All Angles Podcast
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Global Infrastructure

Putting Money to Work in Public Equities

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Global infrastructure as an asset class could be underrepresented in portfolios, but we believe it should be on every investor's radar. Major structural shifts such as the transition to renewable energy, supply chain diversification and reshoring are making companies and countries invest massively to upgrade their infrastructure capabilities.

The transition to renewable energy provides growth opportunities across developed and emerging markets. Renewables are changing the way we produce power. We are moving from a system of large central power plants connected to the grid to one with more decentralized wind and solar farms that must be connected to businesses, homes and the grid. All this puts stress on the grid. At the same time, there is a big increase in the demand for electricity coming from electric vehicles and companies are under pressure to update their infrastructure to reduce their carbon emissions. The result is a sector once seen as boring and stagnant but now providing innovation and attractive growth opportunities.

Our preference for stable, predictable companies

We look for stocks that perform well regardless of the perception of the macro environment, given the difficulty in predicting the path and timing of interest rate changes. We are searching for fundamental, structural and long-term reasons to invest, and we also need to have confidence that management can deliver on the business plan.

The key characteristics we seek in companies are stability and predictability. We prefer to invest in companies that have a mix of existing assets and that are being presented with new opportunities to grow; companies with a high yield but highly levered balance sheets don't interest us. Given that these businesses usually operate in regulated industries, we need them to operate in regions with rational and stable regulations. Very high returns usually attract attention from the regulator as the companies producing them may have a monopoly, so we tend to seek out companies with fair and durable returns. We also think it important to understand sustainability, corporate governance and worker safety issues.

For example, one of our bigger holdings is Iberdrola in Spain. The company has established businesses in networks, power production and renewables around the world, but it also has a substantial pipeline of new projects that it will roll out over the next few years. These are largely in the renewable and network space. Given Iberdrola's existing business and pipeline, we expect the company to grow consistently over the long term.

In terms of risks, we are mindful of stranded assets resulting from the energy transition. This is why we are cautious about companies producing environmentally unfriendly assets like Canadian oil sands. Although regulatory constructs guarantee a return regardless of the volume of oil from these sources, there is uncertainty around the terminal value of the assets. We are also careful about gas infrastructure. Gas can help in the transition to renewables. Additionally, we see gas as the most effective backup option when the sun doesn't shine and the wind doesn't blow. However, battery technology is improving, and companies are retrofitting their grids to transport hydrogen instead of natural gas, raising questions about the durability of gas assets.

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Public and private: Exposure to the same assets but different investment profiles

For most investors, owning and managing infrastructure assets is difficult and requires a significant internal infrastructure. Hence exposure for institutional and retail investors comes predominantly via public, or listed, and private funds. These funds invest in the same underlying assets, but the access routes offer markedly different investment profiles and fees.

Private funds may lock investors in for extended periods and charge a private equity model of 2% base fee plus 20% of outperformance over a benchmark. They tend to have a concentrated asset mix, which means they can be more discriminating about the assets they buy, but this can create additional risk if, for example, the regulatory environment or actual asset changes. To generate a high return on equity, private funds tend to put a lot of debt into the fund and focus on very mature assets, which have the highest cash flows. Given that private funds use internal valuation models rather than marking to market, returns are less transparent but can also be less volatile than public funds, which move more in line with equity markets.

Public infrastructure consists of companies listed on stock exchanges that are involved in essential infrastructure. While these businesses vary by type, they have one thing in common — long-term contracts and stable long-term regulatory frameworks. In many cases, they also have automatic inflation indexing. The investment universe consists of a wide range of businesses: Utilities such as water companies comprise around 50% of the FTSE Global Core Infrastructure 50/50 Index; industrials that are mostly transport-related such as roads, railroads, airports and ports make up roughly 20%; energy and telecom infrastructure comprise the rest.

A combination of public and private

Public infrastructure funds invest in listed companies and are more liquid and transparent but also more volatile in the short term. In terms of performance, our analysis has shown that the returns after fees are similar over long periods for public and private indices. The advantage of public infrastructure is that it offers a greater diversification of assets and a $3 trillion market cap to invest in companies around the globe. The charging structure is more like a public equity fund, so much cheaper and with no lock-ins. Another interesting feature of public companies is that they have often traded at a discount to what is being paid on the private side. This is because private funds can have lots of dry powder and are keen to buy large assets, which creates lots of competition in the bid for assets. We have seen value arbitrage between public and private due to the cheaper access to the same assets provided by public companies.

Considering these material differences, investors should give careful thought to how they gain exposure and may wish to hold a combination of public and private infrastructure funds. Global infrastructure is a huge and long-term opportunity that we believe should be on every investor's radar.

We welcome the opportunity to discuss key sustainability themes with you. Please contact allangles@mfs.com and we will be happy to help.

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