Trip
Insights

LatAm – Part 2

October 2024

4D infrastructure

A Bennelong boutique

This is the 17th in our series of *Trip Insights,* where we share our travel experiences. It follows a trip taken by Sarah Shaw, Global Portfolio Manager, to Latin America. Sarah visited sites across a number of airports and infrastructure assets, meeting with management teams from regulated utilities and transport companies, as well as getting insights from political and economic experts within Mexico and Brazil. Company management meetings and site visits are integral to our investment process, and where possible, we look to visit core regions at least annually.

With so much to report from the trip, we split our insights into two parts. In part 1 of this piece, we highlighted some interesting political themes and observations from the trip that have influenced our ongoing investment in the region. In this second part, we explore the state of play for economics and infrastructure, as well as our portfolio positioning in LatAm.

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Economics

The economic outlook across the region was disparate and highly correlated to the political environment and outlook.

Mexico

The June election outcome saw the Mexican peso drop 10% in a week as concerns weighed. Interestingly, many believed this correction was long overdue and that there is further to go. The peso at 15 (to the USD) was considered the anomaly and unjustified, while closer to 20 was a more normalised structural level.

Ignoring the political influence, the economics look okay, but with greater headwinds ahead.

- Domestic spending has been supported by significant increases in social policies over a six-year period and while these will remain in place, the trajectory of up-tick will slow.
- Investment pipelines could stall ahead of the electoral reform as concerns increase around security of investment returns.
- The government coffers have been significantly depleted under an AMLO government, with a much smaller safety net available to the new administration.

All in all, Mexico is not expected to collapse but economic growth will arguably slow as the new government finds their feet and reassures markets about policy and security of investment dollar.

Brazil

The key point of contention when in Brazil was whether the central bank would increase interest rates within a global landscape of declining rates. The views were mixed when on the ground, but in the last few weeks consensus firmed that the central bank should and would increase rates in September, if they are committed to the inflation bands publicly disclosed. This was priced into markets and was not a shock to see a 25bps increase on the 18th of September. Interestingly, I think the fact that it was only 25bps disappointed markets hoping for a short, sharp correction to inflation.

Are the hikes bad news? We don't think so, because:

- The driver of a halt in rate cuts and subsequent reversal in trend is stronger absolute economics – interest rate expectations have been increased but buoyant household spending and a resilient labour market has also pushed up GDP expectations, with 2024 GDP forecasts increasing from 1.6% earlier in the year to 2.22% currently. Ultimately, these higher activity numbers and GDP, and the higher inflation with protection at the asset level, are fundamentally beneficial to infrastructure valuations.
- Strong policy message as the central bank, with political support as discussed above, is strictly adhering to its inflation targets and moving away from a historical 'loose' guideline.
- Brazilian interest rates are structurally high due to the absence of domestic saving rates. While the headline looks negative, the actual real interest rate is currently below historical trend, so a move up brings it more into structural alignment.
- FX appreciation – the expectation of a widening interest rate differential between the USD/BRL due to hikes in Brazil corresponding with the start of an easing cycle by the U.S. Fed and a tightening cycle by the BCB should favour the BRL in the medium term.

We believe that there will be a short, sharp hiking cycle to appease policy response and get inflation expectations within band before the trajectory shifts down again into the 2026 election campaign (12 months ahead of vote). Curve is pricing in ~150bps increase, which is considered the maximum that would be needed.

Budgets

Whilst on the ground, there was a lot of discussion around the 2025 budget and fiscal spending caps, with Lula struggling to adhere to the SFR. In an effort to appease markets the finance minister pre-released certain elements to the budget reiterating their commitment to austerity measures.

On 31 August, the budget was released, with the government forecasting a zero deficit for 2025. There were no huge surprises but key elements to note include:

- Spending cap moving from R$2.105trn this year to R$2.249trn in 2025, providing the government with a ~$144bn increased spending budget. However, a 6.87% increase in the minimum wage to US$267/month and other mandatory expenditure increases will use up 92% of this increase. This leaves just 8% for discretionary spending including investments.
- Additional R$168bn in revenue identified, although sourcing is not that clear with reliance on increased taxes and administrative measures and the buoyant economic outlook.
- Forecast 2025 GDP growth of 2.64% underpinning much of the proposed spending – should it fall below this then the deficit is at risk given this impacts revenue and expenditure limits.
- As a result of budgeted increased interest rates, the forecast inflation is 3.1-3.3% which is only slightly above target and a drop from the 4.5% it is tracking at.

Despite early concerns, the market was relatively comfortable with what was in the end considered a relatively benign budget. Now it's all about execution, which will evolve in line with the macro environment. We do see two positive read throughs, however:

- The increased social allowances support ongoing domestic consumption.
- To ensure the investment they need, the government is going to increasingly have to rely on private sector capital for infrastructure investment – we expect more asset privatisations and greenfield auctions as a result.

Climate

According to recent reporting from the National Centre for Monitoring Natural Disasters (Cemaden), Brazil could be facing its worst drought in its recent history, with heat waves forecast to continue until at least November. This drought could have ramifications for crops, hydro generation (and as a result, Brazilian generation), waterways transportation (rivers drying up), water usage, increased incidence of fires and the economy in general. This is something we are monitoring closely.

USA

All about the Fed! With a perceived negative relationship between high US interest rates and emerging markets economies, there was much discussion around the timing and trajectory of Fed cuts. As already priced into the market, the first move was anticipated in September and all other things being equal, it was expected to be a positive tailwind for the emerging economies, their currencies, sovereign spreads, foreign flows and equity markets. This particularly held true for Brazil as trend to their rates was currently up.

However, it's worth noting that the historic relationship between emerging markets and interest rate moves has significantly weakened, as dependence on USD debt has dissipated and monetary policy decouples. As such, the fundamental shift from a cut in Fed rates will be less visible than historic rate cycles.

