4D infrastructure

Trip Insights

Latin America & Europe
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A cornerstone of our investment process is company management meetings and site visits. These meetings serve several purposes, including providing an insight into management – how they think and run their business – and whether management priorities align with ours as investors. Our Company Quality Grading process involves explicitly ranking company management, so first-hand contact is vital.

The 4D investable stock universe is dispersed broadly around the globe. This necessitates our team travelling widely to call on companies, meet management and conduct site visits. This invariably provides a great insight into not only the specifics of the company being visited, but also a real perspective on what is happening more broadly in the relevant sector, economy and society. We prepare detailed notes after those meetings which capture and relay the key issues and themes of the day.

This is the fifth in our series of *Trip Insights*, where we share those experiences. It follows three trips during 2018 when Sarah Shaw, 4D Global Portfolio Manager, completed an extensive company engagement and calling program in Latam America and Europe, meeting with management teams from Oil & Gas Infrastructure, Regulated Utilities, Renewables, Transport (road, rail, air sea) and Communications Infrastructure.

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Panama Canal
Source: 4D Infrastructure

Overview

Politics

Populous movements have gained further traction this year, ready to pounce on any electoral opportunities that present themselves – a clear sign that globally the masses want change and are dissatisfied with the incumbent ruling class.

Europe

While the economic mood remains reasonably buoyant for European companies, it has deteriorated over 2018 as a result of politics.

- The Brexit outcome is still very uncertain, despite deadlines looming. There are also increasing concerns around what a government shift in the UK would mean for infrastructure operators, with UK Opposition Leader Jeremy Corbyn arguing for nationalisation of the water utilities.
- Many are still waiting on promised execution by Macron in France as he continues to battle strikes.
- There has been yet another change in government in Spain as a result of corruption allegations.
- The Italian election created significant uncertainty, with a far right and a far left party trying to form a coalition.

Mexico

Santiago airport construction
Source: 4D Infrastructure

The year has been dominated by the elections, with the initial January concerns around the traction gained by populous, left leaning candidate Andrés Manuel López Obrador (commonly referred to by his initials AMLO) giving way to his resounding majority win in July. All eyes are now on how he will execute on campaign promises, including the cancellation of the Mexico City Airport project.

The other big overhang for Mexico in 2018 was the North American Free Trade Agreement (NAFTA), with the consensus view in January of a renegotiation over a cancellation, given the latter would have negative ramifications for both Mexico and the USA. This proved to be the case, with Trump posturing aggressively and then negotiating a new Agreement which was not significantly different from the original.

Reform is critical for the new government in 2019, having promised to clean up corruption, improve rural living standards and improve wealth equality across the country. While some of AMLO's rhetoric has been concerning, we hope that given his supporters include some big names in the Mexican corporate world (e.g. Carlos Slim) his bark is worse than his bite.

From an infrastructure standpoint:

- the cancellation of the ***Mexican airport*** was a major negative for sentiment, but we believe it could represent an opportunity for the existing Mexican airport operators as they develop alternate hubs for transfer passengers – particularly relevant for OMA and GAP;
- we will be watching ***energy reform*** closely, but at this stage AMLO seems supportive of ongoing reform as long as it doesn't involve core national assets (eg. CFE); and
- ***regulatory change*** has not been a focus of the election campaign, so we are not expecting any near-term shifts; and the operators remain confident in the strength of the regulatory model and their contracts, despite an AMLO government.

Brazil

The economy continues to show signs of recovery, but this has largely been overshadowed in 2018 by the October elections. Exiting President Temer has been unable to execute on much-needed reforms, and in some cases has had to backtrack. The mid-year truckers strike saw the government cede some concessions, not to mention de-rail the economic recovery for a number of weeks.

The election in October of far-right candidate Jair Bolsonaro gives hope of some meaningful reforms, including:

- reduced government influence over State-owned companies (Bolsonara is supportive);
- more State-owned companies to be privatised across all sectors (Bolsonara is supportive);
- assets will have to come to the market, which is necessary for the government to raise money. This is starting to happen with Federal road auctions under way and some suggestion of the sale of gas reserves to fund budgets;
- international operators showing increased interest in operating assets – not just the constructors looking, but long-term operators; and
- cleaning out all levels of government with nowhere to hide from the Car Wash (corruption scandal enquiry) fallout.

