Trip Insights

The US

July 2024

With ongoing political and macroeconomic uncertainty in the US, exacerbated by the federal election being held later in November, 4D visited the US to understand what fundamental impact these had on infrastructure earnings and how management teams were navigating the uncertain waters.

Despite some challenges, infrastructure investment is absolutely needed across the US. This investment should support consistent, predictable earnings growth for investors over the long term. The defensive qualities of infrastructure should also be increasingly favoured by investors, should the US experience financial difficulty and weak (or negative) growth.

This is the 16th in our series of *Trip Insights* where we share our travel experiences. It follows Peter Aquilina, Portfolio Manager - Sustainability, as he travels through San Diego, Houston, Tulsa, Los Angeles, West Palm Beach, New York and New Jersey, meeting with management teams from tower communication companies, oil/gas midstream companies and regulated utilities.

In this piece, we highlight some interesting themes and observations from the trip that support our views on the region.

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Trip agenda

Investor meetings included the following companies / regulators:

Company	Sector/Topic	Location
Sempra*	Electricity/gas utility	California, US
Cheniere	Midstream energy	Texas, US
CenterPoint Energy	Electricity/gas utility	Texas, US
Oneok	Midstream energy	Oklahoma, US
Williams Co*	Midstream energy	Oklahoma, US
Edison International*	Electricity/gas utility	California, US
SBA Communications	Towers communications	Florida, US
NextEra Energy*	Electricity/gas utility	Florida, US
Dominion Energy*	Electricity/gas utility	New York, US
Portland General Electric	Electricity/gas utility	New York, US
WEC Energy*	Electricity/gas utility	New York, US
American Electric Power*	Electricity/gas utility	New York, US
Algonquin	Utility & contacted renewables	New York, US
DT Midstream	Midstream energy	New York, US
Entergy Corp	Electricity/gas utility	New York, US
SJW Group	Water utility	New York, US
Xcel Energy	Electricity/gas utility	New York, US
American Water Company*	Water utility	New Jersey, US
Public Service Enterprise Group	Electricity/gas utility	New Jersey, US
Wolfe analysts	Electricity/gas utility	New York, US
RBC analyst	Electricity/gas utility	New York, US
BMO analyst	Electricity/gas utility	New York, US
Wells Fargo analyst	Towers communication	New York, US

** Represents a portfolio holding*

Politics

The upcoming presidential election dominated media headlines while visiting the US, with the November contest expected to be very tight. Anecdotal conversations indicated that domestic concerns mirrored international concerns, including:

- the ability of President Biden to complete another four-year term given his perceived deteriorating mental capacity, and
- concerns from moderates as to the intentions of Donald Trump if he were to win a second, and final, term in office, given his refusal to accept the official results of the previous election, and support of and for autocratic leaders.

Policy differences

The leadership of Biden vs Trump couldn't be more polarising in their approaches to diplomacy, as well as their policy prerogatives. While Biden and the Democrats are focused on implementing the energy transition, increasing regulation of the technology and finance industries, and supporting conditions of lower income and working-class people (including continued support of the Affordable Care Act), Trump is focused on supporting the exploration and production of traditional fossil fuels, reducing regulation and red tape, and extending the 2017 tax cuts he implemented in his first term. Their competing policies are summarised below.

U.S. election policy proposals–what might we expect?
Potential stances on key issues

Key issues	Potential Biden stance	Potential Trump stance
Taxes	Possible partial extension of 2017 tax cuts. Greater chance of higher taxes on wealthy individuals and corporations.	Aim to extend 2017 tax cuts with partial offsets from reduced government spending.
Tariffs	Continuation of tough on China status quo.	Intend to increase tariffs on trading partners, especially China.
Defense	Likely steady emphasis on alliances and multilateralism.	Potential push for more self-reliance from NATO members.
Energy	Aim to reduce emissions and increase energy efficiency. Raise taxes on the fossil fuel industry.	Aim to increase traditional energy production by drilling on federal land and extending pipelines.
Healthcare	Aim to protect and build on Affordable Care Act.	Aim to undo Affordable Care Act.
Regulation	Heightened regulation of energy, technology and financial services.	Aim to reduce regulation of energy and financial services.

Source: Tax Foundation; JP Morgan (as of 30 April 2024)

Of the above issues, some are particularly relevant to the infrastructure investment proposition:

Taxes – Trump's Tax Cuts & Jobs Act (TCJA) of 2018 reduced the corporate tax rate to 21%, reduced tax rates of all individual income tax brackets (significantly supporting highest income earners), and cut the lifetime estate/gift tax exemption in half. The reductions are scheduled to expire in 2025, but it's widely believed both candidates would look to extend them to some degree, putting upward pressure on budget deficits and inflation. Biden is expected to extend some form of tax cuts, but probably not the current state of affairs. It's expected that Trump will be particularly supportive of extending the full suite of tax reductions.

Tariffs – Biden is likely to maintain tariffs on select Chinese goods and support onshoring of manufacturing back to the US. Trump has communicated the potential for a universal tariff of 10% on all imports, and 60% on Chinese goods. The economic impacts of this could cause stagflation for the US economy[1].

Energy – Trump has communicated that he intends to repeal Biden's Inflation Reduction Act (IRA) which supports renewables, cleaner/green energy sources, and Electric Vehicles (EVs) through tax credits. Commentators suggest he may only repeal the support for EVs from the bill. He has also communicated the intention to support drilling for traditional fossil fuels in oil/gas, potentially through Federally streamlining the permitting process for drilling and pipeline development. This move could be detrimental to operators investing in the energy transition (utility sector).

