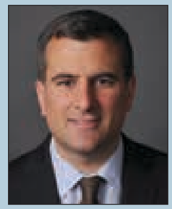
Cohen & Steers

Infrastructure assets poised to outperform

Options for strategizing within the asset class

Recently, **Chase McWhorter,** Institutional Real Estate, Inc.'s managing director, *Institutional Investing in Infrastructure,* spoke with Cohen & Steers' **Benjamin Morton,** executive vice president and portfolio manager for the firm's infrastructure portfolios. The following is an excerpt of that conversation.

CONTRIBUTOR



Benjamin Morton, executive vice president, is a senior portfolio manager and head of Cohen & Steers' global listed infrastructure strategy, with 20 years of infrastructure-related investment experience. Prior to joining Cohen & Steers in 2003, Morton covered the utility and pipeline sectors as a research associate at Salomon Smith Barney and served as a research analyst at the New York Mercantile Exchange.

How should investors think about a listed-infrastructure allocation based on where we are in the economic cycle?

To answer that question, one should take a step back and think about the defining characteristics of the listed-infrastructure asset class. We invest in companies that own and operate infrastructure assets — businesses and assets that collect fees for usage, that tend to be regulated or concession based, or that tend to be commercially based, but with long-term contracts. These characteristics support the hallmark feature of the asset class — predictability of cash flows. In addition, assets tend to be monopolistic, or operate as duopolies or oligopolies. Infrastructure businesses tend to have high barriers to entry, which creates enduring and, hopefully, increasing asset values. Given these characteristics, listed infrastructure has historically delivered equity-like returns, but with about 300 basis points less volatility than the broader equity markets, and about 50 percent downside capture. That means, in periods when the market is down, infrastructure tends to be down only about half as much as the overall market.

We believe we are in the later stages of the business and economic cycle in many parts of the developed world. With that in mind, we expect to see higher risk premiums in the equity market going forward, accompanied by a lower return environment and a weaker credit environment — all of which we believe point to outperformance of assets that provide more predictable cash flows.

How has the maturing cycle and trade uncertainty affected your view of the infrastructure space?

We see a move from a period of above-trend and improving growth to above-trend but decelerating growth, likely transitioning to a below-trend and decelerating growth environment. This has informed our investment views in two ways. First, this is a period in which we expect infrastructure to outperform. This was very evident in the fourth quarter of last year, when listed infrastructure outperformed broad equities by roughly 1,100 basis points. Secondly, it informs our positioning within the infrastructure asset class. For example, a marine port trades very differently than a regulated utility. A marine port is more economically sensitive, with cash flows tied to global trade and leveraged to global freight rates. Utilities tend to be very defensive. We have positioned ourselves more defensively within the universe, which means we are less underweight utilities than we had been, and underweight transportation infrastructure, which tends to be more sensitive to economic conditions. We have been underweight in marine ports for some time. Part of the thesis has related to slowing growth, but also to specific issues around trade and tariffs. The question we are asking ourselves today is this: Given the specific underperformance of marine ports, much of which is due to slowing economic conditions and trade and tariff uncertainty, are we now seeing a value opportunity?

So, essentially, if there is a trade deal made, then those are sold off?

If a trade deal happens, these marine ports should benefit. Marine ports have underperformed to a point that they are embedding very weak growth, particularly in China, where a number of these companies are domiciled. Were we to see a positive trade deal outcome, I think the market might rerate their trade expectations and, therefore, their growth expectations modestly to the upside.

There has been a lot of demand for private infrastructure funds, and we are seeing it internally with our fund tracker. How can listed infrastructure complement those private investments?

We continue to see record amounts of capital raised in the private infrastructure arena, leading to tremendous competition for the scarce deals and assets available for sale. In recent transactions where private players have purchased infrastructure assets, we have seen multiples paid of nearly 18 times year-ahead cash flows, as compared with listed-infrastructure companies that trade at an average of 11.5 times. This valuation discrepancy — listed trading at a significant discount to private transaction values — has become, in our view, a significant driver of the fast-rising institutional interest in the listed-infrastructure asset class.

Furthermore, with listed, relative to private, one can target very specific niche opportunities. For example, if I would like to invest in Brazilian toll roads, I can do that with a press of a button. If a private fund wants access to a very specific theme like that, it can be much more challenging, because it will depend on whatever deals present themselves at any given point in time. A listed portfolio also offers tremendous diversification, while a private portfolio tends to hold a handful of assets, which can lead to concentrated regulatory risk, currency risk or geographic exposure. In a listed-infrastructure portfolio, you can diversify across geographies, subsectors and regulatory regimes, all of which would be more challenging on the private side. Finally, the liquidity of listed infrastructure is quite appealing, relative to the significant lockups for private equity allocations.

With wireless carriers starting to market 5G networks, what are you seeing from the tower companies that gives you confidence in their growth rates over the next year or two?

The biggest driver for towers is the need for wireless carriers to densify their networks to accommodate the massive increase in data-intense mobile traffic. Considering not only the types of connected devices being used today, but also the types of apps that weren't streaming media in this way even five years ago, wireless carriers need to invest significant capital to upgrade their networks to accommodate this massive increase in data traffic. In some cases, this means densifying a macro-cell-tower network, which means leasing out space on a denser network of towers. This is a driver of growth. A second driver of growth, which is somewhat specific to 5G, involves a denser set of smaller cell-tower nodes or cellular nodes, usually connected by fiber. Knowing the demand trajectory for data, and the fact that next-generation technologies like 5G will be necessary to support increased data demand, gives us confidence in the level of spending by wireless carriers that will be needed to support tower growth. The other thing to note about 5G is that it has bipartisan support — most politicians are supportive of efforts to increase network service quality.

With energy prices on a tear to start 2019, how do you see that affecting pipeline companies?

While the key driver of growth for midstream-energy — or pipeline — companies is volume growth, there can be an indirect relationship to commodity prices. If commodity prices are higher, energy production will be higher, thus driving a greater need for storage, processing and transportation of these commodities via pipelines. In the case of crude oil, for example, the significant year-to-date increase in crude oil prices has given investors confidence in continued production-volume growth. Today's record production levels for all major energy commodities in North America are driving higher capacity utilization rates for energy infrastructure assets, which means rising cash flows for pipeline companies. Higher energy prices also impact the health of pipeline companies' counterparties — namely the exploration and production companies. We are also seeing record amounts of exports from the United States, which has been a tailwind for the infrastructure stocks involved.

A last word?

There is $170 billion sitting as infrastructure-dedicated dry powder that needs to get invested. This money is going to find its way into the market, but it will take time. As I mentioned, private funds are typically paying nearly 18 times year-ahead cash flows for assets, and, in some cases, they are buying assets from listed companies. We believe this drives strong support for the listed asset class. Our thesis is not that all listed-infrastructure companies will go private, although this is happening to a degree. But I am happy to see our companies sell assets to private funds for significant premiums to their listed market valuations. We are seeing more of that. Institutions see the challenges faced by the private sector in this more competitive environment, and they are increasingly interested in making a permanent allocation to listed. At the same time, they can use this listed allocation as a placeholder, which, over time, can be drawn down to fund private infrastructure at a time when markets perhaps seem less frothy. There really are many ways for investors to implement a strategy.