LEGG MASON
GLOBAL ASSET MANAGEMENT
RARE

Listed infrastructure and rising bond yields

The current environment: June 2018

Executive summary

- Over the last 6 months listed infrastructure has been one of the more volatile sectors of the market, lagging broader equities.
- As we see it, this was driven by three key factors: 1) rising bond yields, 2) weaker global growth expectations, and 3) regulatory/politically driven volatility.
- However, our view is that sentiment has caused much of this price impact, and that such sentiment does not reflect the long-term fundamentals of infrastructure stocks.
- As such, we believe this pullback has provided attractive valuations and an opportunity to capture mispricing.

Equity market sell-off and infrastructure

The equity market sell-off during the first few months of the year had an unusually large impact on the performance of listed infrastructure, including the Legg Mason RARE Infrastructure Value Fund, the Legg Mason IF RARE Global Infrastructure Income Fund, as well as the common listed infrastructure indices (such as the FTSE Global Infrastructure 50/50 Index) , which all weakened compared to broader equity markets.

The simplistic explanation of performance for the listed infrastructure sector is to attribute the movements solely to the impact of rising bond yields. However, while there is no doubt that rising bond yields had an impact, it is not the only factor.

In the accompanying paper entitled '**Listed Infrastructure and Rising Bond Yields – The impact on price vs. valuation**', we examine how rising bond yields can 1) have a different impact on the **fundamental valuation** and **market price** of regulated utilities and user-pay infrastructure and; 2) how from a portfolio construction point of view, an in-depth understanding of these differences enables an active, benchmark-agnostic manager to navigate through the economic cycles.

Impact of Structural Bond Yield Rise on Listed Infrastructure – Fundamental Valuation vs Market Price

	Regulated Utilities	User-Pay Infrastructure
Fundamental Valuation	Bond yield rises passed through at the next regulatory review/reset. Increase in cash flows are offset by an increase in discount rates, as such, there is a neutral impact to value.	**Inflation-driven bond yield rises** should pass through to cash flows which will offset the increase in the discount rate and has a neutral impact on valuation. **GDP-driven bond yield rises** result in no change in cash flows. However, a rise in the discount rate has a negative impact on value.
Market Price	A Utility's dividend yield appears less attractive relative to bond yields. As a result, the stock initially sells-off. The impact of this sell-off is more noticeable among defensive utilities than growth utilities.	If real bond yields rise because the economy is performing well then usage, namely traffic, passenger, carloads, volumes, etc. increases. As such, post a rate rise, the share price initially rises.

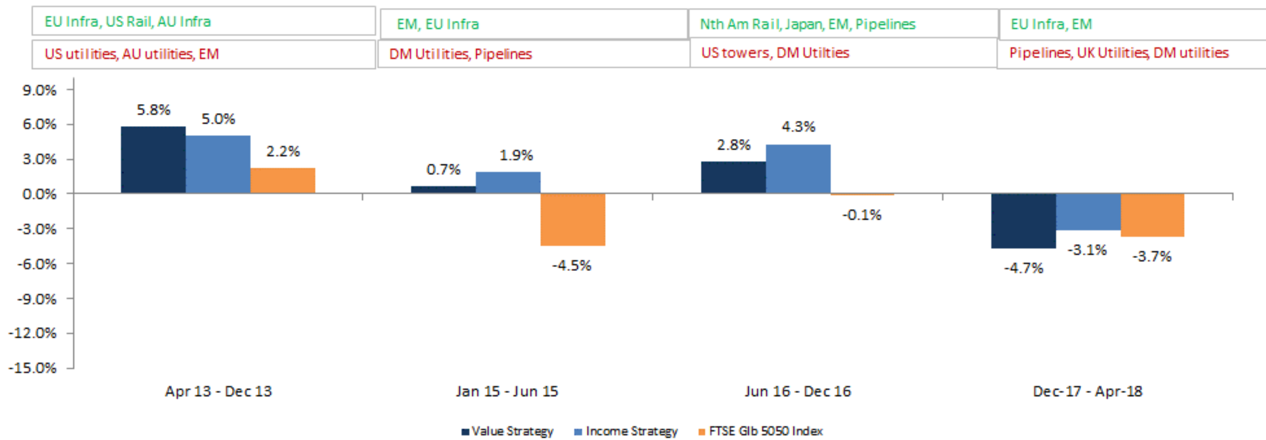
The value of investment and the income from them may go down as well as up and you may not get back the amount you originally invested.

