

In The Know: Episode 62

The infrastructure outlook: Hidden opportunities, real risks

Announcement ([00:00](#)):

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Host ([00:14](#)):

This is In The Know, a monthly investment podcast brought to you by Magellan Investment Partners.

David Costello ([00:20](#)):

This nexus to the AI thematic has seen these merchant generators assume a very tight correlation with the performance of AI bellwethers like Nvidia. So if the AI thematic starts to unwind exactly as we saw following the DeepSeek moment in January this year, these stocks will fall potentially precipitously.

Host ([00:41](#)):

That's **David Costello, infrastructure** portfolio manager at Magellan Investment Partners.

([00:52](#)):

Welcome to In the Know. In today's uncertain environment, is infrastructure still a safe haven and what are the hidden opportunities and risks for infrastructure amid market volatility? In this conversation, Rebecca Hiscock-Croft, investment director with Magellan's Infrastructure team is joined by portfolio managers, Ofer Karliner, Ben McVicar, and David Costello to discuss how they're navigating market volatility. They explore where they see compelling value and structural growth in infrastructure and what they view as key risks including richly valued US merchant power names tethered to the AI boom. To kick things off, a welcome from your Host, Rebecca Hiscock-Croft.

Rebecca Hiscock-Croft ([01:37](#)):

Hello and welcome to Magellan In The Know. I'm Rebecca Hiscock-Croft. I'm an investment director of the infrastructure team and I'm joined today by the three portfolio managers, Ofer Karliner, Ben McVicar, and David Costello. So I think what we'll do is we'll just get started with a very important question just to set the scene. So Ofer, I think keen to get your perspective. We're obviously in an environment of uncertainty across macro and market thematic. It'd be great if you could speak a bit more to how we are seeing this play out for infrastructure.

Ofer Karliner ([02:04](#)):

Yeah, we've had a really interesting year to date, particularly since Trump's come to power, a lot of uncertainty being thrust into the markets not helped by the shutdown of the US government, which has provided a fog of information effectively. We still do see some weak data coming out of the US. Weak job numbers from ADP, they're indicating slower or weakening macro conditions. We've seen a lot of investment from AI-related sectors been contributing, but a lot of other sectors have been stagnating, are going backwards. At the same time, markets are near all-time highs after some jitters earlier in the year. We just don't see some jitters creeping into the AI-related businesses as well. We've seen market commentators like Howard Marks as well as industry



insiders such as Sam Mottman indicating we're seeing bubble-like conditions within that particular sector. So there's some risks around that market there.

[\(02:55\)](#):

Europe tends to be more stable at the moment. We're seeing some risks, particularly around French politics. We've had five prime ministers or six prime ministers if you can, the most recent one, resigning then being reappointed four days later in the last two years. So a bit of volatility there that's led to higher bond rates in that market probably leads to higher taxes in the short term to deal with budget repair there, but we've factored that into our views and valuations and in the UK we've seen weak economic conditions coupled with a sticky inflation leading to some issues there. But broadly, Europe's more stable than what we're seeing in the US overall. The volatility actually doesn't affect infrastructure that much. The business we invest in is pretty resilient to a lot of these factors and as a consequence, we're quite comfortable in the way we're positioned across markets and across subsectors.

Rebecca Hiscock-Croft [\(03:45\)](#):

I think that's really great context and I know that with this uncertainty, we've certainly seen infrastructure have a great run in terms of performance this year. So I think with that in mind, I'd be great if we could turn to talk more about valuation. I wonder, Ben, if you're able to answer that one.

Ben McVicar [\(03:58\)](#):

Yeah, happy to jump in on that. So when we think about the strategy, generally what we expect infrastructure to do is reasonable rates of return, but we're not looking for it to be a shoot the lights out year in, year out type strategy. Now what is interesting from our perspective as we look to the call it, and you can take a few different metrics, but call it the trail in 12 months to October for the strategy, we're sort of looking at just shy of 15% returns. And to your point, that's a strong return for how we look at it. So that sort of feeds into the valuation discussion. Now, how do we think the valuation looks today? Well, we really approach this problem from a lot of detailed work that we do. And so when we think about the valuation, we often will look at these assets on a bottom up discounted cash flow valuation framework.

