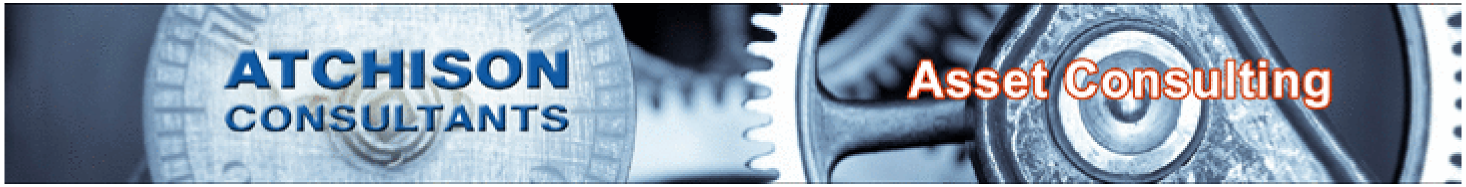

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INFRASTRUCTURE – AN ALTERNATIVE SOURCE OF INCOME

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By guest contributor Atchison Consultants

Infrastructure has become a hot topic in recent months. Ongoing conversations around the need for additional infrastructure to cope with expected demand from population growth and the change in lifestyle of the Australian population (for example internet and broadband requirements).

Infrastructure can be categorised into two subgroups:

Social infrastructure typically includes assets that accommodate social services that provided by governments. These assets are often run by a private operator on behalf of the government and typically include the following services.

Sector	Example
Healthcare	Medical facilities Ancillary infrastructure (e.g. offices, carparks, training facilities)
Education	Schools (primary and secondary) Tertiary facilities Residential student accommodation
Housing	State or Council housing Defence force housing
Civic and Utilities	Community & sports facilities
Local government facilities	Water and wastewater treatment
Transport	Bus stations Park and rides Availability-based roads (excluding demand-risk toll roads)
Corrections and Justice	Prisons Court houses

Economic infrastructure supports economic activity and is often characterised by 'user-pays' or demand-based revenue streams (such as tolls on toll roads or landing fees for an airport). These assets are a medium for providing key services which enhance business productivity and enhance economic activity Examples of economic infrastructure include:

Infrastructure funding

Historically governments have been the primary financiers of infrastructure. Since the GFC, many governments, including Australia, have been running substantial fiscal deficits and to some extent have fragile balance sheets. Their ability to invest in public sector infrastructure has as a result generally been highly constrained.

Locally, the Federal Government has committed over $70 billion from 2013-14 to 2020-21 to transport infrastructure across Australia, using a combination of grant funding, loans and equity investments. The Government is further establishing a 10-year allocation for funding road and rail investments, recognising that many transformational projects are planned and built over many years, thus delivering $75 billion in infrastructure funding and financing from 2017-18 to 2026-27.

Whilst these commitments go some way to building the infrastructure required, it is still a long way off what some estimate as the right level of investment. Many argue that increased investment in infrastructure in Australia is long overdue. Infrastructure Partnerships Australia (a private-sector think tank) estimates that the level of infrastructure expenditure to the required level is $770 billion.

The mismatch between constrained Government infrastructure spending and the required level of infrastructure investment provides an opportunity for private investors to participate in this form of investment. Innovating financial approaches have encouraged private sector investment through approaches such as the Public Private Partnership models (National PPP Policy Framework endorsed in 2008). In line with the Framework, the Australian, State and Territory governments will consider a PPP for any project with a capital cost in excess of $A50 million.

