30 SEPTEMBER 2021

Q3 2021 Review

Partners Group Listed Investments SICAV – Listed Infrastructure

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2021 Q3 review

Q3 2021 was a volatile quarter for global equity markets. During July and August, markets remained quite strong driven by positive H1 results, and a rather benign outlook for inflation and interest rate increases. However, towards the end of August and especially in September, markets turned weak due to rising inflation, indications from the Fed and the ECB that interest rates may begin to rise as early as next year, and rise in energy prices due to higher demand but limited supply. As COVID-19 cases started rising again in the past month, there was also renewed fear of lockdowns in certain parts of the world. Finally, in September, the weakness was compounded by the failure of China Evergrande Group, one of the largest property developers in China, which had a negative impact across the global markets and especially the REITs and the real estate sector.

Despite the weak performance in September, the Partners Group Listed Investments SICAV – Listed Infrastructure fund grew by 1.2% during the quarter but lost its YTD outperformance to the benchmark because of the very strong performance of energy pipelines, and our relative underweight to the sector given its volatility. Other sectors in the portfolio which performed well include airports, regulated water and waste services, while regulated utilities and communication towers were the weakest performers, though with limited company-specific news-flows.

The transportation infrastructure sector, and especially airports, performed strongly in Q3, largely driven by the news of travel resumption between the US and several countries including the EU and the UK from November. EU airports rebounded strongly in September as there was increased optimism regarding cross-Atlantic travel, especially since vaccination rates globally had increased. Sydney Airport was the strongest performer during the quarter, after it received a buyout offer from a consortium of Australian investors, which was at a premium of more than 40% over the previous close. This confirmed interest for long-dated infrastructure assets by institutional investors, and we had also increased our allocation to the company in June, estimating that the price at that time undervalued the asset. Though railroads as a group was a weak performer, Canadian National Railroad (CNR) performance was a contrast, as shares rose after the Surface Transportation Board (STB) denied its request to make use of a voting board for its acquisition of Kansas City Southern (KSU). Investors cheered the news as the voting board was seen as a risky method to close the transaction, with CNR acquiring KSU shares even before the regulator had approved the deal. Subsequently, an activist investor has urged the company to instead focus on improving its lagging operations.

Communication infrastructure overall had a rather disappointing quarter, especially compared to the broader market. There was little company-specific news, with all companies delivering healthy H1 2021 results. Cellnex's results, in particular, was ahead of expectations with an acceleration in BTS (built-to-suit) programs in France and Italy seen as encouraging and it is expected to contribute to solid organic growth in the future. The company also raised its 2021 guidance and reiterated 2025 guidance. Despite the strong results, all tower cos fell in September due to the overall weakness of REITs driven by the concerns surrounding the China Evergrande Group. Equinix was flat during the quarter.

There was a clear bifurcation in performance between the utilities sector and the energy pipelines sector during Q3. The energy pipelines were resurgent following an increase in oil and gas prices driven by higher demand and insufficient supply. Williams Cos was one of the strong performers within the sector, as it announced a USD 1.5bn share buyback program (c.5% of market cap) during September, as management believed that the valuation remained depressed. After upgrading 2021 guidance on the back of better gas volumes in the Northeast, the company also reassured investors that it would meet its leverage targets despite additional capital returned to investors. However, the regulated and contracted utilities were among the weakest performers during the quarter, driven by the poor performances of Orsted and the Chinese gas sector. In the case of Orsted, there were concerns that higher inflation may lead to rising raw material costs and depress returns. Chinese gas distributors were weak in September over concerns surrounding high gas prices, as well as the China Evergrande Group problems. Investor worries are primarily on lower dollar margins, as higher gas prices can be passed through to end customers only with a time lag. Towards the end of the quarter, the Chinese government also ordered factory shutdowns in some provinces to curb power consumption, which will likely reduce industrial gas volumes.

Among other sectors, waste managers and regulated water operators continued to perform well. US waste managers and American Waterworks (AWK) all delivered robust H1 results, which translated into strong share performances, but there was little company-specific news except for these. Social infrastructure operators were flat during the quarter, with limited news-flow.

Portfolio positioning and outlook

Though regulated utilities remain the largest allocation in the portfolio currently, we have been increasing exposure to towers, toll roads and railroads, as well as reducing the cash allocation in the fund this year. Other sectors where we have also increased exposure are renewables, waste managers and data centers. While we do not believe that the risks associated with Covid-19 have abated fully, we found that certain companies offered compelling valuations for us to consider increasing them. In the past quarter, we added two new companies to the portfolio – Aurizon, the Australian railroad operators, and Inwit, the Italian tower operator. We divested our position in Italgas, the Italian regulated utility, and reduced our allocation to ENN Energy, the Chinese gas operator after its strong run in YTD performance until August.

Communications infrastructure remains one of our key sector focuses in 2021, and perhaps over the next few years, given the strong tailwinds for the sector. We continue to see large investment needs for the sector that could drive earnings growth over the medium to long term. We see more scope of outsourcing towers by mobile network operators (MNOs) in Europe, and the 5G investments by the US-based MNOs are expected to accelerate further. Data centres are also expected to benefit from such long-term secular trends. We have been increasing our position in communication infrastructure throughout Q4 last year and in H1 2021, which has supported the strong performance of the fund throughout Q2. We also subscribed to the Cellnex rights issue in April.

We continue to see a few investment opportunities among regulated utilities. Share performance for the sector overall has been flat or slightly negative over the past 18-24 months, while underlying earnings growth remains consistent, leading to lower valuations for the sector. None of these utilities have modified their medium-term investment plans or seen unfavorable changes to their regulation, both of which are promising indicators for the sector's earnings growth potential. However, within the sector, we continue to emphasize on electric and water utilities, and have changed allocations accordingly. Furthermore, those utilities that are subject to stable regulation, have a strong balance sheet and meaningful capex on their regulated asset base, should also provide better performance even in a rising interest rate environment.

We remain positive on the US waste managers, and our exposure to the sector has grown accordingly since the summer last year. Finally, while performance of transport infrastructure has recovered to some extent, we find that toll road traffic recovered meaningfully during this summer, but airport passenger numbers remain rather weak. We continue to take a cautious approach on the sector and believe traffic on toll-roads will recover faster than airports, as appetite for travel remains and people may perceive cars as a safer mode of transport. This was evident during this summer as toll road traffic on French and Spanish toll roads were above 2019 levels during a few weeks. Furthermore, toll-road valuations are attractive and the Brazilian toll roads may also benefit from operating new concessions. We are cautious on airports over the medium-term, and especially on those that are exposed to international long-haul, business and transfer traffic. We further increased our allocation to the railroads during the previous quarter as valuations became more attractive relative to longer-term fundamentals.

In summary, we have slightly shifted our portfolio towards more GDP-sensitive sectors, such as toll roads and railroads, but continue to be very selective on airports. However, 2/3rd of the portfolio remains invested in less GDP-sensitive sectors such as regulated utilities, towers and social infrastructure operators, which still provide growth even in an economic downturn scenario. We believe a balance between defensiveness and growth will be a better outcome for our fund presently. The underlying portfolio companies, except airports, due to the Covid19 situation, continue to perform well from a fundamental point of view. Furthermore, a scenario of rising nominal rates is not a negative per se for Partners Group Listed Infrastructure as more than two thirds of the portfolio companies' underlying revenues are directly or indirectly linked to inflation.

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