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Opportunity: 3 big disconnects in infrastructure

Research & Insights

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We see 3 big disconnects in the global listed infrastructure market that we believe offer compelling opportunities for new and existing investors to enter the sector. Ausbil's Global Listed Infrastructure team talks through these disconnects in the growth of electricity grids, the upgrade of 4G networks to 5G, and the opportunity in regulated water utilities.

10-minute read

Key points

- We are seeing some significant and potentially valuable disconnects in the price and intrinsic value of infrastructure assets. We believe infrastructure valuations do not reflect the cashflows generated from infrastructure assets, and that they are cheap in the current market.
- We believe there is currently a significant opportunity for investors to benefit as global listed infrastructure is potentially rerated on improved earnings.
- Sectors of particular interest include regulated water utilities, electrical utilities and mobile phone towers. We believe that some key infrastructure assets from these sectors may offer upside potential last seen in the pandemic storm brought on by COVID-19.
- With valuations depressed but revenues rising on inflation - and driven by the compelling growth economics of the energy transition, 5G, electrification, Artificial Intelligence (AI), and demand for essential services like water - we believe that these are compelling reasons to have exposure to global essential infrastructure.

Q: In a nutshell, what are these three disconnects you are seeing in infrastructure?

A: We have been seeing significant buying opportunities over the last 6-months as a result of the major monetary policy normalisation that has been taking place across all asset markets in 2022 and 2023. We are at a point of inflection, in our estimation, where the outlook for earnings growth has turned more positive in infrastructure assets as we have reached a stabilisation phase in interest rates. Our outlook for return on equity invested in infrastructure is rising with the stronger cash flows from the impact of inflation, and the more normalised rate environment which we have entered.

Many investors do not understand that infrastructure cashflows benefit from upward movements in inflation through either pre-agreed increases in tolls and receipts (like toll roads), or agreed inflation in the overall asset base against which some infrastructure assets are able to earn a percentage return (like regulated water utilities).

In terms of value relative to price, sectors of particular interest with respect to their earnings outlook include regulated water utilities, electrical utilities and mobile phone towers. Figure 1 shows how far these sectors and the market in general have moved from long-term averages, representing a significant opportunity for investors.

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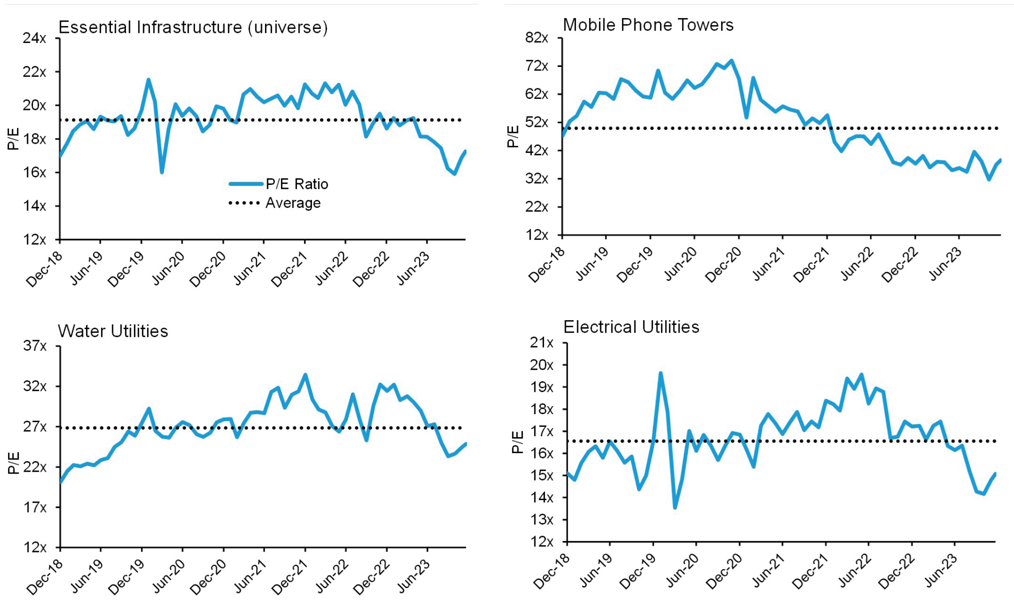
Figure 1: A valuation disconnect across a number of key sectors



Source: Ausbil, Bloomberg. Uses a harmonic mean for the average.

