IMAP Independent Thought Podcast
Episode 21: Infrastructure Investment

This podcast is presented by Charles Hamieh & Greg Pease (Clearbridge)

- Views on airports vs toll roads
- If inflation does peak, how would it impact your infrastructure strategies?
- How infrastructure performs under different economic environments
- Dividend growth
- ESG implications
- Inflation, how would it impact infrastructure strategies?

Moderated by David McDonald, CFA IMAP

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David McDonald - IMAP: (00:15)
Okay. Welcome to this podcast in the IMAP Independent Thought series.

Today I'm joined by **Charles Hamieh from ClearBridge** and **Greg Pease from Evidentia Group** to discuss infrastructure investing in volatile markets.

Charles is Managing Director of ClearBridge Investments and portfolio manager for their global infrastructure funds, and Greg is Head of Asset Consulting with Evidentiary Group.

Charles, maybe we could start with you briefly, if you could just set out the background to infrastructure as an asset class and what sort of sectors, sub-sectors you look at, and what you see as the main drivers.

Charles Hamieh - Clearbridge: (00:54)
Thanks, David. To give you context, infrastructure for us is an asset class where the company y owns an essential service and essentially gets paid to make that service available.

Think about toll roads, airports, think about the transmission of electricity, distribution of electricity, gas, and water.

So these companies are often regulated or they operate on the concession agreements. And within both those frameworks, there's a return that is earned through the assets life. And essentially the asset owner gets paid, as I said, to make the asset available.

And various things are passed through inflation, interest rates, various operating costs, which means there's a very high resilience of outcome. Again, because they're essential services, they're quite inelastic economic outcomes, whether you have a job or not, whether we're in a recession or not, these assets still get used.

So the diversification benefits of the portfolio level are immediate as well.

Charles Hamieh - Clearbridge: (02:01)
Importantly, because of our resilience of cash flow and our predictability of cash flow, you have an asset class where you can consistently achieve a high dividend and a dividend that historically has grown well above inflation.

Now, for us, the sweet spot of our asset class is the regular utilities, so the classic poles and wires businesses, and the user pays assets, the airports, the tall roads, and the port assets. We avoid businesses where there's volume risk or commodity risk, essentially any businesses that makes it hard to achieve a predictable outcome through a cycle.

David McDonald - IMAP: (02:40)
Thanks, Charles I guess one of the important things impacting all asset classes and investments at the moment is a macro background, but maybe before we touch on that, Greg can I just ask you where do you see infrastructure fitting in client portfolios?

Do you see it as an income producing defensive asset as Charles has described?

Greg Pease - Evidentia Group: (03:03)
Yes we do David, we view it as a role in a multi-asset, diversified portfolio, but we also use infrastructure a lot more and we'll use it in a higher weighting for portfolios that we create, that actually do have an income focus.

So it depends on the type of portfolio that we build, but we use it both within a diversified portfolio, and we actually use it for those income characteristics.

David McDonald - IMAP: (03:36)
Ok now I did mention the macro view where obviously the focus in the last year of has been on inflation and very rapidly rising rates across the world.

So maybe Charles, do you want to talk about how your team sees the world at the moment in terms of the outlook for growth inflation, et cetera, but then perhaps the two of you can chat a little bit about how that's going to impact infrastructure in particular?

Charles Hamieh - Clearbridge: (04:02)
Of course, our current view is that we are definitely entering a period where we have seen the peak in interest rates and the peak in inflation, and certainly a period where we'll see softer economic growth.

I think the nuance around whether we enter a recession, a soft landing or a hard landing isn't as important as the path of where economic growth will ultimately go.

Now as it relates to interest rates, certainly to the peak of interest rates and inflation for us is a one area where whilst we do think we've seen the peak and we can see a path towards rapidly decelerating inflation.

We do think it's going to be quite difficult for central banks and governments around the world to manage that last mile of inflation, to bring inflation back to within the target. That's historically about the 2% to 3% range.

Charles Hamieh - Clearbridge: (04:55)
That said, we are certainly in the environment where we've seen the ceiling of interest rates and inflation, softer growth, and that's a really good environment for the asset class.

You have an economy which is a big challenge and challenge globally, and that's going to bring to the real resilience of the asset class in terms of the cash flows and strong earnings growth in particular of the utilities.

