THE INTELLIGENT INVESTOR
VALUE INVESTING EXPERTS
SPECIAL REPORT

The case for essential infrastructure

A LETTER FROM THE AUTHOR

For years we've recommended you avoid Australia's listed infrastructure stocks. Prudence Warywallet summed it up best when she said 'no to infrastructure' (see page 11). The underlying assets were sound but were laden with too much debt, oppressive fee structures and management contracts that encouraged all the wrong behaviours.

Now, however, infrastructure stocks are on the nose. The S&P Global Infrastructure Index is down 34% from its peak, more than the ASX 200's 26% decline. All the while, some of the debt has been repaid, some of the management contracts have been fixed, and the reasons why investors were told that toll roads, airports, pipeline and power stations were an essential part of any investor's portfolio remain in place. Many of these assets *are* natural monopolies. The cashflows *are* predictable. And they *are* relatively immune to the economic cycle.

Such attributes have a particular poignancy at present. The risk of a long and deep global recession remains and, particularly in Australia, there remains the potential for substantial (further) declines in corporate profitability. Having a few highly dependable businesses in your portfolio may well be no bad thing.

The que stion, though, becomes one of price. Does the value on offer compensate today's investor for the high debt levels and management contracts tilted firmly in management's favour?

For the most part the answer is 'no'. Of the 20 stocks we reviewed, 16 were quickly dumped in the garbage bin or too hard basket (see page 12). Some, such as **Asciano**, still look expensive. Others such as **Infigen**, the former Babcock and Brown Wind, were overlooked due to the unpredictability of their cashflows. And many are simply burdened with so much debt that they couldn't be considered a conservative investment by any investor.

That left us with four potentially interesting situations, all of which feature in this report. **Macquarie Airports** will be already familiar to many members. Others may have distant recollections of **Australian Infrastructure Fund**. The other two, **Spark Infrastructure** and **Challenger Infrastructure Fund**, are new to the pages of *The Intelligent Investor*.

You will, no doubt, find yourself with a preference for one or other of these four stocks. But we think combined, in whatever weighting suits your own portfolio preferences, they make an excellent, income-producing opportunity for up to 10% of your portfolio.

Steve Johnson
Managing Director

CONTENTS

How to value an infrastructure business

Bermudan companies; stapled securities; asymmetric management agreements; and bewildering accounting standards. Most infrastructure company's accounts are impenetrable. Here's your guide to untangling the mess.

According to the official bean counters, **Transurban** has never made a profit. The total losses over the past decade add up to some $763m and the best it's been able to manage was a $61m loss in 2006.

Yet, until this year's fall from grace, the company had been able to increase its distribution every year without fail. It has paid out a total of $2.47 in distributions per security.

There's something odd about this. How can a company that doesn't make any profit keep paying cash out to its owners every year? Well, firstly, the accounting numbers are useless as an estimate of this company's earnings capacity. But so is the distribution. Many infrastructure businesses, Transurban included, have been paying out more than they earn by taking on more and more debt.

To value these businesses, we need to completely ignore both the accounting profit and the distributions and reconstruct the accounts for ourselves. The aim, as it is in valuing any business, is to work out how much cash will be returned to shareholders over the business's life.

1. Start with EBITDA

With most infrastructure such a task isn't that complicated, as long as you can find the information you need. With Transurban, all we need to know is how many cars drive on the road, the average toll paid and what it costs to collect the tolls and maintain the roads. That information is relatively easy to come by, as Table 1 implies.

Table 1: Transurban's Australian toll roads

	CITYLINK*	HILLS	WESTLINK	EAST. DISTRIB.	M5	M4
Average daily traffic	677,268	92,139	118,164	47,504	115,563	110,872
Average toll	1.47	3.61	3.71	4.56	3.64	2.67
Average daily revenue	995,584	332,246	438,935	216,423	420,504	295,538

*CityLink reports transactions. One trip can involve multiple transactions.

We've used last year's annual numbers in the table above, with the exception of Westlink. Sydney's newest toll road is still enjoying rapid traffic growth so we've used the March 2009 quarter's results as an estimate for the year. Toll-road traffic is quite seasonal—the March quarter is proportionally lower because of school holidays—but for Westlink the latest quarter is the best estimate we've got.

Multiply the average daily revenue by 365 and you've got the annual revenue for each road. Now we need to determine what each costs to run. That's a simple matter of going to the most recent results presentation and copying the numbers, as shown in Table 2.

We've now got an estimate of earnings before interest, tax, depreciation and amortisation (EBITDA) for each of the roads. This widely used number will be found in all presentations by infrastructure funds, but it's worth calculating for yourself just to understand the dynamic between traffic and tolls, and what increases (or decreases) in each might mean for the total revenue.

2. Subtract the maintenance capital expenditure

Now we need to consider an important but often overlooked aspect of infrastructure assets—maintenance capital expenditure, or 'capex'. One of the reasons the reported numbers are useless is that the official estimates of depreciation substantially overestimate the true economic depreciation of an infrastructure asset, a fact about which most managers constantly remind anyone prepared to listen.

It also happens to be a convenient excuse to completely ignore the true economic depreciation and use EBITDA as a measure of the business's earnings capacity. Don't be fooled. The assets do wear out, and the expense required to keep them fully operational should not be forgotten.

So how do we estimate it? Sometimes the group will provide investors with their own estimate of maintenance capex. If they do, we'd suggest adding something to it in the name of conservatism. If not, you might be able to find an engineer or industry insider to point you in the right direction.

If all else fails, we'd suggest taking a look at the cashflow statement over the last five years and seeing how much cash has disappeared out the door. If you can deduct the spending on new assets from the total, what's left should give you a fairly useful guide to the maintenance component.

Transurban does provide estimates for maintenance capex but says this number is already included in the calculation of operating costs. For the sake of simplicity, we'll give them the benefit of the doubt, but to be truly conservative you would probably want to double the reported numbers.

So in Transurban's case, we'll assume that our estimate for EBIT—the number we need to get to value the assets—is the same as EBITDA, but this will rarely be the case (see MAp on page 6 and AIF on page 7 for examples of the maintenance capex being treated differently).

