HICL Infrastructure

Update
29 October 2019

Summary

HICL offers investors an exposure to over 100 institutional quality, lower-risk core infrastructure assets. The primary aim is to provide a robust and steady income stream, with low correlation to changes in GDP or equity markets. HICL's portfolio has been built up over the past thirteen years, with the manager's aim being to pay a sustainable dividend, as well as to diversify and extend the income stream as much as possible.

The manager invests in lower-risk, core infrastructure assets with good correlation to inflation over the long term, as well as longevity. Whether investing new capital or reshaping the existing portfolio, the manager seeks to continually improve and optimise the portfolio's overall characteristics. Over the past year or two, they have been paying particular attention to the portfolio composition. During the last financial year, the manager took advantage of favourable market conditions to make two strategic disposals (realising a total of £148m) and reinvesting £167m in six assets.

The manager has been successfully extending the average portfolio duration over time, and in the last financial year managed to keep the duration level at 29.5 years, despite a year having elapsed. Over that period the manager reviewed a number of investment opportunities with the objective of improving total returns, portfolio yield, cash flow longevity, and inflation correlation. We understand that during the last year InfraRed looked at 65 deals which fit HICL's investment policy; of these they conducted detailed due diligence on 11 deals on HICL's behalf, which eventually resulted in five investments being made to deploy the capital resulting from the two strategic disposals.

On a total return basis, HICL has outperformed UK equities since its IPO, delivering a total return of 9.4% p.a. to 31 March 2019, against 6.0% for the FTSE All Share. This strong track record applies even over shorter time frames, with the company having outperformed UK equities over both five years and 12 months. HICL continues to deliver consistent returns with low volatility.

The portfolio's discount rate, less HICL's ongoing costs, gives an idea of expected returns going forward. The weighted average discount rate (as at 31 March 2019) was 7.2%, and ongoing costs last estimated as 1.08% pa. Any deviation from this expected return could be a result of either 'alpha' delivered by the manager (upside), portfolio risks such as that posed by Carillion (downside), or changes to underlying valuation assumptions (the company is most exposed to changes in the discount rate and inflation assumptions). The depth of resource and breadth of expertise in the HICL management team helped to minimise the impact of Carillion's failure, and the HICL board has drawn a line under that episode, with a final estimate of the total costs attributable to Carillion coming in at £33m (1.1% of NAV).

Analyst's View

The 13-year history of HICL illustrates why infrastructure investing has proven so attractive for long-term investors, both in the consistency of returns and the lack

Key Information:

As at	22/10/19
Price (p)	169.2
Discount (%)	10.3
OCF (%)	1.08
Yield (%)	4.8
Gearing (%)	0
Ticker	HICL
Turnover Ratio (%)	0.0
Shares (£)	1,791,142,767
Market cap (£)	3,030,613,562

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of correlation to equity markets. Despite the manager's preference for investments at what they view as the lower end of the risk spectrum, the company has handsomely outperformed the FTSE All Share since its IPO, on both a NAV and share price basis, but also over shorter time periods such as the past five years and the last 12 months.

Over the short term, a number of small uncertainties have weighed on HICL's share price. Political pressure appears to have abated somewhat, and the Carillion insolvency is now firmly behind it, with only a minimal negative effect (1.1% of NAV). The one remaining uncertainty (Affinity Water) has been quantified by the board and looks likely to be resolved very soon (by the end of December 2019). The current share price premium of around 8% is in line with the average seen over a longer timeframe.

HICL remains the pre-eminent vehicle for investors to get access to a diversified portfolio of high quality, lower-risk core infrastructure assets. The dividend target for the current year is equivalent to a dividend yield of 4.8%, which looks highly attractive given the robust levels of income that HICL has delivered in the past and looks set to deliver into the future.

