before Interest, Taxes, Depreciation and Amortisation; Earnings Per Share; Dividends Per Share
Source: Company data has been retrieved from company annual reports or similar investor reports. Financial metrics and valuations are from Bloomberg. As at 31 December 2023 unless otherwise noted.

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