[\(04:44\)](#):

And so we'll approach the problem with a lot of rigor and what we see on that basis. So the things look reasonable. Now, the other way you can look at this valuation question is we also look at some of the market heuristics and what we'll consider and infrastructure is always a little bit difficult because the accounting for things like toll roads make it a little bit challenging. So things like simple PEs don't tend to play very well in this space, but things like dividend yields aren't terrible for having a broad brush to look at how things are sitting at the moment and it sort of backs that up. So what we have found is over time the dividend yield has been, call it 4%, that order of magnitude. And the other thing we've noticed there is that it tends to be pretty tightly bound within, call it, three and a half percent to four and a half percent.

[\(05:28\)](#):

Now, if we were to go back to the middle of 2024, so call it June 2024, that dividend yield was at a low ebb. And so we're looking at more like the four and a half percent side of the ledger. And so things looked from our perspective pretty undemanding from a valuation point of view, pretty cheap. And so really what I think we've seen in the last call it year or more has been some of that return is actually the valuation normalizing because when we look at it today, we're just under that 4%, about 3.8% thereabouts. So again, valuations look like they're in a reasonable range, but what I would say is, and we can certainly dive into this more, is that we certainly see within a reasonable type valuation for the universe, we certainly see a lot of pockets of undervaluation as well.

Rebecca Hiscock-Croft (06:12):

That's really interesting to hear and I'd be keen to dig a bit further into that idea just around the pockets of deep value. So when you look across the portfolio, where are you seeing examples of this play out?

Ben McVicar (06:20):

Well, there's probably a few different areas we could go into. So there's specific companies where we continue to see, call it idiosyncratic or specific issues that are attached to those companies. Those we're finding in a trade in at pretty attractive valuations, but you do have to roll up your sleeves so to speak, and really think about the risks you're taking on and the valuation opportunity that you're getting. I'll talk about one of those examples, but just to set it up, we also are finding there's opportunities out there where it's more about the growth opportunity and the value creation opportunity and so that sits there as well. But let me start with one that's interesting from our perspective. So this is a company Cellnex, they're a European business. It's a one that we've followed for a long time but added to the portfolio for the first time this calendar year.

(07:04):

And what is Cellnex? Well, basically these are a mobile tower provider. They're the largest in Europe. They really started life call it a decade ago in 2015 when they were spun out of another infrastructure company. And since then through consolidation and some development, have really built a large portfolio of towers as it stands today. They operate across a number of key jurisdictions, places like France, UK, Spain, and these are big businesses for them. And so what is kind of interesting here is that this is a business that they really built themselves through acquisition and what really caused them problems in recent years is that that leverage caught them out. You have seen them move more towards deleveraging focusing on shareholder returns, and we really think this strategy is right fit for this business at this moment in time. And so we're optimistic on that front.

(07:58):

The valuation looked very interesting to us. We approached from a few lenses as well. So looking at the underlying fundamental valuation, it looks good, but also on I call it free cash flow yield type basis, it looks very attractive versus peers and the peers by the way in this space in North America look pretty good to us at the moment. So we can really see something that's interesting there. And maybe just a simplistic way to think about it, to put it in context of where this business has come from and where it's at now is that this is a business that at the height of the excitement around their roll up, they were trading at over 60 euro per share today. They've been trading more in the range of 25 to 30 euro per share, so significantly cheaper. Now we thought over the 60 euro was probably overdone, but notwithstanding that we think there's good value at these current levels.

Rebecca Hiscock-Croft (08:41):

But the market doesn't always tend to get these things wrong. So what are they worried about?

Ben McVicar (08:46):

I think one of the main ones out there at the moment is I said before that they've got a couple of key different jurisdictions that they operate within what you're seeing in each of these jurisdictions. It's typical in Europe to have, call it, four mobile carriers in that region or in that country. And what we typically find is that four carriers is not a profitable and sustainable equilibrium in a market. We tend to find three is more rational market structure. The problem you've got is Cellnex has contracts with a lot of these players. So the consolidation as we're currently seeing in these markets as you move from four down to three, puts a question mark as to their ability to actually realize those contracts. And so what we, maybe an example is this way to think about this. So in the case of France, you've got one of the large telco providers, SFR, there's been a bid to basically buy them by three other players in the market and break it up.

(09:34):

This is an important location for Cellnex just under a quarter of their EBITDA or earnings. And you can see within that market about over 40% or this one provider SFR. So it causing the question if they do get consultant dealers, do they keep the contract? We think this risk is massively overblown because the reality is Cellnex sits there with SFR with a long-term contract that runs out to 2039 and then they've got some smaller contracts that go out for a decade. So the reality is you can't just buy the business, doesn't mean you can unwind this in a hurry. So we think that looks for us pretty reasonable and we think the reality is that these risks, if they eventuate is de minimis really for the overall investment case. So we think it's a long-term opportunity. We don't think it'll be realized overnight, but that's the type of thing we're seeing in the marketplace.