The inflation pass through remains very, very important because of that stubbornly high inflation That said, it's moderating and the peak in rural rates is important as well, because a lot of the duration businesses in our universe of the toll roads via airports, which have really suffered in the last year because of rising rates.

They are expected to do better going forward as that duration or the rate impacts on infrastructure assets starts to wear off.

So we're very comfortable with the macro environment that we're currently in. Where we could get a surprise is if real rates start to rise again, you know, if it's like a false dawn as it relates to inflation and inflation starts to get sticky again, starts to rise. But certainly it's not our base case.

David McDonald - IMAP: (06:07)
And we've seen a lot of assets move and quite become strongly correlated in the last 12 to18 months, and bonds and equities have moved together for the first time in ages.

How do you see infrastructure moving with bond deals? Is there a correlation there?

Charles Hamieh - Clearbridge: (06:28)
Surprisingly, there isn't, a long-term correlation or a very strong long-term correlation, which I know it goes against conventional wisdom in the near term, certainly because the asset, the defensiveness and the income generating characteristics of the asset class, are deemed as like a bomb proxy in a way.

As rates start to rise, then the attractiveness of the dividend yield and certain utilities becomes, less attractive relative to other asset classes and you get more of an immediate impact on the share price.

But that typically, as we've seen in the past, it really does wash out over the next 6, 12, 18 months. And that's what we're seeing now. As it relates to inflation, the inflation passes through and really provides a very unique hedge for the asset class.

Charles Hamieh - Clearbridge: (07:15)
One thing which is enshrined in the pricing mechanism, in the market structure and with demand volatility, and again, we don't really necessarily worry too much about where inflation is because of that hedge characteristic.

Now clearly within the macro environment different sectors will perform a bit more nuanced depending on where we are in your environment.

If you have an environment where you have recession and low inflation. But obviously utilities, and particularly the more defensive utilities really shine through and some of the user pays assets will probably more likely disappoint.

If you have an environment where you have high growth and high inflation and bond yields are much higher, where we've been then certainly in that environment utilities are a bit more challenged.

But with infrastructure assets, user pay assets will do quite well as they've done recently.

Charles Hamieh - Clearbridge: (08:06)
And if you have an environment where it's somewhere in between, (not necessarily stag inflation where you have low growth, high inflation, but low growth, moderating inflation, then even with within that sort of macro environments its a bit more nuanced.

So UK and European utilities will do probably better than the US.

Utilities infrastructure will be a bit mixed, but negative real yields, which is where we think we are now, moderating or inflecting real yields will really support the asset class more generally.

So it's a bit more nuanced than sort of a blanket "interest rates going up and rates going down", "inflation going up, inflation going down".

David McDonald - IMAP: (08:41)
Right and are there any lingering effects from Covid that you see Charles, things like toll roads, airports, so they back to where they were or getting there ?

Charles Hamieh - Clearbridge: (08:53)
They're across our portfolio and across our universe. Most tolls and airports are pretty much back to pre covid levels.

I suppose the one surprise is how quickly airport traffic got back to pre-covid levels and necessarily toll roads, I think toll roads are always much more resilient as it relates to user pays assets. So we aren't really seeing any of those negative effects. You know, we're certainly well and truly back to pre-covid in many parts of our universe. Some assets are still not, but generally it's a case of no impact from covid for a lot of these assets.

David McDonald - IMAP: (09:34)
That's good. That's encouraging. Now Greg, I know you'd mentioned concerns about yield, and Charles has talked about the sort of steady income.

Is that something that you see … is it steady? is there a threat out there to the yields that you've been getting from these assets? Or are your income targets unchanged

Greg Pease - Evidentia Group: (10:01)
Yes it's been one of the big attractions of global infrastructure for us, if we're building an income portfolio, traditionally a lot of advisors have built out that income portfolio where clients can live off the yield.

So investing is about deploying the capital in assets and living off the yield. The big challenge for us in an Australian environment typically is how do we get more diversification into a portfolio?

Because traditionally advisors that have run that style of portfolio, e.g. overweight the banks nd overweight resources that are paying really good dividend yields out.