We are definitely seeing positive signs for the infrastructure players in Brazil, with:

- the '*New Infrastructure Plan'* highlighting assets to be auctioned;
- new laws to support investment and concession renewals/extensions;
- improvements to the return profiles of utility operators;
- increased auctions in both the transport (airports, roads, urban mobility) and utility (transmission auctions and diversified generation sources) space;
- the sale of State-owned assets – for us, Eletrobras assets are coming to the market in batches and CESP has finally been sold (third time lucky);
- a resurgence in M&A interest from foreign players, as existing operators continue to look very cheap (e.g. Ecorodovias, Eletropaulo); and
- the government making regulated returns increasingly attractive, as they can no longer rely on State-owned enterprises to be the 'buyer' of last resort for new infrastructure projects. This is being seen in the attractive transmission returns being offered – definitely improved from historic auctions as government needs the investment, but has also resulted in increased competition from new and existing operators.

Argentina

What a roller coaster 2018 has been for Argentina. In January, the country was the poster child for the LatAm conference, with panels on Argentina as '*The New Opportunity'* and regarded as the most politically stable of the LatAm nations. President Mauricio Macri continues to work hard to reform the country, but his efforts have been derailed by economics and now with the return of hyper-inflation. It appears the economic base was not stable enough to withstand a rising rate environment in the USA, and this must now be resolved as a priority.

USA

Trump's ongoing nationalism continues to pressure markets, and is now flowing through to global economics. 2018 started with NAFTA and progressed to both Europe and China, with trade wars an ongoing battle.

With NATFTA, Trump took a hard line until negotiations were underway, when he accepted a re-negotiation on very similar terms to the original Agreement. There were some small wins for the USA so Trump can cry success, but in reality his bark proved a lot worse than his bite. This was largely expected as while Mexico would have been hit harder than the USA with a cancellation, key swing states in the USA would have been hit very hard and could have derailed Trump's political career.

1. Trip Agendas

Latin America, January 2018

Company	Sector/Topic	Location
GAP	Airports	Guadalajara
Site Visit GMXT	Rail	Guadalajara
Site Visit Guadalajara Airport	Airports	Guadalajara
Eneva	Power	Santander Conference Cancun
Grupo ASUR	Airports	Santander Conference Cancun
Mexico Power Reform	Power	Santander Conference Cancun
CEMIG	Power	Santander Conference Cancun
Finance Minister of Mexico	Government Policy	Santander Conference Cancun
GAP	Airports	Santander Conference Cancun
Credit Rating Agencies Panel	Credit Conditions	Santander Conference Cancun
OHL Mexico	Toll Roads	Santander Conference Cancun
Ienova	Power	Santander Conference Cancun
Argentina Panel	Government Policy	Santander Conference Cancun
OMA	Airports	Santander Conference Cancun
Rumo	Rail	Santander Conference Cancun
Ecorodovias	Toll Roads	Santander Conference Cancun
Colbun	Generation	Santander Conference Cancun
GMXT	Rail	Santander Conference Cancun
Transportadora De Gas Del Sur	Oil & Gas	Santander Conference Cancun
Site Visit Panama Canal	Transport	Panama
AES Tiete	Contract Generation	Sao Paulo
CCR	Toll Roads	Sao Paulo
Light	Power	Rio de Janeiro
TAESA	Transmission	Rio de Janeiro
Edenor	Distribution	Buenos Aires
Pampa Energia	Power	Buenos Aires
Enel Chile	Power	Santiago
Enel Americas	Power	Santiago
Aguas Andinas	Water	Santiago
Site visit Aguas Andinas Waste Treatment Plant		

Europe, April 2018

Company	Sector/Topic	Location
Engie	Contracted Generation	Paris
Vinci	Diversified	Paris
Eurotunnel	Rail/Toll Roads	Paris
ADP	Airports	Paris
ADP site visit of CDG airport	Airports	Paris
Snam	Transmission	Milan
Italgas	Distribution	Milan
SIAS	Toll Roads	Rome
Inwit	Towers	Rome
ENAV	Airports	Rome
Terna	Transmission & Distribution	Rome
Atlantia	Toll Roads	Rome
Rome Airport site visit	Airports	Rome

Enagas	Gas	Madrid
Cintra	Toll Roads	Madrid
Ferrovial	Diversified	Madrid
AENA	Airports	Madrid
Iberdrola	Power	Sydney

UBS Renewables day, London, September 2018

Company	Sector/Topic	Location
Innogy	Renewables	UBS Renewables day, London
Enel Green Power Aurora Consulting	Renewables	UBS Renewables day, London
Oxford University	Renewables	UBS Renewables day, London
Irena	Renewables	UBS Renewables day, London
Engie	Renewables	UBS Renewables day, London
Orsted	Renewables	UBS Renewables day, London
Drax	Renewables	UBS Renewables day, London