Foreign policy

Biden and Trump are quite divergent on their views on geopolitics. Areas where they are aligned include a continued hard line against China and support for Israel in the Middle East, although their approaches to these particular issues are divergent.

If he wins a further term in the White House, Biden and the Democrats are likely to continue to support the Ukraine and European allies in NATO against Russian aggression. He is likely to pursue unilateral relationships with Western Europe and other international institutions in implementing his foreign policy directives.

Trump, by contrast, has communicated an admiration for Russian President Putin. If he is to win a second term as president, it's likely that he will continue his aggressive stance to NATO partners to take on more of the funding burden. At a stretch, there is the potential that Trump looks to exit the US from the NATO alliance, although there are questions as to whether he has the legal or legislative power to do so without the support of Congress.

The presidential debate

The first presidential debate was held on 27 June 2024, a day after we returned from the US. Going into the debate, anecdotal conversations from the trip indicated that voters wanted to assess if Biden could maintain lucidity while under pressure, and whether Trump could control his temper and avoid making grandiose lies or coming across as "repugnant".

Despite Trump's continual use of factually unsupported statements, and some outright falsehoods, the focus of commentators was on Biden's suitability for the role – not for his communicated policy stances, but because he "stammered indecipherably, struggled to complete his lines of attack and proved his doubters completely correct[2]".

It was immediately obvious that the debate was an unmitigated disaster for Biden and the Democrats' re-election chances. Even Biden's ardent supporter, CNN commentator Van Jones, said "[President Biden] didn't do well at all… He's doing the best that he can, but he had a test — to me — tonight to restore confidence of the country and of the base, and he failed to do that. And I think there's a lot of people who are going to want to see him consider taking a different course[3]."

What comes next?

Following Biden's disastrous performance in the debate, the polls further tilted favour towards Trump and, as of 10 July, according to the national polling average[4], Trump lead by 2.3 percentage points over Biden, while the two candidates were just about tied on the day of the debate.

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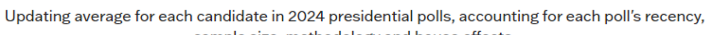
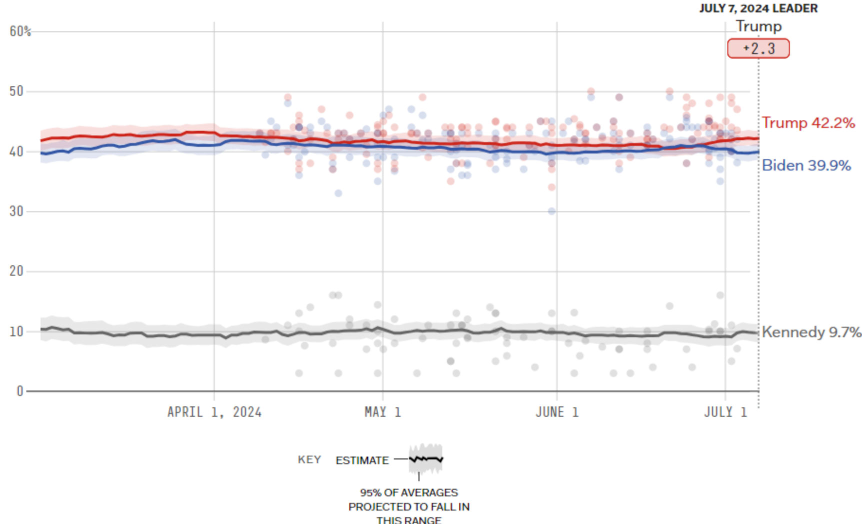
[1] *Can Trump replace income taxes with tariffs?*; Kimberly Clausing and Maurice Obstfeld; Peterson Institute for International Economics; 20/6/2024
[2] *Joe Biden's horrific debate performance casts his entire candidacy into doubt*; The Economist; 28/6/2024
[3] *Van Jones on Biden debate reaction: 'It's not just panic, it's pain'*; Yash Roy; The Hill; 28/6/2024
[4] https://projects.fivethirtyeight.com/polls/president-general/2024/national/





Source: 538 - abc News

Biden spoke at a Democratic rally in North Carolina following the debate at which he acknowledged his poor performance in the debate. Despite this, he passionately reinforced his intention to run for a second term as president in saying "I don't walk as easy as I used to. I don't speak as smoothly as I used to. I don't debate as well as I used to, but ... I know how to tell the truth. I know right from wrong, and I know how to do this job"[5]

It's widely believed that President Biden would have to voluntarily withdraw from the election for an alternative Democrat candidate to be selected. Albeit he has communicated his intention to run for a second term, it's understood some senior Democrats are advising him to withdraw. In terms of timing, for most states, the filing deadline for Democrats to submit their presidential nominee for the general election ballot is between August and September. Alternative Democratic party candidates are being suggested by analysts and the media, which includes Vice President Kamala Harris, California Governor Gavin Newsome, Michigan Governor Gretchin Whitmer, Illinois Governor JB Pritzker, and Transportation Secretary Pete Buttigieg.