So the reality is you just can't get, or it's really hard to get the level of income and yield out of global equities. So we really like global infrastructure from that profile. We're really comfortable with the growth and the resilience of the income at the current levels.

Probably it's one for Charles. One of the questions we get a lot is around dividend growth, so just the growth of that dividend, and we are happy with where it's at, but as far as the growth, do you have any comments on that?

Charles Hamieh - Clearbridge: (11:18)
Of course, Greg. It's interesting that when we build our portfolios, we're always thinking about the likely range of outcomes around every metric, whether it be an operating metric, our

valuation, or metrics of phenomenal internal rate return or the excess return and dividend also forced to that category.

And so for every company we're running the scenarios looking at "what operating scenarios?", "what macro scenarios?" can possibly impact the dividend, and more importantly the dividend growth.

Because we know that's very important. And one of the attractive features of the sector is that over the last 10 years, the dividend growth has been well above the average inflation.

What drives that dividend growth is the asset-based growth and how that asset-based growth flows up into normal equity in the form of capital, and dividends.

So as it relates to the asset-based growth, we're certainly entering a period of what we would call heightened asset-based growth.

Charles Hamieh - Clearbridge: (12:14)
And a lot of that has to do with not only "stay-in business", regular asset-based growth, but also net zero and decarbonisation and what that means for deployment of capital to deal with the variability of renewable energy, transmission of transmission, and distribution hardening, et cetera.

So we are very confident that if anything, whilst currently where we have a 5% dividend with about a 5% dividend growth, that range of outcomes in our view could be possibly skewed to the upside as it relates to growth just because of the strength we're seeing at the moment at the company level.

And that strength, which will be sustained for many, many years driven in part by what we are seeing more structurally in terms of asset based growth.

David McDonald - IMAP: (13:00)
Charles, can you maybe touch on where you are seeing the opportunities?

We've talked a little bit about the sub-sectors and maybe also the geographies.

Which are the particular parts of the world we finding more attractive at the moment?

Charles Hamieh - Clearbridge: (13:13)
Now let's frame that question in the context of the more structural opportunities and what thematics we think are touching the portfolio. And then I will drill down into the sector and geographic opportunities.

Now you know, I've been involved in this asset class for over 20 years, and I can honestly say that the opportunities we're seeing now, are probably as exciting as they've ever been.

And if you think about the thematic opportunities or the thematic drivers that are touching our portfolio, think about decarbonization and net zero. I spoke about this earlier, but to stress of the listeners, there's no sector that is more to the forefront on achieving that policy goal than infrastructure utilities. A lot of Capex required to achieve net zero will be driven by large scale utilities, and a lot of those companies are listed.

Charles Hamieh - Clearbridge: (14:07)
So everyone listening on this call is really benefiting from the thematics. And we're seeing it now across every company, whether it be a US utilities, European utilities, whether it be toll roads, airports, we're seeing that Capex being deployed to meet those policy goals.

Another interesting theme is onshoring or the fracturing of global economies, obviously Covid really pulled forward a lot of that where countries around the world are trying to take ownership

of the supply chains. Now, North America / USA in particular, is really right at the forefront of that. Europe is responding. The rest of the world will as well.

What that means for localized energy is that energy needs localised, you know, infrastructure needs, supply chains, et cetera. Again, very exciting.

Many of the companies in our portfolio and particularly in North America, are really responding to that, and are working hand in hand with local stakeholders, and companies to facilitate the “on-shoring” of manufacturing industry, et cetera.

Charles Hamieh - Clearbridge: (15:03)
Another thematic is digitisation and the way we communicate with each other and how to facilitate that list. And tower companies are right at the forefront of that, you know, telecommunication companies placing equipment on the towers that these companies own or designed to facilitate the transfer of data and improve the way we communicate.

So within the context of that, there's certainly many opportunities at the moment. You know, we think that certainly in North American utilities, which were somewhat challenged last year.

You know that asset based growth story, it's North American utilities, which are really right at the forefront of net zero and decarbonisation, where you can see a real impact on their asset based growth.

They're still achieving very attractive allowed returns, 10% plus nominal return on equities. And that's going to really sustain for a very long period of time, you know, company reported OEs and ultimately total returns, dividends, dividend growth that shareholders will see.

