Cohen & Steers

In a pandemic, tech infrastructure creates cashflow like a core infrastructure investment

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, *Institutional Investing in Infrastructure,* recently spoke with **Benjamin Morton,** executive vice president, head of global infrastructure, and a senior portfolio manager for Cohen & Steers' infrastructure portfolios, as well as **Christopher Rhine,** senior vice president and head of natural resource equities.

How has listed infrastructure performed in 2020, during this period of structural uncertainties?

Ben Morton: Listed infrastructure has disappointed this year in terms of its performance relative to broader equities. Through July, global listed infrastructure is down around 11 percent, while the MSCI World is down only about 1 percent. Infrastructure subsectors have experienced a wide range of implications from COVID-19 related travel restrictions and the corresponding economic slowdown. About one-third of the infrastructure market has been materially impacted, such as transportation — including airports, toll roads, freight railways and marine ports — and midstream energy. The fundamental impact on the other two-thirds of our investment universe has been much less material. This group encompasses utilities — electric, gas, water and renewable energy — as well as telecommunications infrastructure, which includes businesses that stand to benefit from more persistent work-from-home and school-from-home policies. As a result, infrastructure has delivered bifurcated performance, with transportation and midstream underperforming, and communications infrastructure doing quite well.

Tell us more about the areas that have been impacted the most within your universe.

Morton: Mass transport has been impacted the most, with airports at the top of that list. There has been a pretty significant impact from travel restrictions, whether mandated by governments or due to consumers voluntarily making changes in response to COVID-19. Passenger traffic through airports is down over 95 percent in almost every listed airport around the world, hitting bottom in March and April. We have seen a little resumption of activity there, but we are still down 85 percent on average, which is delivering a big hit to aeronautical revenues for these companies. They also receive a significant portion of their revenues from retail, restaurants and other non-aeronautical operations at airports, which have also been significantly impacted by the decline in passengers traveling. Much of the transportation universe is likely to recover to pre-COVID passenger and freight volumes over time. However, we believe behavioral changes around business and leisure travel could have a lasting impact on airports.

Conversely, what businesses perform the best with everything that is going on?

Chris Rhine: Within infrastructure, the strongest businesses have been cell towers and data centers. These companies provide the core infrastructure necessary for digital communication. Even before coronavirus, these sectors were benefiting from strong growth trends, as many organizations and governments were already moving to build out digital platforms and looking to utilize 5G due to the potential economic advantages for first movers. The coronavirus has accelerated this trend, with people working from home but still able to access critical software and systems necessary to do their jobs. Tower companies are up 18 percent year to date through July, while data centers are up 34 percent. Investors are analyzing the growth potential of these markets and many are recognizing that working from home is likely to stay elevated post-COVID. We think that that is going to continue to increase demand for cloud-based solutions and telecommunications infrastructure.

Do you see any other dislocations today across the infrastructure universe?

Morton: U.S. utilities have significantly underperformed the S&P 500 year to date, which seems to us like a big dislocation considering that utility business fundamentals have been less impacted by the coronavirus. We are seeing a reduction in industrial and commercial usage, but much of that is offset by two things: (1) residential usage has increased, which is expected with families spending more time at home, and (2) residential margins are much higher than commercial and industrial margins. So on balance, there has only been a modestly negative revenue impact to utilities. Utilities also benefit from regulatory mechanisms designed to protect essential service providers in times like this. For example, many U.S. states have decoupling mechanisms: If electricity consumption is lower than projected, utility companies are allowed to raise rates. This also works in the other direction when consumption is higher. However, these mechanisms help to reduce the economic impact on utilities. Meanwhile, growth has been accelerated by state and federal mandates for investment in renewable power (predominantly solar and wind), as well as transmission to connect these new sources of generation to demand centers. We are very positive on the utility growth story over the next several years.

Are you seeing other emerging areas of infrastructure?

Rhine: Yes, the technology infrastructure space. As the global economy becomes more digitized, the race to 5G has become a big political issue. Tech services are increasingly considered essential, and one of the key characteristics of any infrastructure company is to provide an essential service to consumers or businesses. During the pandemic, many people are relying on online retailers such as Amazon getting you products you need. You need cloud-based software to connect to work and schools. Sales teams need access to their client databases to make sure they have up-to-date information. Many of the companies providing this software have subscription contracts, which create recurring cashflows similar to the defensive characteristics of what we see in infrastructure companies. They tend to be resistant to economic downturns and have high barriers to entry. You could almost argue that they have monopoly-like characteristics due to the expense and time for new competitors to get into that market. These attributes are similar to what we typically see in a core infrastructure universe. Over the next decade, we believe the secular growth driving this build-out of digital infrastructure will continue. In addition to increasing work from home, there will be a shift toward autonomous infrastructure — autonomous vehicles, smart cities, internet-of-things, smart manufacturing. A lot of investment dollars are planned to move into these end markets, which should continue to drive opportunities and substantial growth potential across the infrastructure investable universe.

With the massive increase of data used just in the last four months, followed by a massive push for renewables, do you have any concerns about grid reliability?

Morton: We are talking with utility companies about pockets of strain, although we haven't really seen many reliability issues pop up, which is interesting given the warm summer in many parts of the country. Grid reliability has been a big focus of utility spending over the last 10 years and a driver of growth — so the last thing utilities want is poor reliability, which leads to poor regulatory relationships and poor regulatory outcomes. All of this comes with a cost, meaning the cost to customers has to go up if you are investing in new generation sources such as renewables. Now there is focus on offshore wind along the U.S. East Coast, particularly in the Northeast. There are costs associated with this, so there is the regulatory question: Will these companies continue to be in good favor with regulators in terms of recouping these costs? To me, this is as much of an issue as grid reliability.

How does infrastructure stimulus relate to these trends?

Rhine: As a result of the virus, countries have not been concerned about raising fiscal deficits to try to stimulate growth. By the time this year is over, the global fiscal deficit likely will be at the greatest level in the history of the world, and you have a lot of major GDP regions that are trying to stimulate economic growth to offset the damage done by the virus. Historically, the fastest way to get that money out there would be to put boots on the ground, building and repairing roads, bridges or some kind of a physical structure. We expect a lot of infrastructure spending will do just that, and we are going to see capital flow there. But that portion of the pie, which used to be nearly 100 percent, is going to be shrinking and creating more room for both renewables and technology investments. Biden has been talking a lot about his initiatives for infrastructure, including 5G and renewables. The European Central Bank has recently spoken about possibly changing operations to fight against climate change and buy assets linked to renewable or green companies. And in March, China launched a new infrastructure campaign to boost growth and innovation — not just focused on roads and highways, but also data centers, 5G networks and internet-of-things. While the stimulus money will still support inner-city transportation and rail systems, there has been a noticeable shift to different types of infrastructure, increasingly on the digital side.

CONTRIBUTORS

Benjamin Morton, executive vice president, is head of global infrastructure and a senior portfolio manager for Cohen & Steers' infrastructure portfolios. He has 21 years of infrastructure-related investment experience.

Christopher Rhine, senior vice president, is a portfolio manager for the firm's digital infrastructure strategy. He has 17 years of investment experience.

CORPORATE OVERVIEW

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