First State Investments

Global Listed Infrastructure

Monthly Review and Outlook

January 2017

Key highlights:

- Global listed infrastructure began the new year with a -1.1% return. The Fund also ended the month down 1.1%, underperforming its benchmark index.
- Growth infrastructure assets such as railroads, ports and airports led the gains.
- Satellites run of significant underperformance continued on concerns for pricing power.

Market review

Global listed infrastructure returned -1.1% in January. In SGD terms, the FTSE Global Core Infrastructure 50/50 index ended the month down 0.7%, while global equities was also down 0.1%.

The best performing infrastructure sectors were **Railroads**, which rallied on improving volumes; the expectation of lower US corporate tax rates; and the prospect of freight rail leadership changes; and **Ports**, which were assisted by undemanding valuation multiples. While Utilities generated broadly flat returns overall, the acquisition of US gas utility WGL Holdings by Canada's AltaGas at a 26x PE multiple highlighted the consistent demand for gas distribution assets, and provided a bullish valuation point.

Pipelines (flat) were mixed as President Trump's promptly-issued executive orders intended to revive the Keystone XL and Dakota Access pipelines provided an early indication of a more supportive regulatory environment for US pipelines. In contrast, bulk liquid storage operator Vopak (-11%, not held) fell on concerns that oil storage demand would be affected by backwardation (when the forward price of a commodity is lower than the current price). Despite the high quality nature of its infrastructure assets - the company owns terminals around the world that are strategically positioned to take advantage of imbalances in global energy markets – market expectations had run ahead of fundamentals.

Satellites lagged on a clouded near term growth outlook and persistent concerns that pricing power was deteriorating. Sentiment was further shaken by UK satellite TV provider Sky, which announced plans to allow customers to access content without first installing their satellite delivered service. Declines were led by Inmarsat (-19%, not held) and Eutelsat (-14%, not held).

Asia ex-Japan was the best performing region. Chinese gas utilities gained on hopes of government support for natural gas usage, in order to reduce air pollution. Steady Chinese PMI data also buoyed the region. **Japan** was the worst performing region as local government opposition to nuclear restarts weighted on its electric utilities.

Fund review

In SGD terms, the Fund was down 1.1% in January, 39 bps behind of its benchmark index.

The best performing stock in the Fund was Hong Kong-listed utility **Power Assets Holdings** as it announced plans to better utilise an under-levered balance sheet. The company is part of a consortium to acquire Australian utility DUET Group and intends to pay a HK$5 special dividend, representing 6-7% of market value. US electric utilities including **NextEra Energy**, **PG&E**, **American Electric Power** and **Xcel Energy** also increased on demand for defensive, income generative assets as bond yields stabilised.

Pipeline operator **Kinder Morgan** gained on Canadian regulatory approval for its substantial Trans Mountain expansion project; and on 2016 earnings numbers which emphasised its focus on prudent capital management. The company continues to de-risk by using predominantly fee-based cash flows to strengthen its balance sheet and to fund growth projects without accessing capital markets. **Enterprise Products Partners** climbed as solid 2016 earnings numbers met market consensus, while the announcement of new projects took its growth portfolio past US$6 billion. Canada's Enbridge Inc declined, despite reiterating a 15% forecast dividend increase for 2017, as the market became concerned about its complex structure post the merger with Spectra.

The Fund's growth infrastructure holdings were a source of positive returns. US freight rail operator **Union Pacific** gained after announcing better than expected fourth quarter earnings, driven by a disciplined approach to cost cutting. Higher energy prices, favourable agricultural markets and improving consumer confidence are expected to underpin 2017 volume growth. **Kansas City Southern**, whose rail network crosses the US / Mexico border generated more muted returns due to continued uncertainty about the Trump administration's approach to NAFTA. Japanese passenger railroad **East Japan Railway** experienced robust December traffic volumes on its shinkansen (bullet trains) and announced solid third quarter earnings numbers.

Spanish airport operator **AENA** and French peer **Aeroports de Paris** continued their run of strong passenger volume growth in December, with increases of 12% and 8% respectively. AENA was also buoyed as the announcement of a tariff agreement covering the next five years provided a long term regulatory framework and greater visibility over

future cash flows. However Mexico's **GAP** underperformed as political uncertainty overshadowed high passenger growth rates and positive 2017 guidance.

In a move consistent with the theme of port sector consolidation, **COSCO Shipping Ports** announced plans to acquire a 17% stake in the world's sixth busiest port, Qingdao Port International, for 5.8 billion yuan (US$844 million). The transaction multiple at 13x PE is in line with the sector average, but represents a significant premium to Qingdao's previous closing price, causing CSP to lag but peer **China Merchants Ports** to rally, as it also owns a small stake in Qingdao.

The worst performing stock in the Fund was **Tokyo Gas**, which declined as a downgrade to financial year earnings, due to a weaker yen and higher oil prices, overshadowed strong operational performance from the underlying business. The company's valuation remains compelling compared to global peers.

Toll road holdings also lagged. **Atlantia** fell on news that the tariffs it is allowed to charge on its network of high quality Italian motorways in 2017 would be slightly reduced. **Eurotunnel** fell on lingering Brexit concerns, despite announcing a 4% increase in like-for-like revenue for the 2016 financial year. Brazil's CCR declined on reports that discussions with the government around the renewal of the concession on its second biggest road have ceased - the market was expecting a ten-year concession extension to the current expiry of 2021. Spanish peer **Abertis (flat)** held up relatively well on news that it had acquired an additional 10.5% stake in French toll road group SANEF, at a reasonable 8.7x EV/EBITDA multiple.

The Fund bought shares in US east coast freight rail operator **CSX Corp**, following the unexpected departure of industry veteran Hunter Harrison from his role as Canadian Pacific CEO. After a successful tenure as Canadian National CEO between 2003 and 2009, Hunter joined Canadian Pacific in 2012. Under his leadership, the company executed an aggressive and successful turnaround program. Hunter is now reported to be targeting a role at CSX, whose operational and financial metrics provide considerable potential for improvement.

Shares in German airport operator **Fraport** were divested after pleasing share price gains in the fourth quarter of 2016 reduced mispricing and moved the stock lower within our investment process

Outlook

The Fund invests in a range of global listed infrastructure assets including toll roads, airports, ports, railroads, utilities, pipelines and mobile towers. These sectors share common characteristics, like barriers to entry and pricing power, which can provide investors with inflation-protected income and strong capital growth over the medium-term.

Looking to the year ahead, investors could face higher than normal geopolitical risks, given the aggressive stance taken by the new Trump administration. Political risks appear high for European infrastructure companies; the continent faces uncertain election outcomes in France, Germany, the Netherlands and possibly Italy. While concerning, risk-off events typically support infrastructure outperformance versus general equities.

Although a focus on rising inflation was a headwind for infrastructure valuations last year, this could represent a tailwind for infrastructure earnings in 2017 as inflation is passed through to customers. In the US, fiscal stimulus would drive strong volume growth for transport infrastructure.

Overweight exposure has been maintained towards toll roads and towers. Recent underperformance has caused several high quality companies with very stable cash flows and commanding market positions to trade down to appealing levels. Fund positioning remains tilted away from interest rate sensitive utilities, and the relatively expensive airports sector.

Infrastructure valuations overall remain full by historical standards. However key risks for the sector, namely political change and rising bond yields, are now better reflected in market expectations.

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