Analyst's View

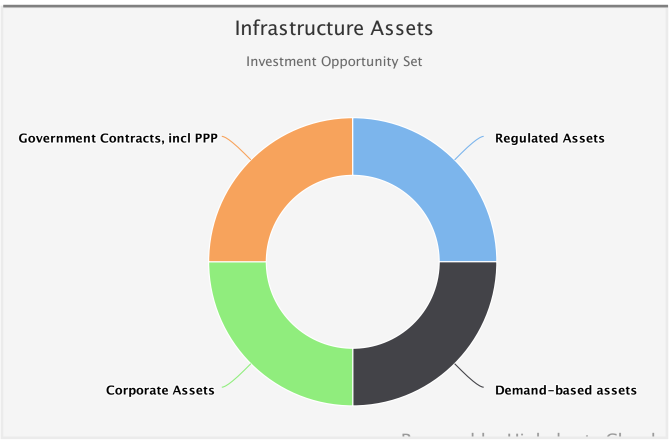
BULL	BEAR
Lower risk, institutional quality infrastructure assets, within a vehicle that has scale	Prospects of a Labour government heavily influences the share price rating to NAV over the short term
Steady yield, with board guidance on dividends, up to 2.5 years out	Rising discount rates, in absence of inflation and/or increases in deposit interest rates, could limit manager's ability to continue to deliver positive NAV progression
Uncorrelated returns to equities	Exposure to third party facilities management companies in event of their insolvency

Portfolio

HICL offers investors an exposure to over 100 institutional quality, lower-risk core infrastructure assets (as at 14 October 2019). The trust's primary aim is to provide a sustainable and steady income stream, with low correlation to changes in GDP or equity markets. HICL's portfolio has been built up over the past thirteen years, with the manager's aim being to continue to pay a sustainable dividend, as well as to lengthen and diversify the income stream as much as possible.

Within their opportunity set, which we represent in the pie-chart below, the manager seeks diversification and what they see as lower-risk investments. Their attention has so far been focused on three of the four areas shown in the chart – namely government contracts including public-private partnerships (PPP), regulated assets, and demand-based assets. In the manager's view, the opportunity set includes a wide range of corporate assets; some of these have characteristics similar to existing investments, which would work for HICL, while others typically offer too much exposure to the economic cycle for a core infrastructure portfolio. Assets which are deemed to be correlated to GDP (such as toll roads) are restricted to 20% of NAV in aggregate at the time of investment.

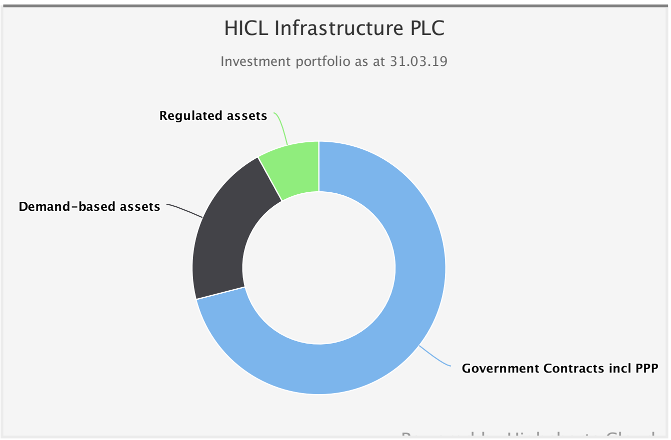
Fig.1: Illustrative Opportunity Set For HICL



Source: InfraRed Capital Partners

Within these broad areas, the manager aims to invest in lower-risk assets with good correlation to inflation over the long term, as well as cash flow longevity. Whether investing new capital, or reshaping the existing portfolio, the manager seeks to continually improve or optimise the overall portfolio's characteristics. Over the past year or two the company has not raised any new capital, so the manager has been paying particular attention to portfolio composition. During the last financial year, they took advantage of favourable market conditions to make two strategic disposals (realising a total of £148m) and reinvest £167m in six assets.