Global

Global demand profiles remain very relevant for the Latin American region, and in particular, the potential for the agricultural industry in Brazil. A global need for food security has supported significant growth in planted areas across Brazil where they are incredibly competitive in the production of many soft commodities, in particular corn and soybean. The message remains very positive - planted areas are expanding, pricing is supportive, and demand is growing. While, of course, there can be cyclical disruptions from weather, crops and global growth, the long-term trend up remains in-tact. This has national ramifications for economic growth, export chains and, importantly, infrastructure investment.

The other global theme widely discussed was decarbonisation and how the region could play a role. We hear a lot about the US, and the EU's large green packages and financing of their energy transition. However, Brazil is already where they want to be in around 20 years: 90% of its power matrix and almost 50% of its energy matrix is already coming from renewable sources of energy. According to McKinsey, Brazil has the potential to become one of the first countries in the world to achieve net zero emissions working towards a 2030 goal. And the opportunity extends beyond domestic borders, with Brazil's potential to export clean energy and low carbon products supportive of a multi decade growth thematic for the Brazilian economy. This includes:

- The ability to manufacture products with lower carbon footprint, such as cement and steel.
- Being a large global producer of biofuels, a competitive advantage in terms of sustainable aviation fuel production.
- Biomethane production is gaining traction, utilising biomass generated in agriculture activities (itself growing) and also through waste decomposition.
- Ethanol production and export.
- Having a stock of critical minerals including nickel, lithium, graphite and rare earths.
- Potentially evolving as a data centre hub given power security.

According to a recent report by the Boston Consulting Group, Brazil is strategically positioned to lead climate solutions on a global scale, with the potential to attract between US$2.6-3.0 trillion in investment by 2050. There was a consensus view from investors and government representatives alike, that in order to capitalise on this opportunity, Brazil needs to establish a legal framework to attract investment to the country. To that end, policy is currently under discussion by congress and the government related to biofuels, offshore renewable plants, green taxonomy, establishment of a carbon market, and climate adaptation, among others is considered incredibly important and urgent.

Infrastructure – a summary

While much is happening across the Latin American infrastructure landscape, this trip highlighted and reinforced some strong thematics including:

- Mexican air travel: while travel demand remains strong, capacity limitations from the grounding of the Pratt & Whitney fleet and restriction of Mexico City airport slots will limit passenger growth through 2024 and into 2025. However, it's widely believed there will be a strong rebound as soon as capacity is available – there's no demand weakness to date, despite significant ticket price uplift. And the long-term sector thematics remain strong from tourism to the emergence of a growing middle class and the evolving near-shoring opportunity.

- Brazilian ports: volumes are recovering well, but the real story for 2024 and ahead, is pricing and margins, with capacity constraints providing a strong bargaining position for the operators.

- Brazilian transport: incredibly resilient traffic data and passenger usage supporting a stronger 2024/25 outlook. With explicit inflation hedges, incumbent operators are positioned well to capitalise on the fundamentals of existing assets to build out recently-won concessions and/or participate selectively in the upcoming auctions.

- Brazilian rail: with the agricultural story robust and capacity again a limitation, the rail operators are well-positioned to lock in take or pay contracts and push for route expansion.

- Energy: the energy transition is a theme in the emerging world just as it is in the developed world, with significant discussion on how corporates can capitalise on it, the long-term investment requirements and who pays for it. With so much to be done, operators are being selective on how they best use their balance sheets to capitalise on the opportunities, with the grids in favour and renewables less attractive over the medium term.

- Management strength: a key takeaway from this trip was the relative strength of various management teams – those capitalising on the opportunities afforded to them whilst cognisant of investor concerns/demands.

We touch on each of these below, as well as wrap up a few other sector dynamics.

Mexican airports

It was great to catch up with the three Mexican airport operators, particularly in light of recent sector headwinds, namely:

- 2023 regulatory change,
- Pratt & Whitney plane recall, and
- Mexico City slot cancellation.

As well as strong sector tailwinds, including:

- very buoyant demand profiles,
- the Cargo opportunity, and
- the Capex opportunity – incorporated into master development plans (MDP) plans.

All of these are discussed below.

Recap of regulatory change

The Mexican Airport Regulation had long been considered some of the best in the world - very constructive, very supportive and very stable having not been "tested" since privatisation over 25 years ago. That all changed on the 4th of October 2023, when the Mexican Civil Aviation Authority sought to unilaterally alter the Mexican Airport Regulation. To re-cap what proved to be a very controversial decision:

- The changes were in contravention of the Concession Contract that state that any regulatory re-design must be agreed between the parties.

- The announcement was a huge shock to the operators and market alike and the operators spent two weeks behind closed doors, with the regulators negotiating intentions versus outcomes.

    - There was no market communication in that two-week period.
    - Between the announcement on 4th October and the 'agreement' on the 19th the proposal was completely remodelled to something the operators could agree to.

- Rationale for the change was supposedly to:

    - reflect the change in capital structures relative to 25 years ago,
    - to properly articulate the return calculation, and
    - to limit the excessive profits being realised by the operators since COVID.

- In a separate announcement, in the same week, Mexico passed a federal law to increase the concession tax on all Mexican concessions from 5% to 9% effective 1 January 2024 (accommodated by regulation).

The stocks completely sold off given the perceived threat to a once-stable regulatory construct, the fact that the operators themselves had been unaware of the threat and a clear lack of detail on the proposals. If, as suggested, the move had been politically motivated, it backfired as the market punished the intervention at a national level.

- Tried to launch a Pemex bond issuance two days after the announcement about the airports which was completely rejected by the market.

- Mexican pension funds are big holders of the airport stock and bonds, so the sell off had a significant impact on domestic Mexican pension balances.

AMLO tried to appease the market with statements that the impact was earnings-neutral, but credibility was lost and it has taken time to rebuild. This is important in light of the proposed electoral changes discussed already – the market will punish a threat to the stability of earnings and foreign capital will flee.

We spent a considerable amount of time assessing the negotiated outcome at both a quantitative and qualitative level – a presentation is available with a summary in *appendix 1* at the end of this article.

