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EXPERTS IN GLOBAL INVESTING

Q&A WITH GERALD STACK

Gerald Stack, Head of Investments and Head of Infrastructure, talks about how covid-19 has affected different segments of the infrastructure and utilities universe, outlines why toll roads and airline operators are still sound long-term investments, and lists the two biggest risks the investment option might face in these turbulent times.

Q: How have different segments of the infrastructure and utility world performed through the crisis so far?

A: Our investment universe comprises regulated utilities and infrastructure companies such as toll roads and airports. Overall, the health emergency has hit infrastructure businesses harder than utilities. Over the March quarter, the share prices of regulated utilities we watch declined by an average of 10% while the infrastructure companies we monitor lost an average of 21%.

Within the infrastructure component there were big disparities. Airports plunged 41%, toll roads lost 25% and energy infrastructure shed 12% while communications Infrastructure rose 4%. The problem for airports, toll roads and rail segments is that they face significant short-term declines in patronage. We are confident that these assets provide essential services and we expect demand for their services to return over time. The duration of the epidemic and any following economic downturn, however, will be key to how these companies recover.

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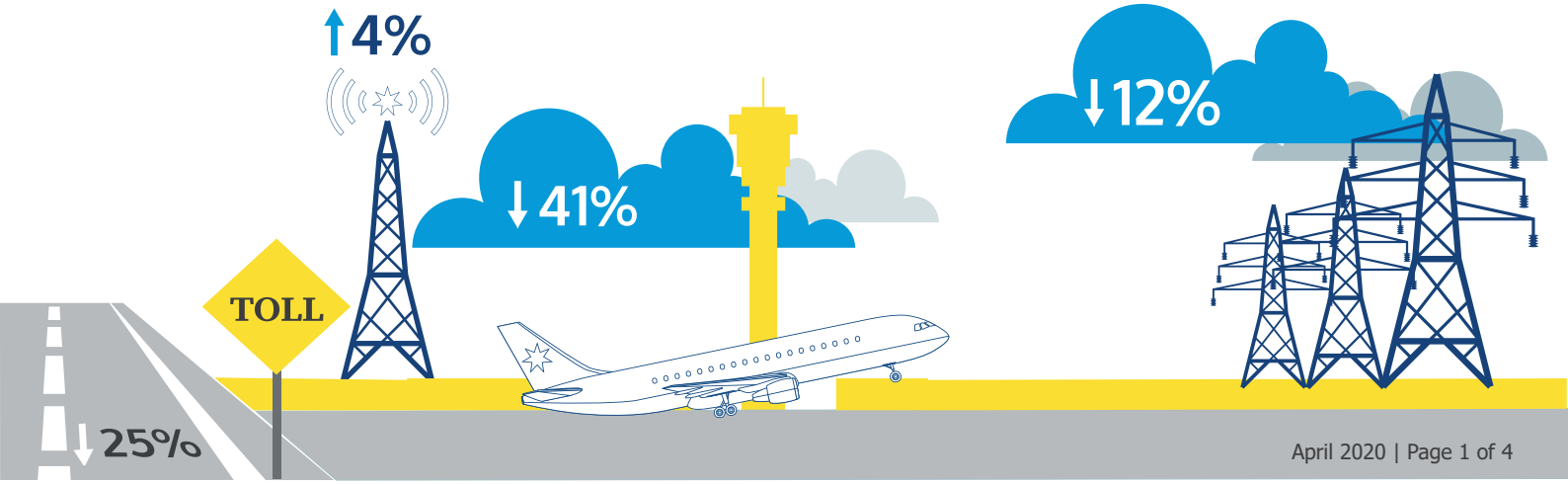
The energy infrastructure companies in the portfolio generate earnings by storing oil, gas and chemicals or transporting oil and gas across their pipeline networks. The revenues they earn from transporting oil and gas can potentially change with movements in volumes but underwritten 'take or pay volumes' usually account for the majority of revenues so we assess the potential risk to volumes to be low. Indeed, for many customers of energy infrastructure companies, access to the energy infrastructure services is essential to their ability to earn revenues. Of course, should



customers have solvency issues then this could cause problems. But the overwhelming bulk of customers these companies serve are investment-grade credit quality. We believe the energy infrastructure companies are well placed to cope with the economic consequences of the virus.

"Within utilities, the differences in performance were less pronounced."

While the pace of development of the infrastructure networks of telecommunications infrastructure companies might slow, we expect the earnings of telecommunications infrastructure companies to be highly defensive in response to this crisis. The demand for data across mobile telephony and the internet will grow, and more investment in telecommunications infrastructure is necessary to satisfy this demand.

