Infrastructure:
The International Investor’s Road Ahead

By Justin Lannen, CFA®

The assets of infrastructure companies are vital to your daily routine. You turn on lights powered by an electric utility, cook with gas delivered by a pipeline company, use water from a local municipal supply, drive on toll roads, and fly in and out of airports. Due to their essential nature, infrastructure assets are stable and defensive. Global listed infrastructure securities provide investors with the opportunity to invest in these assets in today’s volatile times.

Infrastructure assets offer relatively secure cash flows and benefit from several favorable long-term trends. Investors may view their low-beta characteristics more positively amid uncertainty and slowing global economic growth compared with other asset classes. The infrastructure sector has not been immune to the recent global equity market weakness as investors have focused on debt structures and capital commitments, but the market turmoil hasn’t materially affected the operational performance and fundamentals of many global listed infrastructure securities. Infrastructure assets typically are of investment-grade credit quality and have long-dated debt programs. Both of these factors should minimize the impact of wider credit spreads.

What Are Infrastructure Assets?
Infrastructure assets are the basic services, facilities, and institutions that are crucial for growth, development, stability, and prosperity of a community. Infrastructure companies provide necessities of everyday life: fresh water, roads, airports, gas, electricity, seaports, rail service, and more.

Macquarie expects global listed infrastructure securities to gain further traction this year among investors seeking relative safety because the sector is recognized for its defensive attributes. Some attributes of infrastructure companies include the following:
• Essential services: Many infrastructure issuers are the sole providers of an essential product or service (e.g., water/wastewater removal, electricity, transportation services) to a segment of the population, and they often retain this characteristic for extended periods of time.
• Fixed and regulated returns: Regulated market environments may bring access to predictable returns through government-backed regulation or long-term contracts.
• Leverage on a fixed cost base: Once an infrastructure asset is developed and its operations mature, ongoing operational maintenance expenditure may be relatively low and stable. As a result, increases in revenue may not result in proportionate increases in operating expenditure, thereby increasing free cash flow.
• Relatively inelastic demand: Demand for infrastructure-related products or services is often linked to underlying economic or demographic growth and typically is more stable and less sensitive to changes in price or the economic cycle compared with other products or services.
• Inflation linkage: The underlying revenue of infrastructure assets may be linked to inflation, sometimes directly through a regulatory framework or a concession agreement linking price growth to inflation.
• Long-life assets: Infrastructure assets typically have long, economically useful lives, with many operating under long-term concessions or contractual agreements.

Increased infrastructure investment, privatizations, and corporate activity make up a continuing trend in 2008, providing opportunities for investors. Notwithstanding some impact at the margin from the slowing global economy, the sector’s growth should continue to be driven by the need for infrastructure coupled with governments’ decreasing ability or willingness to invest in it.

Trends in Infrastructure Assets
In several developed countries, privatization has been increasing as national governments spend less on infrastructure assets. Governments worldwide have been spending less on infrastructure as a percentage of gross domestic product (GDP) over the past 30 years. For example, Australia’s utilities, toll roads, airports, and other infrastructure assets have become accessible to investors through privatization and listed securities over the past 15 years. A committee in the Australian state of New South Wales issued a report in February 2008 recommending that the state government consider an initial public offering (IPO) of some of the state’s electricity assets. The report argued that such an IPO proposal would create a new listed player to compete with incumbents in the national electricity market. Such an IPO would also represent an expansion of the infrastructure universe and potentially an investment opportunity.
In the United States, where most infrastructure assets typically have been owned by state and municipal governments, the opportunity for the private sector to participate has grown. While the proportion of private to government funding still is relatively small compared with other nations, the trend is apparent as state and municipal governments prioritize expenditures away from infrastructure assets. A recent example occurred in April 2008, when the city of Chicago announced that six major consortia had submitted qualification statements as potential bidders to operate Midway International Airport. Should the proposed long-term lease be signed, Midway Airport would be the first major U.S. airport to operate privately. A bid price of several billion dollars may be reached, with funds possibly directed toward Chicago’s public pension plans and the maintenance of the city’s other aging infrastructure assets. Chicago already has implemented privatization of toll roads and parking. The most notable privatization was the $1.83-billion lease of the Chicago Skyway toll-road to the Skyway Concession Company, a joint venture between Macquarie Infrastructure Group/Macquarie Infrastructure Partners and the Spanish toll-road company Cintra Concesiones de Infraestructuras de Transporte SA.

Furthermore, developing economies such as China and India are experiencing rapidly growing demand for infrastructure assets and services. Risks of government intervention and political instability in emerging markets must always be considered along with such investment opportunities. For instance, in February 2008, the Brazilian federal government announced a series of infrastructure concessions and projects due for auction. The government expects to auction federal roads in the state of Bahia as well as the initial phase of the third Federal Toll Road Concession Program in the latter half of 2008. The government also announced plans to build a high-speed train that would link airports in Rio de Janeiro, Sao Paulo, and Campinas. These concessions are likely to demand significant capital expenditures, and companies such as Brazilian-listed toll-road operator Companhia de Concessões Rodoviárias and its shareholders are well-positioned to capitalize on these opportunities given its market-leading position, strong balance sheet, and potential operating synergies.

An additional positive trend appears in the significant amounts of capital that now are held in various listed and unlisted funds targeting infrastructure investments. Such funds are attracted to the typical features of infrastructure such as long-life assets, defined revenue profiles (often with inflation linkages), strong strategic positions, and predictable cash flows. These investors, as well as pension funds with long-term liabilities, should continue to keep demand strong for ownership of infrastructure assets.

