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Buchanan

Infrastructure bonanza

Stocks trade at a premium as investors chase high-yield potential

SEÁN FLYNN

With the UK's National Infrastructure Plan tabling a slate of work in energy, transport, flood, waste and water projects worth over £375 billion, it's not that hard to see why infrastructure's appeal to investors remains enduring, particularly as associated investment funds can offer attractive dividends.

Funding major public infrastructure has traditionally fallen within the remit of government with significant capital outlay only offering return on investment over a period of decades rather than years. Increasingly however, the practice of raising private sector capital to fund new infrastructure is being employed by cash-strapped governments like UK's as they seek to reduce public borrowing on treasury balance sheets.

Duncan Ball, co-chief executive of infrastructure fund **BBGI SICAV (BBGI)** puts this investment in context: 'In the current market environment yields on many asset classes such as gilts, US Treasuries and cash deposits remain close to historically low levels. There is a strong case for arguing that the infrastructure funds should generally trade at quite sizeable premiums to NAV (net asset value) because of the attractive returns they generate.

'While there have continued to be equity issuances in the sector, most of the equity issues in the last two to three years were also significantly oversubscribed and that continued strong demand for shares also means funds can justify trading at higher premia than in the past.

'The premia have risen partly reflecting some slowdown in equity issuance compared with a few years ago and also the markets belief that there is some "hidden-value" in the portfolios, with scope for discount rates to be reduced and NAVs increased in the short term.'

WATCH THE PRICE

Undoubtedly over the past decade or so, the resurgence of interest in infrastructure investment is epitomised by the fact that many investment trusts in this space are now trading at a hefty premium to asset value.

One such fund is the **HICL Infrastructure Company (HICL)**; currently trading at 152p against a net asset value (NAV) of 137.38p. Tony Roper, infrastructure director for HICL's adviser, InfraRed Capital Partners, sees stability as one of the prime drivers for interest in this space. 'The long-term, stable cash flows of the underlying projects makes the infrastructure fund sector particularly attractive to investors.

'In addition, investors want to be protected from inflation; given that the underlying contracts with the public sector typically have index-linked revenues, there is an element of inflation correlation to infrastructure portfolios that is attractive, particularly to investors with liability matching mandates (such as pension funds).'

Roper also points out that his own fund's track record exemplifies this demand, pointing out that 'HICL has outperformed equity markets since it listed in 2006, whilst displaying very low correlation to the same.'

UNCORRELATED RETURNS

This low correlation theme is similarly touched on by Duncan Ball: 'A key theme among investors remains the search for high quality income, particularly from uncorrelated asset classes. This has made infrastructure a very desirable asset class and resulted in the sector trading at a premium to NAV,' he says.

Stephen Ellis at Gravis Capital Partners which runs **GCP Infrastructure Investments (GCP)** – currently trading at 117.4p against an NAV of 107.27p – also acknowledges the sector's high premiums. 'There is a lot of focus on the premium to NAV,' says Ellis. 'However NAV is simply a function of (in GCP's case) the view of the Valuation Agent (Mazars LLP, in our case) of an appropriate value from time to time. I would suggest most valuers are fairly conservative, and the market is perfectly capable of forming its own view of where NAV should be.'

Ellis goes on to voice his suspicion 'that the market is generally right – values are higher than those stated. This is borne out by the occasional disposals of assets by funds – always (as far as I recall) at a premium to their stated value.' This is amply illustrated by HICL's April sale of its entire 50% equity and subordinated debt interest and 100% junior loan interest in Fife Schools PFI project with profit on disposal, after costs coming in at £0.6 million over the directors' valuation of

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£6.7 million as at 30 September 2014.

DIFFERENT PAST

But it wasn't always like this. If one casts one's mind back perhaps a decade, it was a very different picture. Stephen Ellis points out that 'infrastructure investment was pretty much the domain of the large, sophisticated institutions until a decade ago; then HICL listed in 2006, and a bunch of others (GCP, **3i (III), International Public Partnerships (INPP), Bilfinger (GBF:ETR), John Laing (JLIF)**) have followed; as a result a broader investor base has opened up.'

Tony Roper points to the evolving nature of infrastructure investment over the past decade or so.

'As is the case with any nascent sector, the infrastructure funds had to prove themselves. Back then, there was a lack of understanding of the asset class, and no track record to reassure investors. As the sector has matured over the past decade, we can now point to a solid performance, with the listed infrastructure funds presently trading at a premium to NAV. Not only that, but there is an economy of scale and a momentum behind strong managers – in less than 10 years, HICL has grown to a market cap of almost £2 billion and delivered a 2.5x money multiple on each pound committed at IPO (on a dividend reinvested basis).'

Once we have established that infrastructure investment is based on firm foundations, the question is how much longer this asset class is likely to prove attractive. Stephen Ellis can't see it stopping; at least not any time soon while HICL's Tony Roper anticipates 'continued growth in investor appetite for infrastructure assets, driven by attractive risk-return characteristics in an environment where government gilt yields are at all-time lows.'

Investec's Fin Bodman also highlights the role of the lower yields resulting from the current interest rate environment: 'The low expectation for future rate rises has further boosted the appeal [of infrastructure investment trusts].

'If this rate outlook were to change dramatically, then there might well be a change in the premium ratings of the funds, however, for the moment this looks unlikely.'

The investment proposition going forward for infrastructure investment is summed up by BBGI's Duncan Ball: 'I believe the stable, predictable income generated by the asset class and the low correlation to general equities will result in infrastructure remaining a core holding for most well diversified portfolios.'

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'Is your trust too expensive right now?'

WE ASKED MANAGERS at three funds whether they thought their offering might be too rich for some investors' blood. It might not surprise readers to learn that none did but here's why.

Duncan Ball, Co-CEO BBGI / Premium to NAV: 15.95%
NO. 'BBGI provides its investors with exposure to a diversified portfolio of 36 infrastructure PFI/PPP assets in the UK, Continental Europe, Australia, Canada and the USA.' Ball goes on to outline the fund's benefits including exposure to high quality PFI/PPP infrastructure assets; long-term stable cash flows from assets that are mostly operational (or near operational) and backed by public sector counterparties as well as strong yield characteristics and attractive inflation protection characteristics.

Stephen Ellis, partner at Gravis Capital Partners which runs GCP Infrastructure Investments / Premium to NAV: 10.5%
NO. 'GCP Infra pays out the highest yield of all the infrastructure funds, at about 6.5% pa at our current share price of c. 115p, and I think this has the capacity to come in sharply (i.e. the share price is likely to rise). But that's only my opinion.'

Tony Roper, infrastructure director for HICL's adviser, InfraRed Capital Partners / Premium to NAV: 10.8%
NO. 'At the current share price, the company offers a 4.9% cash yield and a long term total return target of 5.5%. This remains attractive in today's market.'

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