Fig.2: Portfolio Breakdown

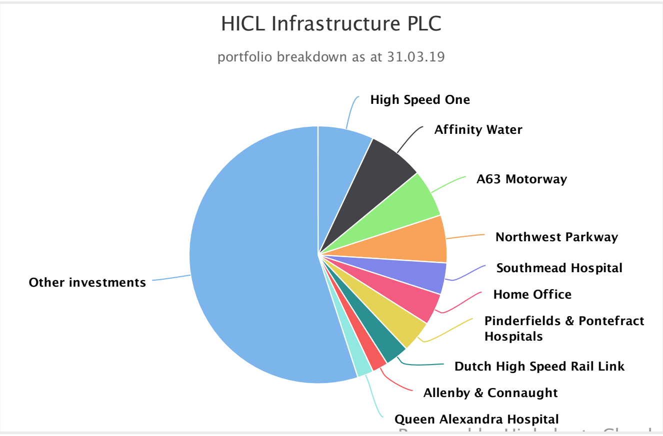


Source: InfraRed Capital Partners

The current overall split of asset types in the portfolio can be seen in the chart below. The vast majority of assets are UK-based (77%), with Europe representing 15% and North America 8%. Currently only two assets, representing 3% of the portfolio, are in a construction (i.e. pre-operational) phase.

HICL is of sufficient size that it can invest considerable amounts of capital in single projects, which helps the trust in terms of both access and ability to control or influence the strategic plan for each asset. That said, the company's manager is mindful of single asset concentration risk, and to manage this risk they have a track record of finding strategically aligned co-investors to take some of the equity in larger deals, for example in Affinity Water and High Speed 1. This approach ensures that HICL maintains a balanced portfolio by limiting the size of positions it takes. In the chart below we show the trust's top ten holdings, totalling 45% of the portfolio, alongside the rest of the portfolio to illustrate their relative size.

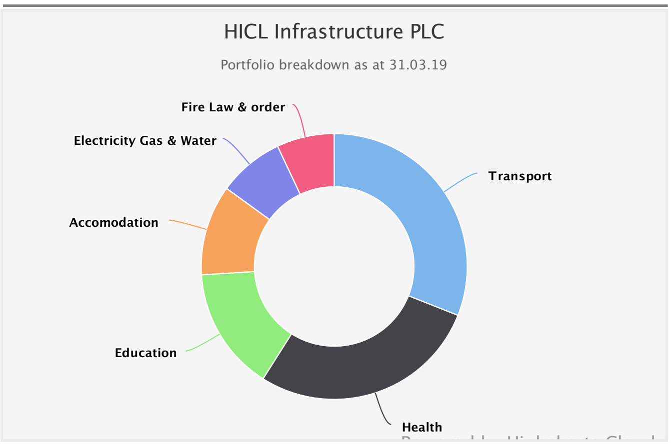
Fig.3: Top Ten Investments Relative To Rest Of Portfolio



Source: InfraRed Capital Partners

The portfolio is broadly exposed to different types of asset, although given they are infrastructure assets it is not surprising that most of the exposure is to transport (mainly

Fig.4: Breakdown By Sector Exposure



Source: InfraRed Capital Partners

roads and HS1), health (mainly hospitals) and education (mainly schools), as the graph below shows.

Overall the portfolio is currently represented by over 100 different assets, with a weighted average life of around 30 years. The manager has been successfully extending the average portfolio duration over time, and in the last financial year managed to keep the duration level at 29.5 years, despite a year having elapsed.

As we note above, the manager has been optimising the portfolio by opportunistically selling assets for what they see as a good price, and reinvesting the proceeds of these disposals to improve the overall characteristics of the portfolio for shareholders. The aim has been to buy assets which improve on yield, cash flow longevity or inflation correlation. We understand that in the 12 months to 31 March 2019, InfraRed looked at 65 deals of which 11 were then subjected to detailed due diligence on HICL's behalf. This process resulted in five investments being made to deploy the capital resulting from their strategic disposals.

The company's second largest asset is Affinity Water, which provides water to parts of north west London and the home counties, but also parts of Folkestone and Dover. HICL owns about a third of the company, which makes up about two-thirds of the 'regulated' assets in its portfolio. Affinity is not a concession, so it has an unlimited life, which is helpful in a portfolio context to lengthen the average life of portfolio assets. As a regulated company, Affinity's business plans and returns on equity are approved at five-yearly intervals by the regulator.

