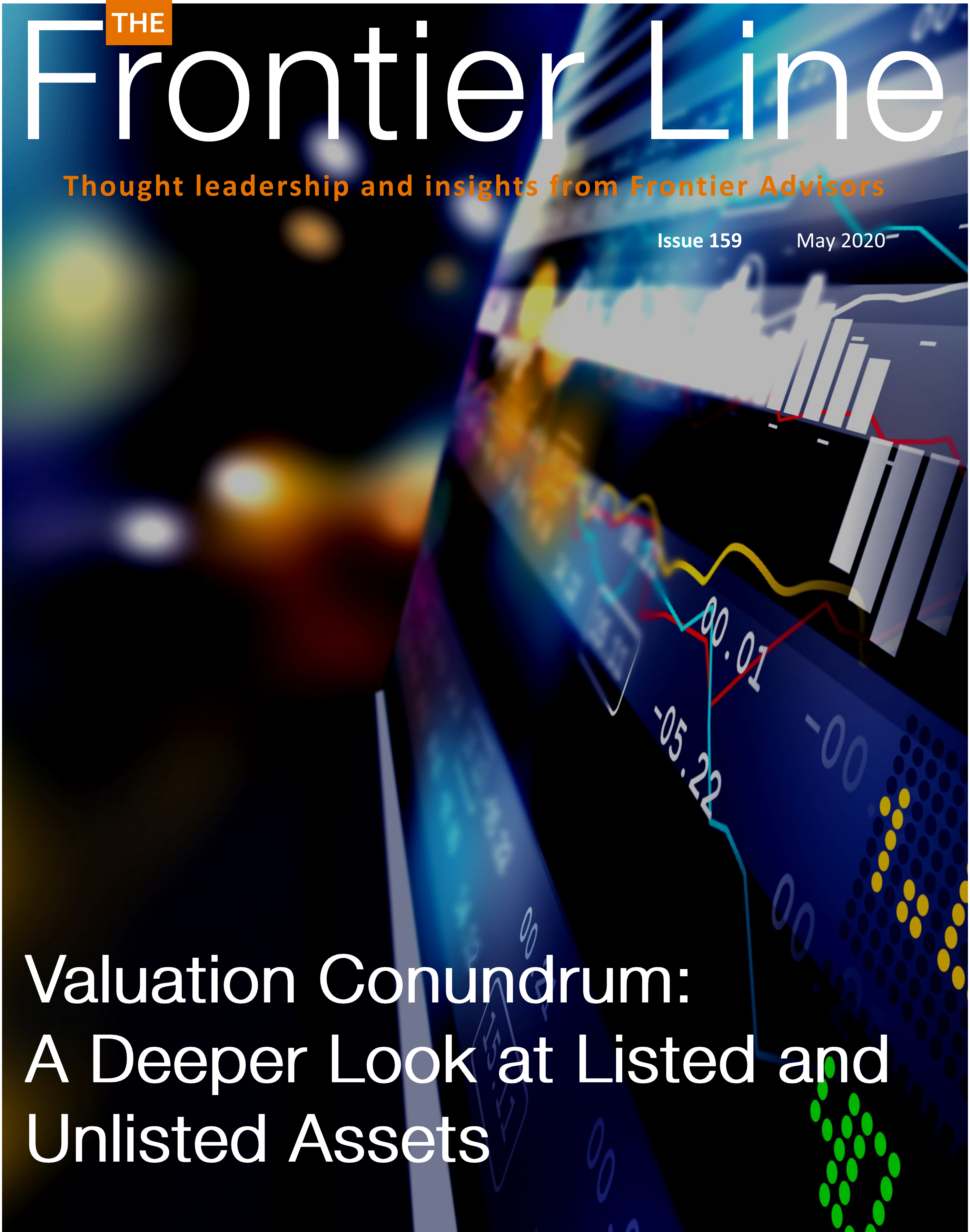

THE

Frontier Line

Thought leadership and insights from Frontier Advisors

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Valuation Conundrum: A Deeper Look at Listed and Unlisted Assets