Source: RARE Infrastructure

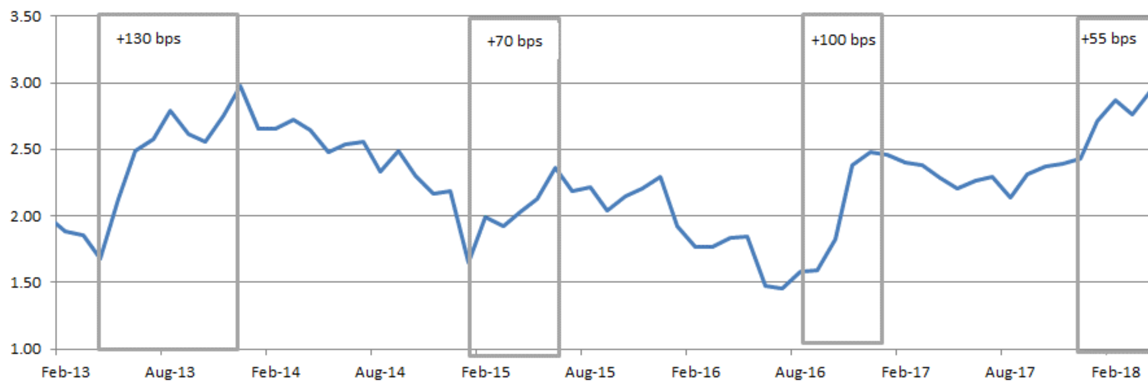
There have been four significant periods of rapidly rising bond yields in the last five years. The performance of the RARE Infrastructure Income and Value strategies and a reference to broader global infrastructure markets using the FTSE Global Infrastructure 50/50 Index are shown in the graph below.

Two key points are evident: 1) that rising bond yields do not always correspond to periods of weak performance; and 2) consistent with expectations outlined above, utilities are generally represented amongst the weaker names, while user-pays infrastructure are generally the top performers (driven more by sentiment than fundamental valuation).

Increasing US 10-year Bond Yield vs RARE *Strategy Performance (ex-CCY)



US 10-year Bond Yield



Source: RARE Infrastructure

Past performance is no indicator of future results.

For the last period from December 2017 to April 2018, performance from listed infrastructure was clearly weaker. It is important to understand all the major drivers of recent performance in order to form a considered opinion on whether they will continue to impact the asset class and establish expectations from here.

We believe that three key factors have contributed to this sharp pullback: 1) Rising bond yields, 2) Weaker global growth expectations, 3) Regulatory and politically driven volatility.

*There may be differences between the strategy composite and the Legg Mason RARE Infrastructure Value Fund and the Legg Mason Rare Legg Mason IF RARE Global Infrastructure Income Fund including differences in the amount of assets under management, cash flows, fees and expenses, and applicable regulatory requirements, including investment and borrowing restrictions. The past performance and allocations of the strategy composite may not be indicative of the Legg Mason RARE Infrastructure Value Fund over the same period.

1) Impact of Rising Bond Yields

During the period December 2017 to April 2018 bond yields (specifically, 10-year treasury yields) broke out of the typical trading range from the last five years and moved sharply above the ~250bps mark, jumping by almost +50bps during the three months from December to February. Although yields continued to rise (eventually passing 3% during April) the market stabilised during March and bounced strongly during April.

These two distinct periods while bond yields were rising produced very different outcomes. This is summarised in the table below:

	December 2017 to February 2018	March 2018 to April 2018
Legg Mason IF RARE Global Infrastructure Income Fund X Dist (GBP)	-7.3%	1.9%
Legg Mason RARE Infrastructure Value Fund - P Acc (EUR)	-8.5%	2.7%

Past performance is no indicator of future results.
Currency exchange rate fluctuations may impact the value of your investment.