The most current review (and determination) is expected to be concluded at the end of 2019. InfraRed believes that, depending on the final determination, this is likely to trigger a reduction in the company's valuation of between £30m and £40m, equivalent to 1.7p–2.2p of NAV per share (1.1%–1.4%). In the manager's view Affinity remains a high quality asset for HICL, and will remain able to deliver attractive returns over the long term. The geographical area served by the company is expected to continue experiencing population growth. This will require investment to ensure that consumers continue to be served efficiently, and to cope with the effects of climate change, putting Affinity in a good position to earn good returns from their asset base over the long term.

Gearing

Overall, structural gearing at a fund level is not part of HICL's strategy. The company has a multi-currency revolving credit facility (RCF) which is typically used to acquire assets and then repaid from the proceeds of share issuance. The company has not raised any new equity capital since 2017. Consequently the manager has been focusing on optimising the portfolio, and this has required use of the gearing facility to manage acquisition and disposal cash flows. HICL's gearing facility is for a maximum of £400m which costs LIBOR +165bps on amounts drawn down. In the company's interim update statement in August 2019, it projected a funding requirement of around £130m by 30 September 2019.

On an underlying basis, HICL's projects almost all employ gearing. This is all non-recourse debt, meaning that if one project (owned by a special purpose vehicle (SPV) gets into trouble, for whatever reason, its liabilities are not recoverable from projects in other SPVs or the group. Within each PFI project, the interest rate is usually fixed, and the loan is typically amortised over time, meaning that at the end of the asset's life no liabilities are incurred. The average remaining maturity of these long-term financing structures is 17.5 years (as at 31 March 2019).

Within the SPVs that HICL uses to structure the ownership of its underlying projects, gearing is relatively high, up to 90% of construction value / capex. These kinds of gearing levels are fairly typical in PFI investments, reflecting the highly robust nature of the asset and the relatively low likelihood that anything will go wrong. As we note above, 71% of the portfolio is availability-based; and much of the risk of assets not being available rests with counterparties and is contractually stipulated. Nevertheless Carillion illustrated that these kinds of investment do not come risk-free.

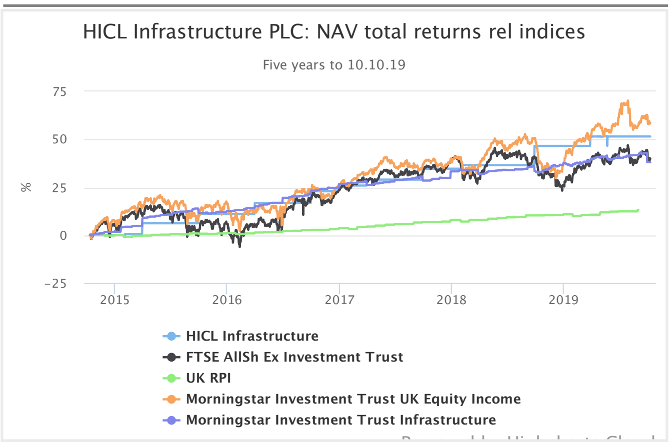
Returns

The aim of the company is to provide investors with long-term stable income. In addition to generating sustainable dividends, the company aims, over the long term, to: (i) preserve the capital value of its investment portfolio, with the potential for capital growth; and (ii) provide a degree of correlation between the return to shareholders and changes in inflation rates. HICL's returns so far have delivered both of these elements.

At the time of the company's launch in 2006, the aim was to grow dividends from 6.1p, paid in the first year, to 7p per share by March 2016. As we illustrate in the dividend section, this target was met ahead of schedule (the company paid a dividend of 7p in March 2013). Since then the company's dividend policy has been to pay out at least as much as the prior year, a target which it has continued to more than achieve. In the last financial year the company paid an annual dividend of 8.05p, representing compound annual dividend growth of 2.3% since the IPO. In May 2020, IPO investors will have had their capital back (99.5p) in dividends. As we discuss in the dividend section, the board provides guidance for dividends up to two and a half years ahead, such that 8.45p is currently targeted for 2021. We expect the board to announce a dividend target for the year to March 2022 when the interim results are released on 20 November this year.

While the company has been delivering its targeted income, HICL's total returns have also been strong. As the graph below shows, over five years the company has been performing strongly against UK equities, equity income funds and infrastructure peers. HICL has outperformed UK equities since its IPO, delivering a total return of 9.4% p.a. to 31 March 2019, against 6.0% for the FTSE All Share.