FRONTIER ADVISORS

25 years

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Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $410b in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Isabelle joined Frontier in 2018 as Head of Real Assets. She leads our research into infrastructure, real estate, agriculture and private equity sectors, and brings over 19 years combined experience in corporate finance and investments. Prior to joining Frontier, Isabelle worked with MENA Infrastructure Fund as an Investment Director in Dubai, HSBC in London in the Power & Utilities team and Babcock & Brown in London/Shanghai and Sydney as an Investment Manager. Earlier in her career she worked at ABN AMRO in mergers and acquisitions and NAB Global Markets. Isabelle holds a Bachelor of Law (Hons) and a Bachelor of Commerce (Hons) from the University of Sydney and was admitted to practice as a legal practitioner in the Supreme Court of NSW in 2003.

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Introduction

Oscar Wilde famously wrote (a cynic) “knows the price of everything and the value of nothing”. When it comes to comparing the performance of listed and unlisted assets, many investors have been mistaken on both counts.

As the coronavirus pandemic has changed the world, valuations of many listed assets have plummeted compared to unlisted assets. It has raised questions about fundamental value and potential mispricing.

A deeper dive suggests there are other factors at play which justify the difference – one which investors can exploit to their advantage.

In this latest edition of The Frontier Line, we take a closer look at the reasons driving the performance of listed and unlisted infrastructure. We also touch on some of the reasons why renewable and social infrastructure asset valuations have held up relatively well thus far during the coronavirus pandemic. Finally, we look at the different valuation approaches of private debt managers.

Key points

- There can be valid reasons why unlisted and listed infrastructure assets are valued differently, including ownership, capital structure, regulations, economic exposure, and competition.
- The performance of listed and unlisted infrastructure indices has been broadly similar over the long term suggesting opportunities for investors to take advantage of mispricing.
- The valuations of renewable power generation and social infrastructure assets such as schools and hospitals have barely been affected by the coronavirus downturn because a large portion of the revenues are contracted regardless of usage level.
- In another asset class, private debt, managers take a variety of valuation approaches and the impact of coronavirus is still playing out.

Why unlisted infrastructure assets are valued differently than listed infrastructure

There are valid reasons why unlisted infrastructure equity has outperformed its listed counterpart as the coronavirus pandemic has swept the world.

The listed FTSE Global Core 50/50 Infrastructure (Hedged) Index dropped 19.3% over the three months to 31 March 2020 as the coronavirus pandemic reshaped the world. However, Frontier's RADIAS Unlisted Infrastructure Index dropped just 4.4% in the same period, a factor which many presumed was a sign that unlisted infrastructure was over-valued.

However, Frontier analysis suggests there are other factors at play.

Listed markets often experience significant short-term volatility but, over the longer term, the average performance of listed and unlisted infrastructure indices is broadly similar (with incrementally higher returns expected in unlisted assets).

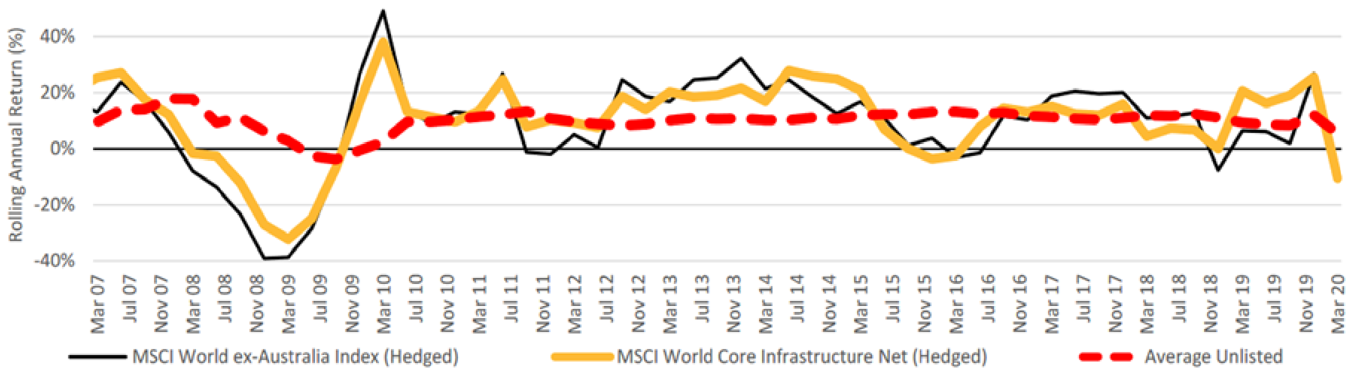
This suggests that listed markets do not always provide a strong indication of short-term fundamental value as short-term market sentiment is more easily reflected in securities that are traded daily.

