BBGI Global Infrastructure

Kepler ALTERNATIVE INCOME RATING

BBGI's increased target dividends is underpinned by its inflation linkage...

Update
19 May 2023

Overview

BBGI Global Infrastructure (BBGI) has a £1.1bn portfolio of low-risk essential social infrastructure assets, diversified around the world across highly rated investment-grade countries. The portfolio consists of 56 investments with a common link in that they are all availability-style, backed by government revenues with high-quality inflation linkage. BBGI has no exposure to demand-based or regulated investments.

As we discuss in the **Portfolio section**, having pure exposure to availability-style assets has meant that cashflows have been secure and predictable, and none have been locked-up. BBGI's geographic diversity is also a differentiator to peers which typically have a strong bias towards the UK compared to BBGI's current 32%.

In other ways too, BBGI is differentiated. There has been an internal management team behind BBGI since IPO in 2011. This set-up gives BBGI a cost advantage over peers, as we discuss in the **Charges section**, but also means that the team are incentivised to manage the assets for the benefit of shareholders, and to only grow assets under management where it is beneficial to investors.

BBGI has paid growing dividends since it was launched in 2011, having delivered a compound average increase in the annual dividend of 3.1% between 2012 and 2022. Reflecting the steady and predictable income flow from the underlying assets, the board aim to give shareholders as much visibility as possible. As a result of higher inflation, thanks to the portfolio's direct link to inflation, the dividend targets for 2023 and 2024 have recently been raised by four percentage points over previous targets, leading to sector-leading dividend growth of 6% per annum from the 2022 level. The new target dividend of 7.93p represents a dividend yield of 5.3%.

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Analyst's View

It is clear from BBGI's recent results and long-term performance that its resilient and defensive strategy is set up to continue to provide long-term, predictable, inflation-linked, and sustainable returns. In being internally managed BBGI has the lowest OCF in the peer group. These factors have been contributors to BBGI delivering an annualised return since IPO of 9.1% on a NAV total return basis. The NAV total return in 2022 was 11.8%.

As we discuss in the **Performance section**, BBGI has proved attractive and defensive even within its peer group of infrastructure trusts thanks to the sole focus on availability-style assets. BBGI's portfolio provides reliable returns, and the diversification across economies and political systems helps to ensure that variability in overall returns should remain low.

In the current inflationary environment, the portfolio's direct link with inflation appears highly attractive. BBGI has announced target dividend and NAV growth in excess of peers', despite those peers' optically higher linkage to inflation (see **Portfolio section**) which have not yet seen NAV uplifts aligned with their reported inflation linkage. This is a key attraction of BBGI, and perhaps explains the fact that BBGI trades close to NAV, when peers are at discounts. Inflation expectations factored into the current NAV are relatively prudent, and, for the financial years after 2024, are unchanged from a year ago, illustrating conservatism. In our view, there is a clear upside for shareholders should inflation remain persistent.

BULL

- Clear investment proposition, targeting 100% availability-style assets with strong ESG credentials and a direct link to inflation
- Geographic diversity helps smooth returns
- Internally managed, meaning BBGI's scale leads to a clear cost advantage and fully aligned team

BEAR

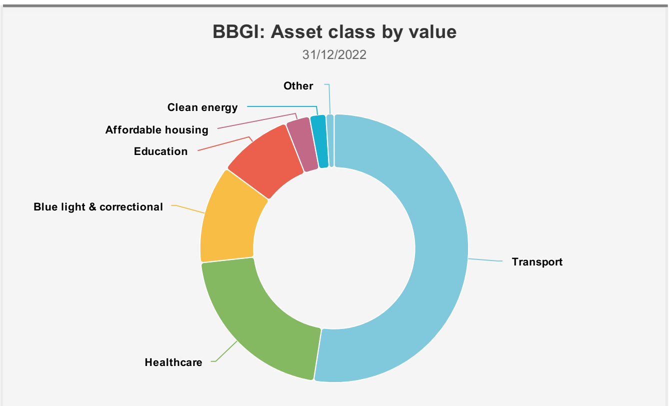
- Any premium to NAV may give way to a discount if the attraction of shares to investors recedes
- Geographic diversity means FX movements will affect cash flows (for good or bad), despite hedging activity which should protect the portfolio (an adverse 10% movement of all currencies against GBP would only impact NAV by 3%)
- Rising interest rates around the world mean investors have a larger range of options for yield