At a Republican campaign rally on 13 July in Butler, Pennsylvania, there was an assassination attempt at Trump while he spoke on the podium. As gunshots rang out during the rally, Trump miraculously avoided a direct hit and said a bullet grazed his ear. A 20-year-old man from Pennsylvania, Thomas Matthew Crooks, has been identified as the shooter. He was killed by Secret Service snipers who were watching over the rally. One attendee in the crowd was killed.

Immediately after the shooting, Secret Service agents rushed in, getting on top of Trump and forming a protective cone around him. After being down for about a minute, Trump rose and pumped his fist while his protective detail shielded him. With blood running down his face, he chanted "fight, fight, fight". The symbolism of the moment showed Trump remaining resolute in his quest for presidency. The Conversation reported, "Trump's near-death experience will give his campaign – already based on portraying him as a victim of Democrats and the establishment – renewed energy. The pictures of Trump with blood on his face, raising his fist in defiance after he was shot, are more valuable than hundreds of millions of dollars in campaign ads"[6].

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[5] *Biden addresses poor debate performance, attacks Trump at Raleigh rally*; Michelle Stoddart and Ivan Pereira; abc News; 29/6/2024

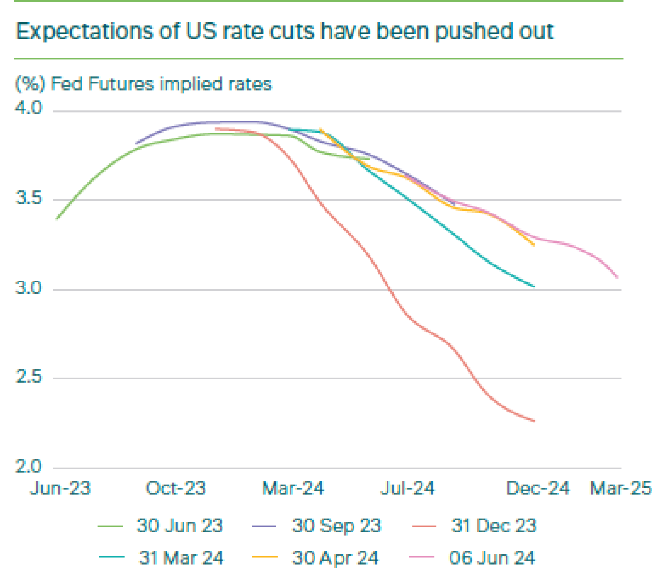
[6] *The Trump assassination attempt has upended the US election race. So, what happens next?*; The Conversation; 15/7/2024

Source: NBC News

Economics

2024 dawned with the market pricing in significant rate cuts throughout the year. In our *2024 outlook* article published in January, we highlighted that “the market had once again got ahead of itself in pricing in such aggressive rate cuts so soon, and there is was a high chance of rate cuts being pushed into the second half of 2024, as central bankers wait for a more sustained period of lower inflation, which should structurally settle higher than pre-pandemic periods.”

In the first half of 2024. inflation, whilst on a downward trajectory, plateaued above the communicated target of the Federal Reserve of 2%. And, as expected, interest rate cut predictions were pushed out from the first half of the year to August/September 2024.



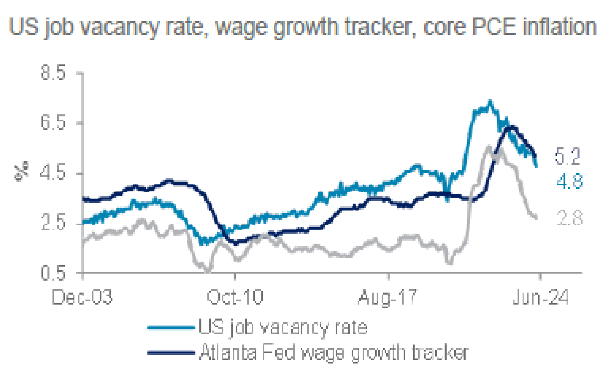
Source: Bloomberg

This initially didn't impact utility company share valuations, but more recently have contributed to poor performance of the utility price index, Utilities Select Sector SPDR Fund (the XLU).

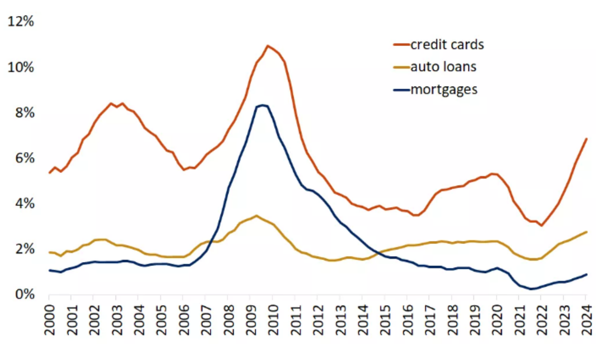
XLU performance for the past 12months to 16 July 2024 – shows improving performance to late May 2024, and a pullback more recently.

Source: FactSet

Despite stickier inflation than was anticipated at the start of the year, and interest cuts being pushed out, recently there have been indicators of a softening job market and increasing credit delinquencies. GDP growth has been hovering at a healthy 3%, but these indicators could be pointing to harder economic times in the US and potentially a recession (markets currently assuming a 50% probability). A cut in interest rates by the Fed could ease financial conditions, but could get ahead of itself, leading to inflation either not reaching the communicated Fed target or increasing again – putting more pressure on consumption.



