ALTERNATIVES

The Case for Listed Infrastructure: Strengthening the Foundation for the Global Economy

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The sorry state of US infrastructure was a major talking point during the 2016 US presidential election, and was seen as one of the few areas that could garner bipartisan political support. But certainly, the need for infrastructure is a global issue that can offer a bridge to economic growth—particularly in emerging markets. Here, the Franklin Real Asset Advisors team builds a case for investing in infrastructure-related securities.

Global Listed Infrastructure: A Bridge to the Future

Of all the priorities competing for attention across the globe, the development of infrastructure—the assets, systems and services required for the operation, prosperity and growth of an economy—ranks among the highest.

Infrastructure impacts every aspect of a community, and to the extent these physical assets perform optimally, they enable essential components of a healthy economy, such as fiscal stimulus and job creation, while also contributing to a higher quality of life.

In the United States, the neglect of infrastructure is glaringly apparent. The American Society of Civil Engineers (ASCE), which evaluates both the condition and performance of the nation's infrastructure in the familiar form of a school report card, gave the United States a "D+" overall.

The ASCE also estimated the United States needs to spend $3.3 trillion on infrastructure through 2025, with a funding gap of $1.4 trillion (2016 report "Failure to Act").

Since 1970, public (or governmental) allocations to infrastructure investments have declined markedly in developed economies, dropping from 5.2% to 3.3% of real gross domestic product (GDP), according to data provided by the Organisation for Economic Co-operation and Development (OECD) and Bureau of Economic Analysis.

Meanwhile, emerging markets are projected to demand an increasing share of global resources and will require adequate infrastructure in order to meet population growth, increasing wealth and economic expansion, as well as to keep pace with urbanization trends. We believe these regional demands will provide investors with potential opportunities across the infrastructure spectrum from roads and bridges to water resources, and from power grids to renewables and energy transportation.

In our view, many economic and social themes are converging across the globe in a way that supports the case for capital investment in infrastructure.

After years of disappointing economic growth, global policymakers may again be warming to infrastructure investments as a way to lift economic growth rates, increase economic efficiency and improve their constituents' quality of life. The reality, however, is that residual effects from the 2007-2009 global financial crisis, including slow growth and government deficits, have created a widening gap between what is needed to build and maintain infrastructure and the resources available to fund these projects.

Due to the enormous capital requirements, we anticipate that attracting significant private investment will be essential for policymakers to achieve their goals. We see a significant opportunity for those listed companies that own, manage, construct or finance infrastructure assets and can step in to fill the gap.

Infrastructure Investment Needs Are Extensive

The need for infrastructure development is truly a global phenomenon. Many developed countries need to repair, upgrade or completely replace aging infrastructure, and many emerging countries need to develop new infrastructure to meet the needs of their growing populations, economies and cities. According to the McKinsey Global Institute, an estimated $57 trillion in infrastructure investment will be required just to keep pace with projected global GDP growth by 2030. That's nearly 60% more than the $36 trillion spent over the past 18 years.[1]

More Than $57 Trillion in Total Infrastructure Investment May Be Needed Through 2030

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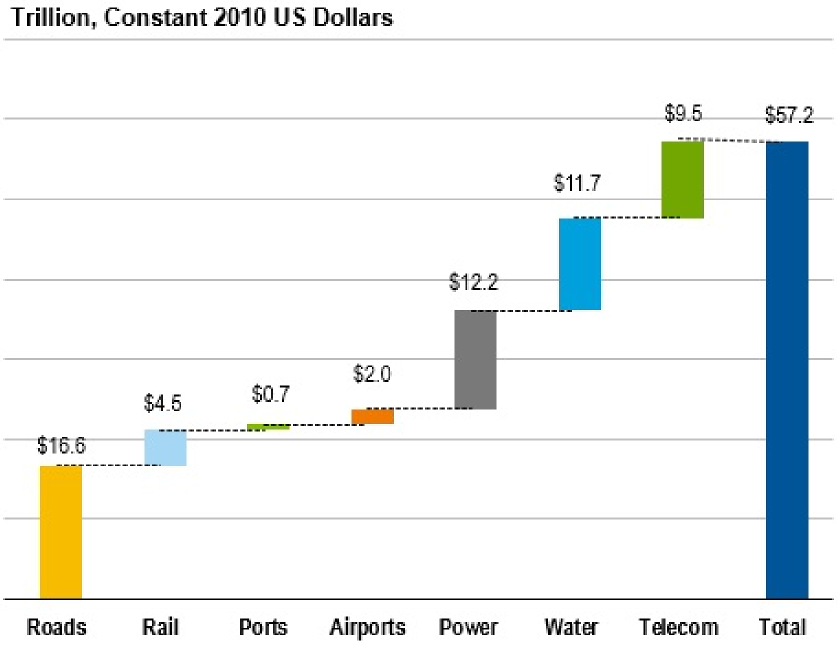
Global Investment Projections: 2013–2030



For illustrative purposes only. Source for Global Investment Projections: McKinsey Global Institute, Infrastructure Productivity: How To Save $1 Trillion a Year, January 2013. OECD telecom estimate covers only OECD members plus Brazil, China and India. Note: Figures may not sum due to rounding. Additional Sources: OECD; IHS Global Insight; International Energy Agency (IEA), 2011; Global Water Intelligence (GWI); McKinsey Global Institute analysis. There is no assurance that any projection, estimate or forecast will be realized. The projected demand by infrastructure segment is based on assumptions which are believed to be reasonable, however actual circumstances will likely vary from the assumptions used and results will likely differ from the projected demand by infrastructure segment shown.