The operators were clear that their relationship with the ministry and regulator had been and remains constructive. The operators also believed that once a negotiated outcome had been reached, there would be no further intervention in the sector and that the first MDPs under the new regulation would be constructive to rebuild credibility. This is incredibly important in light of the new electoral reform. Given the change to framework last year, there has been no suggestion, and the three airport operators and market participants alike, think it incredibly unlikely, that the government is looking to revisit the airport space at any point which is good news.

It's also fair to say that the outcomes of the two MDPs negotiated under the new model have been not only constructive but highly value accretive for the operators giving us increasing confidence in the renewed credibility of the framework.

Grupo ASUR

ASUR was the first to negotiate its MDP under the new regulation with a submission and response agreed within a month of the change. The outcome was very positive, beating consensus and our forecasts providing for a huge jump in Capex and an associated 45% upside to the tariff in nominal terms. This trip enabled us to see exactly how and where that money will be allocated. Continued terminal 4 expansion to support ongoing growth in tourism as well as a revamp of terminal 1 to take much-needed overflow from terminal 2 (handling 15mn paxs with design capacity of 10mn).

This trip reiterated my view of ASUR as a very well operated listed airport operator as evidenced by the use of space and design at Cancun Airport - from margarita bars at arrival to speedy and efficient baggage claim and customs and ForzaMx racing simulators on departure - all designed to keep the tourist happy.

With the destination continuing to offer tourists good value, great weather, easy access and crystal blue warm waters, we see ongoing growth across the airport both in passengers and commercial upside.

GAP

Many thanks to GAP for a fantastic site visit at their flagship Guadalajara airport. From the new hotel and corporate offices, the newly opened and revamped commercial spaces on land and air side, runway 2, new VIP lounges and priority access screenings, kids play areas and a well-utilised mirrored selfie wall. I was impressed with the thought that went into the design, openness, layout and diversity of offering, and most importantly, the clear upside to commercial spend that is coming as construction of phase one ends and these spaces open.

While I was in Guadalajara, management were finalising negotiations on their new MDP and while talking down the outcome, the subsequently released result was incredibly positive with a significant jump in Capex, compensated by a huge jump in the tariffs both of which were again well-ahead of market expectations and highly value accretive for the stock.

This second, very positive MDP, worked further to reinstate credibility in the model and sector and we are increasingly confident in the framework.

OMA

OMA's MDP will not be negotiated until 2025, but on the basis of its peers and anticipated Capex needs we are increasingly comfortable that the negotiated outcome will again be positive. The one overhang for OMA is that it will be negotiated with the new administration. However, as there has been no suggestion that the airports are on the Sheinbaum agenda they are expecting a smooth transition and discussion with the airport regulator next year.

It's worth commenting that the recent change in shareholder control to French airport giant, Vinci, is supporting OMA in all areas of operations from commercial design and implementation, routing, supply chains and we would expect regulatory negotiations. It was very clear that OMA is stronger for the Vinci control.

Pratt & Whitney recall

Another near-term headwind for the global airport space, and in particular the Mexican airport operators, is the ongoing recall of Pratt & Whitney aircraft, which has significantly restricted available capacity for the operators this year. The recall commenced in Q4 23 and has steadily ramped up since. Each plane taken out of circulation is forecast to be grounded for 300 days.

All three Mexican operators flagged that Q3 24 will be the worst quarter in terms of traffic impact with some planes coming back online in Q4, and a steady return through 2025 and very strong growth anticipated for 2026.

This recall was well known leading into 2024, so the passenger weakness is no surprise. From conversations with the operators, I would note:

- Positively - some signs that the recalled aircraft will be back flying earlier than the forecast 300 day recall period.
- Positively - demand remains very strong despite restricted capacity and the operators are expecting a 'hockey stick' style recovery once planes become available – for example, according to GAP, the two impacted airlines (Volaris and Viva) were both at a 90% load factor in July despite a significant hike to ticket prices.
- Positively - passenger impacts have been factored into the MDP demand forecasts, accommodated by the regulatory tariffs.
- Mixed - Viva has managed the situation better than Volaris, which has provided some upside to traffic expectations. While Volaris has just ceased all routes on which an aircraft has been grounded, Viva has leased alternative aircraft for particular routes to keep planes in the air.
- Positively - airlines using the situation opportunistically to mix up routes – bringing back more profitable routes faster and favouring new international destinations over return of less profitable domestic flights. This could see the smaller, more domestic-orientated airports impacted for longer (OMA) but other airports benefiting from improved mix.

Mexico City

It's hard to get excited about Mexico City airport but certainly highlights the stark contrast in user experience between privately managed airports and government-controlled operations. Space availability and utilisation is sub optimal, commercial offerings are incredibly limited and, as such, very expensive and the overall passenger comfort is low.

On the positive side, the airport terminal hotel, owned privately by OMA, was conveniently located, recently renovated and offered the comfort and convenience you would hope for when dealing with late landings and early flight departures.

The big issue with Mexico City Airport has been the cancellation of significant slots, reducing connectivity within and outside the country[1]. The two proposed alternatives are not viable options for the majority of the local population or international connections despite the government cutting slots at Mexico City in an effort to force movement. This has positive and negative implications for the listed airport operators:

- Negatively – in the short term, these cancellations further restrict route capacity between listed airport locations and Mexico City – a critical national hub.
- Positively – with little expectation that Santa Lucia and Toluca airports will evolve alongside the main Jaurez airport as planned[2], there is an opportunity for the listed operators to use spare regional capacity to create alternate transit hubs. This could be an opportunity for OMA (Monterrey a northern hub) and GAP (Guadalajara), both of which see the slot restriction as a net positive for their airport operations. By contrast, ASUR has no plans to capitalise on this given the scarce capacity at Cancun and the lower value of a transfer passenger.
- Positively – as a user, the lower slot allocation means that the once very busy terminal is much less so today, with check-in, immigration and security dwell times lower than they were historically.