Q: Just quickly, how do you look at earnings growth in listed infrastructure where the underlying assets have such long future cash flow profiles?

A: Listed infrastructure companies issue earnings that represent the overall economics of the business, sometimes underpinned by the cashflows of a single infrastructure asset, or by a spread of infrastructure assets. While we use terms like earnings and earnings growth, in infrastructure we typically look at these over the long term, contrary to a typical equity analyst approach that looks at earnings growth in the near term, and valuations as a multiple of these earnings.

In infrastructure, we value assets on lifecycle cashflows, and their owning entities benefit from these and generate reported earnings. Typically, because infrastructure assets are real and have long depreciation and amortisation schedules, we look at earnings growth before these items as EBITDA, earnings before interest, tax, depreciation and amortisation.

Q: Going back to the sectors where you see a disjoint between their earnings outlook and their current prices, can you give us an example, like from electric utilities and grids?

A: Investing in the 'poles and wires' of electricity transmission grids is one of the most exciting infrastructure investment opportunities, and we believe that there is a potential for significant growth in these assets. Take Elia Group for example. Elia, the owner of the Belgium transmission grid and 50 Hertz (part of the German transmission grid), recently upgraded its growth capex forecast to €30bn over 2023-2027 (from €16bn). Elia Group's current market capitalisation is near €7.5bn with an enterprise value of around €14bn, illustrating the scale of this investment opportunity for the company. The key driver of the substantial increase in growth CAPEX is the massive global energy transition that is underway, and the need to connect and integrate a far greater amount of renewable energy as countries seek to decarbonise their economies, and from the additional load growth resulting from Data Centres and AI.

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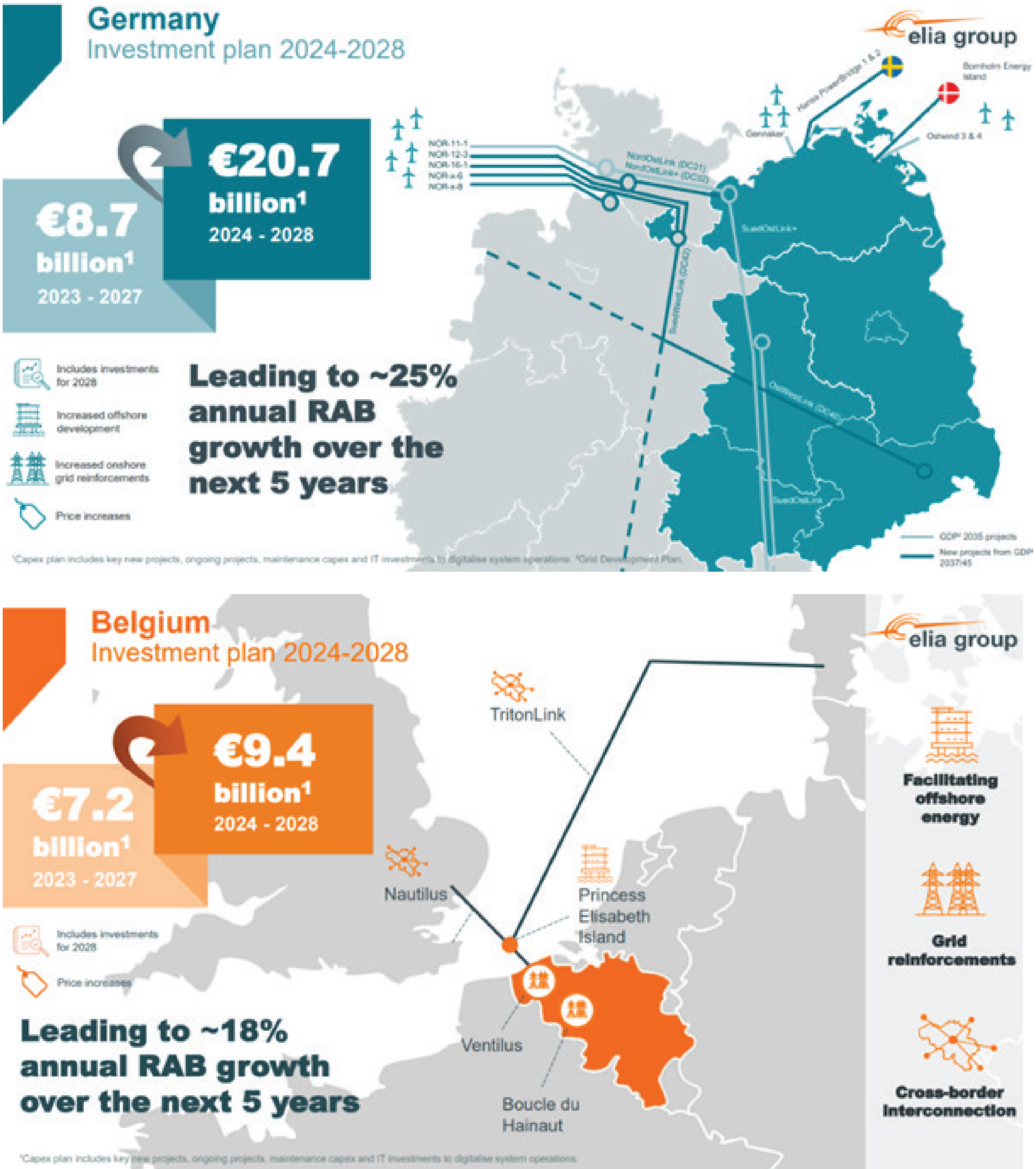
From a sector perspective, prior to the emergence of the key themes of the energy transition and demand growth from electrification/data centres, asset base growth in electrical utilities was typically 0-2%pa in Europe before inflation, with the key driver being asset replacement due to ageing infrastructure. For the period 2023-28, Elia is forecasting strong growth in its regulated asset bases, with around 25%pa growth in Germany and 18%pa growth in Belgium, as illustrated in Figure 2, which also provide electricity to Sweden and Denmark.

