First Sentier Global Listed Infrastructure Fund
Monthly review and outlook

First Sentier Investors

Monthly review and outlook | November 2022

Market review

Global Listed Infrastructure climbed in November on hopes that interest rates may increase at a slower pace than previously anticipated; and on indications that China was considering lifting its strict Covid restrictions.

The best performing infrastructure sector was Other (+9%), consisting of ports, satellites and merchant power operators. Although part of the broader infrastructure opportunity set, these companies are not included in our Focus List. They tend not to demonstrate the key infrastructure characteristics that we seek; namely pricing power, barriers to entry, predictable cash flows and structural growth. Gains were led by Emerging Markets port operators. Even the worst performing infrastructure sector for the month, Airports (+5%), delivered healthy returns as passenger volumes continued to trend positively in October.

The best performing infrastructure region was Asia ex-Japan (+10%), after investors' views towards Chinese infrastructure stocks inflected positively. The worst performing infrastructure region was Latin America (-1%), reflecting a cautious response from financial markets to left wing candidate Lula's win in Brazil's presidential election at the end of October.

Fund performance

The Fund returned +3.1% after fees in November[1], 145 basis points behind the FTSE Global Core Infrastructure 50/50 TR Index (SGD).

The best performing stocks in the portfolio were Chinese infrastructure names. Investor sentiment was buoyed by indications that the country's strict Covid Zero policies may be eased, after widespread protests demonstrated public frustration. Water utility Guangdong Investment (+45%), gas utility ENN Energy (+41%), and toll road operator Jiangsu Expressway (+27%) rallied strongly, along with the broader Chinese market.

US utilities / renewables represented another area of strength for the portfolio, aided by easing bond yields and generally positive September quarter earnings numbers. Arizona-based Pinnacle West (+17%) announced better-than-expected September quarter earnings and upgraded earnings guidance for 2022. The stock was further buoyed by the election of new commissioners to the Arizona utility regulator, leading to hopes of a more constructive regulatory environment in what has previously been a challenging jurisdiction for utilities. Sempra Energy (+10%) achieved better-than-expected September quarter earnings from its California and Texas utilities. The company also announced a deepening of commitments from customers for its planned LNG (Liquefied Natural Gas) export facilities at Port Arthur in Texas, reflecting robust global demand for reliable suppliers of LNG.

UK utility SSE (+10%) outperformed after announcing the sale of a 25% stake in its electricity transmission network business to Ontario Teachers' Pension Plan Board, for £1.5 billion. These transmission assets help to transport energy generated from renewable sources in the north of Scotland to population centres further south. The price paid, of 75% premium to 2023 Regulatory Asset Value, was higher than the market expected, reflecting keen demand for high quality infrastructure assets even in an uncertain macroeconomic environment.

US freight rail operators CSX Corp (+13%) and Norfolk Southern (+13%) gained as the threat of strike action appeared to recede. Extensive negotiations between company management and the rail unions have not yet resulted in an agreement on working conditions. However, late in the month, the White House called for a rail labour bill to halt potential strikes, citing the crucial importance of the freight rail network to the US economy.

The worst performing stock in the portfolio was Virginia-based Dominion Energy (-13%), which operates electric utility businesses in Virginia, North Carolina and South Carolina. The company lagged after investor confidence in the stock was shaken by the unexpected announcement of a "top-to-bottom" strategic review of the company. This led to speculation that the company may sell some of its assets, potentially resulting in downward revisions to its earnings forecasts.

Other underperformers during the month included Brazil toll road operator CCR (-7%). The company announced robust September quarter earnings numbers, supported by recovering toll road and airport volumes. However these were overshadowed by political and macroeconomic concerns; investors became concerned about the country's proposed spending plans under left wing president-elect Lula, and Brazil's October inflation rate was higher than expected. Energy midstream stocks Cheniere (flat) and DT Midstream (+1%) delivered muted returns in November, having achieved strong ytd returns.