Source: Standard Chartered



Source: 4D Infrastructure

Fundamentally, in the event of a recession, the defensive qualities of infrastructure companies should result in a rotation from the investor-loved growth stocks (such as the technologically-focused 'magnificent seven'), to more defensive sectors, such as utilities and communication towers. However, should the US experience stagflation rather than a recession, the increase in inflation and interest rates could negatively impact valuations of infrastructure names (through increased discount rates) resulting in a different market reaction.

As outlined above, political policy between Biden and Trump seems to vary widely, although neither candidate's policy is likely to reduce budget deficits, and both are likely to be inflationary. A BlackRock report recently stated, "we track potential changes on US trade, immigration and energy policy – and see a potential

inflation boost no matter who wins[7]". This represents a macro risk to investments and something we are monitoring closely.

The feel for economic conditions while visiting the US was of cautionary optimism. As a traveller from Australia, everything felt very expensive, more so than previous trips, although its US wages have had increased significantly, which has compensated (at least partially) for the increase in domestic prices. People were out spending, but it's unclear if this was to be maintained.

Electricity and gas regulated utilities

Turbo charged load demand

The core message from many electric utility companies was the expectation for strong power load demand growth driven by a combination of factors depending on the state jurisdiction. These include:

- Net population migration inwards (this could obviously be negative for some states),
- Increased manufacturing (especially from tech companies supported by the CHIPS Act),
- Electrification (transport, space heating, and the oil/gas industry),
- Data centre demand and the energy needs of artificial intelligence (AI)

Despite management teams' enthusiasm for load demand, investors were unclear on the impact on the investment proposition of infrastructure companies. The questions centred around – *whether utilities could grow earnings at 4-8% during a period of benign or flat load demand growth, and if load growth is expected to be high single digits, then shouldn't we expect much higher earnings growth?* The resounding feedback from utility management teams was – <u>increased load demand growth is expected to support the investment proposition of utilities, not change it.</u>

Regarding demand driven by the development of data centres specifically, management outlined caution. It was felt that some of the demand being communicated by tech companies developing data centres such as Amazon, Meta, Microsoft and Google would not come to fruition. To the degree that utilities made investments in generation and/or the network to facilitate this load, and it didn't eventuate due to a decision by the tech company, the cost of that investment would be spread over the remaining customer base – negatively impacting affordability of regular residential customers. This is a major concern for regulators and hence utility companies.

Utility companies are adopting various mitigants to ensure that residential customers don't take on the cost of investment to facilitate data centre load. Some companies spoke of adopting specific tariff structures for data centres, which had them pay for the incremental generation capacity to support their load, as well as a contribution to network investment. This required regulatory approval to implement. Most, if not all, utility companies required data centre developers requesting significant incremental power to sign long term contracts with take-or-pay provisions, which meant that if the demand didn't eventuate or didn't last, the tech company would be required to cover the cost. Utility management teams felt that if these mitigants were adopted, the incremental demand from data centres has the potential to support regular customer affordability by splitting shared network costs over a larger customer base.

Fundamentally, increased load growth supports customer affordability (reduces regulatory risk); enhances investment programs; and should support earnings growth if implemented correctly. Companies are unlikely to increase their earnings guidance significantly due to the cost of equity financing, and potential regulatory scrutiny. However, they could outperform to the upside on a fairly consistent basis.

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[7] *Weekly Commentary: What we're watching in 2024 elections*; BlackRock; Jean Boivin, Wie Li, Christian Olinger, and Ann-Katrin Peterson; 10/06/2024

Public Enterprise Groups' state of the art, gas insulated transformer

Source: 4D Infrastructure

Investment for reliability

Both electric and gas utility companies expressed a strong need for asset replacement of ageing infrastructure and support for reliability enhancement. Regulators across both utility sectors are focused on ensuring safety of operations and reliability of service.

Investment programs of gas utility companies are consistently focused on asset replacement. For example, around 82% of gas utility, Atmos Energy's capital plan is focused on safety and replacement. The company is replacing steel service lines and believes there is approximately 25 years' worth of investment based on replacing 250 miles of steel service lines a year.

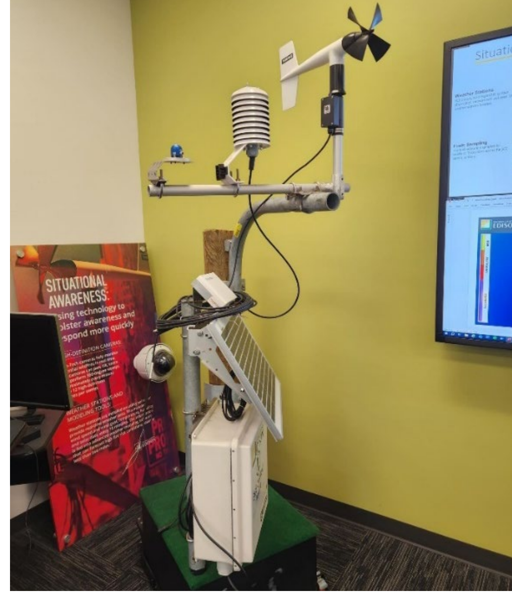
In recent years, investors took notice of legislators in some states such as New Jersey, New York and California, setting mandates to reduce the utilisation of natural gas for space heating. This heightened concern for the longevity of the business model of gas networks in these particular states. With increasing demand for baseload power generation through gas, and increasing concerns around energy reliability, the legislative focus on reducing gas utilisation has subsided. Gas utility management teams outlined anecdotal evidence from discussions with regulators that they understood that gas networks would be around for decades at least, and the investment in them would be maintained for the foreseeable future. Importantly, management teams outlined that regulators across US states were still largely supportive of replacement and modernisation of gas networks, to ensure safety and reliability for customers.