Portfolio

BBGI has a £1.1bn portfolio of low-risk essential social infrastructure assets, diversified around the world across highly rated investment-grade countries. In total, the portfolio consists of 56 different investments (as of the end of December 2022), c. 87% of which are majority owned by BBGI. There are a variety of different types of assets within the portfolio, but the common link is that BBGI invests only in availability-style assets and those that are backed by government revenues with high-quality inflation linkage. Availability-style assets attract contractual revenues as long as they are available for use by stakeholders, and they do not vary by changes in GDP or by how much they are used, unlike demand-based assets.

As we show in the chart below, the majority of BBGI's portfolio is invested in transport, which is weighted to North America, although there are transport assets in five different jurisdictions. Education is dominated by UK investments, whilst the other asset segments tend to be more evenly spread geographically. Originally BBGI was spun out of Bilfinger, a German civil engineering and construction firm, but there has been an internal management team investing and managing the portfolio since BBGI's IPO in 2011. The internal management gives BBGI a cost advantage over peers, as we discuss in the **Charges section**, but the other advantage is that the team are aligned and incentivised to manage the assets for the benefit of shareholders, and are focused on only growing assets under management where it is beneficial to investors. We understand from the BBGI team that they see it as their role to ensure that clients of their assets have a high level of customer satisfaction, which is one reason why the portfolio has a high level of asset availability of 99.9%.

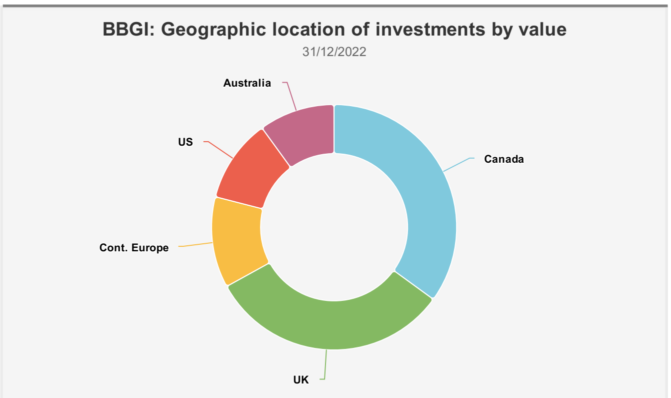
Fig.1: Portfolio Breakdown By Type



Source:BBGI

Infrastructure assets are typically considered resilient to economic cycles and are defensive. However, as we discuss in the **Performance section**, BBGI has proved defensive even within its peer group of infrastructure trusts thanks to the sole focus on availability-style assets. In this way, BBGI's portfolio provides long-term, predictable, and sustainable shareholder returns, but the diversification across economies and political systems helps to ensure that variability in overall returns should remain low. The team will only invest in assets located in AAA/AA-rated economies, and BBGI's geographic diversity is a differentiator to the London-listed infrastructure fund universe, which typically has a strong bias towards the UK, with c. 75% of assets located in the UK compared to BBGI's current 32%. Of course, this does open BBGI up to currency movements. The team aim to mitigate this risk through the prudent use of hedges, which should mean that a 10% move in all currencies against GBP would translate into a more modest +/-3% impact on cash flows.