Examples of infrastructure assets include airports, toll roads, ports and rail systems within the transportation sector, essential services like electricity generation from both traditional and renewable power sources, water distribution and wastewater treatment, telecommunication networks, as well as energy transportation and storage.

The development of global listed infrastructure has opened a door to an asset class that was traditionally illiquid and historically the domain of institutional investors. Underlying increased interest in the asset class are global trends that we believe position listed infrastructure for potential long-term growth.

Regional Developments

United States

As one of his core policy initiatives, US President Donald Trump has proposed spending hundreds of billions of dollars on infrastructure. We anticipate highways will almost certainly be one focus. As such, we believe those companies with both construction and operational capabilities will have the greatest advantage.

A lead water crisis in Flint, Michigan, that made headlines last year also underscored the investment needs of US municipal water systems to simply keep them operating safely. Public-private partnerships are already being used in a number of municipal systems, so the model already exists.

Federal support for new municipal water investments could come in the form of loan guarantees and tax incentives, which might not require federal expenditures. The new administration also indicated support for increasing US energy exploration and production, which, if fulfilled, could lead to the creation of new pipeline projects for energy infrastructure companies.

Just as the world's population is evolving, the development of energy resources is also shifting. The Energy Information Administration (EIA) projects that the United States will move from a net importer to net exporter of natural gas in 2017 and a net energy exporter by 2026.

This will be a seismic shift that should have implications for a number of listed infrastructure companies. The regional imbalance between global demand and supply of natural gas and the high capital cost barriers associated with transporting natural gas globally have led to opportunities for companies involved in the development of liquefied natural gas (LNG) export terminals, for instance.

Developed Europe

In Europe, austerity measures continue to limit public sector spending despite the need to upgrade and refurbish existing infrastructure. The UK government, historically one of the world leaders in securing private investment in public infrastructure since its Private Finance Initiative efforts began in the 1990s, is working to attract additional private sector capital for projects under a revised scheme of public-private partnership arrangements.

Emerging Markets

Meanwhile, in many emerging markets, new infrastructure projects are bolstering economic growth, which is helping to further drive demand for increased investment in electricity, water and energy projects, while leading to increased road and airport traffic.

Because infrastructure is vitally important to sustaining economic growth targets, it plays a central role in governmental planning efforts. In Latin America, for instance, the region's ability to access export markets for its abundant natural resources and agriculture production is dependent on the development of new road, rail and seaport infrastructure.

Both of the two largest developing economies, China and India, have ambitious infrastructure plans. Chinese Premier Xi Jinping's "One Belt One Road" program would potentially build and enhance transportation infrastructure to mimic the old Silk Road trade route, while the Ministry of Road Transport and Highways in India has plans to create 20,000 kilometers of new highways over the next five years.

Global Listed Infrastructure: Potential Benefits

More investors seem to be interested in infrastructure as an asset class, and aware of its potential benefits. Foremost among these benefits has been attractive risk and return characteristics during the past five years compared with a number of other asset classes, such as bonds and international equities.

Dividend income is another possible benefit of an allocation to global listed infrastructure. Dividends have accounted for over one-third of the total return of the S&P Global Listed Infrastructure Index in the past 10 years.[2]

The inflation-linked nature of the revenues of infrastructure businesses themselves may contribute to another potential benefit for investors. For example, under a rate-of-return regulatory regime, utility companies may see revenues rise during periods of inflation and rising interest rates.