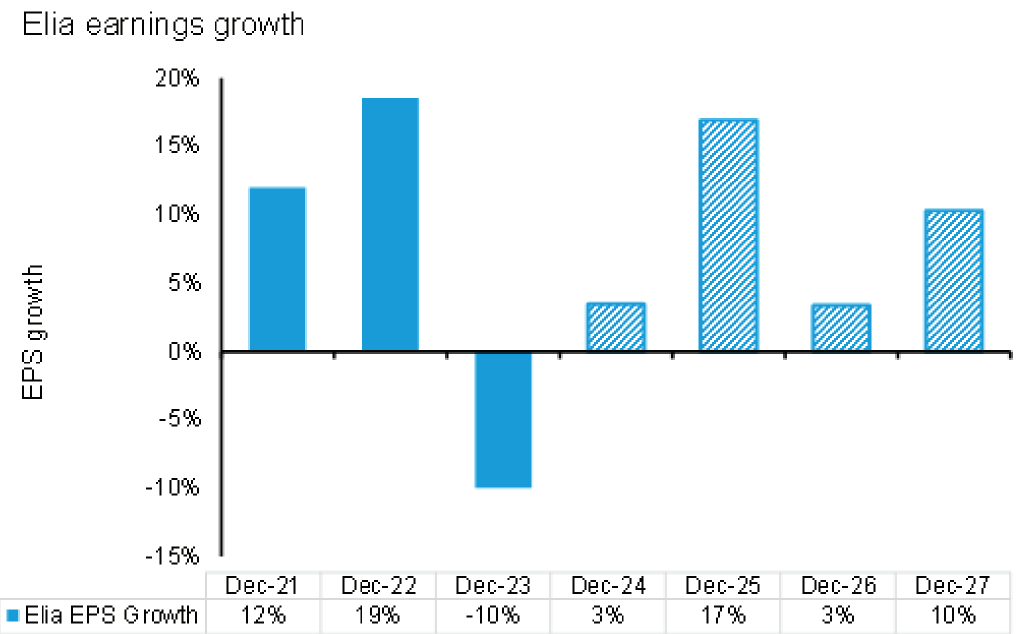
Figure 2: Elia's huge electrical grids in Germany and Belgium



Source: Elia as at December 2023, for Germany to Belgium.