Source: Legg Mason as at 30 April 2018 for Class X Distributing in GBP and Class P Distributing in EUR. Performance is calculated on a NAV to NAV basis, with net income reinvested and after deduction of annual fund expenses

Rolling 12-month performance as at 30 April 2018	01/05/2017 30/04/2018	01/05/2016 30/04/2017	01/05/2015 30/04/2016	01/05/2014 30/04/2015	01/05/2013 30/04/2014
Legg Mason IF RARE Global Infrastructure Income Fund - Cl X Dist (GBP)[1]	-4.4%	-	-	-	-
Legg Mason RARE Infrastructure Value Fund - P Class Acc. (EUR)[2]	-7.6%	13.8%	-8.7%	33.6%	0.7%

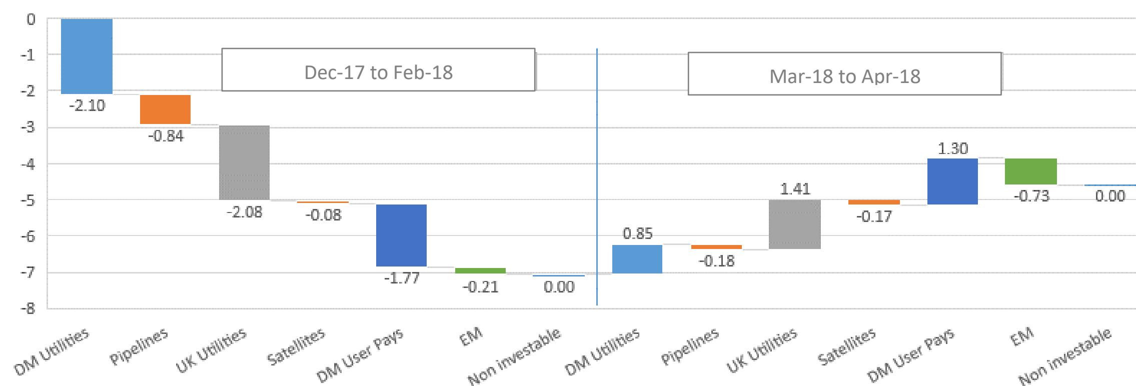
Past performance is not a reliable indicator of future results
Currency exchange rate fluctuations may impact the value of your investment.

[1] Source: Legg Mason as at 30 April 2018 for Class X Distributing in GBP. Performance is calculated on a NAV to NAV basis, with net income reinvested and after deduction of annual fund expenses.

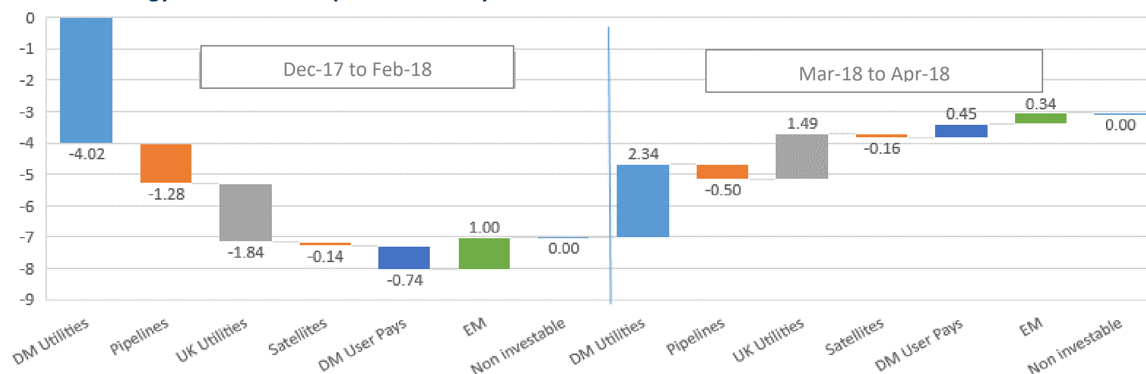
[2] Source: Legg Mason as at 30 April 2018. Performance is calculated on a NAV to NAV basis, with net income reinvested and after deduction of annual fund expenses. This fund was created from the contribution of all the assets of the no longer existing RARE Infrastructure Value Fund ('the prior fund') established on 26/06/2007, with a substantially similar investment objective and policy. Past performance was calculated using historical performance data of the prior Fund therefore it may not be a reliable indicator of the fund's future performance. The performance data should be used for illustrative purposes only, as performance prior to the Fund's inception date has not been adjusted to reflect the fees of the Fund.

Unlike previous periods, while user-pays sectors and some emerging market names offset some of the declines in utilities, in the recent period these were also mostly negative contributors. This begs the question – what else was impacting listed infrastructure during this time? The chart on the next page shows the contribution to performance during the two distinct periods by "theme".