Fig.2: Asset Diversity (Geographic)



Source: BBGI

Availability-style infrastructure investments typically have a fixed lifespan and represent a series of highly predictable cash flows into the future with a zero-terminal value. The weighted average life of BBGI's investments is 20.2 years, as of 31 December 2022, which compares to c. 24 years at the time of the IPO in 2011. BBGI's management team have successfully made accretive investments over time to extend the portfolio's life. Two investments were made during the 2022 financial year, with a total of £64.4m deployed into a PPP hydroelectric power station in Canada (not exposed to any power risk), and a 49% equity interest in the A7 motorway in Germany. Both investments were screened for ESG factors, which, as we discuss in the **ESG section**, is a very important consideration for BBGI.

As we discuss in the **Dividend section**, BBGI pays an attractive, progressive semi-annual dividend, which currently yields 5.3% as of 11/05/2023, and is expected to remain fully cash covered. BBGI's investments tend to have a high-quality inflation link, with cash flows contractually linked to inflation. Being availability-style, the BBGI team observe that this link is direct and mechanical. It is worth contrasting BBGI's experience last year with the experience of investors who own toll roads, particularly in Portugal and Spain who had fee increases capped by their governments, although there will be a way to recover some revenue shortfalls in other ways in future years.

As such, the BBGI team observe that whilst the theoretical sensitivities to inflation of infrastructure peers are perhaps slightly higher than BBGI's are, the practical reality is less clear-cut. As a result of revenues benefitting from inflation and higher deposit interest rates, BBGI's target dividend for 2023 and 2024 have been raised by 4 percentage points over previous targets, representing annualised dividend growth of 6% from the 2022 level. This growth is well in excess of BBGI's main peers (INPP: +2.5%; HICL: 0%), both of which quote a higher linkage to inflation, but have so far not raised dividend targets for the coming years, and both of their last NAV uplifts are not yet aligning with their reported inflation linkage.

Gearing

Over time, BBGI does not expect to have structural gearing or long-term borrowings at the corporate level. However, as is common across the sector, BBGI periodically uses short-term flexible gearing (a £230m revolving credit facility with a £70m accordion tranche, maturing in 2026) to acquire assets. BBGI then aims to repay these borrowings through subsequent share issuance, with that having last occurred in July 2021. This process avoids the problem of cash drag and ensures BBGI can be as fully invested as possible over time.

As of 31/12/2022, BBGI ended the financial year with a relatively small net debt position of £26.3m, representing 2.6% of NAV. BBGI has permission to be geared to a maximum of 33% of portfolio value (or gross assets), which is equivalent to gearing of c. 50% of NAV. That said, over much of the last five years BBGI has not been geared and has instead consistently had a small net cash position over this time. That the credit facility does not mature until 2026 means that BBGI does not necessarily need to tap equity markets in the near term as it acquires suitable investments.

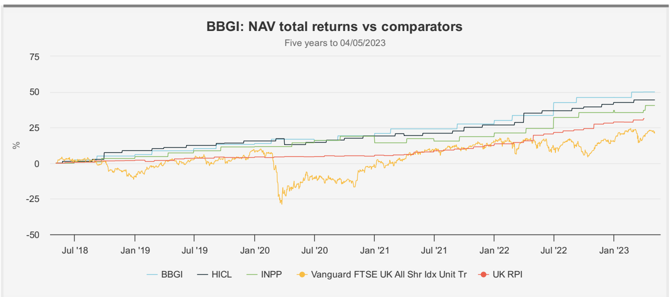
Within the portfolio, it is worth noting that BBGI's assets are held through special purpose vehicles, which make substantial use of gearing due to the strong credit quality of the revenue streams. These borrowings are – with minor exceptions only - fixed rate and fully amortising, meaning that by the end of the life of each asset, all debt will have been repaid which means that BBGI is exposed to minimal re-financing risk.

Performance

By investing in only availability-style infrastructure assets, BBGI aims to deliver long-term, predictable, and inflation-linked shareholder returns. We discuss the characteristics of the underlying investments in the **Portfolio section**, but by focusing on the lowest-risk type of assets, and only in those countries with high investment grade ratings and stable, well-developed operating environments, BBGI occupies the low-risk ground within the AIC Infrastructure sector. A key part of the proposition is the dividend paid to shareholders, and as we discuss in the **Dividend section**, the board aim to provide a progressive annual dividend, which is expected to remain fully cash covered, with as much visibility provided into the future as they are able to.

