VT UK Infrastructure Income Fund

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Politics and macro have aligned behind infrastructure

By **Stephen West** 15 Jun, 2017

There is no doubt that the UK government is committed to infrastructure spending, providing a strong driver to creating value for investors.

Consider just two projects as evidence: Hinkley Point C where the National Audit office estimates the cost based on the strike price of £92.50 MWh (2012 prices) will be £29.7 billion and Crossrail with a cost of £14.8 billion.

Hinkley Point C will be the most expensive object ever built on the planet, for a plant which will generate 7% of the UK's energy needs. Renewables, which currently provide 24% of UK's energy, is a vital sector, and installed solar and wind generation projects are valuable assets, generating predictable amounts of energy over the long term, with almost no running costs.

Looking through to the underlying assets, rather than simply analysing premiums to stated net asset values (NAVs), is vital to understanding value in renewables. Three metrics are crucial.

Firstly, yields at purchase are not under pressure given the ongoing supply of projects, with levels still in the high single digits (despite persistently low gilt yields).

Secondly, discount rates being used to generate NAVs remain highly conservative as they are set by boards or external consultants in the 7.5% to 8.75% range (versus 20-year gilts at 1.65%).

Thirdly, there are a range of pension funds and insurers wishing to lend on long-term fixed rates against these UK public sector derived cash flows at

rates below 3%, with leverage of this nature further enhancing value for investors.

Detailed analysis leads to the conclusion that at current levels, the underlying long-dated, fixed rate, inflation-linked, UK public sector cash flows represent strong value, notwithstanding the notional premiums to company stated NAVs.

The backdrop is similar in the pure infrastructure sector with increased government focus on infrastructure investment stimulating asset production and reducing downward market pressure on rates at which assets are acquired, with ultra-low gilt yields again producing structural leverage, which enhances investor returns and boards using conservative discount rates (between 7.5% and 9.0%).

When infrastructure funds have disposed of assets, they have done so at substantial premiums to the valuations in their NAVs. HICL sold its interest in the Colchester Garrison MoD Project for £21.7 million, 25% above the valuation of £86.6 million and John Laing Infrastructure fund sold two projects this year at £11.5 million, 36% above book of £31.9 million.

A second macro driver is the pick-up in global inflation. Analysis suggests that most inflation in the global system is non-core, driven by energy prices rising off low levels and food prices responding as a second order effect (and also to poor growing conditions globally in the latter months of 2016).

Whilst it is doubtful, therefore, there will be any meaningful pick up in UK core inflation over the medium term (with imported inflation and energy price increases working through the time series over 12 months), increases of any kind benefit infrastructure assets.

An illustration of the magnitude of this effect is evidenced by the second half 2016 NAV performance of Bluefield Solar Income fund Limited where an increase in the long-term assumption of RPI uplifts within their projects by 0.25%, from 2.5% to 2.75%, increased NAV by 2.8%. The contrast against the negative effect rising inflation and market interest rates would have on bond funds is clear.

A third driver – more topical and somewhat unexpected – in the infrastructure sector has been the signalled Conservative manifesto policy to cap Standard Variable Tariffs (SVT) for energy utilities.

Whilst it is possible that a draconian cap based on competitor average rates will be considered, the central case appears to be a cap at the individual company level on the amount by which the SVT can exceed the lowest tariff, and this for certain customer demographics only (though more aggressive action is always possible).

Among the majors, SSE with 91% of customers on SVTs and Centrica with 74%, these companies have SVTs, which exceed their cheapest tariff by 9%

and 12% respectively.

A 6% cap on this relationship, again the central case, would cost SSE circa £131 million of revenue and Centrica circa £441 million.

However, the companies would be expected to mitigate this substantially – at the cost of losing some of those customers who switch regularly (15.9% annual switching rate in 2016) – by raising their cheapest tariff.

At a 50% mitigation of the above levels, the figures represent 8.6% of Ebitda for Centrica and 3.1% for SSE, with their dividend payouts of 6.2% and 6.5% (as at 26/4/17) likely to be maintained.

It is clear that an understanding of the developing regulatory and political process will provide opportunities to find attractive risk adjusted investments in the sector, as prices move on sentiment rather than on fundamentals.

Stephen West is a partner and director at Gravis Capital Partners, advisers to the VT UK Infrastructure Income fund. Over the last year the portfolio has returned 9.9% versus a peer average of 17.5%.