Magellan Infrastructure Quarterly Update

January 2024

Felicity Haines:

Hello and welcome to the quarterly update for the Magellan Infrastructure Fund. My name's Felicity Haines, I'm a Key Account Manager with the Magellan distribution team and today I'm joined by our Head of Infrastructure, Gerald Stack. Hi, Gerald.

Gerald Stack:

Hi, Felicity.

Felicity Haines:

Gerald, we've seen the impact of interest rates on the infrastructure sector. Where are we now in the rate cycle and how does this impact company valuations?

Gerald Stack:

Okay, so we need to think about how interest rates generally affect infrastructure. Interest rates changes are really a response to different inflation in the economy. So we find that when inflation's elevated for a period, that what the central banks will move interest rates up. And if you think about infrastructure assets, they have inherent inflation protection. Their pricing is linked or their earnings are linked to inflation, and therefore the increase in interest rates is typically offset by that impact of inflation on their revenue line. So in other words, to the extent that interest rates and inflation are happening together, then the value of infrastructure assets is largely unaffected by that change in interest rates. Where there is a profound impact is where interest rates move by more than inflation. So if there's indeed an increase in the real interest rate, so the interest rate adjusted for the impact of inflation, then that has a pretty significant impact on infrastructure because infrastructure provides you with income for long periods of time.

There's a long-dated series of cash flows and the compounding effect of those real interest rate changes reduces the value of those longer duration cash flows. So it's the real interest rate we focus on rather than the nominal rate. So if we think about this year, we certainly saw an increase in nominal rates over the first nine months, but in particular we saw an increase in real interest rates over that period and that meant that infrastructure and other long duration assets like property really suffered in that first nine months of calendar 2023. In the last quarter of the year, we saw real interest rates decline and as a result, long duration assets did well and infrastructure did very well. In the last quarter of the year, we saw a significant returns to infrastructure well above what we might've expected, but if we look over the full 12 months, probably a little bit under par for the full 12 months.

So we've seen the impact of real interest rates rising in the first nine months. We've seen [inaudible 00:02:47] interest rates fall in the last quarter. We're sort of agnostic as to where interest rates go from here where we think infrastructure is well-placed. In other words, we think it's pretty good value, but we don't really have a view that interest rates are going to rise or fall. And generally we are typically somewhat agnostic about rates. We don't try to predict where rates are or are not, but we are certainly trying to understand where the best opportunities are for our assets that sit in our defined investment universe, given the state of interest rates at any point in time.

Felicity Haines:

Gerald, we often talk about a CPI plus five return goal for investors in infrastructure. Do you think that this is still an appropriate return goal given that investors can expect 5% from a term deposit or go and buy some inflation linked bonds?

Gerald Stack:

Yeah, so I think that you have to differentiate between short-term returns and long-term returns. When we talk inflation plus five, CPI plus five, we're talking long-term returns for infrastructure. We're thinking through the cycle. It doesn't mean that at any given year we're going to do a CPI plus five, but over the long-term, we would expect to achieve returns in line with that. And certainly we have done that over time and that's structural, that's bound up in the way that infrastructure assets are regulated and the pricing of their revenue or their earnings. So we have a full expectation that we'll achieve that over time. And indeed the big argument for infrastructure as we said, is in the fact that you will grow your wealth with a high degree of confidence over time with an expectation of about CPI plus five. So that's infrastructure. Yes, there are other opportunities at any point in time, as you know you can get fixed interest deposits at the moment, something of the order of 5%, and that's attractive, but that's a very short-term return.

Infrastructure CPI plus five is what we expect over the long term, debt markets will come and go. It wasn't that long ago where fixed interest deposits were paying 1% or less. So at any point in time there might be an opportunity to invest in fixed interest or bonds more broadly. And if we think about that, fixed interest and bonds are a very different risk return characteristics to infrastructure. So we would say that in a portfolio, there's an argument we would think for both, and that's really up to the end investor as to how they structure their portfolio in terms of trying to compare and contrast an investment return at any given point in time. Well, I think you've got to think about that on a for basis and therefore we'd be trying to think about what do we expect out of fixed interest over the long term, as I said, for infrastructure inflation plus five. But we think there's an argument for both in any portfolio.

Felicity Haines:

With our investible universe, have there been any additions or removals from that space?

Gerald Stack:

Well, there are always changes over time if nothing else, through corporate activity, companies get taken over, new IPOs come to market, but probably the largest change for us in the last year has been the addition of Brookfield Renewables. Now historically, the way that we've thought about renewables is that the bulk of renewable energy contracts, the take or pay agreement that the renewable energy producer enters into with the end customer, it's typically been about six or seven years across their book. So in other words, they build a big renewable energy facility and they have a series of agreements with their end customers to sell them the electricity typically at a fixed price or a price that grows with inflation. But the average of those agreements is about six or seven years, and that just hasn't been long enough for us.