Since IPO in 2011 to 31/12/2022, BBGI has delivered a NAV total return of 160.9%, representing a compound annual return of 9.1%. Each financial year has so far produced positive annual NAV growth from the underlying portfolio's cashflows, aided by the active management of the portfolio over this time. The BBGI team target government-backed revenues with strong high-quality inflation linkage for their projects, which as the graph below shows has started to meaningfully add to returns for BBGI as well as peers. Over time, BBGI expects returns to have a linkage with inflation of 0.5, meaning that to any extent inflation is 1% higher than expected, total returns will increase by 0.5%.

Fig.3: NAV Total Returns (Five Years)



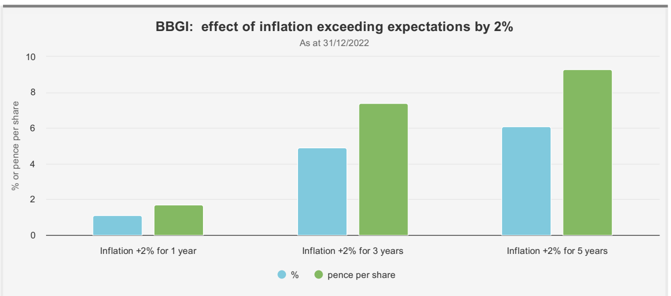
Source: Morningstar
Past performance is not a reliable indicator of future results.

We think it worth noting from the above, that despite positioning itself at the lowest risk end of the infrastructure spectrum, BBGI has outperformed its closest peers on a NAV and share price total return basis. However, since BBGI's IPO, HICL has outperformed on a NAV basis (according to Morningstar statistics). From the Capital Asset Pricing Model (CAPM), one might expect that lower risks might deliver commensurately lower returns. However, we note that the five-year period above includes the COVID pandemic, during which BBGI was entirely unaffected because of its lack of demand-style assets. Peers in the listed infrastructure sector were not so fortunate, with assets such as toll roads seeing falls in revenues that negatively affected the cash flows from those assets. BBGI have so far not had any of their assets in financial lock-up, where revenues fall to the extent that the financing structure prohibits distributions of income from the individual project companies in which assets are held by BBGI. It was therefore a solid performance with no lock-ups during a period that one might see as being the ultimate test for an investment company that has enabled BBGI to outperform its peers over this period.

In terms of outlook, rises in government bond yields have meant that the discount rate has risen to 6.9%, although the BBGI team state that demand for availability-style assets remains very strong. Over the past year, according to BBGI the effect of an increased discount rate has been more than offset by an improved contribution from rising deposit interest rates. BBGI's portfolio companies tend to hold large amounts of cash on their balance sheets, meaning they clearly earn higher returns as interest rates rise. Active treasury management is a key focus of the team. Across the portfolio BBGI estimate that its pro-rata share of deposits would be c. £400m, which is almost 40% of the market capitalisation of the company, demonstrating one of the benefits realised by the company from a higher interest rate environment. The team have spent a lot of time during the last year trying to maximise the benefit of this for shareholders, and optimising the interest earned, and are in the process of concluding virtual pooling agreements to optimise deposit rate income. The team comment that if interest rates do not change from those they are currently receiving, there would be an £8m per annum increase in income to shareholders.

Inflation has been the big shock to economies over the last year, and most central banks have been 'behind the curve' in terms of their expectations. Whilst it would appear that peak inflation has passed, it is by no means certain that once released, the genie will go back in the bottle. BBGI's portfolio arguably has the cleanest exposure to inflation within the peer group, which is of higher quality due to its entirely mechanical inflation adjustment, therefore meaning that BBGI's cashflows will rise in lock-step on an entirely contractual basis. Inflation expectations factored into the current NAV are relatively conservative, and the financial years after 2024 are unchanged from a year ago, in our view illustrating the conservatism that is built in. In our view, it is worth examining the upside should inflation remain persistent, and therefore ahead of BBGI's expectations, which we show in the graph below. In our view, this is a key attraction of BBGI when comparing the current dividend yield to longer maturity fixed income.

