

INFRASTRUCTURE » Infrastructure plays can provide investors with good growth in more subdued times

Searching for inflation proof companies



According to Peter Meany, manager of the First State Global Listed Infrastructure fund, infrastructure is perfectly suited to current market conditions, providing investors with the opportunity to enjoy growth while the prospects for other asset classes are more subdued.

He says: "We are in an environment of lower economic growth and higher inflation, an environment which suits infrastructure quite well. Growth tends to be more structural than cyclical."

Areas that he identifies as tapping into this structural growth story include the investment needed in electricity transmission – "the current systems are so aged that investment needs to be made in updating them" – as well as, more broadly, in airports around the world as "travel continues to get less expensive than it once was".

Moreover, he sees oil storage as a growing concern, with a big geographical imbalance between the locations where most of the oil comes from and where the most demand is leading to a need for more storage facilities. He also believes the infrastructure around mobile telecommunications will continue to grow stating that, while he has no idea what the next big thing will be in technology, "the steel structures that support the networks will only increase in number and value".

Broadly speaking, the manager is tasked with finding bottlenecks, where growth in a sector or service necessitates significant investment in the infrastructure around it. In the current climate he is also looking for companies or industries that are able to deal with the growing burden of inflation.

"On the inflation side, we are looking for pricing power," Mr Meany says. "We are looking at the ability the industry has to pass on that inflation. Many of the companies we invest in are monopolies or have legally binding contracts to protect the work they are doing. Meanwhile, other industries may suffer."

Overall, the manager has a great deal of freedom in choosing where he wants to invest, with no benchmark restraints for either sector or country weightings. However, Mr Meany is keen to maintain a good level of diversification across the fund, with around 40 holdings at any given time across a range of geographical locations.

"The only real restraint we have is a maximum weighting of 20 per cent in the emerging markets," he adds. "That is really so we remain true to label, ensuring a steady and less volatile return. Emerging markets are more of a call rather than a core option for us."

"We do think it is important to retain diversification, but we don't have strict limits. And the performance of the fund has shown the value of that flexibility."

Mr Meany is also keen to be able to capitalise on the possibility of a vast number of companies becoming listed in the upcoming months and years, with a huge potential in US ports and toll roads alone. "We don't want to be hamstrung as the industry develops," Mr Meany concludes.

The fund currently has 30 per cent exposure to North America, with the manager finding opportunities in US rail companies, including Union Pacific.

"These were positions we took up in 2009 with the view that companies in this sector have significant leverage as demand recovers," Mr Meany explains.

"It is an industry that has been undergoing significant restructuring following deregulation, which will allow for core price increases above inflation."

The relatively high weighting in the US has also been driven by the decision to move away from European utilities towards US utilities.

"We have been keeping a close eye on the political risks coming out of Europe and made the decision to move out of European utilities as a result of this," Mr Meany says. "Stocks such as the Southern Company in Georgia are, we think, less vulnerable to political intervention."

According to the manager, 90 per cent of

portfolio construction comes from bottom up stock picking with an "idiot check" of examining what is going on in the macro environment. Infrastructure specialist Mr Meany runs the fund alongside a more generalist equities manager, with four additional analysts also contributing ideas to the fund. Each member of the team travels extensively, meeting with management teams and regulators to enable them to make informed stock decisions.

"As well as having a dedicated team of six, we can also tap into the other teams at First State," Mr Meany adds. "There are 50 people on the infrastructure team alone, which is a great resource. We can also debate stock calls with the other equity teams."

"In addition to that, First State has also formed a macro committee to look at the broader economic picture. This includes representatives from the fixed interest and credit teams, who have helped us keep on top of the sovereign issues in southern Europe."

Of the four analysts working specifically on the fund, one is based in Hong Kong and has been tasked with finding potential stocks within Asia. So far she has identified a number of options in Chinese toll roads, utilities and ports, although these have not yet been included in the fund.

"At the right price these ideas could enter the portfolio," Mr Meany says. "However, we would really need to be compensated for the additional risk that we'd be taking on. There is definitely more stock volatility in this area."

At the moment, the top 10 holdings make up 43 per cent of the fund, led by a 6.9 per cent weighting in Vinci. The team particularly likes this stock because of the strong defensive qualities it has demonstrated through the recession, as well as the potential for growth in the short to medium term.

Mr Meany says: "French motorway assets have been undervalued by the market. The margins are set to improve with the introduction of electronic tolls. More generally, European motorways have been underrated, with legally binding contracts on French, Spanish and Italian motorways ensuring future growth."

Overall, the fund has performed strongly since its launch in October 2007. It has outperformed the MSCI World index by 20 per cent over three years. It has also generated a return of 12.2 per cent over one year, compared to its benchmark – UBS Global Infrastructure & Utilities 50-50 index – return of 7 per cent.

"Half of that is down to the performance of the infrastructure sector as a whole, which has been reasonably defensive in difficult markets," Mr Meany says. "The other half is down to stock picking, through avoiding stocks with political issues and highly leveraged companies in the run up to the financial crisis."

In terms of the future for both the fund and the sector, Mr Meany anticipates good things emerging out of the gloom that surrounds southern Europe.

"Greece, Spain and Portugal will all be looking to privatise assets. It's the silver lining of the sovereign crisis," he says. "Because those assets have typically been inefficient there is a lot of opportunity for companies to add value over time, as long as they pay the right price for them at the outset."

Mr Meany also anticipates an increase in the amount of merger and acquisition activity in the sector, with investors set to benefit from the bonuses that come out of these deals.

"A lot of strategic investors have allocated capital to the infrastructure asset class and they are looking for more pure exposure to the underlying assets," he explains. "They are prepared to pay a premium to the listed infrastructure owners of up to 35 per cent."

"Three of our stocks have recently been taken over and we have received that premium on all of them. It's a real opportunity for investors to get a nice extra bonus."

First State
Investments