Santander Conference NY, September 2018

Company	Sector/Topic	Location
Atlantia	Toll Roads	Santander Conference, NY
GAP	Airports	Santander Conference, NY
Flughafen Zurich	Airports	Santander Conference, NY
Santos Brasil	Ports	Santander Conference, NY
CCR	Toll Roads	Santander Conference, NY
Rumo	Rail	Santander Conference, NY
CFE	Power	Santander Conference, NY
Ienova	Power	Santander Conference, NY
Fraport	Airports	Santander Conference, NY
Engie	Contracted Generation	Santander Conference, NY
Vinci	Diversified	Santander Conference, NY
Naturgy	Oil & gas	Santander Conference, NY
CAAP	Airports	Santander Conference, NY
ADP	Airports	Santander Conference, NY
Santander	Strategy	Santander Conference, NY

2. Economics

Globally

The synchronised global growth story of 2017 looks to be waning and the outlook is less buoyant, with politics and trade wards de-railing some of the upside. We are starting to see inflation emerge in the USA, which is driving Fed moves. The big risk is they move too fast and stall the recovery. With the USA deficit having spiked again, they are not in a great position to provide large stimulus should it be needed. Also, Fed rate hikes in the USA have taken their toll on certain economies such as Argentina, where hyper-inflation is back in play – derailing the buoyant mood that surrounded Argentina in January.

What has also been evident over 2018 is how quickly the economic outlook can turn if the economy is not on a solid footing to start. For example, Argentina post US rate hikes went from being considered the upside story of 2018 to another IMF bailout. And Italy, which was tracking along nicely early in the year, has fallen foul to electoral mayhem with a government wanting to spend, spend, spend.

Looking briefly at each country:

- **Europe:** While Europe's macro outlook remains mixed, the general consensus is that we are looking at a growth environment. Wasn't much expectation of rates rising across Europe any time soon.
- **Spain:** Macro remains buoyant, but ongoing political disruptions and a shift back to the left warrant some caution.
- **UK:** Brexit remains the largest overhang. While economically UK has been okay to date, there are definite signs of weakening and still a very bumpy road ahead with December 2018 and March 2019 critical dates in the process.
- **Italy:** A very disappointing election outcome has put pressure on Italy again, with country spreads spiking as concerns increase around proposed government spending compounded by a budget that has been rejected by the EU.
- **France:** Outlook still solid under a Macron presidency, but he needs to start delivering on his reforms.
- **Brazil:** Signs that Brazil has turned the corner economically, but still very early days as they look to recover from one of the worst recessions on record. The H1 truckers strike closed down the country for two weeks and set the 2018 growth outlook backwards. However, in the absence of further populous action, Brazil should continue to improve with volumes coming back to the ports, traffic coming back to the roads and demand profiles improving. This is supported by still muted inflation and a low interest rate.
- **Mexico:** The NAFTA agreement was a tick for ongoing economic stability and a weaker peso is supporting exports. The domestic demand story remains solid, with domestic passenger growth across the airport network remaining double digit and regularly surprising to the upside. The biggest near-term concern is the political agenda and how this translates into economic policy. Also, as Mexico's economic activity is highly correlated to the USA, the Fed action will continue to be incredibly important for the Mexican outlook.
- **Argentina**: Huge deterioration in the economic outlook over 2018, and Macri's near term battle is now with inflation. IMF bailout in place.
- **USA:** Markets strong, driven by consumer strength and expectation of Trump policies. US can continue on a buoyant path as long as the Fed doesn't raise ahead of needs – watch inflation closely. The biggest near-term threat is Trump's trade wars.

Mexico City from the air
Source: 4D Infrastructure

3. European Infrastructure

Growth profiles

With mature assets, strong balance sheets and large underlying FCFs, a key ongoing theme for the infrastructure players is the search for growth and associated home for capital. This was the case for most of the toll road and airport companies. There were a few exceptions such as Zurich Airport, which was not focussed on M&A as they continue to deploy the Circle project and negotiate their regulatory re-set. This will see them with a very sub-optimal balance sheet.

European rail
Source: 4D Infrastructure

Asset sales

Low growth, de-risked assets and failed expansions are available for sale, with infrastructure operators using an asset rotation strategy to fund further growth.

Capital allocation

As a general rule balance sheets are sub-optimal, or rapidly approaching, with the operators searching for growth. Some expectations of ordinary dividends going up in response to strong FCF generation, but unlikely to see any special dividends at this stage. There are some exceptions – Fraport's balance sheet was optimally structured and Atlantia's was also in good shape prior to the Genoa bridge collapse.