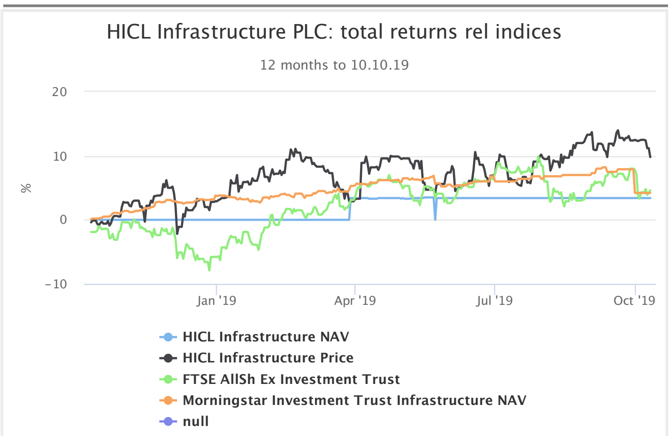
Fig.6: Five-Year Nav Total Return Performance



Source: Morningstar

As the graph below shows, HICL has continued to deliver solid and consistent positive returns in what has been a difficult period for equities generally.

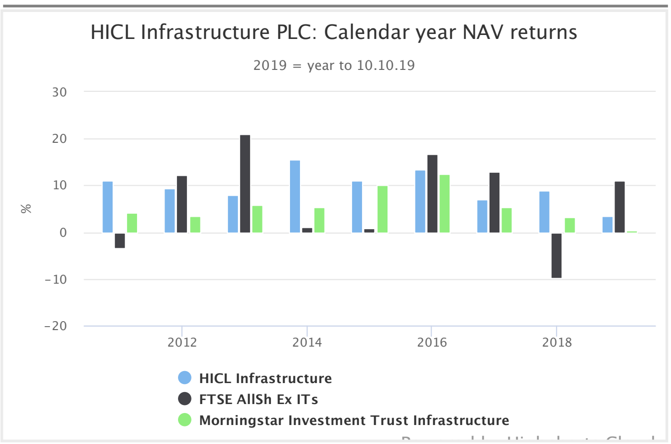
Fig.5: 12 Month Performance Recap



Source: Morningstar

The graph below shows calendar year total returns against UK equities and infrastructure peers. In our view the main points to highlight are the consistency of returns and the lack of correlation to equity markets. The consistency of positive annual returns illustrates the 'tortoise and hare' parallel, which can be applied to HICL versus the wider equity market. Over the short term, equity markets might easily show HICL a clean pair of heels. But over a cycle the charts above and below demonstrate that HICL very much proves itself on a total return basis.

Fig.7: Calendar Year Nav Total Returns

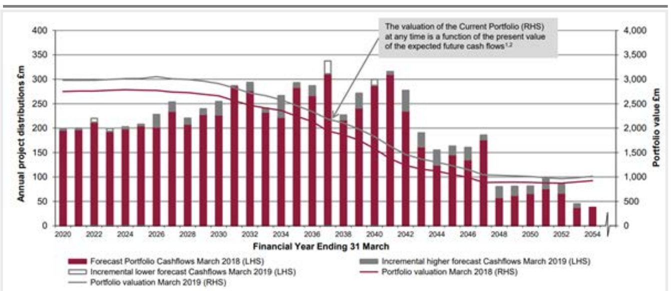


Source: Morningstar

Aside from assembling the portfolio, the manager aims to add value in various ways over the life of an asset. As we discuss in the portfolio section, they have been undertaking a certain amount of portfolio optimisation, selling assets where they believe they can attract good prices, and recycling capital into assets which help the portfolio to achieve more attractive characteristics. As we discussed in our last note, InfraRed looked back at the first ten years of HICL's life to 31 March 2016, and separated the returns – which were ahead of forecast by 44.2p per share over this period – into 'alpha' (30p) and 'beta' (14.2p). The alpha contribution arose through management activities such as cost saving initiatives, economies of scale and opportunistic disposal of assets. Accretive share issuance was also a large factor.