From the perspective of Elia's profit growth potential, Elia is projecting a compound average growth rate (CAGR) of 20% in net profit from 2024 to 2028, and double-digit earnings per share CAGR over the same period, all reflecting the need for additional equity to assist in funding the significant CAPEX expenditure program they have in place. Figure 3 shows projected earnings growth that is expected to come from this significant expansion in operation and capacity.

Figure 3: Elia earnings growth projections



Source: Ausbil, Elia as at December 2023.

Q: What about the impact of 5G on mobile phone tower companies?

A: 5G is the 5th generation of global wireless technology used for mobile and internet services. To state the obvious, the 'G' in 5G stands for generation. 5G is the next stage in the evolution of communication technology that follows the previous 'Gs' from 1 to 4. Over time, the 'Gs' have progressed across faster data speeds, lower latency, increased capacity, and improved connectivity for a wide range of devices, as illustrated in Figure 4. For more on the emergence of 5G, read our thought pieces: Spotlight on communication towers: Why are they so exciting?; and Communication tower infrastructure: explaining the 'Gs' that are changing communications.

Figure 4: Meet the 'OGs' of communication towers

Understanding the 'Gs' of Communications — Supports the following capabilities

	Approx commercial launch year	Technology	Download Speeds (bit/s)	Voice	SMS/MMS	Mobile internet	Video calls	Mobile broadband internet	HD TV	Cloud computing	Internet of things (IoT)
5G	2020	Digital	target up to 10Gbps	✓	✓	✓	✓	✓	✓	✓	✓
4G	2009	Digital	up to 100Mbps	✓	✓	✓	✓	✓	✓	✓	
3G	2001	Digital	>144kbps	✓	✓	✓	✓				
2G	1991	Digital	>14.4kbps	✓	✓						
1G	1980s	Analogue	NA	✓							

Bits explained

8bits = 1 byte	Kilobit per second	kbps, kbit/s, kb/s
8kbps = 1 kilobit per second	Megabit per second	Mbps, Mbit/s, Mb/s
	Megabit per second	Mbps, Mbit/s, Mb/s
	Gigabit per second	Gbps, Gbit/s, Gb/s