Value Strategy contribution to performance by "Theme"



Income Strategy contribution to performance by "Theme"



Source: RARE Infrastructure.

Past performance is not a reliable indicator of future results

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Looking in more detail at performance during the challenging December 2017-February 2018 period:

- While the funds were impacted by their Developed Market utilities exposure, the impact was lower than in typical indices, such as the FTSE Global Infrastructure 50/50 Index, due to the lower relative weighting in US utilities in both portfolios.
- The funds also saw their UK utilities exposure detract: Despite having top-of-the-class regulation and pure infrastructure exposure, the market oversold these companies during the three months on concerns of nationalisation, which were mooted by the Leader of the Labour Party, the government's key opposition. We used the period of weakness to increase our exposure, and during March and April these names rebounded strongly.
- Pipelines were a key negative in both periods, not enjoying the rebound seen in the Developed Market and UK utilities during March and April:
  - In March, the U.S. Federal Regulatory Commission (FERC) announced that Master Limited Partnerships (MLPs), a tax-efficient corporate structure popular amongst pipeline companies, would no longer be able to recover an income tax allowance on certain pipeline service contracts
  - Whilst RARE does not invest in MLPs, this still impacted performance of the pipelines. However, we believe that the FERC's decision presents a positive catalyst for the C-corps (such as Enbridge & Williams) to consolidate their MLP entities into their broader corporate structure (which both companies announced in May).
- User-pays assets also sold off during February on volume concerns following fears over global economic growth (resulting from an upside surprise in wage growth, hawkish comments from Fed officials, and weaker-than-expected economic data from the US). This fear was short-lived with most markets (the exception being European Satellites) rebounding in March and April while equity markets lagged.

Given the fundamentals underpinning the share price of these securities remain unchanged, we believe this mispricing presented a good buying opportunity for long-term active investors.

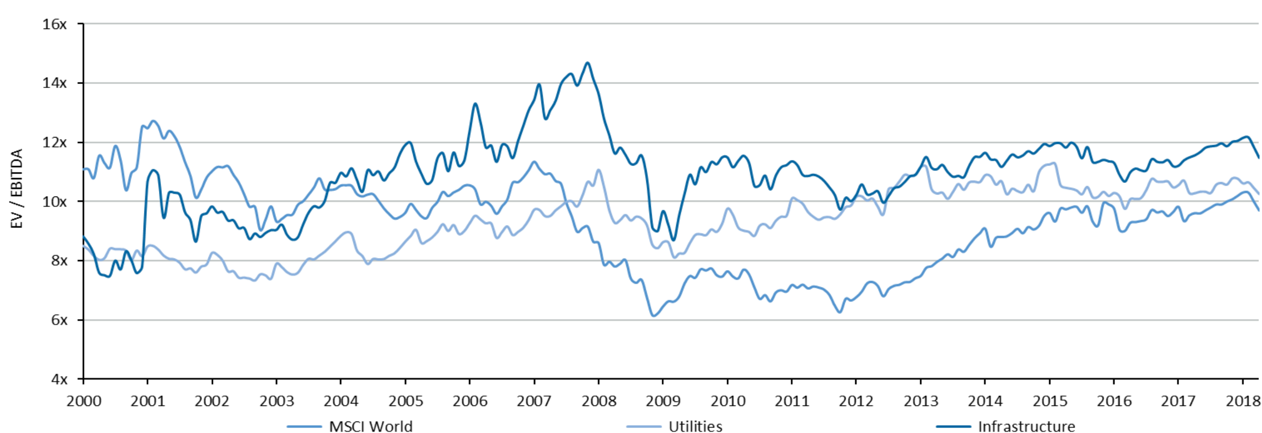
2) Impact of weaker global growth expectations

While bond yields drove a portion of market weakness in the December and January period, growth-sensitive sectors generally performed well, offsetting some declines. However in February, equity markets reacted negatively to expectations that the global economy was starting to grow at a slower pace.

This weaker growth outlook weighed heavily on global equities during February and March as the market grew concerned over forward earnings growth. This concern also weighed on GDP sensitive infrastructure sectors such as user-pays infrastructure (rail, airports, toll roads, ports and telecommunications towers and satellites) causing them to fall at the same time as utilities were impacted from rising bond yields. The chart below demonstrates the "hook down" in the trading multiples for user-pay infrastructure stocks (alongside the fall in utilities) in Q1 2018.

