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Infrastructure remains resilient despite macro challenges

Tightening monetary policy, rising interest rates, the Russian invasion of Ukraine and a limited banking crisis have shifted the macro landscape to the point where a global recession is increasingly likely in 2023. Whilst the infrastructure asset class is not immune to these challenges, we expect it to remain resilient given favourable links to inflation and steady underlying demand.

by Michael Landman, Executive Director Infrastructure April 2023

INFRASTRUCTURE INSIGHT

Macro challenges abound

After years of expansionary monetary policy, central banks are currently walking a tightrope, fighting inflation with rapid rate rises, whilst trying to deliver a soft landing for the global economy and preventing a full-blown banking crisis.

Mortgage interest rates have more than doubled in the past year in the US and UK, and European households are facing the further challenge of sharply higher utility bills as supplies of energy are curtailed.

These global challenges are problematic for investors as the combination of slowing growth, high inflation and tightening monetary policy has resulted in significant weakness across listed equities and fixed income markets in the latter part of 2022. The high correlation between listed equities and fixed income has severely reduced diversification benefits in mixed asset class portfolios. In this challenging macro environment, we think that there are good reasons to believe that unlisted infrastructure will continue to perform relatively well.

Inflation and infrastructure – the natural hedge

The return of inflation and the associated sharp rise in interest rates have been dominant global themes in 2022[1]. We expect them to remain a key focus in 2023, along with the integrity of the banking system and continued geopolitical tensions.

To recap, higher interest rates have traditionally been viewed as a negative for the performance of long-duration investments like infrastructure, as they put downward pressure on asset valuations. This is directly due to the potential increase in the cost of borrowed capital, and indirectly because the discount rate used to value cash flows is likely to increase in response to

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[1] Infrastructure – rising rates and the "natural hedge" (ifminvestors.com)

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changes in the risk-free rate (which is linked to long-term sovereign bond rates).

What we find in practice, however, is that the valuations within a well-constructed Infrastructure portfolio tend to be positively impacted by the root cause of higher rates – namely inflation. Infrastructure assets are often positively linked to inflation through contracted increases in prices for services that are linked to CPI. Such arrangements are common amongst regulated utilities, toll roads and ports, and they normally mean that the negative impacts from higher rates are at least partially offset by the positive influence of inflation on revenues.

There are two important points to note regarding the pressures brought by rising rates. Firstly, infrastructure managers should have been capitalising on the recent long period of relatively low rates, so the impact of increased rates will be gradual as laddered long-term debt is refinanced. Secondly, with respect to discount rates, independent valuation firms used by asset managers tend to take a long-term view when setting the risk-free rate, taking into account historical long-term sovereign bond rates and sustained changes in those rates. These factors are evident in both listed and unlisted markets, where infrastructure valuations tend to be less volatile than the broader equities market in response to negative macro events.

What if the global economy enters recession?

Revenue for most infrastructure assets is of course a combination of price times volume. As populations and economies grow, and the use of essential services increases, this can have positive flow-on impacts to revenues. Therefore, both price inflation and economic growth can provide infrastructure assets with a natural hedge that may offset any adverse impacts from rising rates.

The other side of this dynamic presents a key risk for 2023, namely the possibility that central bank monetary policy tightening proves too aggressive and global economic activity pushes into recession territory. But even in this scenario, we think that an investment in a mature well-diversified infrastructure portfolio would generally outperform broader equities investments, and potentially most other asset classes.

We have this conviction because infrastructure businesses generally operate real assets that provide essential services to the communities they serve. Underlying demand for these services tends not to be subject to the same level of competitive forces that exist in many other industries. Although a period of weak economic growth, particularly accompanied by a rapid deceleration of inflation, could result in more subdued performance of assets within GDP-linked transportation sub-sectors, exposure to a balanced portfolio which includes diversified utilities and contracted services should mitigate the effect of cyclical performance.

Interestingly, this view seems to be well-supported by the recent performance of *listed* infrastructure assets. It is well known that listed investments can be more volatile as they are subject to broader swings in market sentiment than unlisted infrastructure, where best practice is to have investments valued quarterly by professional independent valuation firms, under various well-recognised accounting and valuation standards.