3. How long does the owner have the right to the asset for?

Before we can work out what those earnings are worth, we need to know how long we have the right to receive them.

Table 2: Expenses and EBITDA

	CITYLINK	HILLS	WESTLINK	EAST. DISTRIB.	M5	M4
Annual revenue	363,388,145	121,269,674	160,211,275	78,994,349	153,483,951	107,871,534
Annual operating costs	–46,000,000	–14,300,000	–33,800,000	–10,900,000	–19,800,000	–9,400,000
EBITDA	317,388,145	106,969,674	126,411,275	68,094,349	133,683,951	98,471,534

Most private infrastructure in Australia has been constructed on a BOOT basis. That's build, own, operate and transfer. The important thing for today's buyer is that, at some future date, the asset has to be returned to the government (that's the 'transfer' part) as shown in table 3.

Table 3: Time remaining on concession

CITYLINK	HILLS	WESTLINK	EASTERN DISTRIBUTOR	M5	M4
25 yrs	33 yrs	28 yrs	39 yrs	14 yrs	8 mths

For some, Sydney's Eastern distributor for example, the date is far enough into the future to assume we own it forever. But for others, most notably Sydney's M4, the asset will be transferred to the government in the near future, so we need to adjust the price we're prepared to pay accordingly.

4. How much growth do you expect?

What makes toll roads and most other infrastructure assets relatively easy to value is that the earnings are, almost always, all paid out to the owners of the business. That means we don't need to adjust for different payout ratios.

And, whereas the growth rate for most businesses is unpredictable, the growth in mature toll road earnings can be accurately estimated.

There are two components to the growth: traffic and tolls. Traffic should grow in line with the population of the 'corridor' served by the toll road, although care is needed in making this assessment. We haven't assumed any spending on growth capital expenditure in our earnings analysis although, for traffic to continue to grow forever, the toll road will obviously require more lanes.

It's safer to assume that, without any growth capex, there will be no growth in traffic. In reality, though, traffic can continue to grow in off-peak hours even when the road is capacity-constrained in peak travel times. Any assumption between zero and 1% would be reasonable and, for the purposes of this exercise, we'll take the midpoint of 0.5% in traffic growth per annum.

The tolls on most Australian toll roads are linked to the official consumer price inflation (CPI) numbers. The operator of the road is allowed to increase the toll in line with CPI. There are a few important exceptions in Transurban's portfolio. The M1, M2 and CityLink have minimum increases of 4%, 4% and 4.5% respectively—which means that in times of low inflation, as we're currently experiencing, Transurban can increase the tolls on these roads by more than CPI.

To keep things simple, however, we can assume that the cashflow from these toll roads will increase at CPI plus a small amount that allows for the traffic growth.

5. Value the assets

After all that work, we've collected all of the information we need to value each of Transurban's toll roads: an estimate of an underlying level of earnings, a growth rate and an estimated toll road life.

The limited life nature of these assets offers a great chance to put your discounted cashflow skills to work (see our *Investor's College* articles from issue 111 and issue 163). When done, you should get answers akin to those shown in Table 4 (we've assumed a required rate of return of 10%). As a common sense test, the roads with shorter concessions should earn lower multiples.

Table 4: Appropriate multiples (calculated using a DCF with a 10% required rate of return)

	CITYLINK	HILLS	WESTLINK	EAST. DISTRIB.	M5	M4
II estimate of EBIT	317,388,145	106,969,674	126,411,275	68,094,349	133,683,951	98,471,534
Appropriate multiple	12	13	17	14	9	0.5
Asset specific debt	0	459,000,000	1,250,000,000	516,000,000	500,000,000	8,000,000
Equity value	3,808,657,745	931,605,757	898,991,675	437,320,885	703,155,559	41,235,767

6. Subtract the asset specific debt

Transurban has corporate debt, which we'll come to in a moment, but most of the roads have asset specific debt of their own. This information can be obtained from the annual report or the most recent analyst presentation, included in Table 4. After subtracting this debt from our estimate of value and multiplying that by the percentage owned by Transurban, we have a rough estimate of the value of Transurban's Australian investments.

7. Corporate debt, corporate costs and other bits and pieces

Transurban also owns two US investments and a small stake in **ConnectEast**, a separately listed Australian toll road. We're not convinced the US investments are worth anything, given the amount of debt they're carrying, and ConnectEast has been a disastrous investment for the company. We'll give them the benefit of the doubt (again) though, and assume that these peripheral investments can provide enough value to offset the $17m-odd in corporate costs that are incurred running Transurban on an annual basis.

That means all we need to do is subtract the $3.1bn that Transurban itself owes to its lenders (including $US136m in US debt).

Table 5: Transurban's share of the pie

	CITYLINK	HILLS	WESTLINK	EAST. DISTRIB.	M5	M4
Equity value	3,808,657,745	931,605,757	898,991,675	437,320,885	703,155,559	41,235,767
Transurban ownership	100%	100%	50%	75.10%	50.00%	50.61%
Transurban share of equity	3,808,657,745	931,605,757	449,495,838	328,427,984	351,577,780	20,869,422

8. Calculate a per share value

As you can see in Table 6, that leaves us with a value for

[CONTINUED ON PAGE 4]

How to value an infrastructure business [CONTINUED FROM PAGE 3]

Transurban that's a touch less than $3bn. Dividing by the company's 1.28bn securities on issue, we get a rough valuation of $2.20 per security. We haven't yet addressed management's outstanding record of destroying value but, with the current share price a touch above $4, you can see why we're not interested.

Table 6: Transurban value per security

Transurban equity value	2,804,275,551
Securities on issue	1,282,682,606
Value per security	2.18

So this particular exercise didn't uncover a gem but it is a useful framework for assessing value and uncovering bargains. It's also essentially the same approach we've used to value the four infrastructure stocks that you'll shortly be reading about.

HORSE SENSE Fortunately the man most responsible for wasting [Transurban] securityholders' money, former chief executive Kim Edwards, has already fallen on his sword. But the new management still doesn't seem to get it. The 'new model' revealed alongside this week's mea culpa is full of clichés like 'flexibility to support growth opportunities' and 'corporate reputation and values'.