Ofer Karliner ([10:20](#)):

One of the other great things about Cellnex that people are probably missing is that their new CEO, as Ben talked about, is focusing on capital returns. They've got a billion dollars of capital returns coming to the end of 2026, but they've also got a build to sue program where they've been spending a lot of CapEx over the past few years that's starting to roll off over the next two, three years. When that happens, there's going to generate loads and loads of free cash and then that's cash going to come back to shareholders. So they've got something quite exciting that the market's quite not focusing on right at the moment.

Ben McVicar ([10:48](#)):

That's a really great point, Ofer. Thanks for adding that on.

Rebecca Hiscock-Croft ([10:50](#)):

I think if we turn now to the utilities side of the portfolio, Dave, I wonder if I could just turn to you to talk through potentially some other pockets of value we might see there.

David Costello ([10:58](#)):

Yeah, certainly, Beck. Similar to the Cellnex scenario that Ben described, we saw a number of headwinds and industry noise created an opportunity in the UK water utilities. Going back to the second half of 2023, we saw businesses like Severn Trent and United Utilities trade with an enterprise value broadly equivalent to the book value of their regulated assets. That's an extraordinarily unusual phenomena for these assets. They'd customarily trade at a multiple of something like 1.2 times their regulatory book value. And this weakness in their share price really struck us as an instance of the market indiscriminately pricing, fundamentally dissimilar risks. There were a number of headwinds to the industry at that time. You did see concerns over the environmental performance of the sector, but crucially we think weighing on the stock price was concerns over the solvency of one of their industry peers, an unlisted company that we have no exposure to Thames Water and whether or not that company would survive or would be tipped into special administration a form of temporary nationalization.

([12:07](#)):

But as I said, we very much viewed this as the indiscriminate pricing of risk because Severn Trent and United Utilities look absolutely nothing like Thames Water. Thames Water is financially distressed. It's geared to roughly 85% within the regulatory ring-fence with debt above that, within the hold co structure. By contrast, Severn Trent and United Utilities are geared to approximately 60% broadly in line with the regulators assumed capital structure. Thames has had appalling operational performance and has delivered very poor returns to its shareholders. In fact, over the last five years, Thames delivered its shareholders cumulative real return on their regulatory equity of minus 2% per annum over that period.

([12:50](#)):

By contrast, Severn Trent and United Utilities have delivered extraordinarily attractive returns. United Utilities are real return on equity of more than 6% over the period. That's approximately one and a half times their base return allowance driven by consistent outperformance on financing on outcome delivery incentives and you

adjust for inflation. That's a realized nominal return on equity over that five year period of 11.5% per annum. Similarly, Severn Trent even more so a realized nominal return on equity of 14.2% per annum over that five year period with outcome delivery incentives of \$430 million more than twice the level of any other company in the sector.

Rebecca Hiscock-Croft ([13:32](#)):

So we've spoken about returns. What about operational performance?

David Costello ([13:36](#)):

Thames has had an abhorrent environmental track record and has been fined more than a hundred million pounds over the last five years for its environmental performance. United Utilities and Severn Trent are the best performers in the sector. In fact, Severn Trent has just achieved its sixth consecutive four-star environmental performance assessment rating a record for the sector. So not only do these companies look nothing alike, but the labor government as they were approaching government last year, made it very clear that they had no interest in nationalizing the sector. We observed that these companies didn't bear any resemblance to Thames, but also we observed that their prospects were actually improving, not deteriorating. As we approached the next regulatory period, we saw that a series of new legislative environmental obligations would effectively force the hand of the regulator to approve massive increases in investment by these companies that would support very strong growth in their earnings.

([14:38](#)):

And when we had the final determination for these companies in December last year, that expectation was very much validated. We saw the regulator approve nearly 60% uplift in Severn Trent's regulatory capital value and a more than 40% uplift in United Utilities regulatory capital value. Now coupled with a higher cost of capital reflecting higher interest rates. And that translated to very predictable growth in earnings for these companies. In fact, both of them are expected to more than double their underlying earnings per share over the next three years. Now crucially that growth is expected to continue subsequent to the release of the final determination for the next five years.