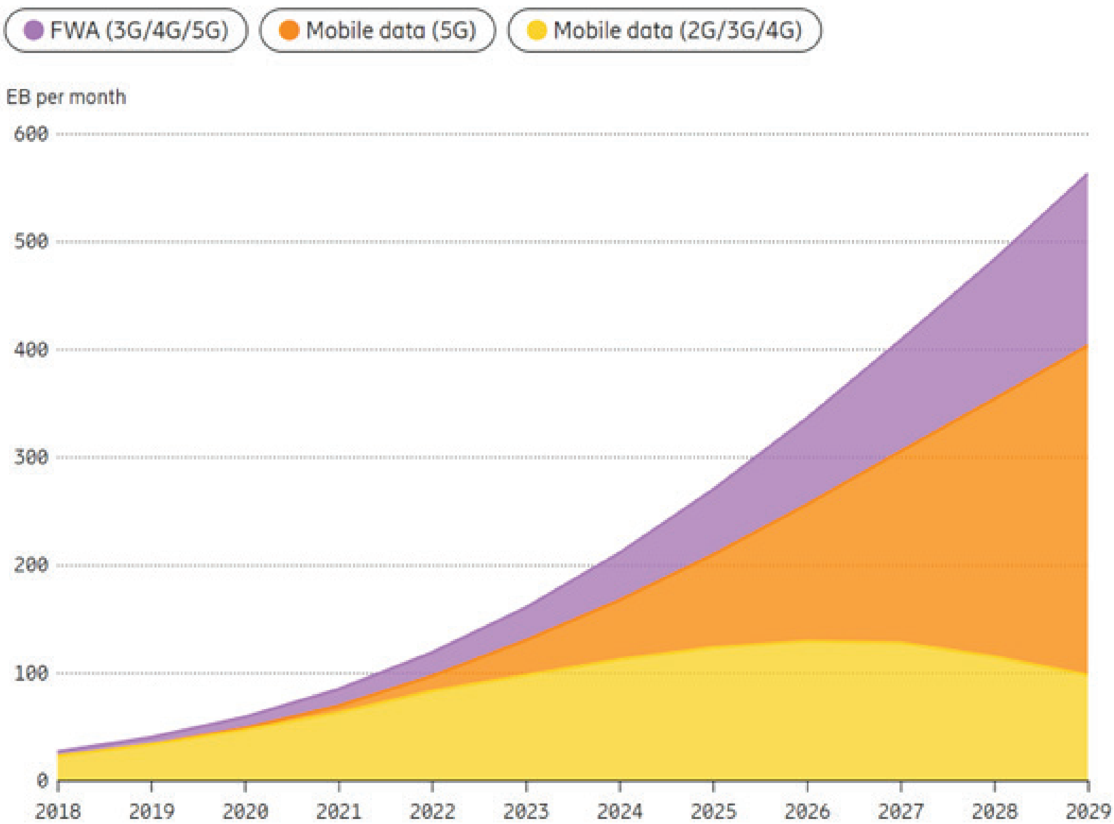
Source: Ausbil

In simplified terms, like earlier generations of communications technology, 5G adopts radio wave technology rather than transmitting through physical conduits, so it is invisible and not something you can touch or feel. Mobile networks typically operate within frequencies from around several hundred megahertz up to 40 gigahertz. Other uses for this part of the radio wave spectrum include TV broadcasting, GPS, Wi-Fi, Bluetooth and cordless phones.

5G builds on advancements in radio wave spectrum usage, and the freeing up of spectrum as services such as analogue TV broadcasting are switched off in a sort of virtuous circle of spectrum recycling. However, there is a visible aspect to 5G, the tangible tower and small cell network that powers the transmission of information that makes the whole system work; this is the area of interest and opportunity for essential infrastructure investing.

5G uses higher frequencies than 4G. As a result, 5G waves are able to carry more data, but the trade-off is that they are not able to travel as far (a few hundred meters on present technology), compared to 4G frequencies which can carry data several kilometres. This means that a 5G network requires up to 10 times more towers, base stations and small cells to provide 'blanket' wireless coverage for users to achieve the same reach as 4G. This need to densify networks to support growing demand for data benefits the mobile phone tower operators, as shown in Figure 5.

Figure 5: Global mobile network data traffic



Source: Ericsson.

While the 5G networks are owned and operated by mobile phone companies, the equipment that is critical to operate these networks, such as antennas and base stations, resides on tower structures and at the base of the towers, as illustrated in Figure 6. The mobile phone tower companies lease space on the towers, land parcels, and small cells that house this equipment to the network operators under a long-term lease agreement, so the addition of equipment results in increased revenues at little or no cost to the tower operator.

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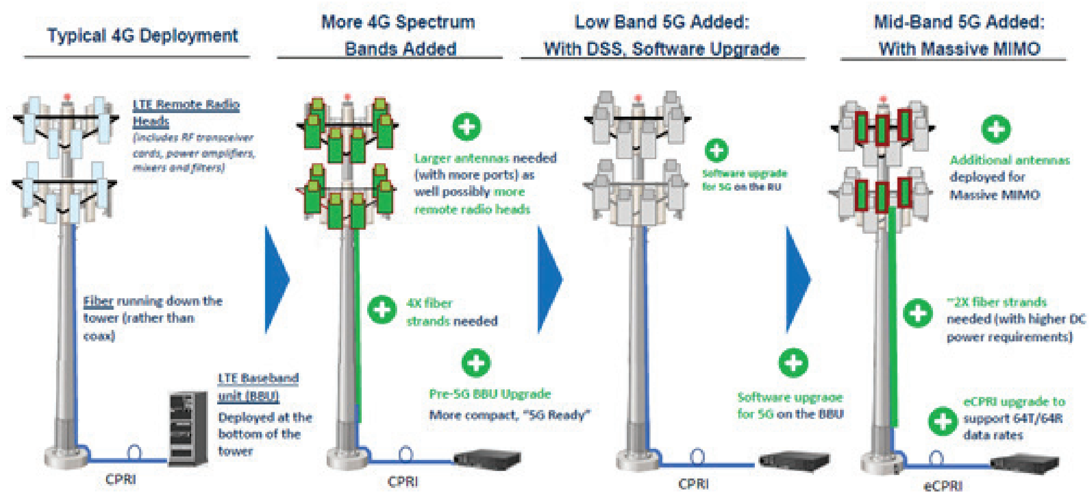
Figure 6: The rapid densification of networks to accommodate 5G with more and more equipment