It's really not that complicated folks. All you need to do is collect the cash and pay it out to the owners.

We've been negative on Transurban for years now and, despite the share price being down 38% since *11 Oct 06 (Sell—$7.45)*, it's hard to change our view with this board and management team in place.

—Folly brings Transurban unstuck, The Intelligent Investor 20 June 2008

Spark's WACCed up returns

This infrastructure fund owns extremely reliable financial assets and trades at an appealing price. It also has the most insidious management contract we've ever seen.

SNAPSHOT

SPARK INFRASTRUCTURE GROUP (SKI)	$1.085
INFORMATION CORRECT AT	1 Jul 2009
STOCK CATEGORY	SECOND LINE INDUSTRIAL
MARKET CAPITALISATION	$1.0b
12-MONTH SHARE PRICE RANGE	$0.83–$1.77
BUSINESS RISK 3 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	BUY FOR YIELD

When Jeff Kennett and his government privatised Victoria's electricity market in the mid-1990s, they didn't do it by halves. The system was split into four distinct sectors—generation, transmission, distribution and retail—and the whole lot was sold to the private sector [see Figure 1].

Some of these assets have made their way onto the stock exchange, including through Spark Infrastructure, a fund that owns stakes in Victorian and South Australian distribution assets.

Distribution networks constitute the poles, lines and substations that get the electricity from the end of the large transmission lines to your front door. Retailers like **AGL Energy** and **Origin Energy** pay the companies in which Spark owns a stake—ETSA in South Australia and Powercor and Citipower in Victoria—tariffs to access their networks.

Simple in theory

In that sense, it's a simple business. Spark owns essential infrastructure and charges other companies a fee to access it. But understanding what fees the companies are *allowed* to charge is a touch more complicated.

ETSA, Powercor and Citipower have monopoly control over the electricity network in their respective geographic regions. As a result, the government-sanctioned Australian Energy Regulator (AER) controls how much revenue they can charge their customers. So, in order to understand what future returns Spark might generate, we first need to understand the regulatory framework under which its revenue is determined.

Here, the details are more nuanced and complicated (a recent document explaining the latest assumptions ran to 450 pages) but the theory and practical outcomes are a good deal less so. The AER determines an appropriate return on the companies' assets and works backwards from there

Spark Infrastructure summary

Assets	Electricity distribution assets in Victoria and South Australia
Manager	Joint venture between Deutsche Bank and Cheung Kong Infrastructure (CKI)
Fee structure	0.5% of enterprise value less than $2.4bn, 1% of enterprise value greater than $2.4bn, 20% of outperformance of S&P ASX 200 Industrials Accumulation Index
Expected distribution	13.75 cents
Expected yield	12.7%

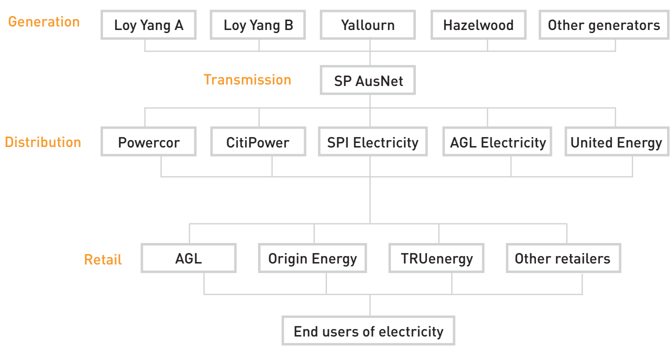
to calculate an appropriate amount of revenue.

It then 'declares' the tariff that should generate this amount of revenue. A number of efficiency incentives are provided and, depending on the performance of the company, the final return could be above or below the return assumed by the regulator. But this is usually playing around at the edges; the final return on assets for the regulated companies will be relatively close to the initial return assumed by the AER.

Weighing up the cost of capital

The appropriate rate of return is determined using a tool taught to most first year finance students—the weighted average cost of capital, or WACC (for a detailed explanation of this nefarious concept, see *Weighing up the cost of capital* from May 07). The short of it is that the regulator allows the owner of these monopoly assets to earn a margin over and above the long-term government bond rate. That margin is a weighted average of the margin the company's debt financiers require to lend money to it and the margin equity investors require to contribute their capital.

Figure 1: Electricity market structure—Victoria



As the rate is reset every five years, it can and does change. The rate, and hence the allowable revenue, might change a little if the AER changes some of the parameters, such as the assumed cost of debt funding. And it might change a lot if the government bond rate is substantially different from what it was 5 years prior.

We'll come back to what that means for Spark soon. But, as things stand today, the returns look attractive.

Attractive looking yield

The underlying assets should generate about 19 cents of cash per security this calendar year. Almost 14 cents of that will be distributed to security holders, equating to a yield of 12.7%. The remainder will be reinvested in the underlying assets, adding to the regulatory asset base of the companies, which should result in increased regulatory revenue in future years.

Compared with most of its peers, the fund and its assets are quite conservatively financed. It has had access to credit even through the worst of the credit crisis. And, after a substantial performance fee was paid last year, today's buyer won't be paying any performance fees for a long time to come (the security price has fallen 34% since the last one was paid on 30 June 2008).

For regulated assets, Spark offers excellent returns, especially with interest rates at historically low levels. But there are a few important caveats.

Circuit breakers

More than 30% of Spark's revenue was generated from unregulated activities in 2008. Spark's companies perform a wide range of services for electricity retailers (installing meters in homes), governments (installing street lights) and corporate clients (Spark's South Australian business generated about $100m in revenue electrifying the Prospect Hill mine site). This revenue isn't included in the regulator's calculations of allowable revenue, which means it boosts returns overall, until, of course, it doesn't. Such revenue is more likely to disappear when, for example, the mining boom comes to an end.

Spark also has to deal with regulatory resets for both of its assets over the next 18 months. As previously explained, the allowable revenue is reset every five years and can change dramatically depending on what the government bond rate is at the time. Should that occur today, the change would not be significant, but there's every chance of a substantial move either way by the time the reset date rolls around.

These two risks are manageable and quantifiable; our main concern is not.