Reliability and safety investment in electricity utilities is focused on replacing aging assets, but also hardening the network against natural disasters, such as wildfires and tropical storms. This is to ensure that electricity networks:

- don't ignite fires, causing massive legal liabilities for companies;
- reduce the application of power shutoffs (PSPs) during high fire risk periods; and
- reduce damage and network interruptions in the case of tropical storms.

Wildfires started out as a risk strictly faced by Californian electric utilities, but a number of utility ignited fires across Oregon, Colorado and Texas have highlighted that it's a risk that faces many utilities. At 4D, we've written a number of white papers on this risk such as *News & Views: The real risk of wildfires to US infrastructure investors*, but without diving too deep, it's safe to say that regulators are more conscious of the need for utilities to invest in plastic wire insulation, under grounding of wires, situation awareness (camera monitoring) and network segregation to avoid such disasters going forward.

Below are pictures taken while visiting Edison International's wildfire monitoring and preparedness centre.



Wildfire situational awareness monito

Electric distribution poles which have wildfire protections

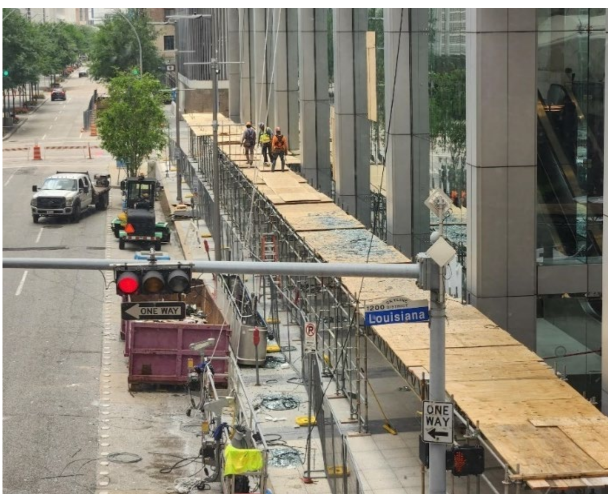
(Both are owned by Edison International)

Source: 4D Infrastructure

Investment to harden networks against the impacts of the increasing occurrence of storms and cyclones is also a prerogative of regulators in affected states. Networks across large parts of the Atlantic coast, Midwest, and South of the US are annually affected by the destructive impact of storms and cyclones. This results in potential long outages for customers, as well as significant cost for repairs.

Utilities are investing in network redundancy, segregation, and hardening to avoid/minimise outages to customers and reduce the physical damage caused by storms. Storm costs are usually recoverable through regulatory account mechanisms, but this generally occurs at a delay, with costs covered by debt in the interim - impacting the credit quality of the utility.

Below is the downtown Houston area, which was struck by a windstorm, or "derecho", prior to visiting. CenterPoint Energy received positive feedback from the Texas regulator for restoring service to customers in an expedited manner (around 85% of customers were reconnected to power within five days).



Workers repairing windows in downtown Houston which were broken by the May 2024 derecho which hit the Texas Gulf region

Source: 4D Infrastructure

More recently, on the 8 July 2024, Houston was hit by Hurricane Beryl. At one point, as many as 2.2 million customers were without power in CenterPoint's operating jurisdiction. This is further evidence of the need for utility investment in hardening the network against storms.

How to best pay for investment?

Nearly all utility companies communicated significant increased investment programs to facilitate increased load demand expectations, to improve reliability and safety, and to continue the energy transition process.

Efficiently financing this increased investment is key for companies to minimise equity dilution. At 4D, we give credit to those companies with efficient financing mechanisms including:

- Higher achieved returns on equity (ROE) supports more operating cashflow, which reduces external equity requirements – e.g., NextEra's utility subsidiary, Florida Power & Light.
- Stronger balance sheets e.g. Atmos Energy.
- Companies with higher share valuation multiples can raise equity with lower dilution e.g. CenterPoint Energy.
- Periphery businesses can be a source of supporting cashflow such as Sempra's SIP, PEG's merchant nuclear facilities, and Dominion's contracted renewables business.

Water utilities

Regulatory scrutiny

Water companies across the US are facing a busy regulatory calendar through 2024. In particular, for jurisdictions such as Pennsylvania and New Jersey, the media had reported on discontent communicated by customer representative (intervenor) groups in their response to filed rate cases by companies such as American Water. Their discontent was focused on customer bill increases implied by the rate case filings.

Management teams of water utilities outlined that it was the usual course of action that these customer representative groups communicated discontent in response to proposed customer bill increases. They said that this has historically not impeded companies achieving constructive regulatory outcomes, and that the increased media coverage of the intervenor testimony was probably the new normal. They outlined the US being in an election year could be the driver for increased media coverage – the cost of living being an election theme.

Despite the increased media attention, there were examples where water companies were achieving constructive regulatory outcomes. American Water received a constructive regulatory decision from the Administrative law judge (ALJ) in Pennsylvania, recommending revenue increases of around 60% of the company's requested increase. Additionally, in late June, SJW Group received a final decision on its rate case filing in Connecticut, which allowed for an increased return on equity of 30 bps to 9.3% (this could be improved with achievement of certain performance metrics). This outcome was far superior to other water companies in the state, such as Aquerion, which had received an allowed return on equity of 8.7% in March 2023.

