ATLAS INFRASTRUCTURE

UTILISING INFRASTRUCTURE STRATEGIES AS A TOOL FOR MANAGING INFLATION PROTECTION

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The ATLAS portfolio is constructed with an explicit guideline of reducing inflation risk and achieving as close to a full inflation hedge as possible.

We have set out below some of our thoughts of how infrastructure assets protect against inflation in useful ways for investors and why ATLAS continue to believe in the value of this protection, even when headline CPI figures might look benign.

INFRASTRUCTURE: THE HEDGE AGAINST THE INFLATION YOU SEE….AND THE INFLATION YOU DON'T

The Covid pandemic and the unprecedented reaction from Governments in terms of both public and monetary policy poses some unique questions for investors: will this crisis resolve like the last crisis of 2008/9 with a period of QE supressed yields and (suppressed) inflation? Or will the combination of latent demand, high savings levels and broken supply chains lead to a rapid increase in prices?

For many assets in investors' portfolios, this will be the first time that returns have been challenged by a period of high inflation. How will asset prices and returns behave in reality, compared with the quantitative models and theoretical predictions?

ATLAS believes that infrastructure assets can form an important source of inflation protection within investors' portfolios. This is based not just on historic observed returns and correlations (given, as noted above, that there is limited history that includes materially higher inflation), but on the intrinsic asset level regulation and contract structures embedded in Infrastructure companies.

For investors concerned about longer term inflation and the limitations of traditional inflation-linked assets, we believe that infrastructure assets provide a compelling proposition as they represent growth (real) assets with monopoly pricing power.

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MANY INFRASTRUCTURE COMPANIES HAVE CPI INDEXED RETURNS DEFINED BY CONTRACT OR REGULATION

Many infrastructure assets have either concession contracts or regulatory agreements which allow for direct pass through of annual inflation (referenced to a local CPI or RPI index) into prices and sometimes into prices and asset values. This ensures that the real value of the asset(s) is preserved under all inflation outcomes and that the companies do not suffer any inflation lag in earnings and cashflows from rising prices.

This inflation protection is an integral part of the regulatory and social contract of infrastructure assets. Being regulated means that infrastructure asset owners must accept the loss of monopoly pricing power and a limitation on excess profits. In exchange for accepting that capped upside, regulation provides specific protection to investors from loss of value from inflation (and bond rate) changes.

Currently, approximately half of the companies within the ATLAS portfolio have direct inflation pass through to revenues; and the majority of those have inflation pass through to asset base values as well. The major asset exposures are:

- UK, Italy and Australian Utilities – where prices and regulatory asset bases are indexed to inflation on an annual basis;
- Toll roads and Rail (Australia, Europe) - where toll and access charges are indexed to inflation on an annual basis; and
- Renewable energy assets in UK - where the contracted revenue prices are indexed to UK inflation.

BUT CPI INFLATION IS ONLY ONE MEASURE OF INFLATION, AND PERHAPS NOT THE MOST IMPORTANT MEASURE

Whilst direct pass through of CPI is a valuable part of the protection offered by infrastructure assets, it is not the only way that infrastructure assets protect against the impact of inflation on investors' returns. This is because CPI is not the only way to measure inflation.

CPI is an important benchmark and is widely used, yet its relevance to real world outcomes has been challenged over recent years. This will come as no surprise to anyone who has seen headlines about falling inflation for the last 20 years - and then tried to buy a house at 1990s prices.

The CPI measure is only as good as the basket of goods that it includes, and this basket has been increasingly influenced by the impact and development of digital technology. Hence central banks might believe that the cost of living is stable because the rise in house prices and labour costs is offset by the fact that the iPhone 12 has twice as much storage and twice as much bandwidth as the iPhone 10 for the same price; however this is not the price reality that people experience.

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There is evidence that capital cost inflation (the cost of constructing physical objects) has been running consistently higher than headline CPI for a number of years as land costs, construction costs and skilled labour costs have risen faster than other prices in the economy (in the US over 1997 – 2019, average private fixed investment price inflation was 3.6% compared with a CPI of 2.1%).

Since investors are often looking to save for their future retirement needs, we would argue that protecting against capital and labour cost inflation is at least as important as CPI protections and possibly more so.

INFRASTRUCTURE ASSETS EARN RETURNS BASED ON CAPITAL VALUE – WHICH IS DRIVEN BY CAPITAL COST INFLATION

Whereas only a proportion of the ATLAS investment universe has direct CPI pass through embedded in contracts or regulation, the majority of the universe has returns that are contractually linked to the capital value of their assets. This value increases every year with capital spend (capex) and reduces with depreciation.

Simple like-for-like replacement of old assets would mean that the capital value of the company will increase in line with capital cost inflation every year since the cost of new assets (capex) will always be higher than the historic book value of the old assets (depreciation).

We see this most clearly in the regulated asset base values of the US utility sector. Although US regulation does not allow for direct CPI indexation of asset values, new assets are acquired at present cost and old assets taken out at book value. As a result, US regulated asset base values have been increasing at between 4% and 6% for the last 10 years, even as CPI has averaged 1.7% and demand growth has been below 2%.

Therefore, for companies that are consistently replacing and repairing their asset base (such as the majority of utility companies), even without direct CPI pass through, revenues and earnings will reflect capital cost growth over time.

Whilst a number of the companies in the ATLAS portfolio don't enjoy contractual CPI pass through, the majority that don't are protected through having returns based on present capital value, being utilities based in the US, Spain and Portugal.

CONCLUSION: GROWING AND REPLACING ASSETS + MONOPOLY PRICING POWER = REAL INFLATION PROTECTION

ATLAS believes that providing inflation protection is critical to ensuring that client portfolios do not suffer any loss of real purchasing power when compared to the costs of living in the future.

We believe that infrastructure assets are very well suited to providing this protection because:

- assets are constantly renewed and growing at least at the level of capital cost inflation; and
- as monopolies, many of these assets have the pricing power to ensure that they earn at least their real cost of capital on their asset base.

We believe that this will be especially true over the coming years as the divergence between CPI and capital cost inflation has been apparent through the pandemic. Once again, we have seen headline CPI numbers decrease whilst at the same time capital costs have been increasing.

In this context, we believe that investors should consider using infrastructure strategies within their diversified portfolios to protect against inflation – whether or not inflation happens to show up as CPI this time around.

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