When Hong Kong investors CKI and Hongkong Electric (HKE) wanted to sell some of their Australian businesses, Australian retail investors were willing buyers. Trouble is, the sellers of those assets wanted to raise cash but not cede control, which is why Spark is an unwanted child that its parents neither want to see nor hear.

The Spark Infrastructure fund owns only 49% of ETSA, Powercor and Citipower because CKI and HKE kept the other 51%. If that weren't enough, CKI and Deutsche Bank, the managers of the fund, have the right to appoint four of Spark's eight directors.

The difference between unlikely and impossible

In some ways this is more straightforward than most of the annual report verbiage that passes for good corporate governance. The reality is that in almost every case small shareholders have very little say in how a company is run. With Spark it's explicit; everywhere else it's simply implied. Still, there's a huge gulf between it being unlikely that the small shareholder will get a say and it being an impossibility. Spark falls into the latter category and it's a disgrace.

Thus far the managers haven't abused their power. The stapled securities listed in 2005 and there hasn't been an acquisition since, despite the base management fee increasing from 0.5% to 1.0% when the enterprise value (the combined value of debt and equity) is above $2.4bn.

How long the manager can resist the pull of fees remains to be seen. In fact, if an opportunity arose, we'd be prepared to bet it would be too much to resist. But the signs of conservatism are encouraging, much more so than others, such as **Macquarie Infrastructure Group**, where investors have (slightly) more control over their destiny.

These governance concerns mean Spark is far from the perfect investment opportunity. But the predictable returns and attractive yield are enough for us to recommend making it a small part of your portfolio. We are introducing Spark Infrastructure as a **BUY FOR YIELD**.

Much to like about Macquarie Airports

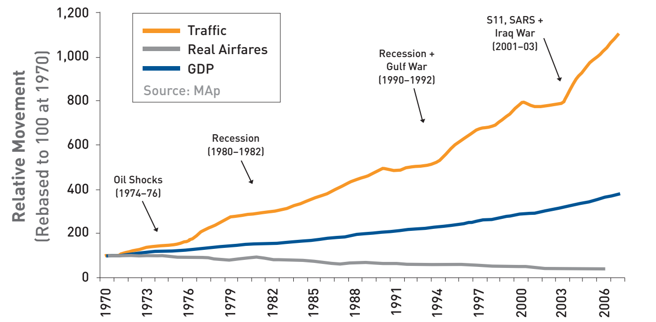
MAp isn't the bargain it once was. But it still deserves a place in our infrastructure portfolio.

SNAPSHOT

MACQUARIE AIRPORTS (MAP)	$2.20
INFORMATION CORRECT AT	1 Jul 2009
STOCK CATEGORY	BLUE CHIP INDUSTRIAL
MARKET CAPITALISATION	$3.0bn
12-MONTH SHARE PRICE RANGE	$1.305–$3.28
BUSINESS RISK 3.5 out of 5	SHARE PRICE RISK 3.5 out of 5
OUR VIEW	LONG TERM BUY

There are many different types of infrastructure investments but airports are in a class of their own. As average incomes increase and technology lowers the cost of flying, for many people getting on a plane is no different to getting on a bus. That explains why airline traffic has historically averaged growth of about one-and-a-half times world economic growth, a trend unlikely to continue forever but unlikely to abate in a few years either.

Traffic rises, fares fall



This fact hasn't benefited the airline industry one jot. Thanks to its highly competitive nature, over its lifetime it has experienced a cumulative net loss. But for the airports, which frequently enjoy a near monopoly over where airlines can land, a different picture emerges. One way or another, landing charges are typically regulated but an airport's ability to cash in on passenger growth through monopoly pricing of car parks, retail outlets and property services is not. Airlines tend to be poor businesses, airports are not.

Not all airports are created equal, of course. The more competition, the less money they make. MAp's two European airports, Brussels and Copenhagen, both have to compete with nearby airports, high-speed rail networks and efficient public transport systems. Sydney Airport, the biggest of MAp's three significant investments, faces none of those constraints, a fact which shows up in Sydney's substantially higher margins.

In 2008, Sydney Airport's earnings before interest, tax, depreciation and amortisation (EBITDA) was 80% of revenue, compared to 55% and 58% for Copenhagen and Brussels respectively. The distinction is between great and outstanding, though—margins like this are exceptional for almost any business.

For the 2008 financial year, after all expenses and interest payments, MAp's share of its airports' earnings was 24 cents per security (MAp has a 31 December year end). By the time Macquarie Group had taken its exorbitant cut, MAp's security holders were left with 21 cents per security in underlying earnings (distributions totalled 27 cents last year but that has been slashed, sensibly, to line up with the underlying earnings). The underlying profit, though, equates to a yield of 9.5%. It's not the 13% it was when we upgraded to Buy on *25 Feb 09 (Buy—$1.575)*, but it's still an attractive yield for assets of this quality and an excellent investment opportunity.

Airports not immune

Still, it's likely to be a turbulent ride over the next few years. Airports rarely escape the effects of a recession and MAp's underlying earnings, at least in the short term, are likely to suffer.

Sydney Airport has been able to offset slightly lower passenger numbers with increases in retail spending and property income, but the European airports are struggling. Earnings before interest, tax, depreciation and amortisation (EBITDA) fell more than 20% at both Copenhagen and Brussels airports in the first quarter this year. Normally, this wouldn't be a concern. Given time, earnings growth should resume, but MAp's use of leverage leaves it with little room to move.

By borrowing more and more money against the underlying assets, since it listed in 2002 MAp has distributed more cash to securityholders than the airports it owns have generated. Every time Sydney Airport's earnings increased, it was used as justification for taking on more debt and paying the proceeds out as distributions.

That process is now playing out in reverse. Each time

Macquarie Airports summary

Assets	The main asset is 74% ownership of Sydney Airport. The fund also owns meaningful stakes in Brussels and Copenhagen Airports and tiny interests in Bristol Airport, Mexican operator ASUR and Japan Airport Terminal (about to be sold)
Manager	Macquarie Group
Fee structure	1.5% of market capitalisation up to $500m 1.25% of market capitalisation $500m to $1bn 1.0% of market capitalisation in excess of $1bn 20% of outperformance of MSCI World Transportation Infrastructure Accumulation Index (AUD)
Expected distribution	20 cents
Expected yield	9.1%

a parcel of debt is due for refinancing, the banks are using it as an opportunity to reduce the underlying leverage by asking for some or all of its money back. Sydney Airport's lenders have refused to refinance the $870m of debt due at the end of this year, requiring shareholders to contribute the entire sum in order to repay the loan (MAp has more than enough cash on hand to fund its share).