Within utilities, the differences in performance were less pronounced. Over the quarter, transmission and distribution utilities lost only 2%. Water utilities shed 5% while regulated gas utilities dived 15% and integrated utilities slid 14%.

Regulated utilities might face some short-term declines in earnings due to the crisis but we do not expect significant changes to their long-term earnings outlooks. The earnings of regulated utilities are defensive and regulators generally allow for losses due to issues outside of the control of the regulated utility to be recovered over the near to medium term.

Q: What is the structure of the investment portfolio between infrastructure and utility stocks? Has this changed over the crisis so far?

A: The portfolio today comprises about 45% utilities, 40% infrastructure and 15% cash. By comparison, at the end of January, the split was 43% in utilities, 55% in infrastructure and only 2% cash. So the portfolio is significantly more defensive.

At the end of March, allocations to defensive sectors such as regulated utilities, communications infrastructure and energy infrastructure combined with the 15% allocation to cash accounted for about 75% of the investment portfolio. The remaining 25% of the investment portfolio is invested in toll roads, airports and rail companies that we concede face challenges in the coming months.

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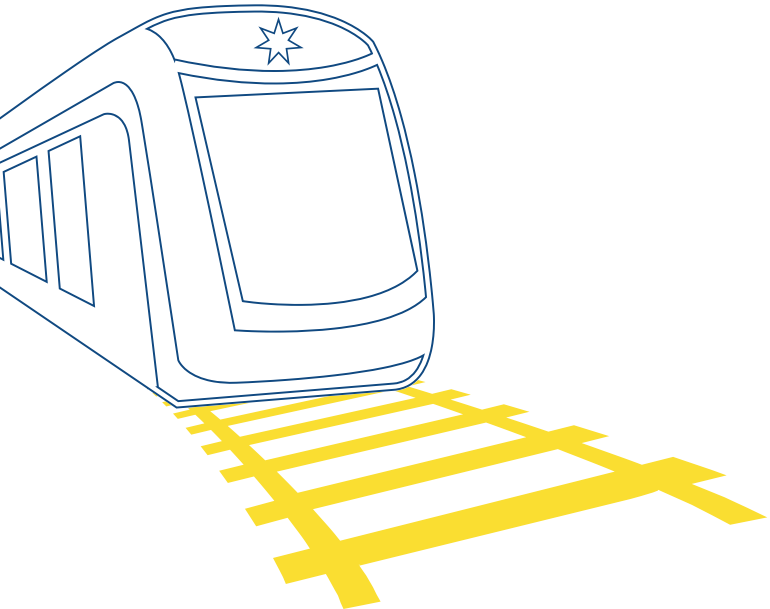
With airports and toll roads, we expect a significant drop in passenger movements and car trips but we assess that our companies have sufficient cash flow and liquidity to cope. While we expect that some of these companies will reduce their dividends in the short term, our experience of previous demand shocks in the transport industry gives us confidence that the demand for transport will recover over the longer term, which will lead to resilient earnings and dividends.

Our rail companies are from Canada and the US. These businesses are diversified across a range of segments and we would expect volume losses due to supply interruptions and economic decline to be recouped as the US economy recovers.



Q: With airports, how has the reduction of passengers affected valuations in the short term?

A: If you take the 41% drop for airport operators for the March quarter, we estimate that means that investors overall are pricing in akin to something like a six-month interruption in passenger numbers followed by a slow recovery after that. If the interruption is shorter then airport stocks could claw back some of their losses.

Q: Do you think forced isolation, travel restrictions and changed working arrangements will have long-term impacts on conventional views and expectations of particular assets? If so, which assets?

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A: The demand patterns established for transport infrastructure have historically been consistent and predictable. However, today's circumstances are extraordinary and there could well be changes to transport demand.

For toll roads, we do not expect their core proposition to change. Toll roads essentially sell time. We expect that as economies and communities recover from this crisis, people will once again get fed up with traffic congestion and the value proposition for toll roads – a time saving – will prove worthwhile. Ultimately, traffic is a function of population and household formation and we do not see these variables as changing sufficiently to shift long-term traffic trends.

Aviation traffic has historically been resilient to demand shocks. Events such as the failure of airlines, regional health crises, terrorism and economic crises have led to big reductions in the demand for aviation but these declines have proven short-lived. On each of these occasions, aviation passenger numbers have returned to the trend line in, say, under 18 months. However, this crisis is a dramatic challenge for aviation and travel. While we are confident that aviation will ultimately recover, we are cautious as to the pace at which that might happen.