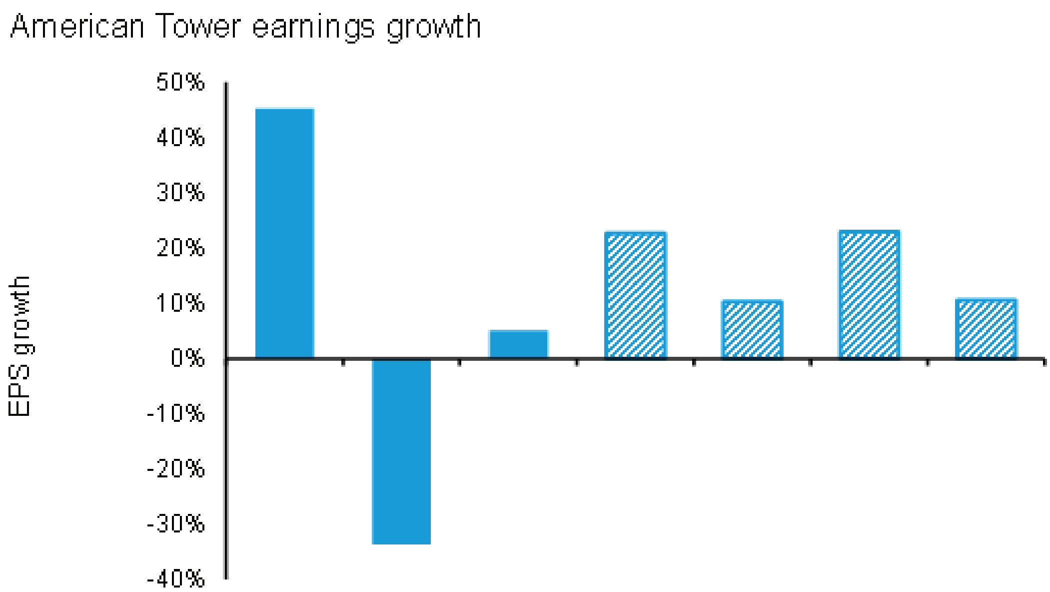
Equipment configuration is growing, with more antennas, fibre and software upgrades



Source: American Tower, December 2023.

Across the communications infrastructure sector we are seeing attractive investment opportunities, one being US mobile phone tower company, American Tower. We are well into the early stages of the carrier's 5G deployments in the US. American Tower's leasing structure supports around 5% compound annual growth in its US tower business through to 2026. In its international business, American Tower is poised to benefit from the completion of 4G networks by carriers, even before the transition to 5G in those markets begins. In addition, American Tower has a small data centre business which is at the forefront of investment to support growing demand from AI. Figure 7 illustrates the earnings outlook for American Tower.