We expect this 'deleveraging' process to continue. MAp has already cut its distribution to line up with the underlying earnings being generated by the airports. Given the amount of debt that needs to be refinanced in 2011, it should go further.

Safe for now

The covenants applying to all of MAp's airports' debt facilities are extremely generous, a reassuring point for prospective securityholders. Default only occurs if EBITDA falls to a level that is 1.1 times the required interest payments—half the current level.

No debt is due for repayment until 2011 and, even after that, the maturities of its different facilities are well separated. If MAp plays its cards thoughtfully, the damage from the deleveraging process should be minimal. Between the $500m or so in cash still remaining after its contribution to Sydney Airport, and the cash the airports will generate over the next few years, it should be able to repay enough debt to keep the banks happy. Should it return all of the cash to securityholders, refinancing might be a much bigger issue.

This deleveraging is going to reduce the average return to MAp securityholders in any case. The existing debt facilities were negotiated at the height of the debt bubble, with margins as low as 50 basis points (0.5%) on senior debt facilities. As that cheap debt is replaced with equity or, at best, substantially more expensive debt, the average return to equityholders will fall.

So MAp has its fair share of issues. But its underlying assets are first class and MAp is well placed financially to deal with the challenges.

The end point—a substantially deleveraged MAp paying distributions out of operating earnings—is also something about which we're much more comfortable than the current situation.

MAp is trading at the equivalent of an enterprise value to earnings before interest and tax multiple of 11 times. That means that if you took every single dollar of debt out and replaced it with equity, you would own an almost indestructible portfolio of airports yielding in excess of 9% pre-tax. That's quite appealing.

MAp cheap without the debt

	YEAR TO 31 DEC 2008
MAp's share of airport EBITDA	$951m
EBIT estimate	$848m
MAp's share of airport net debt	$6,563m
MAp current market capitalisation	$3,008m
Total enterprise value (EV)	$9,571m
EV/EBIT	11.2

The security price is up 40% since our original upgrade on *25 Feb 09 (Buy—$1.575)* and a touch since our most recent review on *26 May 09 (Long Term Buy—$2.18)*. But despite its challenges, MAp owns some great assets and is available at an attractive, if not bargain, price. **LONG TERM BUY**.

Diversity an asset at Australian Infrastructure Fund

We've done very well out of this stock over the years by buying low and selling high. Now it's time to buy again.

SNAPSHOT

AUS INFRASTRUCTURE FUND (AIX)	$1.31
INFORMATION CORRECT AT	1Jul 2009
STOCK CATEGORY	SECOND LINE INDUSTRIAL
MARKET CAPITALISATION	$567m
12-MONTH SHARE PRICE RANGE	$1.11–$2.85
BUSINESS RISK 3 out of 5	SHARE PRICE RISK 3 out of 5
OUR VIEW	BUY FOR YIELD

The father of the theory of evolution, Charles Darwin, wrote in *The Origin of Species*: 'I have termed this principle, by which each slight variation, if useful, is preserved, by the term of Natural Selection'. And so it is that Australian Infrastructure Fund (AIF) has ended up with its portfolio of assets: not through astute initial selection, but through the death or devaluation of the weakest investments and the survival of the fittest.

Investors are thus left with a high-quality portfolio of monopoly assets—airports, seaports and a share in Sydney's M4 toll road. The only problem with letting natural selection manage your portfolio in this way is that the attrition of the weakest can by quite costly. In the case of Australian Infrastructure Fund, more than $100m has been lost on investments in telephone companies, pipelines, monorails and trams.

Management, now apparently living according to the mantra 'airports good, everything else bad', seems to have learnt something from these expensive mistakes.

An airport infrastructure fund

While AIF describes itself as a diversified transport infrastructure fund, the reality is that airports account for about 95% of the fund's assets. That's no bad thing. As the preceding review of Macquarie Airports shows, airports are amongst the finest of infrastructure assets and AIF owns an attractive and diversified portfolio of them.

The largest individual asset in that portfolio is the fund's 29.7% stake in Perth Airport, which accounts for about a quarter of the fund's value. Its 10.1% stake in

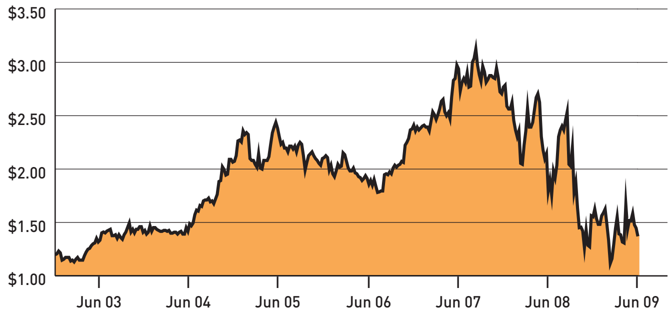
[CONTINUED ON PAGE 8]

Diversity an asset at AIF

[CONTINUED FROM PAGE 7]

Australia Pacific Airports Corporation, which owns Melbourne and Launceston Airports, makes up 22% of the fund's assets. A further 28% can be attributed to its 40% stake in Hochtief AirPort Capital, which gives AIF an underlying ownership of 5.3% of Athens Airport, 4.0% of Düsseldorf Airport, 5.7% of Hamburg Airport and 2.6% of Sydney Airport.

Back to buying AIF



Through other investments it owns 49.1% of Gold Coast, Townsville and Mount Isa Airports (about 14% of the fund's assets), and 28.2% of Darwin, Alice Springs and Tennant Creek Airports (5% of the fund's assets). The non-airport assets include a 50% stake in the Port of Portland (Victoria) and 35% of the Port of Geelong. Next-to-insignificant is its stake in Statewide Roads (which hands Sydney's M4 motorway back to the NSW Government next year) and Metro Transport Sydney, which has been a disastrous investment.