Importantly, the operators don't see further slot cuts, but at the same time, don't see an expansion either so the current situation is the new status quo for the immediate future and well in forecasts.

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[1] Historically Juarez had handled 68 slots/hour and this has been reduced to 43/hour today
[2] There is no connectivity between the three terminals and with Mexico City road congestion what it is they cannot be operated as a Group at this stage. Some suggestions will be a rail link to Santa Lucia but this is still in planning stage

The cargo opportunity

As discussed earlier, near shoring is a significant opportunity for the country as a whole, which has created a growing cargo opportunity, for well positioned airports in particular. Again, this is not an ASUR story, which is all around tourism. However, both GAP and OMA have identified significant cargo potential.

- GAP recently opportunistically acquired a 51.5% controlling stake in Guadalajara World Trade Centre (GWTC). GWTC consists of seven companies that specialize in handling, storage, and custody services for international cargo through facilities classified as a free trade zone at Guadalajara Airport and Puebla Airport. This was a very attractively valued deal, paying just 4.25x EBITDA for an asset anticipating double digit revenue and EBITDA growth in a Capex light model. It was easily absorbed by the balance sheet and positions GAP well to capitalise on the near shoring opportunity.
- OMA also highlighted a growing cargo strategy as Monterrey evolves as a northern hub, and the airport expansion supports significant growth in passengers and commercial upside. Under a Vinci directive, OMA cargo has recently been restructured into an independent entity in order to capitalise on this opportunity in Monterrey and across their airport network.

The cargo opportunity is an evolving one, and given little is factored into valuations at this stage, could represent significant upside to those that capitalise on it well.

Capital allocation

All three Mexican airport operators have incredibly strong balance sheets (arguably sub-optimal), which has allowed them to:

- effectively manage debt levels to optimise regulatory outcomes,
- incorporate huge expansion and associated capex into their MDPs,
- capitalise on synergistic opportunistic deals including GWTC and hotel assets,
- explore what limited M&A is available in the market, and
- reward shareholders with strong ordinary dividends, specials and buy backs.

In conclusion

While the airports are not without some near-term headwinds and negative country sentiment, we believe this is more than priced into current share prices and the risk/reward trade-off continues to favour investment in the sector:

- ASUR – a very positive MDP agreed and executing well on investment program. It's positioned well to capitalise on the long-term demand profile in Mexico as well as being the most diversified player with exposure outside of Mexico to Colombia and Puerto Rico. Further, it fundamentally benefits from FX weakness with international passenger tariffs priced in USD.
- GAP – exceptional MDP negotiations recently finalised and company positioned well to capitalise on Mexican demand recovery, an emerging middle, class, near shoring, airline re-routing and the cargo opportunity.
- OMA – probably the cheapest and well-positioned to capitalise on long-term country thematics. It's also benefiting from its new Vinci ownership. However, it's the only one with a remaining MDP overhang which won't dissipate until 2025.

Other airport stops

A very quick note on the four other airport stops on this trip – again reiterating our view that the user benefits from private ownership and operation.

- Dallas airport – the dread of transiting through a government-controlled US airport was well-placed, with significant delays at immigration (even when not stopping in the USA) and a 40-minute disorganised security screening queue, which was considered 'fast'.
- Panama City Airport – large, well-designed modern privately operated terminal which managed to facilitate a 45-minute transit (from landing to departure) for not only me but also my luggage.
- Gaurulhos Airport Brazil – has been in private hands since 2012 and finally starting to see some optimisation of commercial space and an improved passenger experience.
- Santiago International Airport – a strange mix of government/private ownership with the user benefiting from operations being controlled by a European consortium including Aeroports de Paris and Vinci Airports.

Brazilian user pays

Planes, trains, ships and automobiles -- we managed to explore the opportunity set across the Brazilian transport space and came away strengthened in our conviction of the fundamental opportunity in each, as discussed below.

Rail

Brazil's agricultural theme is an exciting one - for the national economy, agricultural producers and infrastructure operators alike. None is more leveraged to this theme than monopoly rail operator, Rumo, whose network is the backbone for distribution of all soft commodities out of the Mato Grosso region.

Over the short, medium and long term, the theme supports the Rumo strategy and we returned very comfortable in the fundamental investment.

Volumes

Unfortunately, short-term crop outlooks can create volatility in the Rumo share price, despite take or pay contracts and a very attractive long-term dynamic. Thankfully, the current outlook is for solid crop volumes into 2025, albeit with some risk from evolving weather patterns.

The company reiterated a fully contracted model, noting that it gives surety of earnings and also operational ease in planning terminal operation. They are expecting that by year end they will be 70% contracted for 2025 (95% for crop 1 and 50% for crop 2), largely derisking the 2025 crop story.

Importantly, by 2030, the grain production in Mato Grosso is expected to grow over 30% and exports from the Mato Grosso region are expected to grow 60% adding over 30 million tonnes to today's 55 million base. As such, the supply/demand balance for logistics is definitely favouring Rumo's monopoly rail network, supporting its contract strategy as well as pricing. While global commodity prices can impact the attractiveness of expanding planted areas, Mato Grosso is not the marginal supplier, particularly of soybean, so planting will remain robust even through periods of commodity price softness. However, with demand for food sources outpacing supply, commodity pricing should be well supported over the long term.

Pricing

The company is negotiating forward 2025 contracts in an environment with a strong volume outlook. However, trucks have become increasingly competitive this year and producers have been slower to lock in rail capacity. As such, while the company is not expecting the exceptional price uptick achieved in 2024 of +25%, it is not looking to lower pricing to contract faster and is forecasting an above inflation uptick up to 10% for 2025, still ahead of market expectations. Producers ultimately need to commit, or risk having limited means to transport volumes. And, given the ongoing competitiveness of rail over trucks, Rumo should be the first to contract its capacity:

- Rail pricing – R$150-160 per 1000 kms
- Truck pricing – R$250 per 1000 kms.