Regulatory uncertainty

There was increasing uncertainty on the regulatory front from a mix of populous governments, expiring concessions and regulatory re-sets.

4. European Utilities

Growth plans

As with the European infrastructure players, all but a few of the utilities are looking for a home for balance sheet capacity, and to improve their growth profiles. International expansion remains the core opportunity, but populism and competitive dynamics are seeing little in the way of success for core operators

Renewables

The renewable theme continues to gain traction as the future of generation, and many are looking to take part in this development either directly (eg. Iberdrola, Engie, Enel, Orsted) or indirectly by way of connecting the new generation to the grid (Terna). Continuing the theme of 2017, solar has taken over from wind on the cost curve, with an expectation that there will be much more solar investment going forward. Costs are coming down for both wind and solar, which will drive ongoing investment as well as tariff declines.

The renewable thematic is also gaining global traction. Europe was a leader in renewable investment, and this then shifted to the developed world in general. However, it now appears the opportunity set is moving to emerging markets as they also look to increase their transition away from fossil fuels.

A negative thematic is the move towards merchant generation, with many operators seeing merchant as the future renewable model. Slowing the transition to a renewable world is the development of batteries – they are necessary, and the view is that they have a long way to go on both the technology and cost curve to be truly viable.

Asset sales

Non-core assets are for sale, with Engie, Iberdrola and Naturgy all proceeding down this road as a means of generating capital.

Regulation

As with the infrastructure assets, regulatory uncertainty has increased for the utilities.

Capital allocation

There appears to be no threat to existing dividends but still not looking at major increases as they all continue to look for, or execute on, growth strategies.

5. Brazilian Infrastructure

Corruption scandals

Allegations of corruption have caused a significant selloff in core Brazilian infrastructure names this year. As the investigations come to an end, it increasingly looks likely that wrongdoing will be found, and the operators will be looking to sign '*Leniency Agreements'* to end the corporate liability. All involved parties (employees) are no longer with the companies. We think the sector will benefit from clarity, as the stocks have lost significantly more value than warranted by a worst-case scenario.

Santiago Waste treatment plant
Source: 4D Infrastructure

Primary bids

A number of primary bids were due to come to the Brazilian market over 2018 across toll roads, airports and urban mobility – but as always in an election year, things have been pretty quiet. We expect a strong ramp-up in activity in 2019, supported by the Bolsonaro government. Airport bids are increasingly attracting international interest, and don't expect this to change with all the European operators looking to phase 3 bids early next year.

In the toll road space, there were a couple of early year wins for Ecorodovias (CCR did not participate) and more recently a win by CCR in the first of the new phase of Federal concession auctions. With 15 roads to be auctioned over the next few years, we expect much more action on this front now that the election has been finalised. CCR is positioned very well to be competitive (balance sheet strength) and is looking to win the re-auction of its existing assets as well as some additional projects (eg. RIS was a Triunfo asset). In urban mobility, CCR continues to dominate with a Q1 win of subway assets in Sao Paulo.

Secondary market acquisitions

The secondary market continues to be of interest to the toll road operators, but very few assets are currently available. Positively, CCR remains disciplined and walked away from assets that didn't meet their investment criteria.

For Rumo, the opportunity is in the extension of their network further north, with a project in the pipeline that will see significant growth upside from 2020. They see their restructure plan coming to an end and are now looking forward to growth.

Concession extensions /rebalancing

A number of toll road re-balancings are in the pipeline in exchange for additional capex, as well as in relation to the law change on suspended axles. Not much movement in 2018 as it's an election year, but we are expecting to start hearing news on this throughout 2019. The more important renewal is that of Rumo's rail concession (early renewal), which the company still believes could happen before the end of 2018.

Volumes

Real signs of underlying recovery across the transportation network:

- **Road:** excluding the impact of the truck strike and suspended axle change, road traffic has returned to positive growth;
- **Rail**: volumes remain strong, supported by good crops in 2018, and the outlook for 2019 is also solid (not quite as good as 2018 but still buoyant); and
- **Ports**: significant turn-around in volumes at the port of Santos, with an improved mix between full and empty containers – a real sign of economic recovery.

Capital allocation

Balance sheets, as a general rule, remain strong, supporting growth pipelines and dividend policies.