Figure 7: Earnings growth projections for American Tower



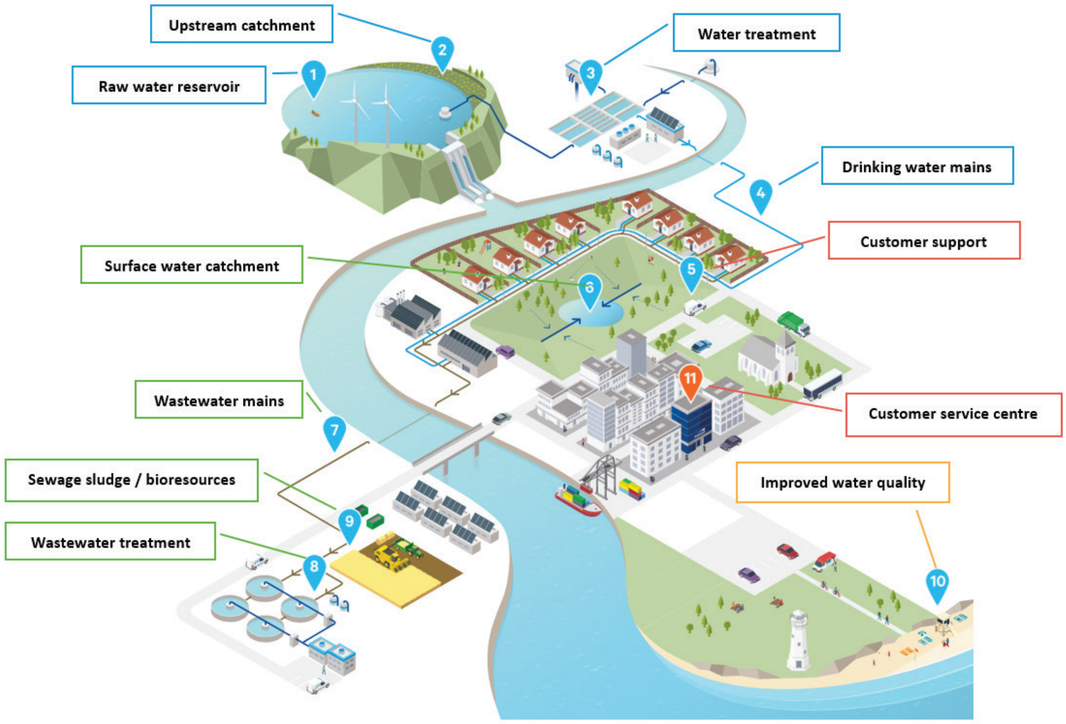
	Dec-21	Dec-22	Dec-23	Dec-24	Dec-25	Dec-26	Dec-27
AMT EPS Growth	45%	-34%	5%	23%	10%	23%	10%

Source: Ausbil, American Tower as at December 2023.

Q: You said there was a disconnect in regulated water utilities as well? How do you see the earnings coming from the water sector relative to their current pricing?

A: Water infrastructure is considered essential infrastructure and is typically monopolistic in nature given that most water infrastructure is unique and utilities in this area typically operate as the only provider of water and waste/sewage services in any given jurisdiction. Figure 8, from the listed water utility, Pennon Group PLC (Pennon) in the United Kingdom, illustrates the various components of water infrastructure, from the gathering, treatment, and delivery of potable water to the gathering, treatment, recycling and disposal of wastewater and sewage.

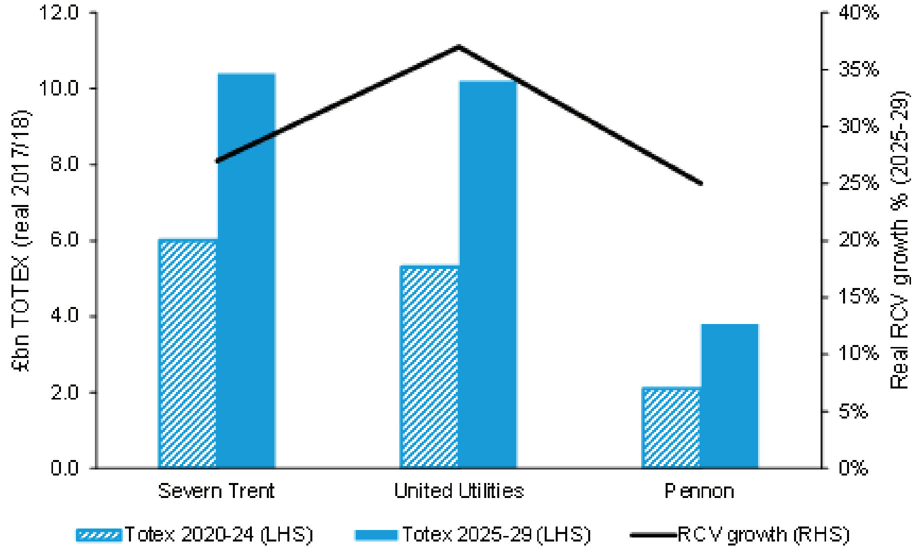
Figure 8: Pennon's water assets: Understanding how water infrastructure works



Source: Pennon, Ausbil simplified, as at December 2023. Ausbil currently holds a position in the listed equity of Pennon, but we may not always hold a position. This diagram helps to illustrate the different ways water infrastructure may generate returns.