More importantly, the company commented that due to the expected time to market of additional system capacity, its pricing power will remain in play for at least the next 10 years at levels well above inflation. It's not rushing to close the gap with trucks due to market share sensitivity, but will balance available capacity with pricing to achieve the best outcome.

Expansion

A key theme for Rumo is the much-anticipated network extension north to Lucas do Rio Verde (LRV) which is due to be completed in phases from 2026 with a capex investment of over R$15bn (real terms). The LRV extension takes the rail network into the heart of Mato Grosso State increasing the agriculture competitiveness of the region and Rumo's ability to capture export market share.

The first phase of the project, a 160km stretch to Rondonopolis is expected to be operational in 2026. Disappointingly, the company recently revised up the Capex profile for this stretch, as more advanced engineering works showed a need to move more land than originally anticipated, hiking Capex/km by 20%. Upon discussions with the company, they remain confident in the return profile of this stretch and overall project as although Capex has increased, so too has the margin per km (due to yield expansion) and as the later has outpaced the former, the expected return has actually improved. The first phase will add 10 million capacity to the network, with the option to expand this by a further 10 million on the same site with the expectation that this capacity will be absorbed very quickly.

We have revised our forecasts and timelines for the project, and are confident that it remains value accretive and will cement Rumo's competitiveness as the core logistic artery for Mato Grosso grain exports. Capex will be elevated for the coming decade throughout execution of the extension, but the balance sheet remains comfortable as the phased opening boosts cash flows.

Competitiveness

Rumo's competitiveness for agriculture logistics is clear to the south and is improving against the trucks as the network drives north, both in terms of pricing and in terms of operational flexibility and efficiency.

There has been some suggestion that expansion of the Northern Arch and northern road networks could reduce their long-term competitiveness for Mato Grosso exports. However, we believe the growth in the Port of Santos (versus northern port capacity) and operational efficiency and pricing dynamics of rail over road continue to support market share gains for Rumo over other forms of transportation in either direction.

On our assessment the risk/reward favours the operator at these levels with an anticipated EBITDA CAGR of over 15% for the next 10 years.

Ports

Whilst in Brazil, media reports suggested that the government was looking to revisit the auction of a new container terminal, STS10, in the Port of Santos. The shares of Santos Brasil suffered on threats of increased competition in their home terminal. As such, the catch up with Santos Brasil and industry experts was very timely.

Competitive threat

Fundamental to the Santos Brasil investment story, is its competitive positioning in the Port of Santos as capacity constraints offer the incumbent operators significant pricing power over shippers. This has been reflected in a rapidly growing revenue per TEU over the past two years.

The Port of Santos is currently operating at about 90% utilisation (close to optimal), with the demand outlook for capacity robust. Both incumbent operators, Santos and BTP, have fast tracked capacity expansions with Santos Brasil expected to add 1mn TEUs by 2026/27 which will support the near-term volume growth outlook. However, the relief will be short lived, with demand projections forecasting that a second wave of expansion at the port will be needed by the early part of the next decade. This is where the authorities are looking at all options for expansion including STS10. According to Santos Brasil, under consideration is the:

- Release of additional land to incumbents BTP and Santos to further optimise and expand capacity by ~1-1.5 million TEUs each. This would require the removal of those currently illegally occupying the land which is always difficult. This is clearly the option that Santos Brasil (and BTP) favours as it would see them control and capitalise on the capacity expansion needs.
- Auction STS10 which would occupy the space of the current Ecorporto cargo terminal, whose concession will not be renewed. Should this occur, the need for Santos and BTP to expand capacity in the early parts of the decade would be mitigated. To date, the project remains undefined and vague in terms of capacity, timing, cost, who can participate in the auction etc. If the project moves ahead, bids are expected next year at the earliest with a build period of 5+ years, seeing it operational in the early part of the next decade when capacity is expected to be squeezed again.

What is key is that either way, the capacity is needed and does not change the utilisation expectations or pricing dynamics of the existing operators, which is core to the current investment thesis. It does, however, potentially change their future investment dynamics and ultimate capital allocation strategy as discussed below.

Organic upside

Strong demand recovery and a 90% port utilisation rate has seen strong revenue expansion and margin upside for Santos Brasil this year and the outlook for 2025 remains robust. Absent global shocks, top line growth should be at least double digits for the foreseeable future as they capitalise on the tight capacity. With a 65-70% fixed cost base, absolute EBITDA growth and margin expansion is impressive underpinning a very strong valuation dynamic.

Capital allocation

For many years, Santos Brasil has had a balance sheet that would be considered sub-optimal in the western world, including net cash at times. They are currently executing on a strong Capex pipeline while working within an 'optimal' leverage structure of 1-1.5x net debt/EBITDA, which, while very low, they believe insulates them from any global shocks and volume volatility. At the same time, they are maintaining a 100% dividend payout and utilising other forms of capital return where possible.

However, even with this as a target, the very strong FCF growth sees them deleveraging fast and without future expansion needs, we could see cash trapped. They have no further profit reserves so can't pay specials and capping the payout to 100%. The recently announced capital reduction of >10% share capital provided a means to improve shareholder returns and help optimise the balance sheet. However, this is not a sustainable strategy. The company did suggest that should their own expansion potential slow (STS10), they would look to

M&A within the port space for future growth – they have had mixed results with M&A, so too much cash remains my one source of concern – but this is a story for 2027+. Alternatively, as it becomes a cash cow it becomes a target for unlisted investors and shippers alike. In the meantime, I remain a buyer of the story.

Roads & urban transport

The two dominant listed transport operators in Brazil, CCR and Ecorodovias, impressed with their positive organic growth outlook coupled with a huge and targeted potential M&A pipeline. How they fund this was the one market concern, but an increasingly disciplined approach to capital management is expected to position them well for the future.

Organic

While the majority of discussion was on future growth, it's worth highlighting that organic growth on existing assets remains strong and much better than expected. This is a function of the stronger economic environment discussed above, the growing agricultural industry and an expanding middle class. Further, these operators have an explicit inflation hedge and a high margin so also capitalising on this economic dynamic. Full year and 2025 earnings have been upgraded supporting valuations.