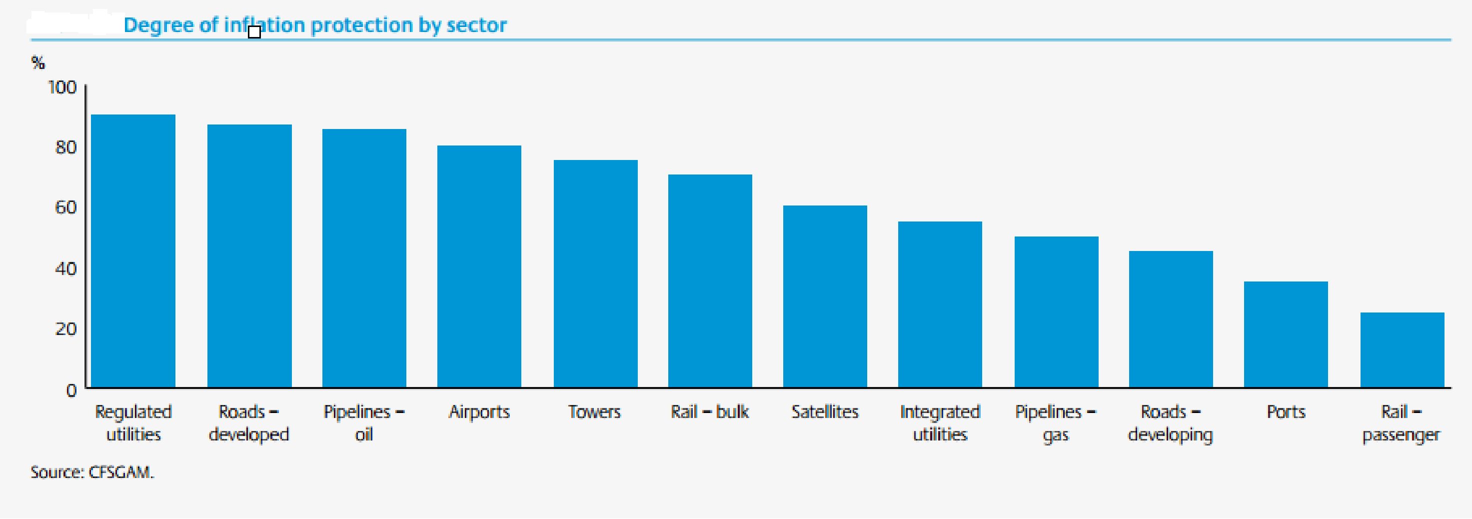
Investing in infrastructure

Infrastructure as an asset class has significant appeal for long-term investors. Typically, infrastructure assets possess a number of attractive investment characteristics including:

- providing long dated and resilient cash flows.
- delivering regulated or contracted earnings streams.
- having monopolistic market positions or high barriers to entry.
- (relatively) attractive potential yield and low volatility in earnings.
- a hedge against inflation.

It's also an asset class where the consideration of ESG (Environmental, Social and Governance) factors in investment decision-making is critical. This is mainly due to the essential social services provided (with sometimes high environmental impacts or benefits), and the significant regulatory oversight which these businesses typically operate under.

A key feature of infrastructure assets is the ability to provide an inflation hedged exposure. The following chart shows the assessed level of inflation protection from infrastructure asset sectors.



This hedge is typically a result of inflation linked pricing structures embedded in the infrastructure's contractual obligations and revenue model.

Accessing infrastructure investments

Access to the infrastructure asset class can be achieved through private market transactions, unlisted infrastructure funds and exchange traded infrastructure securities.

Direct investment is generally only available to large institutional investors such as superannuation and pension funds and life offices. This typically takes the form of direct investment, joint venturing or access through wholesale funds, syndicates or mandates.

A number of larger superannuation funds such as the Australian Super and HESTA, have direct exposures/holdings in infrastructure assets. These exposures are a result of the nature of their member obligations (including defined benefit liabilities) as well as the unique qualities and diversification benefits infrastructure assets provide within an asset allocation decision.

For smaller (non-institutional) investors, the listed infrastructure market provides access to a broad, deep and liquid range of infrastructure investment opportunities. Listed infrastructure provides the non-institutional investor with flexibility to choose, or amend their investment horizon (through liquidity) which may be limited and/or non-existent under private market transactions and unlisted infrastructure funds.

In addition, to generating higher (total) returns (with greater volatility), listed infrastructure provides daily liquidity and generally provide greater diversity of asset exposures due to investment size limitations. Accessing listed infrastructure securities also tend to be potentially cheaper than its unlisted cousins.

There are currently 14 listed infrastructure stocks available on the ASX with asset exposures varying from $295m through to $25.8bn. As at 31 May 2017, the average projected P/E ratio of these stocks was 28.7 against a historical longer term average of 18.7.

