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Infrastructure stocks

What you need to know and why they make good investments

By Dennis Mitchell

Infrastructure, as an asset class, manages to be both sexy and boring at the same time. The sexy side usually rears its ugly head during recessions, when investors flock to the sector. Governments unveil dramatic, "shovel-ready" infrastructure-spending programs, designed to jump start the domestic economy. Investors handicap the companies that are likely to benefit the most from the oncoming deluge of spending and the share prices of these companies soar. This sexy side can generate dramatic capital gains in a sector that is not designed to deliver them on a regular basis.

Most of the time, infrastructure is a very boring sector that ticks along, delivering very predictable, high single-digit to low double-digit total returns. The boredom comes from the prevalence of the investments that make up infrastructure, the simplistic nature of their businesses and the lack of sexy, dramatic growth opportunities. It is this investment ennui that causes many investors to overlook a very strong asset class during periods of market equilibrium.

We view infrastructure as the essential services and structures that allow a society to function cohesively: the veritable "sinews of society" if you will. These businesses are characterized by having a captive customer base, high barriers to entry and little to no competition. Predictably, they are



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often regulated by a public body to protect the public from monopolistic behavior.

We break infrastructure into three buckets of companies with varying levels of regulation and competition. The first bucket encompasses companies with relatively inelastic demand, high barriers to entry and little practical direct competition. Their businesses are regulated and their returns are formulaic and relatively predictable. Airports, toll roads, and transmission and distribution (T&D) businesses are excellent examples of companies in this first bucket.

All three are examples of businesses that are allowed to earn regulated returns on a regulated asset base. For instance, a company with \$1 billion in regulated assets, with an assumed 50 per cent equity capital structure and an allowed return on equity of 10 per cent, will be allowed to earn \$50 million that year (\$1 billion x 50 per cent x 10 per cent). Fees and/or tolls will be adjusted based on historical margins and forecasted expenditures to earn this amount.

All three businesses require significant up-front capital commitments, provide essential services and are not subject to significant amounts of direct competition.

We own positions in **Macquarie Airports Group** (MAP-ASX, \$3.03) and **Transurban Group** (TCL-ASX, \$5.31) in **Sentry Infrastructure Fund**. Macquarie owns managing interests in the Copenhagen and Brussels air-

ports. But its largest asset is a 74 per cent holding in the Sydney Airport, which handles 33 million passengers each year, of which 11 million are international passengers. We favor larger airports in international cities (e.g., London, Paris, New York, Sydney, Hong Kong) since they service business, leisure and transient travellers and the larger, better-capitalized air-travel operators. Transurban Group's major assets include toll roads in Sydney and Melbourne, Australia and Virginia in the U.S. We prefer toll-road operators with longer concessions to operate roads connecting large and/or growing population centres to core employment centres. In an environment of economic expansion, traffic volumes should rise in tandem with tolls as inflation feeds into the pricing mechanism.

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The second bucket we look at contains businesses that enjoy a structural competitive advantage that limits competition. That said, they do face some form of competition and generally earn market returns in a regulated environment. Examples of these sectors include pipelines, telecom and power generation.

All three sectors operate in very heavily regulated industries but still face material competition.

Depending on the type of pipeline (i.e., gathering or transport), it faces competition from trucking, rails and other pipeline networks delivering product to competing locations and/or markets.

Wired telecom faces competition from wireless solutions and power generation faces competition from competing fuel sources in a specific geography. Fortunately, all of these businesses utilize long-term contracts to mitigate some of the risks to their cash flow stream.

We own **TransCanada Corp.** (TRP-TSX, \$38.48) and **Brookfield Renewable Power Fund** (BRC.UN-TSX, \$21.68) in **Sentry Infrastructure Fund**. TransCanada's primary business is a North American network of gathering and transport natural gas pipelines. Its business model encompasses connecting producers and their assets with end-use markets. Shippers generally enter into long-term contracts for specific amounts of pipeline capacity at negotiated tolls. This generally results in a highly predictable earnings stream, where the key variable is volumes transported. Based on heating-degree days, industrial production and storage levels, this can usually be predicted with a fair degree of accuracy.

Brookfield's asset base is almost exclusively large North American hydro assets. Long-term power purchase agreements paired off against long-term water-usage rights create a spread-like return pattern for Brookfield. Fluctuating hydrology is mitigated by large water reservoirs, and management owns 34 per cent of the fund.

Most importantly, although Brookfield competes with other power-generation assets for base load power contracts, hydro is one of the lowest cost sources of electric power and is truly renewable. This creates an enduring competitive advantage that ensures Brookfield's assets are well contracted.

The last bucket of infrastructure we look at consists of businesses that earn market returns and are subject to full competition. These businesses generally service companies in the first two buckets and, as such, are really first derivatives of infrastructure. Some of these companies maintain an enduring competitive advantage that replicates the regulated return business experienced by companies in the first two buckets. Railroad, midstream and engineering firms all fall into this category.