Also, both operators are executing very well on an optimisation strategy, which should see substantial margin expansion over the next three to five years. This is a function of scale, transition of network to a free flow system and a restructure of the holding structures to remove obsolescence. Both have reported visible success to date and are very confident in their longer-term goals, which for Ecorodovias includes an 80% margin target which would see them a standout in the global toll road sector.

M&A

2024, particularly the second half, is expected to be a very busy period in the transport auction market, with new roads and metro assets and re-concessioned assets at a federal and state level, as well as amendments to existing assets all set to hit the market. Both operators are being very selective and sitting out auctions that don't offer the best capital allocation return, seeing neither winning a bid this year yet.

In roads alone, over the next three years, 10,000kms of new roads with investment requirements of >R$125bn are expected to hit the market. In urban mobility, four new concessions and five amendments with a total investment opportunity of R$69 billion are also expected to be auctioned.

CCR identified a suite of nine projects in roads and urban mobility across new, re-auctioned and amendments that were on their focus list. This suite has Capex requirements of over R$70 billion and are detailed in *appendix 2*. CCR is targeting at least two wins, with a benchmark return unchanged at cost of capital +200-300bps in real terms. It reiterated yet again that they bid conservatively so do not expect to win all it participates in. However, if it is more successful than expected it would consider other funding mechanisms including equity, bringing in a partner and/or an asset rotation strategy with its airport portfolio already identified as a source of capital and a willingness to exit certain regions such as Rio de Janeiro. That is, it won't not bid if they find an attractive use of capital. Interestingly, the biggest concern for the company was not the funding thereof but the ability to execute on the Capex embedded therein – today CCR are tracking at ~85-90% of Capex planned, and wouldn't want this to change by taking on too big a load.

Ecorodovias, conveyed a similar story of potential. However, its capacity is more restricted given recent wins and ongoing execution of what is a substantial Capex profile. Again, it does anticipate some delays to Capex deployment which will help smooth the peaks and reduce near-term demands on the balance sheet. In terms of new wins, its focus was very much on potential amendments (three under discussion), as well as core auctions in areas with synergies to its existing network as well as in Sao Paulo which is considered the national artery. While its leverage is actually tracking better than originally anticipated due to better operational performance, any new wins will require alternative funding mechanisms as discussed below.

The overall competitive dynamic remains robust, with existing players and new private equity and international operators (Vinci) participating. However, with the quantum that needs to be done, the operators believe they can be targeted and conservative in bids and still win a solid pipeline of future growth in assets well suited to their existing portfolio. They certainly have proven to be disciplined year to date and now we wait for execution.

Capital allocation

Considering the huge potential growth pipeline, it's worth touching briefly on the capital allocation priorities of the two players.

- CCR currently has balance sheet capacity to participate in new growth with leverage below its cap of 3.5x net debt/EBITDA. Importantly, some of the potential wins would be EBITDA accretive immediately, so limited disruption to the leverage dynamic. However, should opportunities present in more greenfield assets, it could (doesn't wish to) push leverage above 3.5x for a brief period. Also, it has potential to bring in partners or adopt an asset recycling strategy that could realise ~R$5-10 billion over time. Importantly though, if leverage moves above 3.5x it would trigger a cut in the dividend payout from the 50% today to 25%, where it would stay until leverage returned to sub-3.5x. I think its capital allocation strategy is well thought out and limits the risk of over extension in pursuit of future growth. It's known to be conservative and I don't see risk of this changing.

- Ecorodovias. The recent wins with associated Capex deployment will see leverage peak around 4.5x in 2027/28, and the company is unwilling to go above this. While it continues to look, and will participate in auctions it sees as offering a strong risk/reward dynamic, its balance sheet has significantly less capacity. As such, future wins are likely to trigger further equity raises or alternative financing structures such as partnerships and an asset disposal strategy. I am not against equity issuance if the proposition offers better value than existing trading metrics, which the company is convinced it can achieve and will need to be very clear in disclosure.

I continue to like both names with risk/reward dynamics supporting a position in both at current prices.

Brazilian utilities

Hydrology concerns increasing

Due to weak rainfall, water levels in reservoirs are falling, reducing hydroelectric power generation capacity. To compensate, Brazil is using more thermoelectric power, leading to higher energy tariffs. Generators with uncontracted capacity should be able to benefit through year end into 2025, as spot pricing peaks offering a near-term earnings tailwind. However, for the system as a whole, reservoir levels heading towards 40% will see increased risks of restrictions again – the trajectory is not as bad as 2018-2020 at this stage but certainly deserves monitoring.

Curtailment

Energy curtailment is the deliberate reduction in electricity generation to maintain the balance between supply and demand in electric power systems and/ or reduce stress on the grid. It's becoming an issue for the Brazilian system and was a key topic of conversation for the utility sector and arguably the biggest sector concern coming out of the visits. While many argued that it was a short-lived issue, rectified by the build out of much needed transmission lines, others indicated that the issue is more structural.

- Short lived – curtailment to date has largely been to support the grid and operators like Serena believe that a large part of the curtailment will be mitigated by new transmission lines entering the system. This is certainly one cause and increased transmission investment will help – it's also a reason we favour transmission investments over generation in Brazil at the moment.

- Structural – others believe the curtailment issues are structural given the exponential increase of distributed generation as a result of government subsidies. CPFL Energia forecasts that there is currently a 20% overcapacity in the system, while Engie Brasil estimates a long-term structural curtailment of 5% of wind and 10% of solar.

What is clear to us from the integrated players is that further investment in renewable assets was taking a back seat to investments in distribution and transmission. I think it's a medium-term overhang for the pure play renewables in the country, with many operators already factoring in ongoing curtailment to their forecasts.

Importantly, it's also a message to the rest of the world: renewables without supporting grid investments will lead to curtailment of the generation and an inefficient energy system in general. It is also the reason we believe grid investments are the most attractive way to gain exposure to the energy transition theme at the moment.