It was also clear from discussions with management that the need for investment in water networks was still very strong. The Environmental Protection Agency (EPA) had implemented new water quality thresholds regarding PFAS (including PFOA and PFOS) chemicals, or 'forever chemicals', in US drinking water supplies. Achieving this threshold, of 4.0 parts per trillion (ppt), requires significant investment and ongoing management on behalf of water companies, which management teams suggested was very achievable. The EPA was also considering Lead and Copper Rule Improvements (LCRI), which looked to identify and replace lead and galvanised water lines by 2037. Water companies believe the investment requirement to implement the renewed LCRI is understated by the EPA.

Irrespective of the deadline adopted by the EPA (if any), it's clear that massive investment is required to replace lead pipes, and water companies want to ensure that it's facilitated while maintaining affordability for customers.

Taken in the foyer of American Water's headquarters in Camden, NJ

Source: 4D Infrastructure

Consolidation still needed

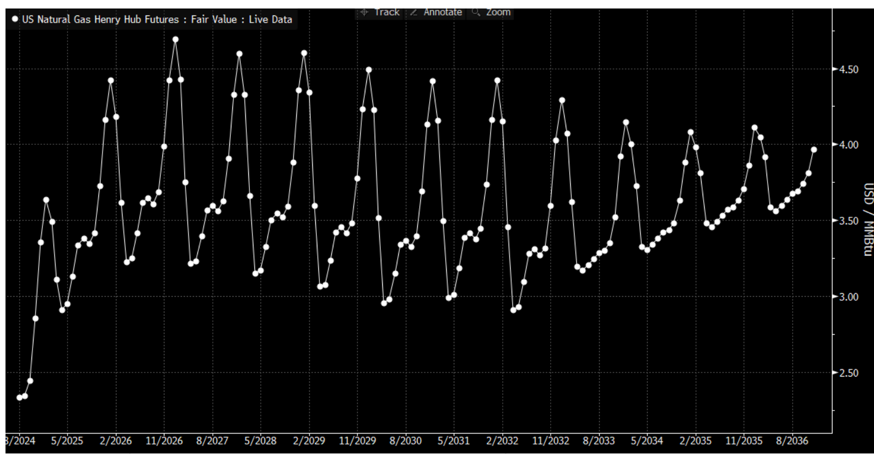
Water company management teams were optimistic about continued sector consolidation. The drivers for consolidation were still present, including 1) stretched municipal balance sheets; 2) increasing investment needs; and 3) cost savings and therefore customer benefits, from increased scale. Fair market value (FMV) legislation, which supports consolidation, was challenged in Pennsylvania by legislators. However, this challenge only resulted in slight wording changes and confirmed the desire of legislators for industry consolidation in the state.

Midstream oil/gas

Long-term natural gas utilisation

While passing through Houston, TX and Tulsa, OK, I met with a number of midstream (pipeline) oil/gas company management teams. They were generally optimistic regarding prospects driven by their belief in the long -term requirements for natural gas and refined products, combined with their current healthy credit positions and cashflow generation.

At the time of visiting, spot natural gas prices were around $2.50/MBtu, but the forward curve represented strong contango. Management teams outlined that the upward trajectory in expected natural gas prices was probably supported by increased domestic and liquefied natural gas (LNG) demand through the back end of 2024 and into 2025. Although realisation of these higher gas prices was continually being pushed out and were somewhat mitigated by high gas storage levels. Current levels are approximately 500 Bcf higher than average, and would take some time to dissipate for gas prices to escalate.



Henry Hub futures curve

Source: Bloomberg and 4D Infrastructure

Irrespective of the short-term demand dynamics for natural gas, companies were aligned in believing that natural gas would be part of the energy mix in the long term, and an essential part of the energy transition process. Gas generation would support the rollout of renewables in addressing their intermittency, which would require the continued build out of supporting infrastructure.

Predominantly, this required investment would be in capacity increases on major transportation pipelines and within storage assets. This trend is only exacerbated by the expected electrification dynamics and increasing demand from tech manufacturers and data centres.

The international market for LNG

With regard to the international market for LNG, recent short-term weakness in overseas prices was utilised by Chinese and Indian buyers to buy up volumes. Irrespective of shorter-term dynamics, exporters like Cheniere are confident that LNG would be utilised "for decades", predominantly in emerging markets such as China, the sub-continent, and southeast Asia.