It has meant that at the end of that six or seven years, when those contracts come to be repriced, you're open to merchant power risk, and over time the price of electricity, the price of renewable electricity has declined appreciably. So that's meant that as you've repriced those contracts, it's not necessarily been a wonderful experience for investors. So we've had concerns about that on the basis that six or seven year average take or pay. What we've found with Brookfield Renewables, the reason we've included it in our universe, is that Brookfield Renewables provides wind power, solar power amongst other renewables. It has an average take or pay an average contract of around about 14, 15 years across their book. So it's well into the long range planning. It certainly achieves what we would expect them to achieve. It means that their pricing is set, so you're not exposed to that merchant power price risk, which is akin to a commodity price risk. You are exposed to volume risk, but in this respect, this is very much like a toll road.

In a toll road, you know the toll, but you don't know the volume of traffic. So to us, that very much meets our criteria and we see Brookfield Renewables as a part of the energy infrastructure space. So that is, it's not a utility, it's selling electricity, but it's not a utility as we would see. We see it as part of the infrastructure space. And in infrastructure generally what we find is that it's priced that gets regulated or dealt with through contract, in this case through contract, but that there's no... You don't have volume certainty and therefore you can, as we said, if we find the right assets, you can invest in infrastructure assets with an expectation that you'll grow your returns over time, that you'll earn a growing return on your capital over time and that hopefully we can identify those that are attractive for us. So we brought Brookfield Renewables into our space, big renewable producer, very successful over a long period of time with very long-dated renewable energy contracts.

Felicity Haines:

And looking forward to the year ahead now, can you talk us through the portfolio positioning and also your outlook for 2024?

Gerald Stack:

Sure. Our portfolio today is roughly 55% infrastructure and about 45% utilities, regulated utilities. There's a little bit of cash in there, so those numbers move around a little bit, but that's essentially, in other words, it's a slight overweight compared to where we would expect to be over the long run. Typically, we think we would expect over the long one to be roughly 50/50, 50% infrastructure. That is assets involved in the transport of people, data and goods, essentially transport infrastructure and about 50% in regulated utility. So at the moment, about 55, 45 or thereabouts. Now within that three major positions are electric utilities, which represent a little over 30% of our portfolio. Toll roads, which represent a little over 25% of our portfolio and airports at about 10% of our portfolio. So collectively about 65% of our portfolio in those three sectors. Now, electric utilities we'd liked for a long time because we see them as being a big beneficiary from the transition to net-zero. For the world to transition to net-zero, it needs a significant amount more of renewable energy, and that renewable energy has got to be connected to the grid and then the grid itself has to be strengthened and made more resilient, particularly as we electrify economies. Electrifying economies, shorthand for saying as we move from the internal combustion engine motor vehicle to electric vehicles.

So we think there's real opportunities for electric utilities over time. We don't think it's a get rich quick scheme. A lot of infrastructure in that regulated utilities earn a regulated return. So we don't expect them to earn more than their approved return today, which sits at about nine, nine and a half percent. But we expect that return to grow five to 6% per annum or perhaps even a touch more as they continually invest in their opportunity. So that's a significant portion of our portfolio. The next largest is toll roads. As I mentioned before, what we've found with toll roads is that traffic has been extremely resilient over time. Clearly, during the pandemic when governments wouldn't allow people to move about when we were quarantined at home, traffic levels fell. But that traffic has come back very quickly and we continue to believe that in jurisdictions where toll roads are in existence, that toll roads are there because the free roads are full.

And as those jurisdictions continue to grow their population and grow their business world, we expect more and more traffic to come into that and for the toll road to win an outside market share of that traffic. So we see strong opportunities for toll roads as we move forward. So electric utilities, toll roads. The third one is airports, which as I said, roughly 10% of our portfolio. We've seen airports similarly bounce back pretty strongly through 2023. 23 was a strong year for the aviation industry. The most recent data we have at the time of filming this is that at the end of October, that for the month of October, that global aviation passengers are about 2% below where they were in 2019. So that's come back essentially back to where we were in 2019. Now that was before what we expect to see was a continued recovery in November and December.

So I dare say that by December we'll be back to 2019 levels. Now within that, what we've seen is that the North America and Europe have basically returned to 2019 levels. US a little bit above. Europe, a little bit below, but Asia Pacific, the third major region remains about 10, 15% below where it was in 2019. And as the Chinese, Japanese and South Korean economies continue to open up, we expect to see more passengers come into markets and that airports will be a beneficiary of that. So we continue to see strong opportunities in the airport space. So they're the three key components we think our sector, broadly speaking, attractively priced at the moment. Part of that is the rundown in real bond rates. We don't see that as being fully reflected just at the moment. So we see some attractive opportunities, but it will very much depend upon how those assets perform as we move forward over the next 12 months.

Felicity Haines:

Great. Thanks, Gerald.

Gerald Stack:

Thanks, Felicity.

Felicity Haines:

And thank you for watching. If you have any further questions, please contact my colleagues and I in the Magellan distribution team and please feel free to share this video with any clients and colleagues.