Railroads earn market returns against legitimate competition in a heavily regulated industry. In North America, the industry is dominated by six companies: the Canadian duopoly of CN and CP, and the oligopoly in the U.S. of Burlington Northern (purchased by Warren Buffett), CSX, Union Pacific and Norfolk Southern.

These companies generally don't compete with each other but against other methods of long- and intermediate-distance shipping (e.g., marine, air, trucking). However, railroads are an extremely cost-efficient method of shipping and enjoy an enduring competitive advantage over their competitors. In addition, many shippers are actually captive to the local rail carrier with no potential alternatives (e.g., coal, bulk products, wheat). It is highly unlikely that another Class 1 railroad will be built in North America again — it costs approximately \$3 million to build a mile of track — which further limits competition and extends the competitive ad-

vantage of the existing railroads.

Many consumers have their homes heated by natural gas and utilize gas barbecues in the summer. However, raw natural gas must be processed into commercial-grade products before it can be utilized by consumers or companies. Producers are looking for integrated midstream solutions to take the gas from rock formation, to processing plant, to storage, to market.

These solutions often integrate into monopoly networks that may face individual competition from different service providers at different stages of the process, but little competition from similarly integrated solution providers. As new gas assets are unearthed or production ramps up, the throughput on the integrated midstream network increases. Assuming costs and margins remain stable, cash flow and earnings growth should materialize.

We own positions in **Norfolk Southern** (NSC-NYSE, \$63.70) and **Keyera Corp.** (KEY-TSX, \$36.95) in Sentry Infrastructure Fund. Norfolk is one of the most efficiently operated railroads in North America, consistently outperforming its peers. Its rail network spans the entire eastern seaboard of the U.S., tying into every major port, Canada and other competing U.S. rail networks. The diversity of products shipped (e.g., automotive, coal, wheat) makes the company effectively a call option on U.S. economic expansion coming out of a deep recession.

Keyera enjoys monopoly status on approximately 85 per cent of its gathering and processing pipeline network (i.e., no other options for producers but to tie into Keyera's network). This pipeline system feeds into an integrated network of processing plants that purify the gas and strip out valuable natural gas liquids

for resale. The combined business of gathering, processing, storage, transport and NGL marketing creates a compelling value proposition for producers, which creates a significant barrier to entry for competitors. As a result, Keyera has historically generated very predictable total returns with surprise to the upside on volumes, margins and earnings.

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Much has been made about the infrastructure deficit in developed nations and the looming spending to come. However, we find that most of the infrastructure names we look at don't stand to benefit very much from any planned infrastructure spending.

Engineering and construction firms like **SNC-Lavalin Group Inc.** (SNC-TSX, \$56.13), **Genivar Inc.** (GNV-TSX, \$32.70), **Stantec Inc.** (STN-TSX, \$28.20) and **Balfour Beatty PLC** (BBY-LSE, 346.20 GBp) will likely benefit from increased spending on infrastructure projects and that is one of the reasons we own all four names in the fund.

However, many of the other firms will only benefit indirectly if the economy as a whole picks up steam as a result of stimulus spending by governments. Should some of the developed nations turn to asset sales to bridge their budget deficits, then some of these infrastructure companies may benefit from making accretive acquisitions in privatization transactions.

At the end of 2009, according to the Pension Investment Association of Canada, the largest 100 pension plans in Canada had 3.8 per cent of their assets or \$35 billion in-

vested in infrastructure assets. OMERS was the clear leader with 15.7 per cent or \$7.6 billion invested in the sector. Canadian pension plans are looking for long-term assets with predictable and recurring cash flow streams to pair against their long-term, cash liabilities. Infrastructure assets appear to be a perfect match for these large pools of capital and this bodes well for the outlook for this sector.

Canada Pension Plan Investment Board (CPPIB) and Ontario Teachers' Pension Plan (OTPP) have been particularly active in the global infrastructure sector. CPPIB owns assets in the water, telecom and utilities industries, and has made recent acquisitions in the toll-road space (Intoll Group in Australia, which owns 40 per cent of the 407 highway in the GTA). OTPP has concentrated its infrastructure investments in airports, and water companies, and has an investment in publicly traded Northumbrian Water Group in the U.K.

Infrastructure is designed to be a low-growth, stable-return industry. Occasionally, market forces arise that produce outsized returns in the sector, but over the long-term, investors should realize that a regulated-return business will generate its allowed return on equity, or slightly less. The advantage is that these returns should be delivered with volatility below that of the market, given the transparency of the businesses involved and the formulaic nature of their earnings streams. This makes infrastructure, in our view, an excellent addition to the portfolio of retail investors looking to finance their retirement going forward.

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