Nevertheless, despite the choppy market conditions in 2022, the S&P Global Listed Infrastructure Index (USD Hedged Net Total Return) was up 3.8% over the 12 months to 31 December 2022, while the broader MSCI World Equities Index (USD Hedged Net Total Return) performance was significantly weaker at -15.4%. Further, although Infrastructure is often classified as being a mix of "defensive" and "growth" investment styles, listed infrastructure significantly outperformed both Value and Growth stocks in 2022 as shown in Figure 1. We believe this demonstrates that even listed asset markets are recognising the resilience of the infrastructure asset class in the current volatile, rising rates and inflationary macro environment.[2]

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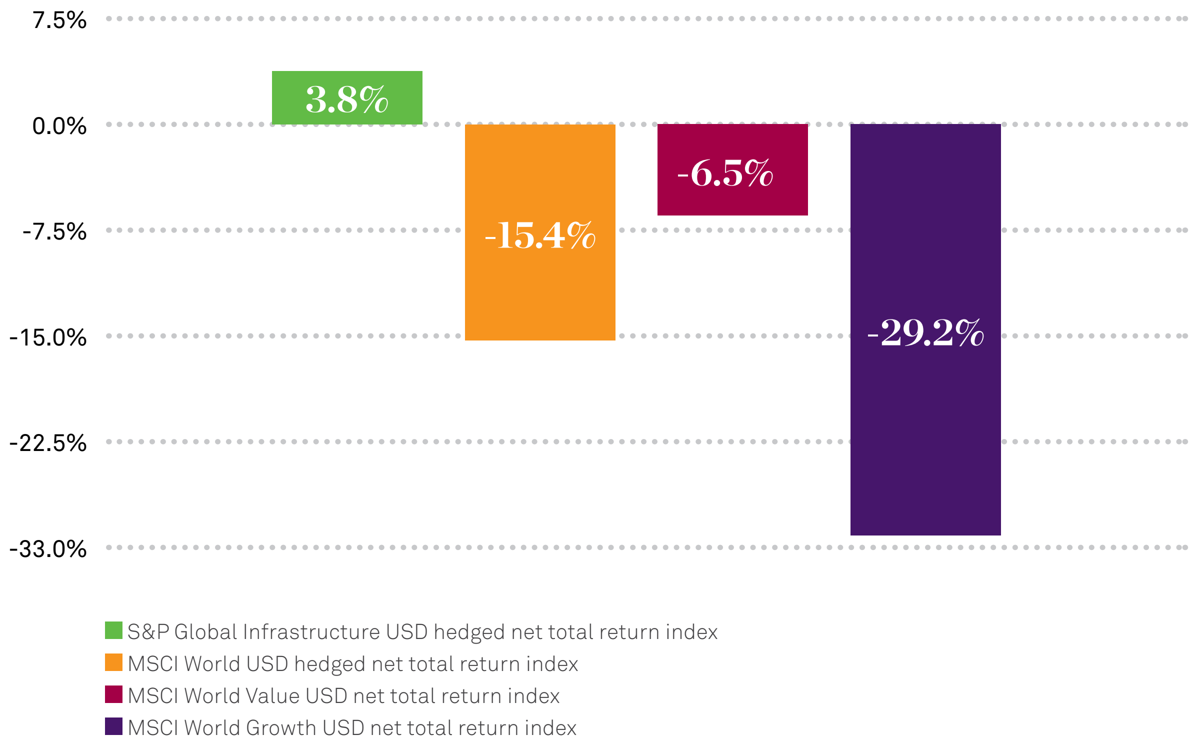
Diversification cannot ensure a profit or protect against loss in a declining market. It is a strategy used to help mitigate risk.

[2] Although markets remained volatile at the beginning of 2023 led by a recovery in growth stocks, the relative performance for the period 1 Jan 2022 - 21 March 2023 remains similar to that in Figure 1, with the S&P infrastructure index significantly outperforming the other listed indices.