Reflecting the limited life nature of the portfolio's assets, over the very long term the NAV will decline, assuming the manager is unable to extend its overall life or boost returns through asset management initiatives. Nevertheless it is the manager's aim to extend the asset life of the

Fig.8: Project Distributions And Portfolio Value

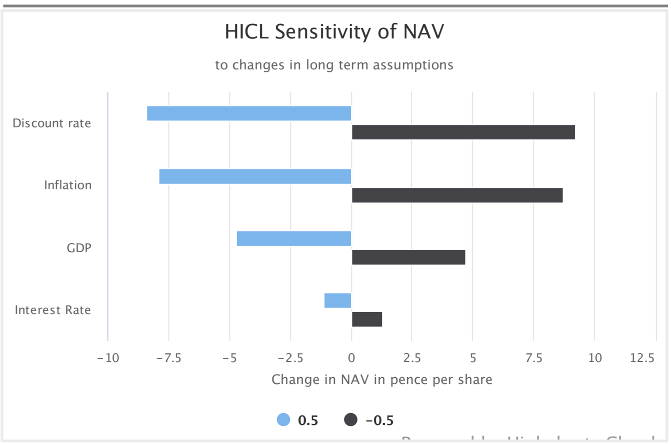


Source: HICL

portfolio, and in the last financial year, they achieved this by maintaining the portfolio's weighted average unexpired concession length (duration) at 29.5 years, despite a year having elapsed. The current projected cash flows, and changes from the last financial year, can be seen in the table below. In our view, this is a key graph for shareholders to monitor over time.

The portfolio's discount rate, less HICL's ongoing costs, gives an idea of expected returns going forward. The weighted average discount rate (as at 30 March 2019) was 7.2%, and ongoing costs last estimated as 1.08% pa. As such, a rough estimate of returns going forward might be in the order of 6.1% pa. Any deviation from this could be a result of alpha delivered by the manager (upside), portfolio risks (downside, such as that posed by Carillion, of which more below), or changes to underlying valuation assumptions (positive or negative). In the chart below we reproduce the portfolio's sensitivity to long-term assumptions. According to the manager, the portfolio is most sensitive (in terms of a 50bps shift in the long-term rate) to changes in the discount rate and inflation assumptions.

Fig.9: Nav Sensitivities



Source: InfraRed Capital Partners

In terms of other risks impacting returns – aside from the financial-type assumptions and impacts outlined above – the main risk shareholders face is the failure of counterparties or service providers. In order to illustrate this risk, it is worth revisiting the Carillion episode, which the board deemed to be fully resolved (from HICL's standpoint) in the report and accounts published in the summer of 2019. At the time Carillion went into administration, the board provided for a total of £59m (equivalent to 2.8p of NAV per share, or 1.8% of NAV per share as at 30 September 2017). Carillion provided facilities management services to ten of the PPP project companies in which HICL is invested, representing approximately 14% of the portfolio at the time.

The whole point of PPP contracts is that private investors, rather than taxpayers, shoulder the responsibility for the risks. Consequently the board has now made a final estimate of the total costs attributable to Carillion, at £33m (1.1% of NAV), having written back £27m of the original provision. This reserve was funded entirely from project cash flows (meaning HICL's overall income over the period was lower), but crucially it required no additional capital from HICL. While this cost is unfortunate for shareholders, it should be viewed as simply part of the risk that they shoulder for the returns they have enjoyed so far. The Carillion episode in fact illustrates why public-private partnerships benefit taxpayers. The total costs included the cost of agreeing new contracts with other third parties to take over contracts from Carillion, as well as the direct liabilities that Carillion had incurred to clients or the owners of projects (including HICL). It is clear that the depth of resource and breadth of expertise within the HICL management team at InfraRed helped to minimise the impact of Carillion's failure. Portfolio management is part of this, and accordingly Bouygues and Engie are now HICL's largest facilities management and operations counterparty exposures, at 15% and 13% of portfolio value respectively (as at 31 March 2019).