Utility vs Infrastructure consensus EV / EBITDA

EV / EBITDA - Historical trend using FY1 EBITDA



Source: As at 31 March 2018. RARE Infrastructure. Arithmetic average, current EV divided forward consensus EBITDA, EV = Market Cap + Net Debt + Minority Interest and Preferred Stock. Past performance is not a reliable indicator of future results.

The above chart shows Utilities vs User-Pays Infrastructure vs MSCI World Index compared using Enterprise Value (EV)/Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA). This chart shows that utilities have traded at 10 to 11 times earnings since 2012, while in the same time frame multiples for the MSCI World Index have risen from around seven to just over 10 times earnings.

Utilities have maintained their earnings multiple due to new investment – for example among companies that own electricity distribution assets there has been the modernisation of grids in response to the creation of renewable energy production and battery charging stations for electric vehicles.

As we get closer to the end of the current economic cycle, utility companies that are not GDP sensitive in nature and have very predictable earnings growth based on continued investment in their underlying assets, will continue to attract flows (including from generalists), which we believe will lead to outperformance over broader equities.

3) Impact of regulatory and politically driven volatility

Infrastructure, whether listed or unlisted, is always subject to regulatory and political risk. Understanding both is a key aspect of RARE's approach to long-term investing starting from the scoring methodology applied to determine our investable universe. We believe that the need for private sector involvement in the funding of global infrastructure spending for decades to come will underpin attractive allowed returns and a constructive approach by regulators and policymakers, however, shorter-term impacts from real or perceived risks can cause volatility.

We believe investors in listed infrastructure portfolios with a long-term focus and a mandate to be truly active can take advantage of this volatility. The key triggers for volatility we have seen recently were mentioned earlier in this paper:

- Nationalisation fears surrounding UK utilities
- Negative sentiment in the North American Energy Infrastructure sector following the FERC ruling applying to MLPs

RARE took advantage of both events in both the Value and Income portfolios.

While UK utility nationalisation is a low probability, RARE undertook deep analysis on the likely purchase price scenarios should UK Labour win a general election and implement its nationalisation policy. The results showed the sector was mispriced. Expected IRRs were attractive and the trading multiples of Enterprise Value to Regulated Asset Base (EV/RAB) were in the range of 1.0x to 1.05x, levels seen only twice in the last 18 years. RARE increased holdings in both the Value and Income portfolios during March, to c. 13% during March and April 2018.

Similarly, the FERC draft ruling (expected to be finalised in August) will result in non-tax paying entities (generally partnership structures) being unable to collect a tax allowance which caused the sector, including the corporatised entities in RARE's universe (RARE excludes the partnership structures from its universe), to sell off. A key catalyst for the market to re-rate Enbridge and Williams Company is the simplification of their corporate structures, including the "roll-up" of the partnership structures they sponsor. The FERC announcement is actually a positive for Enbridge and Williams, both of which announced roll-up transactions in May. The sector remains volatile however Enbridge is a top holding (and Williams is outside the top 10) in both portfolios with 90% of revenue contracted and guidance that its c.7% dividend will grow by 8-10% pa until the early 2020's.

Alongside this, the portfolios have also been taking profits from Brazil in favour of Asia Pacific Emerging Market companies in anticipation of further volatility leading up to the elections later this year.

