Renewed interest in infrastructure development could bring a much-needed spur to global building projects and create fresh investment opportunities, says Newton global real return portfolio manager Philip Shucksmith.

Since U.S. President Donald Trump's pledge to spend US$1 trillion on an overhaul and build-out of American services in the next few years, infrastructure has become an increasingly popular theme for investors.

Tied in with what has become known as the “reflation” trade, the assumption is that if growth is improving and governments are on hand to support or sponsor a greater number of large-scale construction projects, then companies involved in such an expansion could benefit.

A decade after the onset of the financial crisis, the long shadow it has cast appears to be fading. Consequently, all sorts of cyclical sectors have surged. Performance in the financials, materials and industrials sectors in the S&P 500 was up 10.7%, 6.7% and 4.6% (in dollar terms), respectively, only a few weeks after Trump's victory.1

However, investment in infrastructure has not always been about riding a politically induced construction wave, nor should it be reduced to that now, says Shucksmith. He says: “There is an infrastructure food chain. At one end there are underlying companies that provide components needed for building projects. These range from materials companies to global commodity producers to firms that provide machinery or component parts.” The contractors in charge of builds are obvious beneficiaries of infrastructure spending. However, these firms are often working on tight margins, says Shucksmith.

ANCILLARY SERVICES

The companies that manufacture and sell construction machinery could see a boom if there is a surge in infrastructure spending, although this is a very competitive sector with a lot of price competition, he explains. Shucksmith believes some other ancillary services could benefit as well, including the licensees of computer-aided design software and building information management services. Both are playing increasing roles in large infrastructure projects as they become more digitized.

With such a range of market participants, many sectors could be set to benefit from increased government funding of large-scale building projects. Equity investors have participated in the reflation trade by allocating to some of these sectors, a shift that saw cyclicals largely outperform immediately after Trump's election.

Yet even if “Trumponomics” flourishes and new infrastructure spending is approved, Shucksmith points out many of the beneficiaries may be cyclical and not necessarily exhibit the characteristics investors have traditionally looked for, such as infrastructure companies’ reliable income streams and insulation from the economic cycle. For such attributes, he looks at the owners/operators of infrastructure assets, the listed funds that manage the properties or venues once they are constructed.

He says there is also an important distinction to be made between different types of assets: those which are availability-based and those that are volume-based. In the case of an availability-based asset, such as UK public hospital concessions, as long as the doors are open and the terms of the contract are being fulfilled, the concession will receive payment from the government regardless of the number of users. However, with a volume-based asset, such as a toll road or airport, revenues are dependent on the number of people using the facility.

“Both concession types can make for attractive investments as long as the risks are priced appropriately and depending on what you are looking for. If one is more cautious on the economic growth outlook, then the stability of cash flow produced by availability-based assets is very attractive. If, however, you are looking to benefit from a pickup in economic activity, then clearly volume-based assets will be of more interest to you,” he adds.

“We like some listed infrastructure companies because we are skeptical about the global growth outlook and the sustainability of many market valuations. A cyclical company that benefits from the optimism surrounding GDP projections would not be a particularly good diversifier if those projections prove unfounded, whereas we would expect availability-based infrastructure owners to be largely agnostic of where we are in the growth cycle.”

RISKS

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