FIGURE 1 LISTED MARKET RETURNS – CY2022



Source: Bloomberg

PORTFOLIO EXAMPLE

Indiana Toll Road's links to inflation and growth

IFM infrastructure portfolio company, Indiana Toll Road (ITR), is a good example of how infrastructure assets often have built-in resilience to economic conditions:

- ITR benefits from rising economic activity through increases in its traffic volumes, which remained particularly robust during the COVID period due to the strong demand for goods transported by heavy vehicles, offsetting the reduced car traffic experienced at the time.
- ITR has inflation protection embedded in its toll escalation mechanism, which allows for annual average toll increases at the greater of CPI, nominal GDP per capita or 2% (which provides a floor on price escalation).
- Negative inflationary impacts on ITR's operating cost base benefit from the three-pronged revenue protection mechanism above.

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IFM Insights - Infrastructure resilience across sectors

Infrastructure assets are showing significant resilience to the current macro volatility as illustrated by the following insights we have gleaned from some of our portfolio companies.

Toll Roads

The resilience of the movement of freight has been remarkable, both locally and globally. While COVID triggered supply chain disruptions, and higher logistic and input costs have been negative influences, trade has generally held up well. This has broadly supported transportation sector assets, including many in our infrastructure portfolios.

For example, most of our toll roads have experienced record truck movements, exceeding pre-COVID levels, since March 2021 (as highlighted in the previous ITR example). This is significant as trucks pay higher tolls than cars due to their increased footprint on the road and their greater impact on wear and tear of the road surface. In addition, tolling concession pricing is frequently linked to CPI.

Seaports

Similarly, seaports have also remained resilient, with the movement of goods underpinned by the general strength in consumer demand. All IFM's seaports remained operational throughout the pandemic period, reflecting the critical role these assets play in local and global economies. While the impact of the Russia-Ukraine conflict (particularly at European ports) and steeply higher shipping costs have been negative impacts on performance, we have observed a strong recovery in volumes, with 2022 volumes trending above pre-COVID levels.

Though existing supply chain congestion continues, additional planned fleet capacity and the continued reopening of Chinese trade is expected to support a positive global trade outlook. Whilst volumes may come under pressure if there is a global economic slowdown, an offsetting factor is port tariff regimes that are often linked to inflation.

Airports

Airports globally experienced significant disruption from early 2020 due to the pandemic. But in 2022, there has been a widespread return of people to short and long-haul travel, even though ticket prices are materially higher. Airports are generally experiencing demand levels similar to pre-pandemic era and this is largely being driven by leisure travel. Our airports show passenger numbers tracking at approximately 80- 90% of pre-pandemic levels towards the end of 2022.

Interestingly, this recovery has really been held back by supply constraints, not a lack of demand. Airlines are generally running with higher load factors (meaning that their planes are largely full) whilst charging relatively high prices for tickets. If this continues, the next 12 months could be a profitable period for the airlines, enabling them to strengthen their balance sheets and potentially expand capacity.

Utilities

Utilities are normally classified as 'defensive' investments for good reason. These assets are typically backed by inflation-linked revenue mechanisms and an element of downside protection to rising rates due to the positive linkage between the regulatory cost of capital and the market cost of debt. This is reflected in our global portfolio, where regulated capital values and returns at Anglian Water are set in real terms by the regulator and Enwave Energy's revenues are supported by long-term CPI-linked contracts with customers.

The resilience of these assets was displayed at the onset of the COVID pandemic, when there were concerns relating to potential customer defaults and bill collections. Issues with revenue collection were found to be quite limited, aided by pre-emptive measures such as tracking payment behaviours and monitoring customer stress. More recently in Europe, there has been a significant increase in utility bills due to the Russia-Ukraine conflict, disruption to gas supplies and recent moves by OPEC to cut production of crude oil. Measures and policies by most European governments are in place to curb the impact of rising energy prices on households and businesses. So far, our assets have experienced limited exposure to direct energy markets or geographies impacted by the underlying geopolitical tension.

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