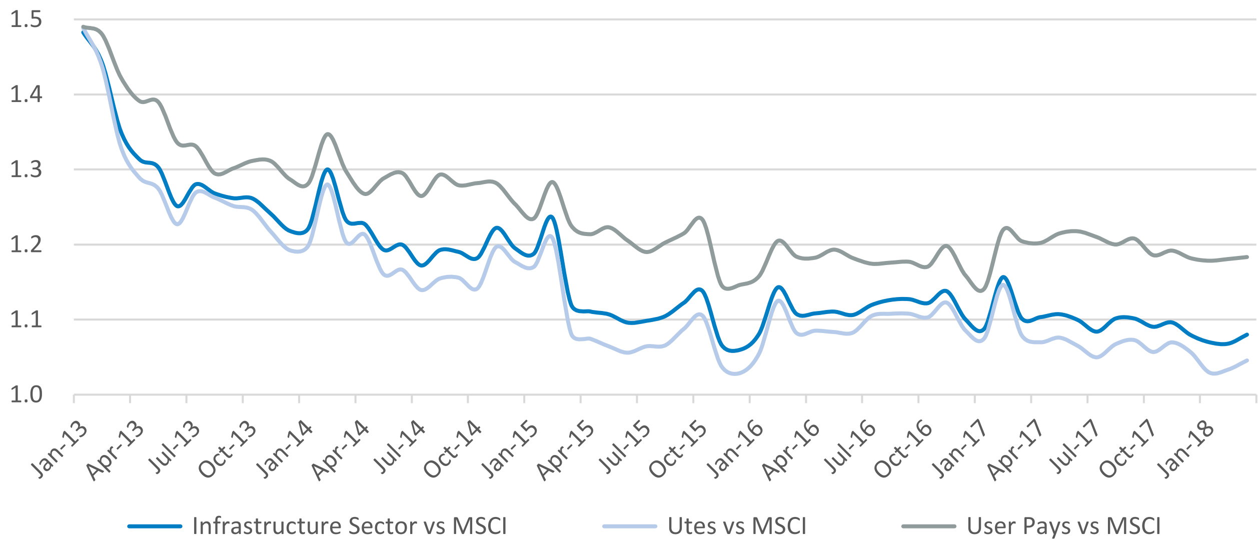
Outlook: The Valuation Opportunity

Notably, while global growth is still robust, there are signs the US is getting later in the business cycle and companies are trading at historically high multiples. A conventional response is to increase bond allocations at the expense of equities however, despite recent rises, bond yields globally are still repressed by quantitative easing. As such, investors are seeing value in reallocating capital towards defensive equities that offer an attractive yield and are attractively priced.

The valuation opportunity in infrastructure stocks can be seen in that their key measures of value, such as EV/EBITA, have fallen in relative terms compared with global equities (as measured by the MSCI World Index).

User Pays Infrastructure, Utility (Utes) and the Infrastructure Sector Multiples relative to MSCI World Index

Rolling 3 month EV/EBITDA – Historical Trend using FY1 EBITDA



Source: RARE Infrastructure

Conclusion

RARE believes that the performance of the infrastructure sector in the December 2017 to February 2018 period was an overreaction by general market investors who value infrastructure companies on shorter-term equity-like measures.

Companies in the infrastructure sector look attractive on a long-term discounted cashflow basis and we took the opportunity to position the portfolio into companies with resilient cash flows and stable dividends. As equity markets began to retreat in March and April global investors again looked to the quality cash flows delivered from our companies and we believe that investors should take this opportunity to take profits from markets that have run higher and rotate more into companies with resilient cash flows as we move further into this economic cycle.

FUND RISKS

Concentrated fund: The fund invests in fewer companies than other funds which invest in shares usually do. This means that the fund does not spread its risk as widely as other funds and will therefore be affected more if an individual company has significant losses.

Derivatives: The use of derivatives can result in greater fluctuations of the fund's value and may cause the fund to lose as much as or more than the amount invested.

Emerging markets investment: The fund may invest in the markets of countries which are smaller, less developed and regulated, and more volatile than the markets of more developed countries.

Fund currency: Changes in exchange rates between the currencies of investments held by the fund and the fund's base currency may negatively affect the value of an investment and any income received from it.

Fund operations: The fund is subject to the risk of loss resulting from inadequate or failed internal processes, people or systems or those of third parties such as those responsible for the custody of its assets, especially to the extent that it invests in developing countries.

Hedging: The fund may use derivatives to reduce the risk of movements in exchange rates between the currency of the investments held by the fund and base currency of the fund itself (hedging). However, hedging transactions can also expose the fund to additional risks, such as the risk that the counterparty to the transaction may not be able to make its payments, which may result in loss to the fund.

Investment in company shares: The fund invests in shares of companies, and the value of these shares can be negatively affected by changes in the company, its industry or the economy in which it operates.

Annual management charge from capital: The fund's annual management charge may be taken from its capital (rather than income). This may adversely affect the fund's overall growth.

Fund currency: Changes in exchange rates between the currencies of investments held by the fund and the fund's base currency may negatively affect the value of an investment and any income received from it.

IMPORTANT INFORMATION

All Information as at 01 June 2018 unless otherwise stated.

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