

# Income Strategy

QUARTERLY COMMENTARY | JUNE 2023



Our global listed infrastructure strategies performed in line with infrastructure benchmarks and underperformed global equities for the quarter.

The combination of peaking interest rates and inflation continues to cause volatility as investors weigh the probability of a recession against reasonably strong economic data, while China is experiencing volatility as its economy reopens post the easing of COVID-19 restrictions.

Inflation continues to moderate, but remains at an elevated level, with recent data showing that economic strength is making it difficult for central banks to loosen policy quickly. Although maintaining a tight position is common across most economies, varying economic circumstances may see monetary policy diverge from this position. Consensus remains divided on recessionary expectations, with the duration and depth of a recession remaining the largest risk to investors.

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## Portfolio Performance

On a regional basis, Latin America was the top contributor to quarterly performance (+0.83%), with Brazilian electric utilities Eletrobras (+0.50%) and CPFL Energia (+0.24%) being the lead performers.

Centrais Elétricas Brasileiras SA (**Eletrobras**) is one of Brazil's largest integrated utilities operating in the generation and transmission segments. Eletrobras saw a rebound in share price as the chances of re-nationalisation now appear increasingly unlikely. This will allow Eletrobras to continue as a private company and give them the chance to deliver on their lucrative turnaround plans.

CPFL Energia is one of Brazil's largest distribution and generation companies, with a 13% market share in distribution and a 3% market share in generation. CPFL's distribution assets include eight separate federally regulated concessions and generation assets consisting of a mix of hydro and renewable assets that are underpinned by long-term take-or-pay contracts. CPFL saw favourable tariff reviews granted by the regulator this quarter and was a beneficiary of a general market rebound in Brazil.

Turning to Asia Pacific, Japanese rail operator West Japan Railway (+0.33%) also contributed to quarterly performance.

West Japan Railway (**JR West**) is one of Japan's largest passenger railway operators. JR West operates the Shinkansen high-speed rail lines near Kansai, as well as commuter trains within the Osaka metropolitan network. JR West's share price rallied with Japan reopening their borders post COVID-19.

Portuguese renewables utility Energias de Portugal (-0.42%) and U.K. water company Pennon (-0.43%) were the largest detractors from quarterly performance.

Energias de Portugal (**EDP**) is an integrated utility based in Iberia, operating electricity distribution, generation and energy supply businesses. It has a growing exposure to global renewables, through its 83% owned subsidiary EDPR, which is primarily onshore wind farms. EDP also operates electricity distribution and generation businesses in Brazil through its 50% owned EDP Brasil. EDP's share price was dragged down by weakened global renewables sentiment, which affected EDPR's performance and in turn EDP, which has about two-thirds of its value coming from EDPR. In addition, drought across Portugal in April and May caused concerns over power output for EDP's hydropower plants there. We view these factors as transient and remain confident in the longer-term fundamentals of the company, being a meaningful player in the clean energy sector which is undergoing structural growth through decarbonisation. Valuation remains attractive at current levels.

Pennon (**PNN**) is a U.K. water and waste services company comprising two wholly owned water utilities: South West Water (SWW) and Bournemouth Water. PNN pulled back primarily on the back of rising bond yields in the U.K., which impacted the performance of regulated utilities. This was accompanied by rising concerns of political and regulatory scrutiny on the U.K. water sector regarding sewage overflows and pollution, which was aggravated by the financial collapse of its unlisted sector peer ,Thames Water. PNN, in particular, faced more uncertainties around the ongoing investigations by Ofwat and the Environmental Agency on pollution issues with unclear timelines, as well as a new investigation by Ofwat on data accuracy.

All returns are in local currency.



## Positioning and Outlook

On a regional level, the strategy's largest exposure is in the U.S. and Canada (44%), consisting of exposure to regulated and contracted utilities (30%) and economically sensitive user pays infrastructure (14%).

For the **Global Infrastructure Income Strategy**, the primary quantitative tool in portfolio construction is excess return, on which our stock-ranking system is based. The Global Infrastructure Income Strategy also uses yield quality as a secondary measure. As such, driven by valuation, the Investment Committee initiated positions in U.S. electric utility NextEra Energy and Italian electric utility Enel. Similar to Iberdrola (its Spanish integrated utility peer), Enel operates both regulated electricity networks (primarily in Italy and Spain, but also in Latin America) and a renewables portfolio, which is expected to grow by nearly 13 GW over the next 3 years to a total of 63 GW in operating capacity. Enel is a strong creditor, with a BBB+ balance sheet, which will be further strengthened through an asset rotation strategy where Enel is looking to monetise their Peruvian and Argentinian utility businesses.

The strategy also used the opportunity to crystallise some gains by exiting the U.S. renewables utility Clearway Energy and U.S. gas utility Southwest Gas. For Clearway Energy we saw increased levels of capital markets risk which impacts the stocks cost of capital, and we exited Southwest Gas as our initial excess return expectations are no longer realistic given some of value-destructive actions by management, including the sale of their Mountain West Pipeline for an unattractive valuation, and subsequent equity raise to de-lever the balance sheet.

## Quarterly Stock Highlight

This quarter we review Spanish toll road operator Ferrovial.

Ferrovial operates and develops toll road concessions and airports globally.

Over 75% of Ferrovial's equity value is attributable to the U.S. managed lanes business and its stake in the 407 ETR (**Express Toll Route**) in Toronto, Canada. Additionally, Ferrovial has a 25% stake in London's Heathrow Airport as well as a pipeline of airport and toll road development projects that it develops via its construction division.

Ferrovial owns high-quality, long-duration infrastructure assets predominantly within well developed economies with robust legal regimes.

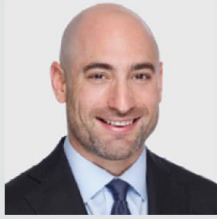
The key components to our investment thesis are:

- Ferrovial is the largest minority shareholder of high-quality infrastructure assets such as the Canadian 407 Express Toll Road and Heathrow Airport. These assets represent the bulk of value. However, given these are minority holdings, financial statements are dominated by non-infrastructure construction and services divisions, which we believe causes the market to undervalue the total business.
- Non-infrastructure businesses have underperformed over recent years, driving Ferrovial share price weakness, despite being a small part of its overall value. We expect the non-infrastructure components of the business to improve over time and the value of the core infrastructure assets to be better reflected in share prices.
- Increasing managed lanes business is expected to account for a higher proportion of earnings over time (aided by weak non-infrastructure), but is unlikely sufficient to mitigate the impact of non-infrastructure earnings on share prices. Over the next two years we expect Ferrovial's dividend to be fully covered by infrastructure.
- Capital allocation remains a key risk. Ferrovial's strategy is to rotate assets into high-complexity concessions. Ferrovial have a chequered history of M&A (albeit there have been management changes). This may also result in the sale of existing high-quality infrastructure businesses.

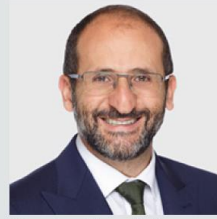
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