([15:18](#)):

We had the government release an independent water commission report and that report resoundingly affirmed that this high rate of growth that we've seen initiated in the coming regulatory period is likely to be sustained all the way out to 2050 driven by what the companies are describing as an environmental super cycle. As they invest in their resilience of their assets, they render them secure against the impacts of climate change and they start to invest into new threats, things like PFAS and microplastics. So we think these assets have a very bright future ahead of them. They've already re-rated significantly now trading at about 1.15 times their regulatory capital value, but we think they could go materially further from here.

Rebecca Hiscock-Croft ([16:02](#)):

Thanks, Dave. That's a really compelling example, and I think so far we've been focused on examples around idiosyncratic value that we see across the portfolio. I think I'd now like to turn to look at some structural growth opportunities and I think, Ofer, maybe I'll turn to you to ask are there any key names that you want to discuss or subsectors in the portfolio?

Ofer Karliner ([16:18](#)):

Yeah, sure. I think we can talk about North America and North American Rail in particular. We see some really attractive themes underlying that the stocks themselves looking reasonably cheap to us. First of all, we've had three years of a freight recession in the US has seen due rating of these companies. There's some idiosyncratic factors underlying that. Obviously tariffs has been an impact there as well as an oversupply trucking market coming out of COVID. There's some light at the end of the tunnel, if you excuse the pun, with trucking rates

pushing up a little bit towards the back end of this year as well. So we're seeing some of that oversupply coming out of the market, which is certainly a positive for these guys. Of most note for the US rail though is the proposed merger between Norfolk Southern and Union Pacific, and that was first proposed in July this year.

(17:02):

At the moment we have is a duopoly on the east coast of the US and a duopoly on the West Coast of the US. This would create the first transcontinental railway system. Now this hasn't been done historically. There's a couple of things that have been in the way largely the STB, the regulator, Surface Transportation Board, has been very clear that any merger had to be beneficial to competition, not just neutral. We think the change in government to the Trump regime has probably opened the door to a more friendly interpretation of that. So we've got an opportunity here to actually see that happen. Now creating a transcontinental railway actually creates significant synergies and opportunities to both grow business and to remove costs from the system benefits both the companies and the customers. So if you think about it, rather than having to rail to the middle of the country then switch to another provider, all of a sudden you can bypass major congestion humps where that happens.

(18:00):

You don't have to unload and reload individual containers of boxes or cars and as a consequence becomes much more efficient from a time and a cost point of view. It also opens up new markets. So to the extent that a line or a service wasn't economic for a short haul operator, so if you're in a particular area and you only get to haul the cargo for a short amount of time, then have to pass it on to someone else, that's probably not economic for you. By opening up that whole corridor, all of a sudden that is economic and therefore creates value for customers as well. So that's pretty attractive. And the Norfolk Southern and Union Pacific merger is the first example of this is probably an 18 to 24 month timeline is the expectation. It could get pushed out by people pushing back on the merger and asking for more as soon you give back to them ultimately.

(18:45):

So we'll wait and see in terms of what the conditions are imposed on that. The second order effect of that is the other two companies, BNSF, which is owned by Berkshire Hathaway and CSX, if the merger gets approved, would likely be at a material disadvantage not having that transcontinental operation. And it probably means that ultimately they'll have to see a merger between those two parties as well to be competitive. So again, as we roll off the freight recession, we get to more normalized environments as the oversupply comes out of the trucking market and you combine that together with an opportunity from consolidation. We think it's some really attractive themes in the rail sector.

Rebecca Hiscock-Croft (19:21):

Thank you. That's very insightful and it would be great to speak more to a stock example.

Ofer Karliner (19:25):

At the stock level, the biggest position in the fund is Aena. It has been for quite a while, continues to be, it's been a really strong performance for the last three years, over a hundred percent. Part of that's been driven by really strong traffic growth. We would expect that to moderate over time, but we still see reasonable growth coming through that's going to be supported by increased deliveries of jets over the next two or three years. We've seen some real supply chain issues through Boeing as they've had restrictions after some accidents and then Airbus having some engine issues. That's starting to our mind luckily Airbus reaffirmed their guidance to four-year plane deliveries or jet deliveries this year, Q3. It means there's a big acceleration coming in Q4, but certainly they're targeting full delivery of planes this year, record number of planes this year and likewise next year we expect continued growth in jet deliveries in both of the major suppliers. So that's going to be supportive.