[1] Fund performance is based on the Singapore unit trust, net of fees, expressed in SGD terms.
All stock and sector performance data expressed in local currency terms. Source: Bloomberg.

Fund activity

A position was initiated in regulated US utility Exelon, which operates electric and gas transmission and distribution (T&D) assets across service territories that include Chicago, Washington DC, Baltimore and Philadelphia. The company has lagged utility peers since the announcement in July of the US Inflation Reduction Act, which includes a broad range of proposals in support of renewables and low carbon energy sources. As a T&D-focused business, Exelon has less scope than some other utilities to benefit directly from those measures. Negative investor sentiment was then exacerbated when the company lowered its 2023 earnings forecast. We believe that the market over-reacted to this news, presenting an appealing entry point to a stable, well-managed business with clear earnings visibility and a healthy medium-term growth outlook of between 6% and 8% per annum.

A holding in US-listed tower operator SBA Communications was sold on the view that peers with lower levels of borrowing on their balance sheets (American Tower, ~4% of the portfolio, and Crown Castle, ~3% of the portfolio) were better positioned in the current higher interest rate environment. Danish-listed renewables developer Ørsted was divested after rising cost pressures, mounting competition in the offshore wind space and project delays reduced our confidence in this company's near / medium term earnings growth prospects. Gas utility China Gas was also sold; China's slowing economic growth rate represents a headwind for natural gas sales volumes and new connection growth rates, while higher natural gas procurement costs could put margins under pressure.

Market outlook and fund positioning

The Fund invests in a range of listed infrastructure assets including toll roads, airports, railroads, utilities and renewables, energy midstream, wireless towers and data centres. 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.

Toll roads represent the portfolio's largest sector overweight, via positions in European, Asia Pacific and Latin American operators. The sector is set to benefit from inflation-linked toll increases, with year-on-year toll uplifts of between 5% and 7% likely for many developed market roads. We expect this will lead to healthy earnings growth; while higher tolls may reduce demand to a certain extent, they don't usually have a material impact on traffic volumes. We are alert to potential headwinds, such as an economic slowdown leading to a dip in truck traffic on longer distance roads; or lacklustre commuter traffic levels on some intra-city roads as the return-to-office trend settles. Overall however we expect toll roads to be strong performers in 2023 as toll increases support earnings growth, and demand proves more resilient than expected by the market.

The portfolio has a small overweight exposure to Towers / Data Centres. Consumers and businesses alike continue to move activities onto digital platforms, underpinning growing demand for communication infrastructure assets. 2023 is likely to see the continued rollout of 5G mobile technology, which will require tower leasing. In data centers, we expect users to seek IT efficiencies through a combination of colocation (facilities in which users operate their own data centre hardware) and cloud (the delivery of computing services, run from the cloud provider's data centre) services. While the revenue outlook remains robust, we are conscious that rising interest rates may be more of a headwind to EPS growth than in previous years.

A substantial part of the portfolio consists of Utilities / Renewables stocks. Decarbonisation, electrification and resiliency spend represent large and growing investment opportunities for these companies. These investments drive utilities' rate base growth, leading in turn to earnings growth. However, in the near term this growth is likely to be tempered by rising interest costs. There is also scope for greater regulatory and political risk. As higher energy prices push energy bills up, regulators and politicians may seek to offset this by setting lower allowed returns for utilities, or by introducing windfall taxes or price caps. Despite these headwinds, we still expect utilities to deliver reasonable earnings growth in 2023, underpinned by plentiful capital investment opportunities and aided by limited sensitivity to a weaker economic backdrop.

An underweight position has been maintained in the Energy Midstream sector, with exposure consisting of high conviction positions in companies that have secured long term contracts with reliable counterparties; or that are positioned to benefit from growth in US LNG exports. We remain conscious of the structural headwinds that Net Zero initiatives may present to this sector in the longer term.

Source : Company data, First Sentier Investors, as of 30 November 2022.