6. Mexican Infrastructure/Utilities

Airports

The traffic evolution at Mexican airports remains very strong and well ahead of MDP forecasts, largely driven by domestic passenger growth and the emergence of the middle class. The successful negotiation of a *'new NAFTA'* removed a near-term threat to OMA's domestic traffic routes, which were dependant on US trade. The biggest current threat is now a political one with the new AMLO government.

The cancellation of the Mexico City airport was a key election promise of AMLO. While negative for sentiment, it could be an opportunity for the existing operators to create alternate hubs for transfer traffic – particularly relevant for OMA and GAP. Another near-term threat is the financial health of airline Interjet, which must change its business model if it wants to survive. The operators don't see any imminent threat of collapse, but are cognisant of being paid on time.

Rail

The recently listed GMXT could represent an attractive investment opportunity – it is a restructuring story and has been likened to Rumo of three years ago. We need proof of execution before we get too excited, but definitely one to watch. Biggest issue near-term is executing on their capex program to improve capacity by way of automation and speed – this will also help them combat rail theft which has become a major issue.

GMexico railroad yard
Source: 4D Infrastructure

Toll roads

The Mexican toll road space continues to offer very attractive traffic growth, well ahead of GDP growth. As congestion still abounds, investment in the space also remains very strong and favours existing operators such as PINFRA and the old OHL Mexico, who both have a pipeline of new assets. As the middle class continues to evolve we see even further support for the sector.

Energy sector

Ienova remains committed to executing on a strong pipeline of energy projects, and sees continued opportunity as Mexico executes on its energy reform. Management don't believe AMLO is a significant threat to energy reform – he supports it in principal, he just doesn't want to see core national assets in private hands.

The market has become more competitive, with Europeans and North Americans wanting to take part in the transformation. Ienova believes the pipeline opportunity is over for the moment, with focus shifted to storage opportunities in both liquids and gas.

7. Brazilian Utilities

Hydrology & new generation

Hydrology remains an ongoing issue, with lower than average rainfall impacting generation and pricing yet again in 2018. After a number of years of high spot pricing, the generators have positively restructured their business model to keep a larger percentage of their generation un-contracted so they can manage hydrology, GSF and spot pricing more effectively.

LNG tanker on Panama Canal
Source: 4D Infrastructure

Brazil continues to need more generation capacity with the operators focused on diversifying their sources away from hydro via investments in wind and solar plants.

Transmission investment gaining priority

With huge investment needs in the transmission sector, a function of new generation (hydro and diversified sources) coming online, as well as significantly improved headline returns, the transmission sector is attracting a great deal of interest from existing operators as well as new entrants to the sector, both domestic and foreign. For example, TAESA is executing well on seven greenfield projects. However, with the increased interest recently the returns are now being squeezed again and they have turned their attention to secondary market opportunities.

Secondary market

A number of operational assets have made, or are making, their way to the secondary market this year including some from Eletrobras, Cemig, CESP and Eletropaulo.

Regulation

The regulatory environment has improved over the past few years, particularly in the transmission space, with the government recognising a need for increased sector investment and that existing return profiles/project terms aren't encouraging that investment.

8. Chilean Utilities

Regulation & capital allocation

The biggest overhang at the moment is the next regulatory reset in both Distribution and Water**.** Strong balance sheets and supportive dividend policies provide downside support for these stocks.

9. Argentinean Infrastructure/Utilities

A real turn-around story

The new government is executing on reforming the entire sector, with strong upside for the following:

- **Distribution:** tariffs have been normalised through a staggered implementation, and are now subject to an inflation increase every six months. That is the reinstated regulation, and when we met with the companies in January everyone was excited to move forward under this model – however, with hyper-inflation back in the market we need to see proof that this model is working.
- **Generation:** after a decade of under investment they need significant new capacity, and the model is in place to encourage investment. There was increasing interest from foreign players, including Enel Americas. However, this too has stalled as a result of the return to economic crisis levels, and Macri is focused on stemming the decline and not in investing in generation.
- **Energy losses**: there has been a big jump in energy losses as tariffs have increased, and the operators are actively working to mitigate via disconnections and public shaming of those stealing.
- **New opportunity:** Argentina is advancing on developing gas sources to address their huge deficit. At this stage they are subsidising upstream investment, which is encouraging investors. We are more interested in the pipeline operators such as Transportadora De Gas Del Sur who are looking to capitalise on the volume story.
- **Airport:** The recently listed airport operator CAAP has seen its share price halve since IPO. Has an attractive portfolio of assets, dominated by Argentina, and is widely acknowledged as being cheap. However, there is significant overhang on the Argentine regulatory and economic front at this point in time.