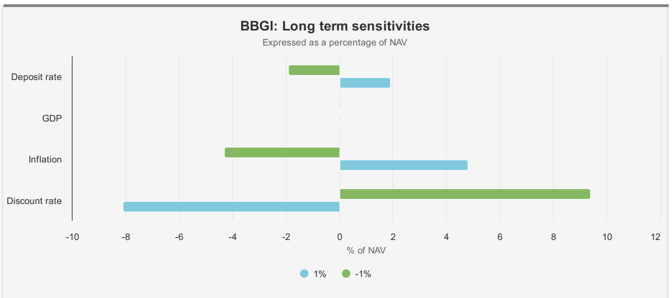
Fig.4: NAV Impact From Inflation



Source: BBGI

The future NAV returns will clearly be influenced by changes to long-term macroeconomic assumptions. Having an internationally diversified portfolio does expose shareholders to an element of short-term exchange rate movements. However, BBGI aims to mitigate FX exposure by hedging a proportion of cash flows, meaning that a change in all FX rates relative to GBP of 10% will only translate into a 3% cash flow impact. We show the main sensitivities of the NAV to changes in assumptions in the chart below.

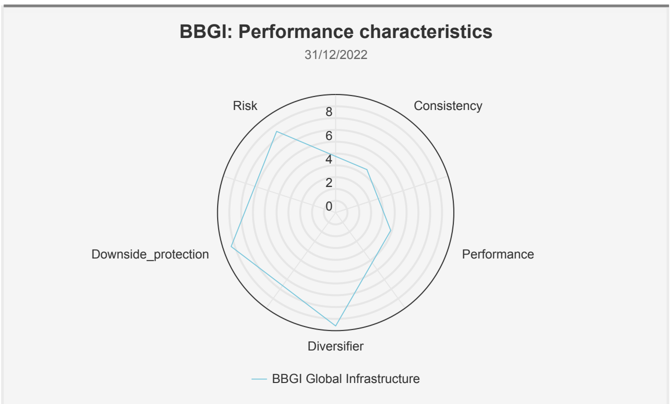
Fig.5: NAV Sensitivity



Source: BBGI

In our proprietary spider chart below, we show how BBGI has performed in NAV terms versus an expanded peer group of all infrastructure, renewable energy, and commercial property trusts over the past five years in some key categories. Each category is scored out of ten based on rolling 12-month returns over the last five years, and scores are normalised to the peer group. This data reflects the performance characteristics investors would have experienced over the last five years. As one might expect, BBGI scores strongly for risk, downside protection, and diversification characteristics relative to the peer group.

Fig.6: KTI Spider Chart



Source: Morningstar/Kepler Partners LLP

Past performance is not a reliable indicator of future results.

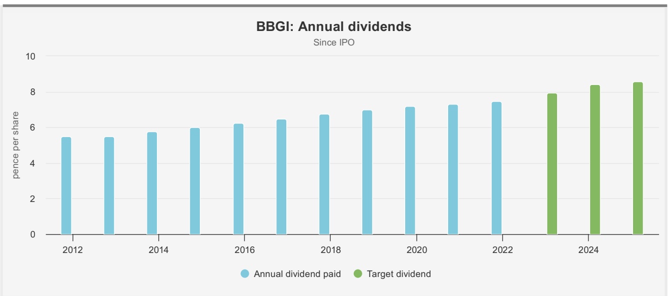
Dividend

BBGI has paid a steady stream of growing dividends since it was launched in 2011, so far having delivered a compound average increase in annual dividend of 3.1% between 2012 and 2022. Dividends are paid semi-annually, and reflecting the steady and predictable income flow from the underlying assets, the board aim to give shareholders as much visibility on dividends as possible. As such, they typically provide a target dividend for the next three financial years (although there is no guarantee that they will pay the target dividend).