Recession, what recession?

Traffic numbers at the various airports have held up surprisingly well given the economic situation. For the four months ended 30 April 2009, versus the same period last year, passenger numbers in Perth and at the fund's Queensland Airports rose by about 6%. The Northern Territory Airports experienced 3% passenger growth and Melbourne and Launceston a 0.8% decline. Sydney Airport experienced a 3% decline, while things were tougher in the three European airports, which showed declines of between 4% and 10%.

The fund is managed by Hasting Funds Management (a subsidiary of Westpac) for a fee that we'd call typical, rather than fair. It charges a 1% management fee based on market capitalisation (capital raising, anyone?), as well as expenses incurred for the management of AIF. It also charges a performance fee of 10% of any outperformance of the ASX 200 Industrials Accumulation Index.

Beefing up the balance sheet

AIF is currently undertaking a 1-for-2 non-renounceable rights issue at $1.10 per security, which has the potential to increase its equity base by 50%. After the issue, AIF will have no corporate level debt, and some cash tucked away for expenditures like the Perth Airport expansion.

There is debt within the various assets, with Perth Airport having a net debt-to-asset value ratio of 36.3% at 30 April 2009, Hochtief AirPort Capital 41.5%, and Australian Airport Corporation 34.1%. Post-raising, the overall net debt-to-asset value ratio of AIF will be around 34%, a level we deem conservative for assets of this quality.

Moderately cheap, both ways

There are two logical ways to value AIF. The first is based on a simple distribution yield. In the year to 30 June 2008, the stock paid partially franked distributions totalling 16.5 cents. For the year ended 30 June 2009, that will have dropped to 13 cents. But both those amounts overstate the amount of cash actually flowing from the underlying assets and this management team, like many others, is rethinking its distribution policy.

Distributions for 2010 are expected to be 10 cents per security, in line with underlying cash flows. That would put the stock on a 7.6% yield, a figure we'd expect to increase nicely over the years. On this basis, the stock is probably somewhere between cheap and fairly valued.

A more complicated valuation, but one that makes it easier to compare with other infrastructure stocks, is to look at the enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) ratio. Post raising, AIF will have 577m stapled securities outstanding, which will translate to a market capitalisation of $756m. We estimate its asset-level debt amounts to roughly $900m, and post-raising it should have no corporate debt and about $100m in cash. So its enterprise value is roughly $1,560m.

Roughly in line with MAp

In the full year to 30 June 2008, AIF achieved EBITDA of $165.5m and, if the following six months was any guide, it should at least match that in the current financial year.

Australian Infrastructure Fund summary

Assets	A diversified bunch of mostly Australian airports and two relatively small port investments in Geelong and Portland, Victoria.
Manager	Hastings Funds Management
Fee structure	1.0% of market capitalisation Management expenses 10% of outperformance of ASX 200 Industrial Accumulation Index
Expected distribution	10 cents
Expected yield	7.6%

On an EV to reported EBITDA basis, AIF is trading at 9.5 times.

But management estimated that it spent $21m on maintenance capital expenditure in the 2008 financial year so it makes sense to account for this. On a EV to EBITDA less maintenance capital expenditure basis, it's trading at 10.8 times. And if we want to adjust management's maintenance capital expenditure forecast upwards to $30m (such estimates tend to be chronically understated), the figure rises to 11.5 times.

That's similar to the figure on offer with Macquarie Airports (see page 6). On the plus side, AIF owns a substantially more diversified portfolio and the underlying assets are more conservatively geared. But its minority stakes make it a passive investor in these assets, whereas the specialist airport team at Macquarie can have a substantial influence on the operational performance of its investments. Given AIF management team's record, we're not sure we'd want them too closely involved anyway.

Weighing it all up, we think the two stocks are broadly comparable at current prices but Macquarie Airports, with its additional debt burden, has a higher risk profile. That makes AIF a **BUY FOR YIELD**.

Challenger Infrastructure priced for failure

Challenger Infrastructure fund owns a few businesses that will profit from cheap debt for a long time to come. It also looks very cheap.

SNAPSHOT

CHALLENGER INFRA. FUND (CIF)	$1.50
INFORMATION CORRECT AT	1 Jul 2009
STOCK CATEGORY	SECOND LINE INDUSTRIAL
MARKET CAPITALISATION	$535m
12-MONTH SHARE PRICE RANGE	$1.20–$3.01
BUSINESS RISK 3 out of 5	SHARE PRICE RISK 3.5 out of 5
OUR VIEW	BUY FOR YIELD

This managed fund epitomises the infrastructure boom. It owns three infrastructure assets that, between them, don't generate a cent of revenue in Australia. The reason they're owned by an Australian listed fund is that, of all the places in the world, it was here that investors were prepared to pay the highest prices.

Now that the security price has tumbled to $1.50, those investors who paid a total of $3.50 per security might not be so favourably disposed. But for the rest of us, the substantially lower stock price makes it worthy of investigation.

A portfolio of pounds and euros

As you can see in the summary table on page 11, CIF owns 80.4% of Inexus, a UK gas and electricity distribution business, 66.2% of LBC, which owns a number of chemical storage terminals around the world, and 15.3% of Southern Water, which has a monopoly over water infrastructure in south-east England.

With an equity valuation of £1.2bn, Southern Water is Challenger Infrastructure's most significant investment. It's also the most leveraged, although it doesn't have any meaningful debt maturities until 2015 and some don't mature until after 2030.

Being an essential service monopoly it's heavily regulated. As with Spark Infrastructure (see page 4), its revenues are effectively capped. Together with the locked-in debt facilities its distributions are therefore extremely predictable, a factor of some comfort to income investors.

After all expenses, including maintenance capital expenditure and interest, Southern Water was left with £239m of cash in the year to September 2008. But not all of that will come back to the owners of the business. Southern Water has substantial capital requirements for new assets over the next few years although, as with Spark Infrastructure, any capital expenditure on new assets adds to the regulatory asset base and results in increased future revenues.