For example, unlisted airport valuations fell by a modest 12% average in the March quarter compared to the much larger fall of listed Asia Pacific airports of around 39%.

However, unlisted airport valuations have also risen less than listed airports such as Sydney and Auckland in recent years. The larger fall of listed airports through the coronavirus downturn has simply sent their performance back towards the unlisted average.

Similarly, the valuations of listed seaports such as Port Napier and the Port of Tauranga increased significantly over recent years compared to unlisted ports. They also fell further as the coronavirus pandemic swept the world. One factor in this divergence is that unlisted seaports have limited exposure to stevedoring revenues, which are more volatile.

Chart 1: Rolling annual returns (%)



Source: Bloomberg, Frontier's RADIAS
Note: MSCI World Core Infrastructure is used due to its extended performance history. The track record for Frontier's preferred benchmark, the FTSE, begins in 2009.

A diverse range of assets across listed and unlisted sectors

A key reason behind listed and unlisted valuation differences is the nature of the infrastructure assets themselves. The factors that drive valuations vary across the infrastructure sector, which is highly diverse. At the top level, comparing the performance of indices is not a like-for-like proposition. The composition of the listed FTSE index is more strongly weighted towards higher-risk sectors such as power generation and communications assets. The unlisted RADIAS index has a heavier weighting towards lower-risk sectors such as regulated utilities and social infrastructure assets. There is similar diversity in the real estate sector where differences between listed and unlisted valuations exist.

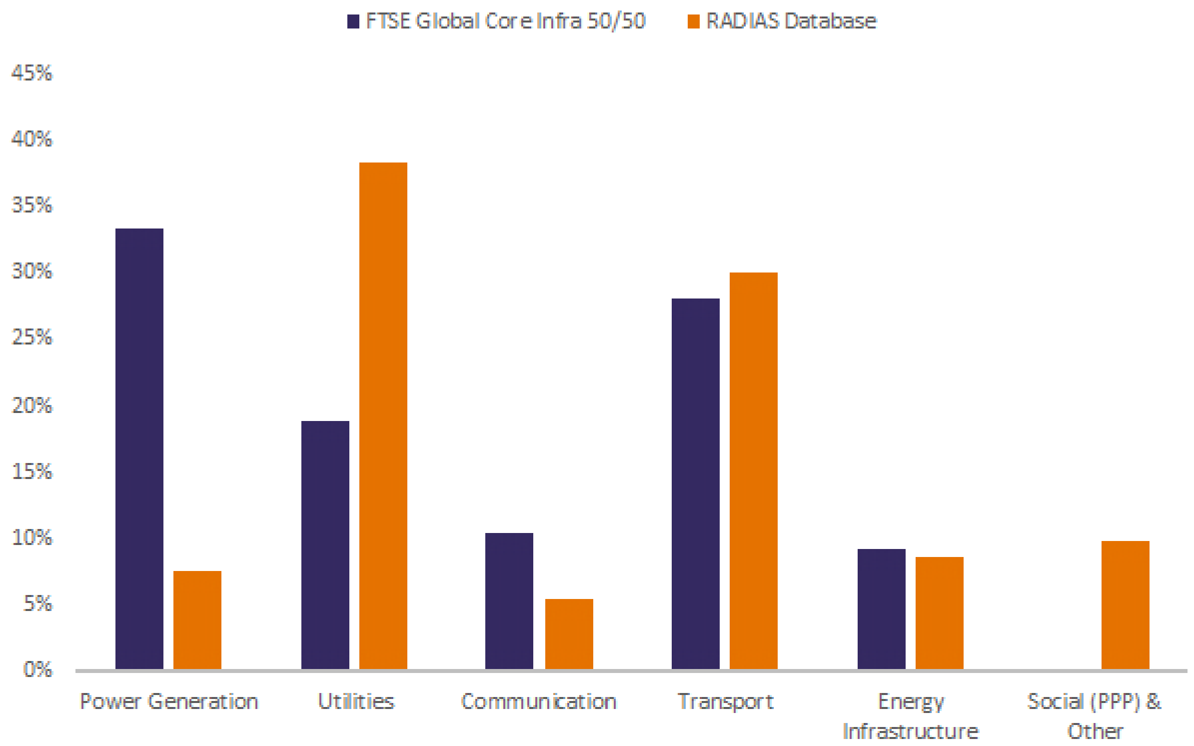
Certain real estate sub-sectors, geographies and certain listed stocks typically trade at perpetual premiums or discounts to net asset value, often prompting M&A activity.