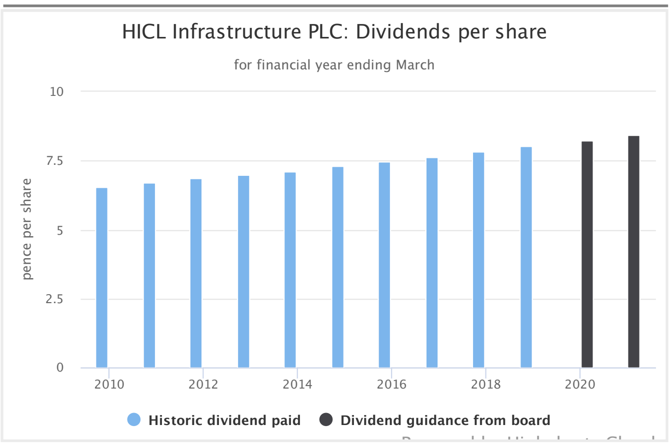
Dividend

Since 2015, HICL has paid a quarterly dividend to shareholders; prior to that it was semi-annual. At the current share price this dividend yields a prospective 4.8%. Infrastructure investing is all about steady, predictable cash flows. To ensure that shareholders achieve this kind of experience from their investment in HICL, the board sets out a projected dividend target (which of course cannot be unquestioningly relied on) for over two years ahead. The board has so far stated that, assuming no unforeseen circumstances, it expects to pay a dividend of 8.25p for the year ending March 2020 (a 4.8% yield at the current share price) and 8.45p for the year ending March 2021. We expect that the board will be looking to extend this dividend projection when the company's interim results are announced on 20 November this year.

Notwithstanding these projections, HICL's dividend policy is to pay out at least as much as the prior year. The company's cash flows are largely uncorrelated to the economic cycle. According to the manager distributable income, net of costs, is expected to fully cover the dividend. Dividend cover clearly varies from year to year, depending on the underlying performance of the assets and to what extent the short-term gearing facility is deployed. In the last financial year (to 30 March 2019), net operating cash flows from investments (excluding disposals) covered dividends by 1.03x (1.1x in the previous year).

The graph below shows dividend progression over the past ten years, as well as the board's guidance for the next two years. An interesting statistic is that when the final dividend is paid for the year ending March 2020, shareholders who invested at IPO will have received their entire initial investment of 100p back in dividends.

Fig.10: Dividends Per Share



Source: Morningstar

Part of the objective of the company is to provide an internal rate of return that has a "degree of correlation" to inflation. In the most recent report and accounts (as at end-March 2019) the manager published an inflation correlation figure of 0.8%. As such, the manager currently models that if inflation turns out to be 1.0% p.a. higher than currently forecast, in all future periods, the expected returns from the portfolio would increase by 0.8% (from 7.2% to 8.0%). The majority of returns for HICL shareholders come in the form of dividends, but it is worth noting that the dividend is not directly linked to inflation. Indeed, the manager believes that the majority of the increase in the dividends paid since launch has been due to their delivering performance over and above expectations when the assets were purchased.

Management

InfraRed has a 20+ year track record in infrastructure and real estate funds, with over US$12bn of equity under management. The company is responsible for all aspects of the management of HICL's investments, including operations and financial management, and sourcing and executing new investments.

Harry Seekings has overall day-to-day responsibility for leading the InfraRed team in relation to HICL, which was the first infrastructure investment company listed on the main market of the London Stock Exchange. Harry joined InfraRed in 1988, and is co-head of the infrastructure business. The InfraRed team employs around 160 staff and has its headquarters in London, with other offices in New York (since 2008), Sydney (since 2013), Hong Kong, Mexico City and Seoul.