The debt facilities are inflation linked, which means the interest payments will be substantially higher in the latter years than they are today. So the £239m of cash last year overstates the true distributable cash. But, were it not for the exorbitant fees paid to Challenger, we wouldn't disagree with the £1.2bn valuation placed on its stake in Southern Water. Indeed, CIF sold one third of its stake in December last year at a price that equates to this value (the locked in debt makes it attractive to potential purchasers).

Southern Water valuation	
Value of equity	£1.2bn
CIF share of equity	15.6%
CIF equity value (AUD/GBP = 2.05)	$384m

On this basis, the remaining two thirds—15.6% of Southern Water—would be worth about £187m, or $384m at today's exchange rates. According to management, that's only one third of CIF's total asset value. Unfortunately, the remainder of Challenger Infrastructure's assets aren't so easily assessed.

Inexus customers connected to the grid

Inexus is also a regulated UK utilities business. It connects new housing developments to the gas and electricity networks and then charges an access fee to use its infrastructure. The connection fees are not regulated but the ongoing access fees—74% of the total revenue and 90% of EBITDA—are. The decimated UK property market will slow the number of new connections but Inexus' total revenue will still grow over the next couple of years. Sadly, when it comes to debt financing, management hasn't shown

[CONTINUED ON PAGE 10]

Challenger Infrastructure priced for failure [CONTINUED FROM PAGE 9]

the same foresight as their counterparts at Southern Water.

Inexus has £420m in debt, all due to be refinanced early in 2011. Given it is only expected to generate £30m of earnings before interest and tax this year, that's a huge undertaking. An issue of more equity beckons.

As a large backlog of connections works its way through the pipeline, the regulatory revenue will grow quite substantially in the next few years. But there's every chance that replacing such a large pile of debt will require a significant equity contribution. The business will also have to bear the burden of substantially higher margins on the debt it does refinance, and potentially the cost of unwinding interest rate hedges on debt that it is unable to refinance (Inexus has locked in fixed rate debt costs well beyond the term of its debt).

Inexus valuation	
Value of equity (current book value)	£224m
Value of equity (Int. Inv. estimate)	£112m
CIF share of equity	80.4%
CIF equity value (AUD/GBP = 2.05)	$184m

Those factors combined will, at best, reduce the cash available to distribute to CIF. The accountants have already slashed the carrying value of Inexus by almost 20%. It could, in theory, be worth zero given the amount of leverage involved. But given debt markets have improved, the regulated nature of the assets and the seemingly active unlisted market for these types of assets, we think that's unlikely. It should be able to refinance at least some if not all of that debt, or sell out altogether.

We've ascribed a value that's half of the current book value but the next few years will be crucial in determining whether it plays out along these lines. While cognisant that the range of potential outcomes is wide, we view this as a conservative standpoint.

Liquid Bulk Chemical tank terminals

LBC owns specialised storage facilities at ports in Europe, Asia and the US. The company stores chemicals on behalf of the giants of the chemicals industry, like Dow Chemical for example.

More than 80% of LBC's revenue is from long term 'take or pay' agreements where its customers pay for a fixed capacity whether they use it or not. That makes revenue reliable, but of CIF's three businesses, this one is most exposed to the vagaries of competition and recession.

LBC valuation	
Value of equity (current book value)	€240m
Value of equity (Int. Inv. estimate)	€192m
CIF share of equity	66.2%
CIF equity value (AUD/EUR = 1.74)	$221m

Fortunately LBC, unlike Inexus, managed to lock in long-term funding at the height of the debt bubble. There are a couple of insignificant facilities that need to be repaid in the next few years but the vast majority of its €453m of debt is not due to be repaid until 2014.

That gives it plenty of time to get its finances in order. Indeed, in the six months to 31 December, LBC declined to make a distribution, citing 'capital management' as its reason for retaining the cash.

There might be a few more years without a distribution but that should only add financial security to what are reliable, predictable assets from an operational perspective.

As things stand, the business generated €47m of free cashflow in the past 12 months and a substantial amount of infrastructure has already been built that will add to cashflow in future years. Our conservative valuation is a 20% discount to the current book value. But it could be worth less—debt has a way of destroying value. That said, of the three assets, LBC is the one that could be worth substantially more than its current value.

Two out of three ain't bad

Which brings us to one of the most pertinent facts in assessing Challenger Infrastructure's value: It is currently being priced as if at least one of its investments isn't worth anything at all. With cash on hand and no debt at the fund level, it's hard to support that position. In fact, as you can see in the table below, we think it's worth substantially more than the current security price.

There may be a few years of lean distributions while the companies in which the fund invests repair their balance sheets. But once that process is complete, this year's expected distribution of 16 cents per security should be an absolute minimum, with a figure of 20 cents eminently achievable.

Are there any other substantial risks? When you purchase Challenger Infrastructure you're buying into assets located overseas. That adds a currency risk that may well impact distributions, although over time you'd expect this factor to even out.

Challenger Infrastructure Fund (CIF) valuation	
Southern Water	$384m
Inexus	$184m
LBC	$221m
Cash	$102m
Redeemable preference shares	($104m)
Adjustment for management contract (10%)	($78m)
Net value	$709m
Securities on issue	350m
Value per security	$2.02

And finally the manager, listed Australian company **Challenger**, has shown itself most adept at wheeling and dealing but not especially competent at building shareholder value. As with many such funds, management incentives aren't necessarily aligned with those of the ordinary shareholder, although the on-market buyback currently taking place at CIF looks like a notable exception. It may bode well, it may not.

But the juicy potential yields are sufficient compensation for these concerns. We're introducing Challenger Infrastructure Fund as a **BUY FOR YIELD**.

Australian Infrastructure Fund summary	
Assets	15.6% of Southern Water, a regulated water utility in South-east England 80.4% of Inexus, a UK gas and electricity connections business 66.2% of LBC, a chemical storage company with terminals in the US, Europe and Asia
Manager	Challenger
Fee structure	1.0% of market capitalisation Management expenses 20% of outperformance of ASX 200 Industrial Accumulation Index
Expected distribution	16 cents
Expected yield	10.7%

From the vault 15 March 2006

Prudence says no to infrastructure

As one of our intrepid subscribers discovered more than three years ago, infrastructure funds weren't as safe as they were cracked up to be.