Q: Can you discuss the risks that companies in the infrastructure sector might default on their debt obligations and the consequent impacts on equity holders?

A: We have reviewed the balance sheets and forecast cash flows for the companies in our portfolio. Our analysis shows that our companies are generally in strong positions in terms of solvency – that is, their ability to fund their obligations – for at least the next six months.

Should the crisis extend beyond six months, we would expect some companies in the transport space – notably airports – would need to either raise capital via debt or equity raisings to fund their obligations.

We note that in recent weeks some airports have raised additional debt capital to fortify their balance sheets for a long period when they need to call on their cash holdings. While the ratings agencies have downgraded the debt ratings of some airports, the major airport companies on which we focus have strong investment-grade ratings.

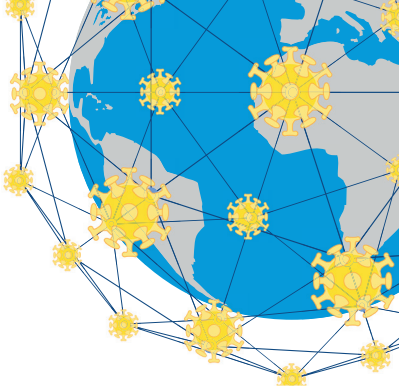
"Higher credit spreads only have a limited effect on the portfolio at present."

Q: What do higher credit spreads mean for the portfolio?

A: Higher credit spreads only have a limited effect on the portfolio at present. While credit spreads have increased, they remain at levels we consider reasonable given the extraordinary circumstances. We have seen some companies in the portfolio raise debt in recent weeks and the pricing of this debt, while elevated compared with the start of the year, remains low compared with historical standards.

Companies we own typically have their debt maturities spread over 20 or more years. That means the debt coming up for refinancing in any single year is only a small portion of total debt obligations. As a consequence, the exposure to an increase in credit spreads is generally limited in the short term.

Q: Does the strategy to use infrastructure to diversify equities exposure still apply?



A: We believe infrastructure remains a diversifier for an investment portfolio – notwithstanding that, in the face of the pandemic, the investment option has been highly correlated to broader equities markets.

To construct a diversified investment portfolio, an investor must allocate to a range of assets whose earnings or income streams reflect different drivers. Provided these drivers respond to events in different ways then investment returns will be diversified. The nature of a diversified portfolio is that at any given time some of the investments will be winners and some will be losers but, overall, the investment portfolio is structured to achieve its long-term investment objectives.

In this situation, transport infrastructure, which represents a significant proportion of the infrastructure universe, is exposed to the same factors affecting broader equity markets – the lockout of consumers from physical commerce. As a result, infrastructure investment performance through the first quarter of 2020 has been correlated with equity markets.

Notwithstanding the performance through this crisis, we believe that the investment returns from infrastructure typically reflect different underlying drivers to broader equity markets. This will ultimately mean infrastructure diversifies an investment portfolio.

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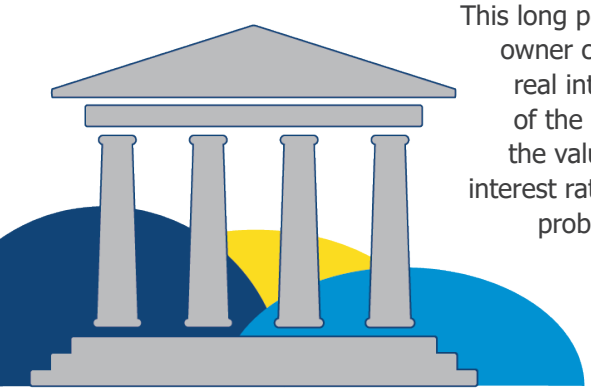
Q: What are your greatest concerns for global infrastructure?

A: The nature of infrastructure as an investment option is that the owner of the infrastructure asset builds a big piece of capital equipment – an airport, a toll road, an energy pipeline – and commits significant capital to do this. So there is a large initial cash outflow. The infrastructure asset provides an essential service and so the initial cash outflow is followed by a long period of reliable cash inflows to the owner of the asset.



This long period of cash inflows means the key risks are those that impede the asset owner collecting those cash inflows. We typically focus on two key risks. The first is real interest rates. A movement in real interest rates can change the present value of the cash flows the asset owner will receive – that is, if interest rates rise then the value of the future cash flows falls. Given today's circumstances, we expect interest rates to remain at low levels for well into the future so this shouldn't be a problem.

The other risk is changes to government policy. As infrastructure and utility assets provide essential services and we are likely to see much economic hardship, government might act against the interest of asset owners. This risk appears to be elevated compared with recent times.

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