Energy tariffs

A strong consensus view is that the structure of the electricity bill in Brazil needed to be redesigned to facilitate energy investment in the country. While Brazil continues to have one of the lowest costs of power generation globally, increasing subsidies to distributed generation and the shift of large consumers to the free market has increased the burden of the grid on a smaller pool of customers, largely retail. This must be addressed as they move into a cycle of large grid investment, particularly in light of investment thematics such as data centres.

Importantly, the Undersecretary for Economic and Regulatory Affairs of the MME, Mr. Gustavo Estrella, recognised the issue and commented that the "MME is working on redistributing sector costs and a new policy could be presented soon". He also noted that the new contract will give ANEEL the power to improve tariff structures and potentially charge different tariffs across the customer base.

Distribution renewals

The renewal of the distribution concessions is one of the most underappreciated stories within the Brazilian utility space this year. A decision has been long awaited and the conclusion to move forward with the concession renewal without additional cost to the distributors was very positive for both the operators and for the system, as it looks to keep up with demand, quality of service issues and the potential of new technologies.

The new contracts require significantly increased levels of investment (much like networks globally) with associated tougher consumer satisfaction metrics. Importantly, the potential ability to incorporate investments into RAB annually helps incentivise and accelerate the needed growth as companies are remunerated very quickly.

The signature of the new contracts is expected within the first half of 2025, removing a key overhang for the sector (albeit I think very little residual risk) and anticipate revised investment programs throughout 2025 with impressive RAB growth expectations.

The one ongoing overhang is, as discussed above, who and how this grid investment is supported by bills in the regulated market.

Water

There's a lot of buzz around the successful privatisation of Sao Paulo's water utility, Sabesp. The sector has had a strong run this year, with a regulatory framework finally in place, paving the way for the entry of strategic investor, Equatorial, and the ultimate sell down by the government. The story is now about execution, with the company responsible for a significant investment pipeline as well as delivering on promised efficiencies. We are positive on the thematic that is water and sanitation in Brazil, and had good meetings with both Sabesp and Equatorial with consideration now to be given to how best to gain exposure.

Other

To comment on a few of opportunities that were raised when in Brazil, which I think are worthy of monitoring and will be discussed in greater detail in future articles:

- State of Para – Para is set to host Cop30 in 2025 and showcase Brazil's strategy for decarbonisation. The current governor spoke at length about the national opportunity set, but I wanted to flag one state initiative that is unique. The state is set to auction a 'reforestation' concession, which will provide a 30-year concession to reforest, illegally deforested, sections of the Amazon. In exchange for this reforestation, the owner of the concession will receive credits for nine million tonnes of carbon. For those looking to offset carbon emissions, this could present a unique and simple way of capturing carbon.

- Offshore wind – there's legislation in parliament to set the framework for decarbonisation goals including the future of offshore wind in Brazil. The federal environmental regulator is currently considering close to 100 projects with a capacity of over 230GWs. An initial auction could be in play as early as 2025, with capacity online by 2030.

- Data centres – private equity funds have been investing heavily in the Brazilian data centre opportunity, given the country's potential to provide clean and abundant energy. Brazil sees the opportunity to establish themselves as a data centre hub and are working to design the energy system and security of water supply to support future growth.

- Climate investment – the floods in Rio Grande do Sul (RGS) earlier this year, and the recent Sao Paulo fires, have highlighted the growing climate risk from the increasing frequency of extreme weather events. Impressively, RGS has done an exceptional job in recovering operations, including infrastructure (roads cleared in 10 days, airports to be operational in October). However, it has also opened the door for increased investment to strengthen core infrastructure and prepare for future weather-related events – so called adaptation and prevention initiatives. This is not as yet something that is quantifiable but the rebuild of RGS will certainly provide a benchmark to the opportunity set for all states.

Portfolio positions

Despite ongoing political and economic headwinds across the region and the globe, this trip sees us reaffirm our investment in Latin America. We have factored in the risk and believe the value proposition of the quality infrastructure names continue to be very attractive.

In summary:

- Mexican airports: we remain exposed to the Mexican airport operators. Having factored in increased country risk, we believe the risk/return trade off favours the operators, who we believe should be largely insulated from the political and economic overhangs – all offering value but continue to favour ASUR and GAP.

- Brazilian toll roads: there's strong organic momentum coupled with a huge pipeline of growth with companies exhibiting capital discipline in bids. Valuations are offering significant upside without growth incorporated, and we believe risk/return on bids is to the upside. We maintain positions in both.

- Brazilian rail: this is strongly leveraged to a key Brazilian and global growth dynamic being the expansion of the agricultural industry in an effort to meet global food demand. Significant near-term competitive advantages and long-term growth drivers reaffirms our investment in the core logistic provider supporting this thematic, Rumo.

- Brazilian ports: Santos Brasil is supported by near-term competitive advantages and midterm expansion opportunities. Valuation is further underpinned by an improved capital structure and attractive shareholder return strategy. One concern over the longer term is cash trap, but doesn't dissuade us from our core position at these levels.

- Brazilian utilities: a mix of positive and negative discussion points here. Of concern was increasing hydrology risk as well as ongoing system curtailment which sees us less favourable on the generation sector. By contrast, strong upside coming from the distribution concession renewals and significant ramp up of investment in grids to see us increasingly positive on the integrated regulated names as well as pure play transmission & distribution operators, both of which are undervalued at the moment.

- Other: there are significant interesting infrastructure opportunities to explore in greater detail moving forward, including unique climate concessions, Brazil's preparation ahead of 2025 COP30 and the potential of near shoring and data centre growth across the region.

As always, we maintain a diversified portfolio of high-quality infrastructure names globally, and at the moment, believe parts of LatAm are offering an attractive mix of quality and value.