We believe water companies offer attractive elements of yield and growth. Yield comes through the allowable return regulators support given prevailing returns on debt and equity for infrastructure assets. As the utility's assets grow (as represented by the Regulated Capital Value or RCV), the yield for an allowable return naturally increases. Asset values grow through additional allowable capital investment a utility makes in improving and expanding their services and network to meet the water demands and environmental objectives of their region. In the UK, the regulation is in 'real' terms meaning equity investor returns enjoy inflation protection characteristics. The RCV is inflated by actual inflation annually.

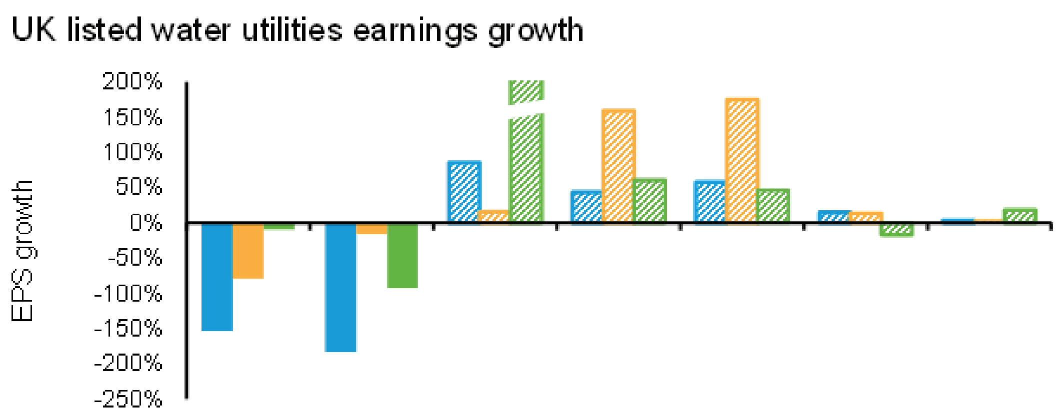
Figure 9: Investing in their business and earnings growth through TOTEX



Source: Ausbil, Pennon, Severn Trent, United Utilities.

We believe there is a growing need for much greater investment in water and wastewater infrastructure in the UK, presenting investors with an unprecedented growth opportunity for UK water companies. This much higher investment is required to protect water quality and enhance the resilience of the networks, address storm overflows, reduce leakage rates and protect the environment from climate change. The 3 listed UK water companies are projecting a step-up in total expenditure (TOTEX) on their networks from 2025-29 (compared to 2021-24) of between 73-92% in real terms. This significant increase in expenditure, if approved by the regulator OFWAT, we think will translate into real RCV growth of between 25-37% over the period, ultimately translating into higher earnings, cash flows and dividends for shareholders over time, as shown in Figure 9. We believe this increase in the overall regulated asset base is expected to translate into earnings growth for all three listed water companies, as illustrated in Figure 10.

Figure 10: Earnings growth projections for listed UK water companies



	Mar,22	Mar,23	Mar,24	Mar,25	Mar,26	Mar,27	Mar,28
Severn Trent	-154%	-183%	86%	43%	58%	15%	4%
Pennon	-80%	-17%	16%	159%	175%	13%	4%
United Utilities	-10%	-93%	721%	60%	46%	-17%	18%

Severn Trent Pennon United Utilities

Source: Ausbil, Pennon, Severn Trent, United Utilities as at December 2023.

Q: If you could sum up what excites you in infrastructure in 2024, what would you say?

We see the compelling value proposition for essential infrastructure over the next twelve months as being a combination of three things. Firstly, the short-term underperformance relative to global equities has led to a significant valuation upside opportunity. Secondly, the benefits of recent inflation are yet to feed through into revenues and cashflow, and with inflation set to remain above trend for the next few years, this benefit will take several years to be fully realised in higher profits. Finally, the long-term secular growth drivers such as the energy transition, repowering Europe, mobile phone technology transition from 4G to 5G, and the impacts of AI have never looked better. To us as infrastructure investors, this is both compelling and exciting, and we are positioned in essential infrastructure to benefit from this over the next twelve months.

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