

Guest speaker spotlight: David McGregor



The SMF welcomed David McGregor as a guest speaker on 23 August 2021. Dave is a partner at Atlas Infrastructure, a global listed infrastructure manager. Prior to this, Dave worked for RARE Infrastructure where he was responsible for analysing a range of infrastructure and utilities securities. Dave shared his insights on risk management, with the discussion focusing on the impact of ESG and climate transition on investment portfolios.

Some of the key insights that Dave shared with the SMF are summarised below, as well as the Q&A session that followed.

Industry related

ESG integration

ESG is important to incorporate within the risk and return considerations that guide investment decisions. This recognises that all infrastructure assets operate under an implicit ESG 'contract', which will ultimately influence long-term cash flows.

For example, Atlas Infrastructure models the operations of utilities that use coal fire generation allowing for potential government policy changes, assessing the impact on cash flows. To further enhance the focus on ESG in selecting stocks, two non-cash flow-based measures have been added to the risk management framework:

- a) Projected Scope 1 and 2 emissions compared to a target budget by 2030 and 2050.
- b) Alignment with climate transition goals, with companies assigned into four categories spanning from aligned to non-aligned.

Atlas Infrastructure also engages with infrastructure companies that do not meet their frameworks, and conveys changes that are needed to management.

Investment universe

Atlas Infrastructure begins by identifying an investable universe of companies with infrastructure characteristics, including equity cash flows that are relatively stable over differing macro cycles and ideally inflation and interest rate protection. Specific consideration is given to the cash flows arising from contract structures, regulation or position in the economy. The following metrics help determine the quality of Infrastructure companies:

- Monopoly assets
- Regulated returns
- Contracted returns

- Asset duration
- Inflation protection
- Interest rate hedge

These metrics are measured, and companies given a quantitative score, and assigned to either Atlas Infrastructure's Core universe, the Enhanced universe, or otherwise treated as Excluded companies that not considered for investment.

Q&A

1. Do you think the proposal of paying coal fired generators to sustain capacity is viable?

Atlas Infrastructure focuses on the broad direction and magnitude of policy change. Coal fired generation technology is not an effective capacity filler as it takes 24 hours to get burning. Rather, open cycle generation gas is now the marginal provider of intermittent power. Similar policy measures have been seen in Germany, where there is a union to protect the coal industry. The proposal is likely to be a short-lived bridging mechanism to where we need to, and where the policy is heading.

2. What would you look for in an infrastructure asset or company to ensure that rising input costs will not negate the benefits of having inflation linked revenues or cash flows?

In many infrastructure assets there is explicit inflation pass through, such that if inflation goes up by 1% then revenues also go up by 1%. Most of the regulated network's costs are directly passed on to users. For assets like toll roads and windfarms, there are not a lot of maintenance requirements and therefore input costs are not highly relevant.

Another issue is how increases in inflation translate through into bond yields and allowable rates of return under regulation, i.e. if a static real rate of return is accommodated. It is important to determine if the company's assets have interest rate protection, and if that is able to be passed through. Most regulated networks have this, and it will pass through to their cost of capital. Companies that do not have this protection are interest rate sensitive purely because of the impact on cost of capital.

3. What changes in policies, and related legal and regulatory risks, do you monitor that could impact the base case scenario for transition to renewables?

Many renewables are now cost-competitive. We are currently looking at policies around storage and firming, for instance the way that batteries or hydrogen are being integrated. Effectively, you can only model renewables getting to 50-70% of your generation before you need a real solution to storage and firming. We are not seeing this in Australia as yet but are seeing it in Europe.

In relation to air travel, we are looking at both policy change and the ways that companies are using air travel. As an example, in Europe there is legislation emerging that limits short-term flying by companies when there is a rail alternative.

4. What are your views on actively incorporating offsetting measures such as carbon capture technology or carbon credits?

Some companies incorporate these aspects, but we do not give them credit for it. The reason is that carbon markets are not sufficiently formalised to have a clear and measurable effect on overall carbon output. When thinking about carbon offsets from trees being planted, there is no formalisation around how many trees survive to permanency and how much carbon is captured. We also do not give credit to technologies like carbon capture as it is not yet commercial on an industrial scale.

Some investors adopt the view that it is ultimately right to own renewables and wrong to own coal assets. This is not healthy, as it creates bubbles where investors buy renewables to such an extent that attractive equity returns are no longer available in renewables, and instead become available

in airline and coal assets. We steer away from subjective labelling of assets. Rather, we look to the future, and focus on what individual companies can do to be as aligned as possible with overall transition towards net zero.

5. Do you believe that ESG investments such as renewables are being driven by social considerations?

Investing has turned into more of a social good and hence less of a financial good. We have seen real bubbles emerging where the equity returns offered by companies in the renewable sector are now low or negative. In Europe, governments are starting to regulate these sectors, which is capping returns. This process has been seen before. We see it as essential to understand the financial return on offer, and to protect investor capital.

6. How do you assess the impact of COVID-19 on the macroeconomic outlook? Are you viewing it as a 3-year scenario that will taper out, or a scenario that may cause structural change over a 50-year outlook?

Some of the work we have done in response to COVID has looked at the short-term macro implications that economists already covered. For the long term, we are sceptical that COVID will result in substantial fundamental changes. We focus more on policy change as opposed to changes in personal behaviour and preferences. For example, people have been seeking to travel around the world for hundreds of years, and we do not believe that this will stop. We are already seeing this reflected in Europe, where markets are opening back up and the demand for travel is still there.

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