As we discuss in the **Portfolio section**, most of BBGI's assets benefit from a contractual link to inflation, and so in the most recent results announcement, the board was able to increase its target for 2023 and 2024 dividends by four percentage points over previous targets, representing annualised dividend growth of 6% from the 2022 level, with dividend targets expected to be fully cash covered. The new target dividend of 7.93p for the current financial year (ending December 2023) represents a dividend yield at the current price of 5.3% [as of 11/05/2023]. This compares to BBGI's closest comparable peers HICL and INPP, which both offer yields of 5.4% (based on 2023 target dividends and share prices as of 05/05/2023). The target dividend growth for 2023 of 6% compares to growth in targeted dividends of 0% and 2.5% for HICL and INPP respectively.

As we discuss in the **Portfolio section**, BBGI's revenues have high-quality inflation linkage, which if inflation remains persistent, should continue to provide a tailwind to revenues and therefore dividend cover and/or dividend growth. In the last financial year, the dividend was covered c. 1.47x, slightly higher than the team's long-term target of 1.3x. We note that there is an element of seasonality in BBGI's cash flows, with more cash now being received in the first half of the year (absent one-offs), and so dividend cover in H1 is typically higher.

Fig.7: Dividend



Source: BBGI

Management

BBGI is an internally managed investment company, with the managers and staff being directly employed. BBGI was established in 2011 and the management team comprises c. 27 individuals. BBGI is headquartered in Luxembourg, with management teams in North America, the UK, Germany, the Netherlands, and Ireland.

The original leadership team in place at the time of the IPO remain, with Duncan Ball and Frank Schramm having been co-CEOs of BBGI since inception. They were joined by CFO Michael Denny in early 2012, shortly after the IPO. Duncan, Frank, and Michael represent the management board of BBGI, and a supervisory board comprising five independent members is also in place.

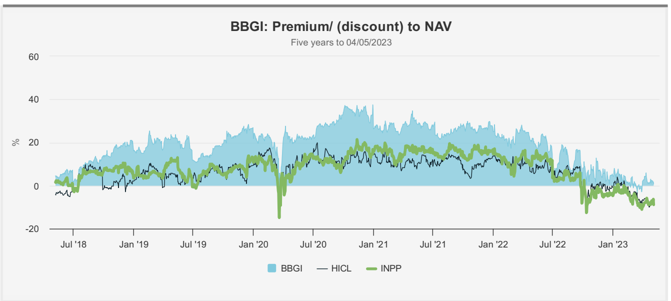
As we highlight in the **Charges section**, having an internally managed team responsible for BBGI's assets is a differentiator. The team are 100% focused on BBGI and fully aligned with shareholders as a result, with the team not being paid or incentivised to grow the NAV for growth's sake. The investment company's OCF is the lowest in the peer group, and given its structure this ensures that the OCF will reduce as BBGI grows in size, with fixed costs reducing as a proportion of a larger asset base.

Discount

BBGI has generally traded at a premium rating in absolute terms, but also relative to peers. As the graph below illustrates, this remains the case today, despite the picture having changed dramatically over the past 12 months. In our view, the below graph suggests that the market currently favours BBGI's 100% availability-style portfolio of assets, rather than HICL and INPP which both have an element of demand- and regulatory-based assets which might be considered slightly riskier asset classes. At different points in the cycle, it may be preferable to have demand-based assets in the portfolio because of their greater growth potential. However, with the global economy potentially dipping into a recession, BBGI's portfolio is clearly finding appeal in a more risk-aware market environment, not to mention the higher progression of the target dividend for 2023 and 2024 as we discuss in the **Dividend section**.