A closer look at specific infrastructure sectors shows the impact of ownership and asset-specific factors on valuations.

These can include operating structure (cost structures, traffic profile), regulatory mechanisms (full regulation or light regulation for airports), economic exposures (drivers of trade for ports), and competition.

For example, Sydney Airport's heavy reliance on overseas traffic means it is likely to be more significantly affected by the coronavirus pandemic because international travel restrictions will remain in place longer than domestic.

Chart 2: Composition of infrastructure benchmarks



Source: FTSE, Frontier's RADIAS

Different owners, capital structures and return objectives affect valuations

Key differences between ownership of listed and unlisted infrastructure assets can also affect valuations.

Listed and unlisted investors may have different objectives, such as short-term yield versus long-term value, which means they value cash flows differently.

The conflicting motives of owners can go deeper. For example, partial government ownership of an infrastructure asset may limit the motivation to maximise shareholder value if those decisions would also cause a political backlash.

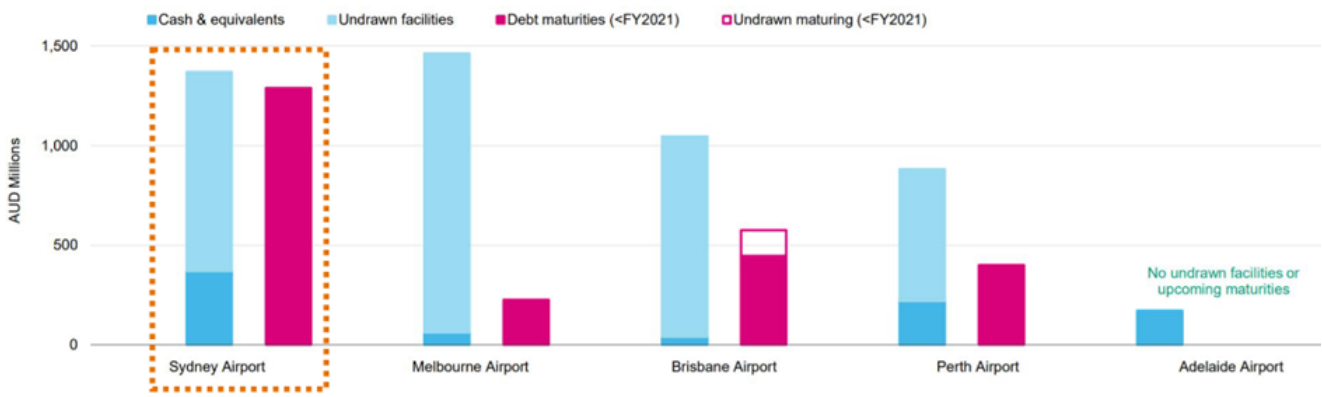
Even regulated energy utilities that predominantly generate revenues without taking volume or price exposure currently face risk to their earnings as political pressure mounts to provide price or bill relief to customers during the pandemic.