While the number of infrastructure IPOs temporarily has slowed due to market volatility, new listings inevitably will pick up as the ongoing trend of less government ownership and expenditure continues. Additionally, reduced volatility in asset markets is likely to lead to further IPOs of infrastructure assets held by corporations.

Global Implications and Opportunities

With regard to potential global implications of a U.S. economic slowdown, investors should be comforted by essential service companies that are largely uncorrelated to movements in the business cycle. Toll roads, electricity distribution and transmission assets, water, and oil and gas pipelines are significantly less leveraged to GDP or other standard economic indicators than most other segments of the market.

Attractive opportunities reside in a number of infrastructure subsectors such as toll roads, seaports, and airports worldwide. In the United States, the trend of robust growth in North American energy infrastructure and the pipeline market is forecast to continue in 2008. This trend can be explained by 1) long-term annual demand growth of approximately 2 percent for crude oil, natural gas, and refined products; 2) shifting sources of supply (e.g., Canadian Oil Sands, Rocky Mountains, increased natural gas drilling in East Texas and Gulf Coast LNG); and 3) the aging state of North American energy infrastructure assets (e.g., a significant portion of the U.S. infrastructure was built during or shortly after World War II). More importantly, this demand has subsequently provided opportunities for the pipeline industry (particularly those under the master limited partnership structure) and should result in continued expansion and investment activity over the near to medium term.

Importantly, many listed pipeline companies have limited sensitivity to commodity-price fluctuations because they tend to have long-term contracts that are not price-dependent. Pipeline revenues thus are relatively secure.

As noted above, the change in sources of supply for crude oil, natural
gas, and refined products will continue to drive major pipeline projects in 2008 and beyond. A good example is Enbridge Inc., which is leading the industry’s efforts to deliver crude oil produced from Canada’s Alberta oil sands to the U.S. market. Enbridge, which has already committed to spending approximately $12 billion on projects that will transport up to 4.4 million barrels per day by 2016, should begin to see the first of its major projects (Southern Access Expansion) come online in 2008. Another major project due to begin service this year is Kinder Morgan Energy Partners’ $4.9 billion Rockies Express Project (REX), which will deliver 1.8 billion cubic feet per day (Bcf/D) of natural gas to U.S. midwestern and northeastern markets. REX-West is expected to be in full service this year; REX-East will begin construction in 2008 and 2009. Highlighting the shortage of energy infrastructure, both Enbridge and Kinder Morgan’s projects are fully contracted under long-term contracts, and these projects have generated additional new expansion opportunities. These two examples aren’t likely to be the last of the large projects announced this decade; a number of industry players are discussing the potential for a $30-billion natural gas pipeline from Alaska that would deliver 4 Bcf/D to the lower 48 U.S. states.

**Funding Requirements**

Forecasts call for 2008 to be an active year in new pipeline projects, and the same could be said for financing requirements. Market estimates indicate that the industry may raise more than $15 billion in combined debt and equity capital. This may create a challenging environment in both credit (e.g., liquidity and wider spreads) and equity (e.g., significant backlog of IPOs and secondary offerings) markets for future projects. These challenges have surfaced this year because a number of initial and secondary equity offerings have been withdrawn, delayed, or lowered. However, pipeline projects in progress are unlikely to be impacted because companies tend to have committed financing in place and capital markets remain positive on such defensive assets. Additionally, funding requirements tend to be less challenging for companies that are larger in market size and have proven track records in generating returns.

Price performance in 2008 for North American pipeline companies is expected to be consistent with annual dividend/distribution growth in the absence of broader negative movements in markets. This should bode well for total returns. Brokers forecast that industry distributions will grow by an average of 12 percent in 2008, driven by attractive projects undertaken over recent years.

Looking further into 2008 and beyond, the pricing of global listed infrastructure securities overall should revert more closely to the fundamentals of underlying infrastructure assets. Investors should select investments based on the quality of assets and ability to provide attractive risk-adjusted returns. The fundamentals of the many infrastructure businesses remain largely unchanged, notwithstanding credit market concerns.

Companies of investment-grade credit quality with long-dated debt programs, both of which minimize the potential impact of wider credit margins, are particularly attractive. All-in funding costs have benefited from generally falling government bond yields and London interbank offered rate (LIBOR). While varying by country, several companies have stated that their funding costs actually have fallen year over year, although it is fair to say that debt costs in total have risen globally over the past 12 months.

The fundamental strength of infrastructure's underlying assets and the robustness of their capital structure should provide long-term international investors with attractive risk-adjusted returns.

Justin Lannen, CFA®, is a portfolio manager with Macquarie Capital Investment Management LLC. He earned a Bachelor of Engineering and a Bachelor of Commerce from the University of Melbourne. Contact him at mgu-questions@macquarie.com.

Disclaimer: This article has been prepared by Macquarie Capital Investment Management LLC (“MCIM”) from publicly available information, is for informational purposes only, and does not constitute a recommendation, investment advice, an offer or solicitation to buy or sell any securities or enter into any transaction. This article has been prepared without taking into account the reader’s financial situation, objectives, or needs, and should not be relied upon in evaluating the merits of any particular investment.

Whilst MCIM has taken reasonable care in preparing this article, subsequent changes in circumstances may occur at any time and impact on the accuracy of the information. Opinions and estimates offered in this article constitute MCIM’s judgment as of the date of this document and are based on current market conditions. We believe the information provided here is reliable as at the date of this article but to the extent permitted by law, MCIM does not warrant its accuracy or completeness and accepts no liability for errors or misstatements, negligent or otherwise, or for any loss or damage suffered by any person in relation to the material. We have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources. MCIM does not guarantee that an investment in infrastructure assets will yield any particular rate of return or that such an investment will be successful. Past performance is not an indication of future results.