(20:18):

At an individual level, we see there's a big CapEx plan that's been proposed by Aena for the next regulatory period, which is 2027 to '32. They'll submit that formally at the start of next year. In total, it's 13 billion of CapEx, 10 billion of that is regulatory CapEx. So people get scared by big CapEx numbers. But again, if you roll your sleeves up and do the work in a regulated environment, high CapEx means high growth earnings. Ultimately, that's how you grow your earnings. If people are being concerned about the level of charges, they'll be able to get for that or charge increases, they'll be able to apply for that. What we have seen is, and we've spoken to the regulator that we're quite comfortable to get a fair rate of return for this, and the history of the regulator has been very consistent in allowing fair rates of return.

(21:05):

In fact, through legislation, it is relatively protected and should be allowed to earn a fair rate of return. So we're quite comfortable there. The non-aero CapEx, about 3 billion euros. Ultimately that helps grow things like retail surface area, increasing spend by passenger, which again is a creative and that's not regulated. It's uncapped in terms of earnings. They've done an exceptional job at Aena of growing that business, growing the minimum annual guaranteed rents that we managed to sign up over the major airport. So very confident in the long-term earnings growth there as well.

Rebecca Hiscock-Croft (21:35):

Oh, that's great. So I think we've spoken so far an opportunity we see in terms of value and also structural growth. But I'm keen to just touch on before we wrap up, conversely, where we see more risks. So I wondered, Dave, if you could speak a bit more to parts of the market that you see as being overdone at the moment?

David Costello (21:50):

Yeah, Beck, we see enormous risk in the merchant power generation market in North America in particular. This is not a space where we play, but it is an area that's attracted a lot of attention recently. Businesses like Vistra and Constellation Energy have delivered extraordinary share market returns over the last several years. A business like Vistra up nearly 900% over the last three years, Constellation Energy up more than 300%. And that very strong performance has arisen as these stocks have become tethered to the AI thematic that's dominated global equity markets more broadly. And the thesis for these names is that as AI workloads grow exponentially, that they will drive structural tightness in power markets. And because these companies operate in wholesale power prices and earn the volatile power price on their output, that that will drive accretion in their earnings in the longer term. But we're very circumspect about this thesis for three key reasons.

(22:55):

The first is to the extent that investors are allocating to this space in their infrastructure portfolios, we believe that these assets just don't generate predictable cash flows that support the kind of consistent returns that investors expect from infrastructure. When you look at the development of companies like Constellation and Vista's earnings, you see extraordinary year-on-year volatility. But secondly, I'd observe that not only do you see volatility in these companies earnings, but this thesis that high power prices will continue to see their stock prices move higher is by no means guaranteed. In fact, it's an inherent risk of this business model that you'll end up short the electricity price in periods when electricity prices move high and you don't have sufficient generation to support that demand. We saw this for Vistra Energy during winter storm Uri several years ago when power prices surged to very high levels in Texas, but the company was unable to supply the contractual commitments they'd made to their retail customers in that environment.

(24:03):

And so they had to step into the market and purchase power at the market cap of \$9,000 a megawatt hour realizing losses of approximately \$2 billion over the space of about a week. This is relative to a company that generates annualized earnings of, call it, three to \$4 billion, so catastrophic to their earnings. So they just don't generate the kind of predictable earnings that you'd expect from infrastructure businesses. But there's even more risks lurking here that are less apparent. This nexus to the AI thematic has seen these merchant

generators assume a very tight correlation with the performance of AI bellwethers like Nvidia. So if the AI thematic starts to unwind exactly as we saw following the DeepSeek moment in January this year, these stocks will fall potentially precipitously.

(24:51):

So at that DeepSeek moment, Nvidia fell approximately 17% on the day, Vistra Energy fell 28%. That's not how infrastructure security should behave. And finally, we'd observed that these securities have become very expensive as expectations as these high power prices have just ramped higher and higher to the point where now you see Constellation trading at a P multiple ahead of companies like Microsoft and Amazon. These are some of the most competitively advantaged businesses in the world benefiting from profound network effects. Constellation Energy sells a perfect commodity. This doesn't make any sense.

Host (25:27):

That was investment director Rebecca Hiscock-Croft in discussion with infrastructure portfolio managers, Ofer Karliner, Ben McVicar, and David Costello. We trust you've enjoyed this episode. For more information on previous episodes, visit magellaninvestmentpartners.com/podcast where you can also sign up to receive our regular investment insights program. Thanks for listening.

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