Risks of investing in infrastructure

There are several key risks of infrastructure investing. Some of the more salient risks include the following:

- Entities being too optimistic in their cash flow assumptions and forecast of future use and performance of the underlying asset(s).
- Unlisted infrastructure projects are often unique so it can be difficult to compare one to another and this can also make an investment difficult to sell.
- Each infrastructure sub-sector has different risk factors, return drivers, and economic sensitivities.
- Different countries have different political, regulatory and legal frameworks. Regulatory decisions may be inconsistent thus increasing uncertainty for investors.

- In the case of unlisted infrastructure, entities are less liquid than some other investments, which means they cannot be as easily sold and converted to cash.
- Credit market conditions impact the amount, cost and terms of credit available to infrastructure assets.

Past performance

The table below outlines the return and volatility of returns of listed infrastructure vs unlisted infrastructure over one year, three years, five years and 10 years to 31 March 2017.

	1 year		3 years (p.a.)		5 years (p.a.)		10 years (p.a.)	
	Returns	Volatility	Returns	Volatility	Returns	Volatility	Returns	Volatility
Listed Infrastructure	24.7%	13.3%	14.1%	13.5%	12.6%	12.2%	5.6%	15.4%
Unlisted Infrastructure	13.4%	2.3%	12.4%	2.3%	13.2%	3.3%	10.7%	4.2%

Source: MSCI, CFS, S&P/ASX

Performance of listed infrastructure has been higher than unlisted infrastructure over one year and three years to 31 March 2017. Over five years and ten years to 31 March 2017, unlisted infrastructure outperformed listed infrastructure, attributable to the downturn during the Global Financial Crisis.

The performance of infrastructure, particularly unlisted assets, has been among the most stable. Listed infrastructure, like all assets with relatively high liquidity, fared less well. Volatility of returns of listed infrastructure has been higher over all periods to 31 March 2017.

The table below shows the correlation of the listed and unlisted infrastructure to other major Australian asset classes over 10 years to 31 March 2017.

10 year correlation	Listed Infrastructure	Unlisted Infrastructure
Australian Shares	0.69	-0.01
Australian Fixed Interest	-0.13	0.00
Australian Cash	-0.42	-0.14
Australian Listed Property	0.65	0.14
Unlisted Infrastructure	0.26	-
Listed Infrastructure	-	0.26

Source: MSCI, CFS, S&P/ASX, Bloomberg

Over 10 years to 31 March 2017, the correlation between listed infrastructure and unlisted infrastructure was 0.26 (slight positive correlation). Unlisted infrastructure valuations lag listed markets which explains to some extent, the relatively low correlations with listed infrastructure over the period.

Over 10 years to 31 March 2017, listed infrastructure had a higher correlation to Australian shares and Australian listed property and a low to negative correlation to other Australian asset classes.

Over 10 years to 31 March 2017, unlisted infrastructure had a low to negative correlation to other Australian asset classes.

Yield returns

Over 10 years to 31 March 2017, based on data from MSCI Real Estate Analytics, the income yield from unlisted infrastructure ranged between 4% and 5% p.a., which is lower than the income return/yield of 5.9% p.a. from listed infrastructure over the same period.

Summary and Allocation

Infrastructure assets provide stable and predictable cash flows with inflation linked revenue. Exposure to the infrastructure asset class can be accessed through private market transactions, unlisted infrastructure funds and exchange traded infrastructure securities.

Infrastructure has a low correlation to movements of other alternative Australian asset classes, making it attractive as a diversification play. An allocation to unlisted infrastructure is likely to provide even better diversification benefits.

Stocks across the listed infrastructure sectors are currently yielding approximately 4%-5% p.a. (as at 31 March 2017). We expect yield growth in listed infrastructure to be approximately 3%-4% over the next year with limited growth in valuations. Our expected returns over the short term for listed infrastructure securities which derive most of their revenue from mature assets range from 7% – 9%.

A modest allocation to infrastructure (both listed and unlisted) as part of the growth component of a diversified portfolio may be beneficial on a risk-return perspective amidst geopolitical risk and falling markets as infrastructure provides a safe haven for investors.