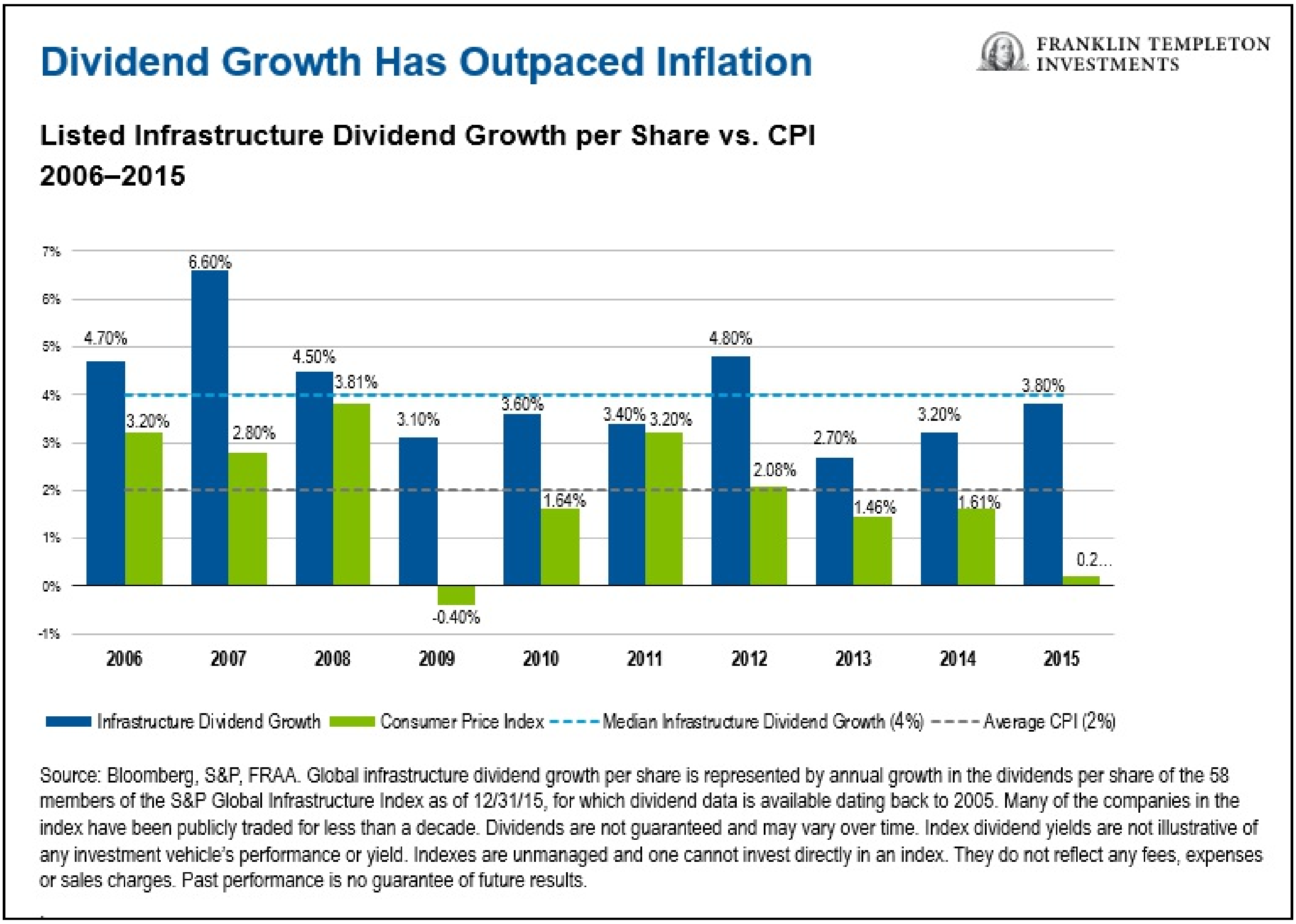
Many companies in other industries are also subject to contractual relationships that contain escalators tied to inflation. In the US energy transportation market, for example, regulated returns for pipelines benefit from annual Producer Price Index (PPI) escalators.[3]

Similarly, a toll-road operator may be permitted to raise toll rates in line with the Consumer Price Index (CPI), or a power purchase agreement that governs the long-term purchase price between a utility and a renewable source of generation may be adjusted annually for inflation.

Operators of those assets that have substantial exposure to GDP growth, such as ports or airports, will also likely see revenues move closely with inflation.

In our view, the most tangible potential benefit for investors as it relates to these inflation linkages is that listed infrastructure companies have historically been in a position to grow dividends at a rate that has exceeded increases in CPI as a result of both inflation linkages as well as new capital investment opportunities.

Financing capital intensive infrastructure investments will require increasing levels of private funding based on revenue generating models, many of which are already well established in different countries.



In our view, investors will need to see positive investment characteristics for the successful capital formation that will be required. These include stable and growing cash distributions, attractive risk and returns and potential diversification.

In sum, we believe listed infrastructure companies will be important sources of capital in order for policy makers to satisfy their economic development goals.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Infrastructure securities will be subject to certain risks including risks associated with the general economic climate, geographic or market concentration, the ability of the operating partners to manage the underlying funds, government regulations, and fluctuations in interest rates. In addition, changes in global economic conditions, as well as conditions of international financial markets, may adversely affect infrastructure securities. In particular, because of the long lead-time between the inception of an infrastructure project and its completion, a well-conceived project may, as a result of changes in investor sentiment, the financial markets, economic, political or other conditions prior to its completion, become an economically unattractive investment. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

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1. Source: McKinsey Global Institute and McKinsey Infrastructure Practice, Infrastructure Productivity: How to Save $1 Trillion a Year (January 2013). There is no assurance that any projection, estimate or forecast will be realized.

2. Source: Morningstar. Dividends are not guaranteed and may vary over time. Indexes are unmanaged and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Past performance is no guarantee of future results.

3. The Producer Price Index (PPI) is a Bureau of Labor Statistics program that measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.