Cohen & Steers

The macro trends driving today's infrastructure market

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Benjamin Morton,** executive vice president, head of Global Listed Infrastructure and a senior portfolio manager, and **Chris DeNunzio,** vice president and senior analyst, at Cohen & Steers. Following is an excerpt of that conversation.

What challenges are institutional investors facing today?

Benjamin Morton: A main challenge today is allocating in an evolving macro environment, which features slowing growth, persistent elevated inflation, and a period of tightening financial conditions — in the form of rising interest rates and tightening monetary policy in most parts of the world. Other challenges include the lingering impact of the pandemic, as well as the supply-chain disruptions that partly stem from the pandemic but also relate to other dynamics, such as the Russia-Ukraine war.

How does Cohen & Steers' global listed-infrastructure strategy help investors meet those challenges?

Morton: Infrastructure assets provide essential public services that help facilitate economic growth, and we invest in the owners and operators of infrastructure businesses. They tend to be regulated or concession based, though some assets are competitive in nature. Infrastructure assets also tend to have monopolistic market positions, although some can operate in competitive environments — though those that do tend to have long-term contracts. As a result of these characteristics, these businesses offer relative predictability of cash flows. For investors, this has historically led to equity-like returns, but with lower volatility than broader equities, and with attractive downside protection. In markets characterized by slowing growth and persistent inflation, infrastructure has shone, given that downside protection and inflation "beta" provided by pricing mechanisms that allow companies to pass inflation through to customers in the form of higher rates.

What longer-term secular trends may drive infrastructure returns?

Morton: We think there are several secular themes that will be important drivers of infrastructure returns over the long term. First is the digital transformation of economies and what that means for the growth of data demand. Data intensity of mobile devices and the applications we use, as well as the number of connected devices, are all going up significantly. This phenomenon is driving a strong increase in data consumption, a theme that creates attractive opportunities for cell-tower companies, which transmit, and data centers, which store, that data.

The second theme is the clean-energy transition. This transition means moving from fossil fuel–based sources of energy to renewables, and it offers potential investment opportunities for infrastructure companies that develop, own and operate clean-energy assets. Importantly, while we think "transition" is the clear path over the medium to long term, this dynamic is occurring within the context of near-term concerns over grid reliability and energy security.

Third is the travel recovery coming out of the pandemic. Reopening is an opportunity for our passenger transportation sectors, although the cadence of travel normalization varies around the world.

One of the trends you mentioned was the energy transition. Can you tell us more about that in the context of infrastructure?

Chris DeNunzio: We think the power-generation mix will continue to get greener over time. However, investors have been overly optimistic about the timing of that transition. It won't happen as fast as some people would like it to, but we think it will happen. For example, coal accounts for roughly 20 percent of generation in the United States today. More than half of that coal will likely be retired by the end of the decade. In many cases, those assets will have reached the end of their useful life. When you look at the cost of replacement alternatives, we think renewables — and, in some select cases, natural gas — will be the solution. Part of the rationale is economic, but there is also broad political and regulatory support for the renewable transition. Seventy-four percent of U.S. states have some type of renewable requirement, so clean energy is more of a bipartisan issue than many people appreciate. We believe that the companies we invest in, both utilities and contracted renewable developers, will see tangible growth opportunities from building new resources and the transmission and distribution infrastructure to connect these resources to consumers.

What are some of the energy security implications for infrastructure subsectors and companies?

DeNunzio: We think energy security actually creates strong opportunities for investors. Cheap natural gas and aggressive growth in solar generation are really the foundations for U.S. power markets, in our view, and the country is having problems with both of those resources right now. Natural-gas prices have started to move higher, and there is the potential for additional tariffs on solar panels. With regard to gas, rising prices are partly attributable to the war in Ukraine and partly due to a lack of production growth in the United States, the latter being driven, in some cases, by the fact that we simply don't have enough midstream energy infrastructure to get supply to market. As for solar, the U.S. Department of Commerce is reviewing imports from several countries in Southeast Asia to see if they are circumventing existing tariffs on goods from

China; these countries account for 80 percent our imported solar panels. If we enact additional tariffs, costs could increase and renewable projects could be delayed. I would add that these supply issues are happening at a time when demand for electricity is growing — we have more electric vehicles, more data centers, we're seeing onshoring of manufacturing, and we're seeing Bitcoin mining. Our view is that we're in a high power-price environment in the near term. Long term, this growing demand will likely be very good for renewables. Companies are sourcing alternative supplies, and we think supply concerns will ease as economies continue to reopen.

Beyond those that might benefit from the energy transition or a growing focus on energy independence, what other infrastructure sectors are you watching right now?

Morton: Cell towers are a subsector that we're extremely excited about over the long term. They tend to be high-growth, high-multiple businesses in a market that has recently penalized high-growth, high-multiple businesses amid rising interest rates, so they have lagged in 2022. The group did well through the pandemic period and underperformed in the reopening; we think this creates a valuation opportunity. We find towers interesting in context of improving sentiment around wireless-carrier spending this year and what that means for organic growth for these companies, which has largely been positive. The independent-tower model is gaining adoption in many parts of the world, as the telecom companies that historically owned towers realize they can be more efficiently owned, and valued more attractively, if spun out or sold. A second space we are watching is freight rails. A big driver of performance is freight volumes in North America. Volumes are a bit of a coincident indicator as we think about impacts of supply-chain issues, inflation and labor availability. We spend a lot of time focused on the fundamentals of freight rails to help inform our macro views as they impact businesses across the infrastructure universe.

As we emerge from the pandemic, which infrastructure businesses do you expect to see impacted the most?

Morton: First, mass passenger transportation businesses are the ones that declined the most through the pandemic. As we emerge from travel restrictions and lockdowns, at various cadences in different parts of the world, airports and passenger rails are positioned to be the most significant beneficiaries. The second implication relates to the shipping of freight, which impacts both marine ports and freight rails. Some of the supply-chain and logistical constraints related to the efficient production and delivery of goods could have an impact on volumes that move through ports and on freight railways. These are businesses that are also being impacted by lockdowns and labor shortages in different ways in different parts of the world. Those dynamics should improve with reopening and drive stronger fundamentals for those subsectors.

There is a lot of private capital finding its way to the listed-infrastructure universe. What are the near- and long-term implications of that dynamic?

Morton: The challenge facing the private sector today is an unabated rise in capital flowing into private infrastructure funds, which has led to a large amount of dry powder — more than $330 billion, unlevered. That money needs to be invested, and we're in an environment in which a limited number of deals present themselves at any point in time. Why is this relevant for listed infrastructure investors? This money is increasingly finding its way into the listed markets — either in the form of asset sales, sales of stakes in assets, or listed companies selling themselves in full. Some management teams have woken up to the benefits of taking advantage of the cost of capital arbitrage between private and listed markets. The private side tends to operate with a lower cost of capital, so our companies are transacting in a way that is accretive to the listed company — given that the deals often occur at significant premiums to where these assets or these companies are trading. We think this activity provides a strong valuation floor to listed-infrastructure assets. In fact, there has been so much activity that is seems as if there have been more deals that involve the listed space in the past 15 months than in the prior three years combined. That is how active the private side has become, and we continue to expect another strong fundraising year in 2022.

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CORPORATE OVERVIEW

Dedicated to the pursuit of excellence, **Cohen & Steers** is a leading global investment manager specializing in real assets and alternative income, focused on delivering attractive returns, income and diversification. Cohen & Steers maintains a global presence through the following offices: New York, London, Dublin, Hong Kong and Tokyo.

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