Charles Hamieh - Clearbridge: (16:05)
At the same time, more selectively, we're starting to see some opportunities in user pays assets globally, in particular the airports. Certainly the first part of the year we saw a big run up in airports but they've sort of come back a bit now.

And we see the resumption of travel and how that fits into passenger mix and the various airports around the world, how they'll respond to that. We're getting a bit more excited about the valuation story there.

And then within that there's always these idiosyncratic opportunities, with companies where we're just able to apply our infrastructure lens and price the risk a bit differently. Also price the opportunities a bit differently, whether it be Southern in North America, whether it be Iberdrola or EDP, you know, in Europe companies are a bit differentiated, but certainly not to us. And when we look at these companies, we certainly see ample opportunity for really meaningful long-term, growth.

So there's a lot of opportunity at the moment David, an opportunity which is anchored in a lot of a structural drivers we see, but at the same time, which is driven by really strong compelling valuations and really strong idiosyncratic drivers of a stock level across our universe.

David McDonald - IMAP: (17:20)
Thanks, Charles. One other topic I think might be interesting.. that both of you might have comments on is the differences between listed and unlisted infrastructure, and also from valuation point of view, I mean there's been comment lately about valuations of unlisted assets, perhaps not being as up to date as they should be.

Greg Pease - Evidentia Group : (17:44)
From our point of view we only deal with listed infrastructure. So most of the portfolios that we run are under a managed account structure, like an SMA structure.

And so typically this requires us to have 80% liquidity within 20 business days under the kind of scheme. So we only really deal in the listed infrastructure space.

Having said that, what we're looking at for both property and infrastructure is how it's trading versus, with net tangible assets and the underlying assets and how the private market exposures are trading as well. So we do look at that, but yes all of our exposures are through listed infrastructure and we're happy with that.

Charles Hamieh - Clearbridge: (18:33)
But certainly David as an infrastructure investor, certainly there's been (as you suggested), a lot of noise, a lot of discussion recently about some of the valuation differences we're seeing in listed and unlisted and sometimes you have the same asset class, sometimes the same regulator, very similar cap capital structures, yet a persistently stubborn valuation gap between quite high transaction multiples in unlisted, and much fairer trading multiples enlisted.

And that's something which we've seen now for five years, certainly wasn't the case when I was running unlisted money over 15 years ago. Now, back then both transaction multiples, and listed multiples were very close. Now the gap can be up to 40% in some sectors, and we think it's just a function of the huge amount of money that's been raised.

Charles Hamieh - Clearbridge: (19:25)
You know over $300 billion has been raised in direct infrastructure over the last five years, and that needs to find the home and high quality core infrastructure assets. You know there's really high quality toll roads, those really high quality regular utilities that just don't really exist outside of the listed landscape. So when they do come to market, there's really extreme competition.

And so the ability of direct to get a cheap asset is almost zero because of that really intense competition. But what it means for listed is really important.

What we've seen is really three things happen over the last three to five years as a result of this really persistent valuation gap.

One is unlisted companies have just taken over list of companies, and we've seen that in Australia. We've seen the airports, you know, Spark, AusNet, a false start with ALX, but we'll see how that plays out and a few others globally.

Charles Hamieh - Clearbridge: (20:24)

Two, we've seen many listed companies start to sell off non-core parts of their business to unlisted investors.

They're seeing these valuations. They're saying, Hey, we have this, we have this asset, it's not core to us, right? They're able to sell it at a very attractive valuation, then reinvest those proceeds into their core business. This really strengthens not only the company specific, i.e. cash flow, dividend, dividend growth story, but also the universe. It's making a much higher quality as they really sell these non-core assets.

But thirdly, it's an interesting time because if you are ambivalent to how you want to hold the sector, whether it's listed or unlisted, and your time horizon is more than a day and you do have a longer term time horizon, then we think right now it's quite a unique opportunity for a listed infrastructure investor.

Charles Hamieh - Clearbridge: (21:16)
We certainly think that buying the asset class now is an listed investor and holding it by virtue of your lower entry prices should earn a higher return than an unlisted counterpart.

