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AFTER THE VOLATILITY WHO MAKES THE CUT?

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WHY INVEST IN GLOBAL LISTED INFRASTRUCTURE?

JASON BEDDOW

Recent sharp falls in global equity markets underscore the benefits of diversifying investment exposure to more defensive asset classes. Offering stable, long-term returns, global listed infrastructure stocks can provide a 'defensive layer' to an investment portfolio and diversification benefits for investors heavily exposed to Australian shares. Here I answer some key questions about global listed infrastructure from an investment perspective, and outline the factors contributing to a positive outlook for the asset class.

What is infrastructure?

A diverse range of real or 'hard' assets critical to economic growth and the functioning of society. These assets fall into four broad categories: transportation (toll roads, ports, railways and airports); midstream energy (including pipelines and storage); utilities (including gas, electricity and water); and communications (such as wireless towers and satellites).

Why invest in infrastructure?

While infrastructure assets cover a broad range of industries, they have a number of shared characteristics which make them attractive to investors, including:

Stable and predictable cash flows: The essential service nature of infrastructure assets ensures demand is reasonably inelastic. In turn, this consistent demand generates stable and predictable cash flows, even in economic downturns.

High barriers to entry: Infrastructure assets are costly to build and difficult to replace. This reduces competition and creates monopolistic market positions and pricing power.

Long life assets: As infrastructure assets are typically built to last 30 to 50 years plus, they provide long-term investment income.

Inflation-linked pricing: Asset regulators generally take inflation into account when setting asset pricing structures. This means, as inflation rises, asset operators are often permitted to increase user fees.

What are the benefits of listed versus direct infrastructure investment?

Listed infrastructure companies own the same assets as unlisted private infrastructure owners, with the added benefits of exchange-traded stocks, such as transparency, daily pricing and liquidity. The listed infrastructure universe is highly liquid providing active investors with the flexibility to adjust portfolio positions as opportunities arise and conditions change. In contrast, direct infrastructure investments typically require significant capital commitment over the long-term.

The small minimum investments required to invest in infrastructure stocks provides investors with an effective way to create a highly diversified portfolio.

Why look overseas to invest in infrastructure?

Opportunities to invest in domestic listed infrastructure companies are very limited and highly concentrated. There are only about a dozen ASX-listed infrastructure companies which are predominantly focused on toll roads, utilities and airports. Furthermore, the three largest Australian infrastructure stocks account for approximately 60% of the $98 billion domestic listed infrastructure universe available to investors.

In contrast, there are around 350 listed infrastructure companies, across 16 countries globally. With a combined market capitalisation of approximately $2.4 trillion, the global listed infrastructure universe is approximately double the size of Australia's entire share market. In addition, offshore companies offer exposure to infrastructure asset categories not accessible directly through the ASX, including communication towers, satellites and water utilities.

Why is infrastructure considered a defensive investment?

Infrastructure assets' fundamental characteristics, including their essential, long-term nature and inflation-linked pricing, translate into steady, long-term income streams through various economic cycles. A key feature of global listed infrastructure is its historically low correlation to broader equity markets. This can provide investors with downside protection which means in a falling market, the asset class falls by considerably less than general equities.

What are the diversification opportunities?

The global listed infrastructure universe is vast and highly diversified. It spans both emerging and developed markets and all asset types. As cash-strapped governments globally turn to the private sector to fund infrastructure, investors are gaining to access new assets across various markets. In contrast, Australia's infrastructure sector is mature and new investment opportunities are limited.

What are the risks?

As with all general listed equity investments, there are risks investing in global listed infrastructure. The key areas of risk relevant to infrastructure assets are:

Regulation: Infrastructure assets are often heavily regulated because they play an essential economic and social role. Although regulators overseeing infrastructure assets usually take a reasonably predictable approach, political leaders may be less consistent, for example, confiscating economic returns from infrastructure businesses to generate public support. As a counterpoint, governments worldwide are heavily indebted, increasing their potential reliance on the private sector.

Interest rates: Infrastructure assets are capital-intensive which can make them sensitive to interest rate movements, although sensitivity varies across industry subsectors. Although infrastructure assets typically react negatively when interest rates rise, historical data shows after this initial impact, infrastructure companies recover as investors again focus on fundamentals.

How can these risks be mitigated?