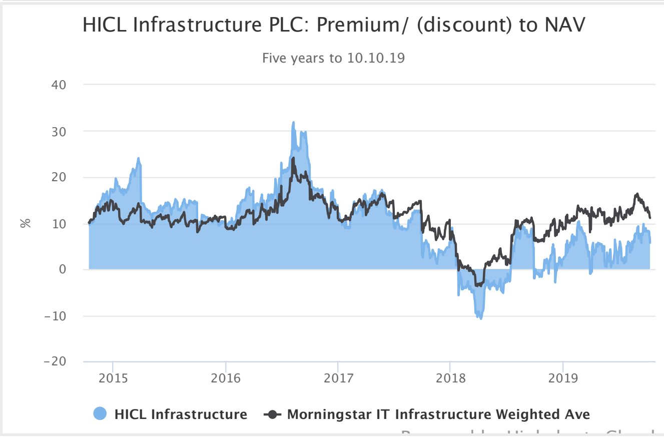
Discount

HICL was the forerunner of the listed infrastructure fund sector when it issued its IPO in 2006. Up until 2018 the company has largely traded at a premium to NAV, which allowed it to grow steadily and to raise over £2.2bn of equity over this period. However it is fair to say that UK politics has, at times, caused a fair degree of uncertainty for investors in the infrastructure space. The most dramatic impact came in 2017. As is clear from the graph below, the second half of that year saw the HICL premium rating narrow sharply following a spell of 'sabre-rattling' from the Labour opposition, who were threatening to nationalise PFI / PPP projects should they be voted into government.

This effect was then compounded by the insolvency of Carillion in early 2018. As a result, HICL suffered some negative share price pressure, and at one point the discount to NAV reached double figures – which in retrospect looks like a buying opportunity. Subsequently the trust bounced back to a premium when Equitix made an unsolicited bid for one of HICL's peers, John Laing Infrastructure Ltd. This takeover was completed in autumn 2018, catalysing the sector and helping HICL regain its premium rating to NAV. The current share price implies an 8.2% premium to the cum-income NAV estimate from JPMorgan Cazenove of 158.7p (as at 21 October 2019). We expect HICL to release an updated NAV (and interim results) on 20 November, covering the half year to 30 September 2019.

The graph below demonstrates that HICL has so far not regained its historic premium rating when compared to peers. As we discuss in the portfolio section, HICL has endured some uncertainty which, at the margin, has likely held the share price back. Much of the uncertainty appears now to have been resolved, but the one remaining unknown is the potential revaluation of Affinity Water, which represents 7% of HICL's portfolio value. The regulators' determination on the management business plan is expected towards the end of the year, but HICL believes that it could trigger a reduction in valuation of between £30m and £40m, equivalent to 1.7p–2.2p of NAV per share (1.1%–1.4%). Incorporating this projection into the NAV implies that HICL is trading on a premium of around 9.3%–9.6% after adjusting for the effect of the expected Affinity Water revaluation.

Fig.11: Premium (Discount) To Nav



Source: Morningstar

Charges

The manager charges a tiered management fee on gross assets. The fees are 1.1% on assets up to £750m, 1% to £1.5bn, 0.9% to £2.25bn, 0.8% to £3bn and 0.65% thereafter. With gross assets (as at the last valuation date on 31 March 2019) of £2.9bn, HICL is close to reaching the lowest tier of this management fee structure for some of its assets. The company's ongoing charges figure (OCF) as at 31st March 2019 was 1.08%, and the Key Information Document Reduction In Yield cost was 1.38%.

ESG

The manager observes that HICL invests in projects and companies that provide physical assets, often supporting essential public services in the communities in which they are located. InfraRed, the investment manager for HICL, has held an A+ rating from Principles for Responsible Investment (PRI) for the past five years; and within the underlying portfolio 86% of HICL's portfolio companies have an environmental, social and governance (ESG) policy. Clearly the infrastructure assets are vital to the lives of the people who use them; accordingly HICL states that the company is committed to a sustainable and proactive approach to asset management and stakeholder relationships. The board and manager say they are united in taking a long-term perspective to the management of the portfolio, aligned with the nature of their investments and the long-term cash flows that deliver the annual dividends. We interpret this as an acknowledgement that, for infrastructure investors, long-term value creation requires long-term, meaningful stakeholder relationships. This philosophy is particularly relevant given the current political environment and the position of the Labour party towards public-private partnerships.

Overall we believe those looking for ESG attributes in a trust like HICL – as an infrastructure fund – are likely to take a view based on two factors. First, what the underlying assets do for society and the communities they are located in. Second, and more quantitatively, how well aligned the fund is to the UN Sustainable Development Goals, using a specialist ESG rating agency such as GRESB (which specialises in property and infrastructure). Currently the company does not specifically report on an ESG scorecard, and we look forward in due course to seeing the results of the review currently being undertaken by the board.

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