History has shown that through a passage of time, the return outcomes between both listed and unlisted are very, very similar. Obviously you have higher beta in the listed market and volatility, but for us, it's a good thing because what that means is that we can buy or be better, and add a layer of return over what we will consider a typical infrastructure return just by being active managers with our own universe, et cetera. So, you know, that's where we think we are right now on the cycle.

David McDonald - IMAP: (21:59)
Yes that makes a lot of sense, Charles, and you would imagine the same asset should deliver the same returns over 10, 20 years no matter how it's held

Charles Hamieh - Clearbridge: (22:09)
And that's been the case as the numbers clearly bear that up.

David McDonald - IMAP: (22:14)
Maybe one last topic I was intrigued in, Charles, you mentioned about the move to Net Zero and how some of these sectors are leaders in achieving that. And I know there's a lot of focus on ESG and climate change and so on for investment portfolios, but in one of our conferences recently, we actually had a session with the topic is Net Zero a new asset class?, and you're raising that here that, as you're not just "not buying things that harm the climate", but you're actually buying things that are doing the right thing and heading us in the right direction.

Charles Hamieh - Clearbridge: (22:55)
Certainly, and we've been a signatory to UNPRI since 2008, and the sector itself has a very high threshold as it relates to ES. Think about every time an asset's built, the environmental requirements, the social license to operate, the disclosure requirements.

So there's a really high threshold in our process. It's key and it's been key for a very long time.

And for us it's always been about two things.

One is obviously understanding the risks and being able to price them, but equally as important is understanding the opportunity and being able to price that, and investors benefiting from that.

And it's important as I made the point earlier, that the asset class is really unique because it's an essential service. So it plays a pivotal role in society. And whether we achieve net zero or not, it's an asset class, which is here to stay, you know, we'll always need water, electricity, gas, airport storages.

Charles Hamieh - Clearbridge: (23:49)
So it's about managing the asset class, spending the required Capex to ensure it plays its role in achieving net zero.

And you made the point earlier about what does that mean?

You know, electrifying the grid is probably the only way we can get close to achieving net zero, and that means renewable energy spend.

It means EV charging stations, it means strengthening transmission and distribution lines to deal with the variability of renewable energy.

It means utilities, scale, battery technology, hydrogen technology, all that is occurring in listed companies. The Capex required, the renewable energy companies that are spending the money, all those are listed and growing their asset bases, and growing their generation mix, the transmission and distribution lines.

All those companies are listed a lot of hydrogen, the piloting of hydrogen projects, all the technology around hydrogen is occurring in listed companies, you know SNAB, A-Gas, and APA in Australia.

So the sector plays a very pivotal role and we'll continue to do so for many, many years. Even gas as an asset. The role gas plays as a transition fuel so we can safely move away to primarily renewable energy, nuclear energy as well.

So there's many parts of the net zero decarbonization, thematic, and ecosystem which directly are impacted and influenced by what our companies, what the list of companies that we're investing in are doing.

David McDonald - IMAP: (25:15)
Greg, is ESG generally a topic that's become more and more at the front of your clients' minds? Is it something they want to focus on a lot more now?

Greg Pease - Evidentia Group : (25:27)
I think the answer is yes. Definitely I think ESG comes up with every single client. However, rather than how ESG typically is playing out within a portfolio series for a private wealth firm, we tend to be building our ESG policy for that firm.

And what I'm seeing with ESG policies is we might have, call it a light ESG policy over there, a lot of their normal portfolios, and then they'll build out like an impact or a heavier ESG portfolio that they'll actually call a sustainable portfolios.

So we are seeing the impact of ESG, but we're probably seeing at a policy level, at a portfolio level, and then those firms specifically selecting ESG strategies for those portfolios.

David McDonald - IMAP: (26:23)
Okay. Well look its been a great discussion. So I think we've used our time and covered some really good issues there. So it just remains for me to thank Charles Hamieh of ClearBridge and Greg Pease of Evidentia Group for joining us today and giving us more insight into the role of global infrastructure in portfolios.

And finally, a reminder that the annual IMAP Awards are now open for entries and this year, as well as the usual categories such as multi-asset e s g small companies. We've introduced a new category for boutique licensees to give an opportunity to smaller and mid-size firms who have a great process, but maybe think it's difficult to be compared with some of the very large institutions that enter. So details of the Awards are on the IMAP website, so please have a look.

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