Active portfolio management can play a critical role in mitigating these risks by reducing exposure to geographies and subsectors facing headwinds and deploying capital to other opportunities. Specialist infrastructure managers can also provide in-depth knowledge and on-the-ground insights into the regulatory and economic environment of individual countries and assets across the large infrastructure universe to help achieve stronger returns.

What is contributing to demand for private infrastructure investment?

Structural, rather than cyclical factors are driving the continued and increasing need for infrastructure investment globally.

WHICH STORES WILL E-COMMERCE HIT THE HARDEST?

ROGER MONTGOMERY

Research by UBS shows that online purchases in the US will grow to around 20 per cent of all purchases by 2022. This upward trend should also occur in Australia. But the pain won't be equally felt by all brick & mortar stores. Some might be hit particularly hard.

Today, it's impossible to put the retail sector into one basket, from pet food to clothing to cars, there are almost as many sub-categories as there are consumers. But no matter whether they're selling Lego or lingerie, one thing every retailer is trying is e-commerce. I cannot remember the last time I couldn't find something I was looking for online.

The question for investors however is not whether an item will be available online, the really important questions are 1) how much of the retail dollar will migrate online for each category, and therefore 2) how much disruption will be experienced by brick & mortar operators in those categories?

I don't believe the online juggernaut will kill store-based retailing, but I do believe retail strips and malls will, in a decade, look nothing like they do today. I suspect the change might be painful too, which we can speculate might explain why the Lowy family chose to exit retail real estate when they did.

But some categories are succeeding with a traditional store concept. The Australian fast fashion jewellery chain Lovisa, with its affordable prices, small basket size and the instant gratification that spur-of-the-moment purchasing provides, has given Lovisa success, which it is rolling out globally.

According to a fascinating piece of research by UBS, who examined e-commerce migration and how penetration rates might evolve in each category, predicts 'online' will grow from about 13 per cent of US retail sales today to circa 20 per cent by 2022. This represents growth significantly faster than the expected one per cent aggregate growth of brick & mortar stores.

So, there will be some terrific opportunities, especially if the market falls in the meantime.

Adopters of E-commerce

E-commerce has been most widely embraced by the younger generation. If we remember that younger people usually don't have the money to make big ticket purchases, e-commerce is dominated, currently at least, by categories where the price point is relatively low.

The categories experiencing the highest online penetration, and therefore the most disruption for traditional retailers, has been books and music. More than 50 per cent of US retail sales in these categories is conducted online. Other categories witnessing between 30 and 50 per cent online penetration include, sporting goods, electronics, power tools, appliances, clothing, toys and shoes. Bath and bedding is currently just under 30 per cent and groceries around 10 per cent.

But according to UBS, bath & bedding (think towels and pillow cases) is a category in which brick & mortar stores face great risk. And that puts businesses like ASX-listed Adairs, which must also contend with the slump in residential activity and house prices, in the firing line.

Adairs reported a strong FY2018 result. On the back of a 19 per cent jump in sales, the company reported a 45 per cent increase in earnings per share and a 69 per cent rise in dividends per share. But the outlook for 2019 - 2020 is perhaps not as optimistic.

If the Australian economy slows, not only will that impact the revenue line, but a weaker Australian dollar could also materially increase the cost of its imported items. Meanwhile, declining confidence among consumers – related to the weakening housing cycle – and the fact that the company is cycling very strong numbers last year suggest it may have a tough time maintaining the growth rates of prior years.

While the Adairs' share price has already fallen considerably from its October 2018 highs, the risk of further downgrades and the longer-term risk of growing online penetration in the category suggests investors should become more alert.

Roger Montgomery
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WHY INVEST IN GLOBAL LISTED INFRASTRUCTURE?
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Historic underinvestment and compelling demographic forces underpin the need for infrastructure spending across both developed and emerging markets. In fact, McKinsey Global Institute estimates that $3.7 trillion must be invested each year until 2035 to meet projected global economic and population growth. With stretched balance sheets, governments around the world are turning to the private sector to meet funding shortfalls.

What is the outlook for the asset class?

Although listed infrastructure is a popular and well-understood investment in Australia following numerous privatisations over many years, overseas investors are less familiar with the asset class. Attracted by stable and consistent cashflows, individual investors, sovereign wealth funds and other institutions are increasing their allocations to this asset class. According to the Global Listed Infrastructure Organisation, there are now over $85 billion of assets managed by specialist global listed infrastructure managers.

How can I invest in global listed infrastructure?

The simplest way to get diversified exposure to the asset class is through a specialist, managed global listed infrastructure fund.

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