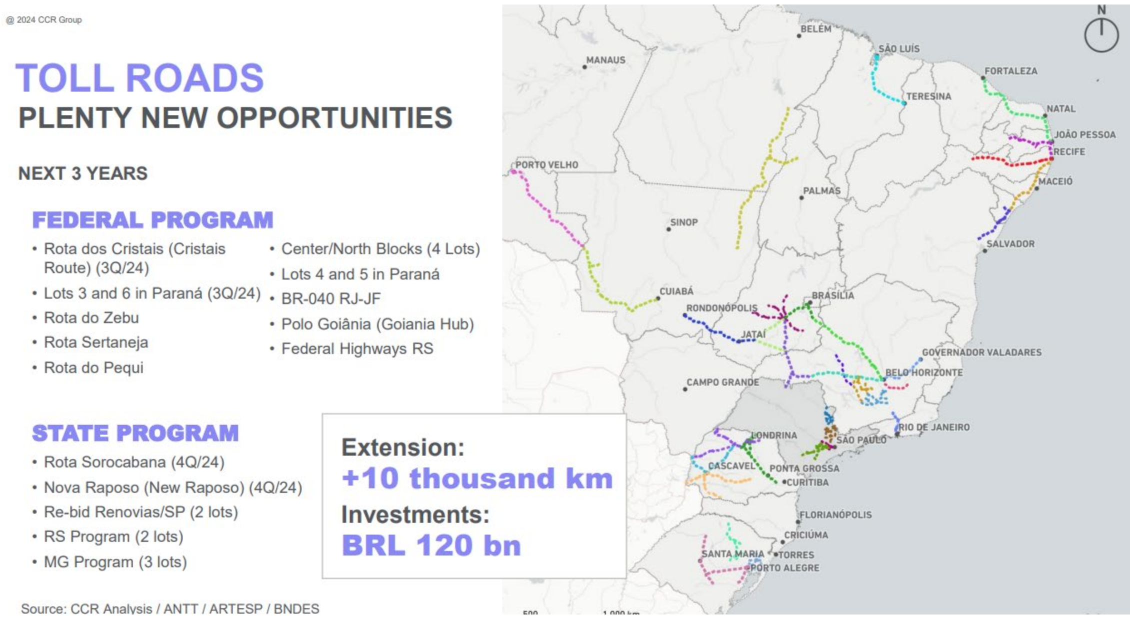
Appendix 1 – Changes to Mexican Airport regulation – a summary

Basis	Proposal	Rationale	Impact
Taxation	Increasing the concession tax from 5% to 9% effective 1 January 2024	Federal Law change	This will have an impact - quantum depends on the operator's level of Mexican commercial revenues
Regulation	3% excess passenger cap	The post COVID recovery saw operators earn exceptional profits and Regulator wanted to mitigate this potential moving forward	Valuation neutral as not retroactive and we don't forecast traffic out-performance
Regulation	Move from Cost of Equity to WACC to calculate regulatory return. Based on operator's actual Mexican airport capital structure so can be managed	To properly reflect capital structures of airports today relative to where they were on privatization To align with global standards To provide greater transparency around calculations	Positively have significantly increased clarity and transparency on the calculation of the WACC Will have an impact but can be managed by the operators through their Mexican Capital Structure
Regulation	Long bond rate tenure	Historically the cost of equity was calculated using the average bond rate 2 years before the MDP negotiation. This has been moved to the average of the 5 years to align with the MDP tenure	Could be positive depending on timing
Regulation	Terminal Value Calc	Increases importance of terminal value calcs in Reference Value to promote accurate forecasting	Neutral
Regulation	Reference value re-balance	Fixes a structural problem at smaller airports	Positive

Appendix 2– CCR target bids

Of the significant pipeline of assets coming to market, CCR identified the following as priorities.

- Roads
    - BR040 (Rota dos Cristais)– September 2024 – this is a continuation of a road that was auctioned in H1 with a capex commitment of R$6.5bn (CCR bid very conservatively at just 1% tariff discount and did not win). It is already operational so contributes EBITDA immediately. Post the trip we received confirmation that CCR has submitted a proposal for this road as have 3 others including Vinci, 4UM/Opportunity and BTG. *I think it unlikely that they will be successful*
    - ViaOeste – a re-concession of an existing CCR asset (ends in March 25) which will be offered in two stretches in October and November this year with a capex requirement of R$17bn (Phase 1 = R$10bn and Phase 2 = R$7bn). This asset will be restructured as a 100% free flow road and is a priority for CCR as they know the asset very well and again would contribute EBITDA immediately at ~R$1.5bn pa. *Given current ownership, I see them as the natural winner of this asset although Ecorodovias is also targeting it for strategic importance and could be aggressive*
    - MSVia – a re-auction of a currently unviable concession. CCR set to hand this road back and government looking to re-structure and return to market. The new concession is expected to have a capex commitment of over R$10bn. This is a turn around story as currently loss making but with a restructure would immediately contribute EBITDA which is expected to grow rapidly over the next few years. *CCR know this asset very well and I see them as the likely winner of this asset*
    - Parana State– 2 assets coming both with capex requirements of ~R$10bn. Awaiting the bidding documents to assess attractiveness



- Urban metro
    - SP Urban mobility Lines 11,12 & 13 – to be offered in one concession with a capex requirement of R$12bn. As a highlight, line 13 connects SP to the International airport. Bidding documents expected before year end and bids in February. CCR has seen very little competition on the metro assets and are very hard to compete against given their expertise and synergies. *I see them as the likely winner of this asset*
    - Amendment to existing concession Via Quatro to add an additional 2 stations with a capex commitment of R$3.5-4bn – have agreed to undertake the feasibility studies and if prove to be

an attractive use of capital the amendment would be signed in 2025 and capex commencing in the same year. *I see them as the likely winner of this amendment but must stack up within the balance of opportunities or expect will not proceed at this time*

- Amendment to existing concession for Line 5 to also add an additional 2 stations with a capex commitment of R$3.5-4bn. As with Via Quatro the feasibility to be considered this year with potential execution next. *I see them as the likely winner of this amendment but must stack up within the balance of opportunities or expect will not proceed at this time*

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