Another factor is how the ownership can affect credit risk and the potential for financial distress.

Share prices for listed toll roads have declined 30-40% from peak-to-trough through the crisis, partially driven by balance sheet concerns. Sydney Airport's high leverage (debt/EBITDA of 6.9x in CY19 vs the unlisted average of approximately 5.9x) and near-term refinancing risk is also a factor affecting its relative valuation compared to unlisted peers.

A concentrated pool of private investors such as sovereign wealth or pension funds can find it easier to raise capital for unlisted assets. Moody's has said that unlisted Australian airports benefit from the "likelihood of ownership liquidity support" which reduces the short-term credit risk for very long-term, core infrastructure assets.

Chart 3: Australian airport short-term liquidity (%)



Source: Moody's

Why social infrastructure assets have outperformed during the crisis

Social infrastructure assets such as schools, hospitals, sports stadiums, convention centres and prisons have attracted increasing investment, albeit from a low base, in recent years.

While each asset has its own idiosyncratic characteristics, valuations have not changed materially during the coronavirus pandemic. The average valuation of 30 social infrastructure/public private partnership (PPP) assets monitored by Frontier declined by just 1.4% in the March quarter.

The key reason for this outperformance is that revenues are largely underwritten by state and federal governments, and medium to long-term financing is in place.

Around 90-95% of revenue is paid by governments solely based on having the infrastructure available, regardless of usage level. Only 5-10% of revenue is usage-based, minimising exposure to economic, volume or price risks.

However, there are still risks to be wary of including:

- Assets facing short-term refinancing may be negatively impacted as margins have increased; and
- Lower inflation may have a negative impact on some PPP projects if cashflows are indexed.

Renewable infrastructure asset valuations remain strong

Valuations of renewable investments have also outperformed, with portfolios monitored by Frontier declining by an average of just 0.5% in the March quarter.

The strongest performing renewable investments have been those with long term power purchase agreements (PPAs) for all (or the majority) of their power output.

However, those PPAs can be held with a range of different organisations such as distribution companies, governments, or corporates.

In such an uncertain environment, any changes to those customers' credit quality could affect renewable investment asset valuations.

Greenfield projects could also see construction delays with countries in lockdown and challenges to source materials.

The challenges of valuation: a look at private debt

Valuing unlisted assets is challenging due to the proprietary nature of data and time lag of information. As we have seen, the value of infrastructure assets is determined by multiple factors that can also differ depending on whether those assets are privately or publicly owned.

The negative price impact of coronavirus and the recent oil price shock on public credit markets has been clear but the impact on private debt markets is still playing out. The result will vary by strategy depending on portfolio composition (including sector exposure), diversification level and valuation approach.

The private debt managers reviewed by Frontier take a variety of valuation approaches:

- A combination of marking to market and testing for credit deterioration/impairment to revalue their portfolios.
- Using credit deterioration/impairment as the main driver of valuation (although market pricing movement is taken into consideration).
- Reliance on market benchmarks such as the Credit Suisse leveraged loans index, while others have relied on current market pricing of comparable private debt transactions.

It is likely in some instances that covenant breaches will occur and deal restructuring may be required, however managers are not currently concerned with a material risk of impairment to their portfolios.

The final word..

As coronavirus has swept around the globe, many of the most fundamental assumptions about how we live and work have been overturned. The same is proving true for investment markets. The rules have changed, some temporarily, and others on a more permanent basis.

Valuing assets accurately is a fundamental skill that can reveal investment opportunities.

There are often valid reasons why unlisted and listed infrastructure assets are valued differently over the short term. Over the longer term, the performance of listed and unlisted infrastructure indices tends to reconvene, although we expect unlisted assets to marginally outperform over the very long term.

The valuations of renewable and social infrastructure assets have held up relatively well thus far during the coronavirus pandemic.

The impact of the pandemic on private debt markets is still playing out and the outcomes will likely vary by strategy depending on portfolio composition, sector exposure, diversification level and valuation approach.

Frontier is vigilantly monitoring our clients' investments and the way they are valued as the impact of the coronavirus pandemic continues to evolve.

