Infrastructure trends

Valuation considerations

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Infrastructure trends

Over the last ten years, infrastructure as an asset class has become increasingly popular. Infrastructure investments generally provide high and stable yields, which are attractive to superannuation and pension funds focused on providing returns for ageing populations.

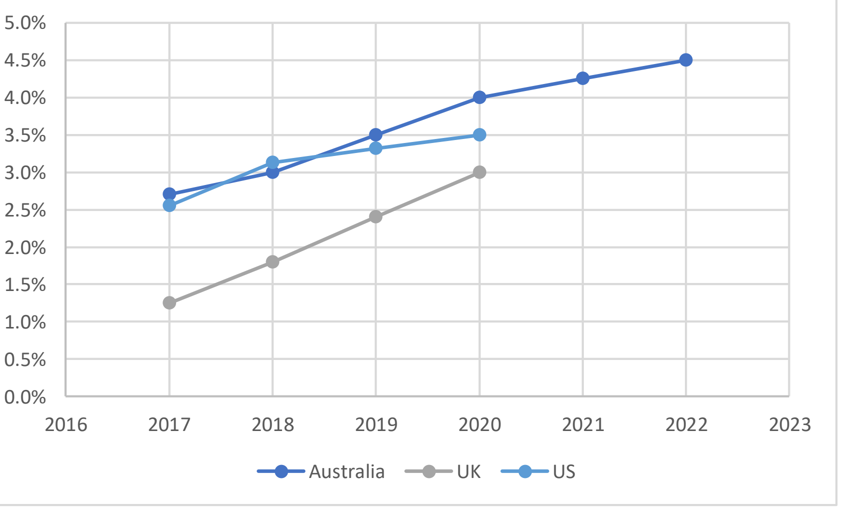
The high demand for infrastructure, together with a limited supply of investments has led to high prices and yield compression.

In Australia and the UK there has been increased scrutiny of foreign investment in infrastructure on national security grounds, with some transactions halted, for example, the sale of Ausgrid to foreign investors was blocked in Australia in 2016 due to national security concerns.

There is also an increase in debt margins with bond yields forecast to rise. The graph opposite shows forecast 10-year government bond rates for Australia, the UK and the US.

These trends have led some infrastructure investors to stop actively pursuing infrastructure. For example, in a Financial Review article in June 2017, Mark Delaney, CEO of Australian Super said they were not actively pursuing new investments (unless a great asset becomes available) as they believed most infrastructure was now fully valued and, in addition, rising interest rates would put pressure on returns.

Forecast 10-Year Government Bond Rates



Sources: Australia: Median of Consensus Forecasts, AMP, OECD and NAB forecasts 2017 and 2018, AMP forecasts 2020 and 2022, interpolated in between. UK: Median of Consensus Forecasts, OECD and Goldman Sachs 2017 and 2018. US: Median of Consensus Forecasts, OECD, Goldman Sachs and NAB 2017 and 2018.

Valuation considerations

While many infrastructure assets may be fully valued, different classes of infrastructure assets have different characteristics and their respective values are likely to respond to current trends in different ways. Even within infrastructure classes, it is important to understand the unique characteristics of each asset when valuing infrastructure, because no two assets are alike. We shall discuss four general infrastructure classes (GDP linked growth infrastructure, energy infrastructure, social or PPP assets and regulatory assets) and the likely impact on value of recent trends.

GDP Linked growth infrastructure

In an article called "*Direct infrastructure valuations and bond rate increases: it's not what you expect*" published in April 2017, AMP stated the value of GDP linked growth infrastructure (e.g. ports, airports, roads) should improve under a moderate debt margin growth scenario, because many infrastructure assets in Australia are valued using discount rates that assume a higher long term risk free rate than the current spot rate. This higher risk free rate will provide a buffer as rates increase, and in addition, growth will outweigh increased debt costs. However, if debt margins grow significantly, this could result in an increase in both the discount rate and debt costs, reducing value.

The larger GDP linked growth infrastructure assets have been in very high demand and many may be fully priced, with forecast cash flows assuming significant cost reductions and steady levels of growth.

It is important to consider the unique characteristics of each asset within this class to determine if it is fully priced; for example, while larger airports are likely to benefit from ongoing growth, many smaller or regional airports have low profitability and may not be able to afford the capex required to fund future growth. Cash flow forecasts, that assume airlines will pay for increased capex required to support future capacity, may not be reasonable.

For growth assets, there are a number of important valuation considerations, including:

- effective management able to maximize value by cutting costs and by growing revenue sources where possible (e.g. Transurban's ability to maximize road networks and the ability of some ports and airports to find additional revenue sources);

- accurate traffic forecasts;
- sufficient capital expenditure to sustain growth; and
- the financing strategy.

The highest value assets are those where there is growing demand, experienced management able to maximize returns, and where capital expenditure sufficient to meet forecast capacity has already occurred.

Energy assets

Each energy asset has unique characteristics and will be affected differently by current issues facing the sector. Many have a risk-free rate buffer built into the valuation, and many have long term hedged debt, moderating the impact of interest rate increases.

These issues, though, are secondary to the impact on value of sector-specific factors. In the Australian electricity sector, there is currently a supply shortage, which will mean that some assets will continue to perform well in the short term until new supply is added to the system. However, regulatory policy uncertainty and rapidly evolving technology in battery storage means that the medium and longer term outlook for prices received by generators is difficult to predict.

There are also vast differences in how energy assets perform in different areas of the world, and in how investments in energy are structured. For this reason, the impact of current issues on energy asset valuations needs to be considered on a case by case basis.

Social/PPP assets

AMP has stated that bond proxy assets, such as Public-Private Partnership (“PPP”) assets, may benefit from moderate increases in debt margins if increases in the debt margin are shared with a counterparty, cash flows are CPI linked and the entity is required to hold high cash reserves to meet debt service coverage ratios (because the interest on the cash reserves will partially offset the debt costs). Again, if debt margins grow significantly, this could result in an increase in both the discount rate and debt costs, reducing value.

PPP assets typically provide debt-like cash flows with downside risks that need to be taken into consideration in valuations. For PPP assets, critical valuation considerations include:

- contract terms;
- counterparty risk;
- the financing strategy; and

- whether the asset is CPI linked.

Most PPP assets have been subject to lower demand than large cornerstone transport assets and there may be some value in certain PPP assets, particularly those that have locked in low-cost long-term debt for the duration of the project life. However, there are likely to be PPP assets where rising interest rates may negatively impact value.

Regulated assets

According to AMP, regulated assets will be largely unaffected by rising debt margins as regulatory discount rates tend to reflect long term bond yields.

Critical valuation considerations for regulatory assets are:

- the regulatory regime;
- how management deals with the regulator; and
- how efficiently regulated assets are managed.

Regulatory assets may underperform when there is a temporary (or permanent) disconnect between the regulatory cost of capital and debt margins.

Conclusion

In conclusion, different asset classes are affected differently by current infrastructure trends. While many assets are likely to be fairly priced (or over-priced) given current trends, there are some assets that may provide value for investors. Running scenarios that consider the effect of potential interest rate rises as well as other asset-specific opportunities and threats is useful in pricing infrastructure assets in the current environment.

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