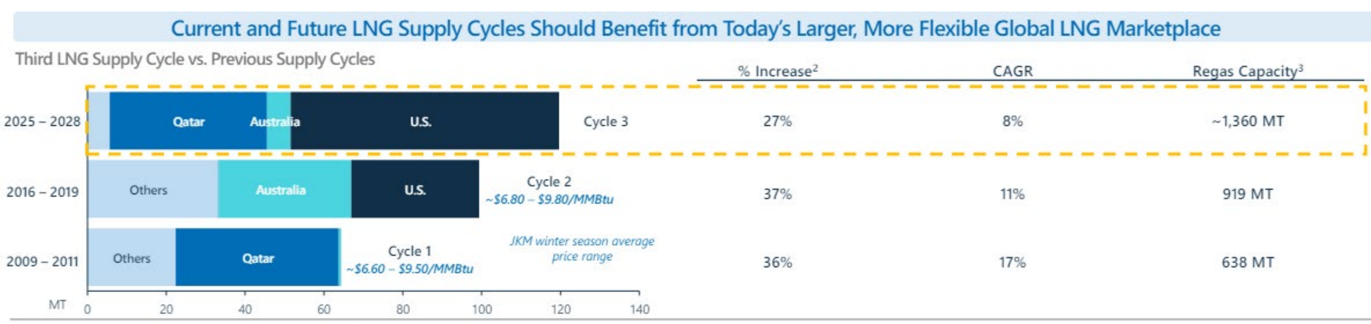
Model LNG tanker from Cheniere's office

Source: 4D Infrastructure

With the expectation for significant LNG supply to be commissioned in 2025 through projects such as 1) Corpus Christi phase 3 (Cheniere) – 10 Mtpa; 2) Golden Pass LNG (ExxonMobil and QatarEnergy) – 18 Mtpa; and 3) North Field LNG (QatarEnergy) – 8 Mtpa[8]; there is market concern for oversupply and weak prices over the medium term. Cheniere was of the view that any excess supply would be quickly absorbed by the global

[8] *Global LNG Outlook 2024-2028*; Institute for Energy Economics and Financial Analysis; April 2024

market. The graph below indicates that the increase in supply from the upcoming development cycle covering years 2025-2028 represents a smaller increase than previous supply cycles (such as 2016-2019), implying less market disruption. There is also significantly more regasification capacity operational now than in previous cycles, which can be a proxy of buyer capacity.



Source: Wood Mackenzie and Cheniere

How to spend excess cash? A good problem to have

All midstream companies have repaired their balance sheets in recent years and are largely firmly investment grade rated. They are generating strong operational cashflows, which healthily cover dividends and often capital investment. Therefore, how do management teams plan on utilising capital? Management teams communicated the following capital allocation priorities:

1. Pay a consistently growing dividend – usually in line with earnings or cashflow growth;
2. Invest in organic investment opportunities – usually lower execution risk and higher return;
3. M&A opportunities – mainly where significant synergies exist eg. Oneok/Willaims Co; and/or
4. Buyback stock (some adopted valuation considerations) e.g. Cheniere.

Mural depicting Oklahoma's oil/gas drilling past at Tulsa International Airport.

Source: 4D Infrastructure

Communication towers

To varying degrees, the three US communications towers in 4D's investment universe have experienced poor share price performance in recent years due to coinciding factors, including increasing interest rates; the negative cashflow impact from customer churn; and concerns regarding the ability of mobile network operator

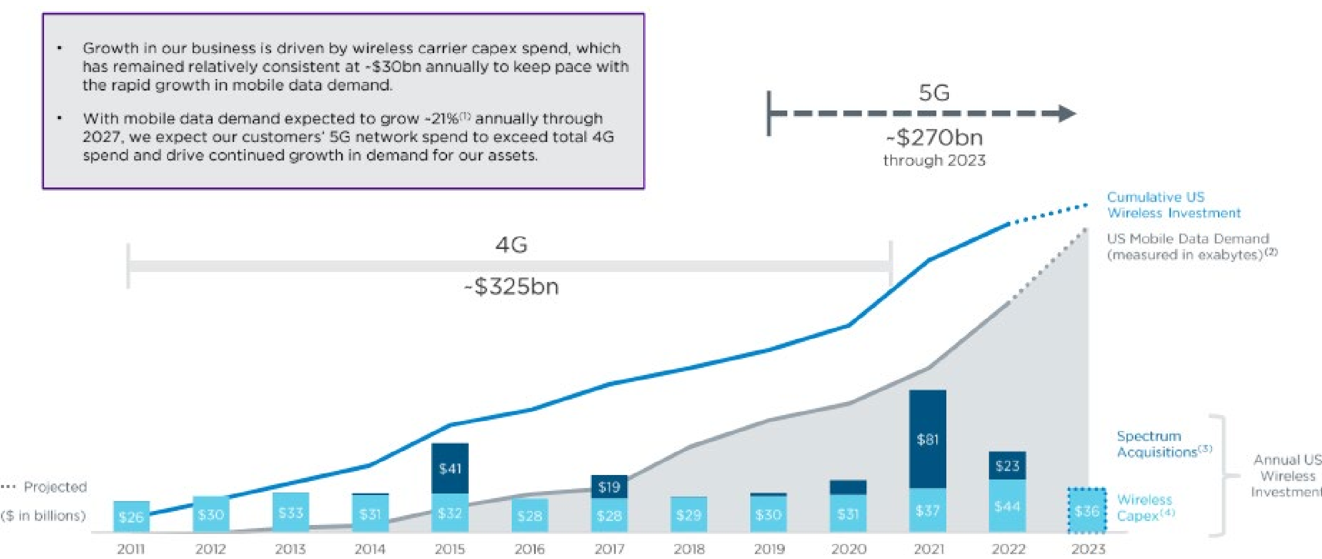
(MNO) customers to invest in upgrading networks to facilitate 5G. It seems the investment proposition of towers is still intact over the long term, but the short term presents challenges.