When Prudence Warywallet's broker, Bert, was selling her the merits of infrastructure funds back in 2006, she shot his argument down in flames. Bert told Prudence he had just the thing for her, 'infrastructure funds.' He even directed her to the ASX website, which said these funds were 'not considered volatile'. After doing some research, Prudence painted a very different picture. Here are her abridged comments (view the full article online).

On asset revaluations

Essentially, [these infrastructure] assets get revalued upwards when a higher value of cash is expected to be received in the future. Using a toll road as an example, that may be because traffic is expected to increase, because tolls are expected to rise, or because lower long-term interest rates have increased the value of future cash inflows. Falling long-term interest rates have been a feature of the past few years and this has driven valuations of infrastructure assets higher ... if assets can be revalued upwards, then they can be revalued downwards too. One way or another, with the 'revenues' from these assets being so heavily influenced by revaluations, the suggestion from the ASX that they are 'not considered volatile', seems somewhat wide of the mark.

On equity accounting

Minority-owned investments are simply entered on the balance sheet as 'investments'. This can give a company's balance sheet a false sense of security, because the investments just mount up on the balance sheet, while any debt they carry is not shown.

Looking at the recent interim report from **Macquarie Infrastructure Group** (MIG), for example, Prudence finds that it has net debt of $2.6bn. But MIG's proportionate share of the debt held by its investments comes to a whopping $5.6bn, to give a total of about $8.2bn. The debt held by MIG's investments is 'non-recourse' debt, which means that, in the event of a problem, the bankers can't come crying to MIG. But it's there nonetheless, and it magnifies any changes in the value of MIG's investments. And with the $8.2bn debt amounting to only a little less than the $9.0bn market value of MIG's equity, that's a lot of magnifying.

Two more recent infrastructure sector reviews reveal further problems. *Congestion in infrastructure*, in issue 151/May 04, explained how the popularity of these assets had pushed up their price, and *Empire building in infrastructure*, in issue 180/Jul 05, discussed problems with the fees paid by many of these funds to their managers.

On the fee bonanza (for the banks)

So Prudence runs a quick check on the fees paid by her sample of funds, and she's astonished to see that MIG has paid 54% of its operating cash flow to **Macquarie Bank** in the past three years. The reason for this huge figure is that MIG's underlying assets have seen significant increases in value. **Australian Infrastructure Fund**, by contrast, has not performed as well over the years, so it's been missing out on the performance fees. It seems to Prudence that when she does well, the bankers take a huge slice of her profits and when she does badly, they still take a generous cut. It's safe to say that Prudence Warywallet takes a dim view of such arrangements.

When Bert calls back, Prudence is hoping he'll help her get to the root of some of these issues. Unfortunately, she's left disappointed.

'Hello Mrs W,' says Bert. 'I was just wondering how you got on with the infrastructure funds. Pretty good, aren't they.'

'Well, I'm not so sure actually, Bert. Much of their profit appears to come from asset revaluations and they have considerable off-balance sheet debt. I also have some concerns about the increasing popularity of the sector and the bidding up of asset prices. Finally, the fee structure seems to encourage managers to build empires rather than value, and they take a large cut if I win, and a medium-sized cut even if I lose. I'm not sure they're for me.'

'Er, OK, Mrs W … fair enough. Sorry … got to go.' Click, brrrr …

And those that didn't make it

We looked at more than 20 stocks while researching this special report. Here's a selection of the ones that didn't pass muster.

In April this year, Babcock & Brown Wind changed its name to **Infigen Energy** (IFN) and internalised the management of the fund ('internalised' is short for paying the manager a fee to get it out of the picture). Infigen owns wind farms in Europe and the US and looks, superficially at least, cheap.

But while the assets are interesting, for the amount of debt it carries Infigen is too much like an ordinary business. The price of the energy it sells is market driven, not regulated, and can therefore fluctuate wildly, as can the wind it harnesses. Too much debt, too many variables for our liking.

Macquarie Infrastructure Group (MIG) is the granddaddy of the infrastructure sector. Since listing in 1996 it has raised billions of dollars from investors but the manager, **Macquarie Group**, is the only one to make any money from it. Whilst the security price is the lowest it's been in many years, it's still not cheap enough.

ConnectEast (CEU) is one of the few infrastructure assets you can buy without also paying obscene management fees. It owns the EastLink freeway in Melbourne and traffic has been growing nicely since the road opened a year ago. We're interested at the right price but want to take a good look at the full year results before pulling the trigger.

Brisbane's two new toll roads, operated by **BrisConnections** (BCSCB) and **Rivercity Motorway** (RCY), are still under construction. Until we get some idea as to how many commuters are prepared to pay the tolls, we've no interest.

Toll Holdings spinoff **Asciano**'s recent capital raising has certainly done the banks a favour. We weren't convinced that the business was worth more than the debt outstanding and, while it's much safer than it was, replacing that debt with equity doesn't necessarily make the business worth any more now than it was before. At a price substantially lower than today's we'd take another look.

SP Ausnet is a similar business to **Spark Infrastructure** (see page 4). It owns the transmission assets that deliver electricity from the power stations to Spark's Victorian distribution networks and is regulated under the same Australian Energy Regulator framework. We prefer Spark due to its lower gearing but SP Ausnet is also worth watching.

So is **Auckland International Airport** (AIA). Unlike **Macquarie Airports** (see page 6) and **Australian Infrastructure Fund** (page 7), it enjoys much lower levels of debt and is internally managed, which means the fees paid to the manager are much more reasonable. The only major drawback is the price—it's not cheap. Hopefully, we'll get a chance to look at it again at a much lower price.

Last and most certainly least are two funds still carrying the Babcock & Brown moniker. While Infigen has been able to distance itself from Babcock's downfall, **Babcock & Brown Power** (BBP) and **Babcock & Brown Infrastructure** (BBW) are left with the legacy of the mothership's love of debt. Both have far too much of it. Even with substantially improved debt markets it's hard to see how either will survive without annihilating ordinary securityholder value. We suggest you give them both a wide berth.

DATE OF PUBLICATION 1 Jul 2009.