Mobile network operator activity

SBA Communications (SBA) and Crown Castle expect a continued drag on cashflow growth due to churn associated with the T-mobile/Sprint merger. This churn occurs as contractual commitments end on tower agreements and T-mobile/Sprint look to rationalise their overlapping coverage post their merger in 2020. Management teams of the towers companies outlined that this is expected to be a headwind to cashflow growth in 2025 and 2026. It's expected to be diminished/eliminated from 2027.

2023 represented a period of reduced MNO activity as a result of balance sheet stress, combined with a moderation in activity following a busy year in 2022 when MNOs quickly looked to establish 5G coverage, having just acquired high(er) frequency spectrum in 2021. This reduced the service-related revenues earned by the towers companies, and it also heightened market concern that the trend of growing cashflow generation from 5G wasn't going to be sustained.

The graph below shows the 2023 wireless capex of the MNOs was actually around the longer-term average, and despite being lower than 2022 (following the 2021 spectrum auctions), there is no sign that the 5G rollout will end.



Indicates MNO spectrum and wireless investment for 4G and 5G roll-outs

Source: Crown Castle

More recently, there have been signs that the MNOs have increased activity slightly in rolling out 5G coverage. AT&T are continuing the rollout of its 5G coverage, while T-mobile has achieved coverage across most of the US, and over time will look to increase density to facilitate higher 5G data uses.

Shifts in strategy?

With influence from an activist investor, Crown Castle was in the process of undertaking a strategic review of its small cells business. The company was looking to ascertain the valuation of the business in order to make a decision as to whether it's in the best interests of shareholders to continue to own the business.

There was market conjecture as to the number of interested buyers, and hence what the market valuation of the small cells business would be – most believed the small cells business would fetch between 9-12x EV/EBITDA valuation multiple. If it was sold, Crown Castle would represent a pure play US focused towers business.

SBA had also communicated that it was reviewing the geographic jurisdictions in which it operates. Management communicated they wanted to focus operations in markets where the company had sufficient scale to exert influence. Without referencing specific plans, management outlined that they were interested in the European market, albeit recent transaction valuations didn't represent sufficient value to them. Discussions with brokers outlined that SBA had vigorously participated in the sale process for Cellnex's Irish business segment.

Capital allocation and balance sheets

SBA management outlined that balance sheet strengthening was a priority of capital allocation, with the goal of achieving an investment grade credit rating "over time". The company was managing potential cashflow headwinds as a result of refinancing maturing bonds in a higher interest rate environment. They are considering potentially issuing shorter maturity bonds, with lower interest rates to minimise the drag on cashflows.

They were not alone in focusing on balance sheet strengthening, with American Tower communicating that they were still working to reduce their leverage levels to below 5.5x Debt/EBITDA. American Tower has been through a period of M&A, which increased debt gearing at the company, but is now focused on utilising operating cashflow to reduce gearing again. This was supported by the sale of American Tower's underperforming Indian business, although proceeds from the sale were not as high as anticipated by analysts.

Outside of balance sheet repair, towers companies would continue to grow dividends (usually in line with long-term cashflow growth), and using excess cash for buybacks. This is to maintain growth in dividends at a consistent, maintainable rate, and utilising excess cash to support investor returns through buybacks.

Generally speaking, the communications towers investment proposition implies strong organic growth through inflation escalators and tenancy/enhancement improvements; and cashflow generation. The issues outlined above are causing headwinds to the investment proposition in the short/medium term. The drivers of organic growth and cashflow generation in the long term are still sound.

Still optimistic on US infrastructure investment opportunities

As the markets wrestle with the timing and magnitude of interest rate cuts, this will no doubt feed into US infrastructure valuations over the second half of 2024 and into 2025. The fear that politically motivated fiscal policy could ignite inflation and put upward pressure on interest rates again is a risk to valuations.

In addition, markets currently believe there is roughly a 50% probability that the US economy encounters a recession. The earnings resiliency of infrastructure stocks would presumably be appreciated by investors as compared to other sectors if this scenario plays out.

Based on conversations with infrastructure company management teams, investment prospects for specific sectors vary, with different dynamics influencing earnings potential.

- Electricity and gas utilities: the need for investment has arguably never been greater, and is based on increasing load demand, continued decarbonisation efforts and the need for asset replacement/hardening to support reliability. Affordability is still very much in focus, but correctly managing increasing load demand can help alleviate this.

  4D likes –Sempra.

- Water utilities: noise around regulatory risk has been over emphasised, and the achievement of constructive outcomes should alleviate this with time. The need for network investment to improve water quality and replace ageing assets is outweighing concerns around affordability. Consolidation is still perceived by legislators and decision makers as important for the sector.

4D likes – American Water.

- Midstream oil/gas: future price curves point to improving natural gas prices, which would be supportive of organic volume growth on midstream networks. Irrespective of volume growth, pipeline and storage investment required to support increasing peak loads continues to be required. Free cashflow generation is very attractive and allows for value accretive M&A and/or share buybacks.

  4D likes – Williams Co.

- Towers communication: cashflow growth is challenged in the short term due to churn driven by MNO customer consolidation, moderating MNO rollout of 5G, and the higher cost of refinanced debt. The longer-term investment proposition regarding organic earnings growth and strong cashflow is still intact.

  4D likes – not invested at this time.

Despite the macro and geopolitical uncertainty, as well as certain company specific risks, we believe there are still some very attractive investment opportunities in the US infrastructure market, and the recent trip reinforced this view.

We remain focused on companies that offer attractive valuations and exhibit stable earnings, predictable cashflows and have quality management teams.

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