Over the last five years, the premium at which BBGI's shares have traded relative to NAV has averaged 19.1%. Given the significant rise in global interest rates, it is perhaps no surprise that this premium has come down, and BBGI currently trades on a small premium to the 31/12/2022 NAV of c. 0.5% as of 11/05/2023. Over the long term, the appeal of BBGI's income characteristics will likely remain undiminished, so investors may see this as a potentially attractive entry point. We note that should BBGI trade at a sustained discount to NAV, the board has the ability to make share repurchases. The next continuation vote will be held in 2025, and every second year thereafter.

Fig.8: Discount To NAV

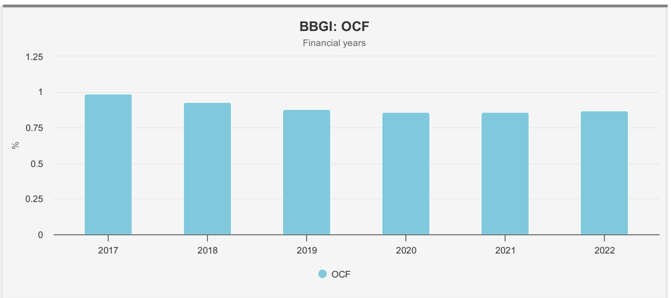


Source: Morningstar

Charges

BBGI is the only trust in the AIC Infrastructure sector that is internally managed. As we discuss in the **Management section**, this means the team are solely focused on managing the assets on behalf of shareholders. However, the other effect is that given BBGI has a significant scale (net assets of c. £1bn), it also has the lowest OCF. BBGI quotes an OCF of 0.87% (as of 31 December 2022). As a percentage of average NAV, fees directly linked to investment performance recorded in 2022 were 0.09%, whereas for 2021 they were 0.1%. Combined, the aggregate of ongoing charges plus investment performance fees was 0.96% in 2022, the same as that for 2021. This compares to HICL and INPP, which have current OCFs of 1.05% and 1.09% respectively.

Fig.9: Ongoing Charges



Source: BBGI

The senior management team are remunerated through an annual bonus and an LTIP, both of which are set formulaically and depend on financial and strategic KPIs (including ESG KPIs, which represent 10% of the LTIP award). Remuneration matters are set by the remuneration committee of the independent supervisory board and aims to ensure that executive and shareholder interests are closely aligned and focused on long-term sustainable performance. The BBGI team argue that as a result, they will not pursue growth for the sake of growth. Over the years, as the asset base has risen, the benefits of having a directly employed management team have been felt in a reducing ongoing charges figure. We show below the progression since 2017, over which the OCF has fallen from 0.99%. BBGI's KID Reduction in Yield figure is 1.33% (as of 30/06/2022). We note that calculation methodologies can vary between different investment trusts and sectors.

ESG

ESG is fully integrated into BBGI's business model, and it is an Article 8 fund, defined as promoting environmental or social characteristics and follows good governance practices. BBGI incentivises strong ESG performance by directly linking results to executive compensation. As we discuss under **Charges**, 20% of the management board's LTIP compensation is linked to ESG performance, ensuring that the board is aligned with investors. The management team's approach is aligned with six UN Sustainable Development Goals (SDGs). In its UN PRI assessment report, BBGI was rated as five out of five stars for Investment and Stewardship, and four out of five for Direct Infrastructure.

BBGI was a signatory to the Net Zero Asset Managers initiative in 2021. The team have published a Net Zero Plan for BBGI and the key goals at the corporate level and for portfolio companies include the following:

- Reduce corporate GHG emissions by 50% by 2030
- Net zero corporate GHG emissions by 2040
- Report Scope 1, 2, and material Scope 3 emissions at all of portfolio companies from June 2023 onwards
- 70% of portfolio companies by value to be 'net zero', 'aligned', or 'aligning', by 2030 (meaning these companies will have a long-term goal to be net zero by 2050 or sooner)

Overall, the team have identified the ten most material sustainability topics and strategic ESG areas of focus. These ten topics have shaped BBGI's ESG commitments and KPIs, which the team track closely to ensure continuing progress in the delivery of positive stakeholder outcomes. Carbon reduction represented three of the ten topics, with three areas of focus being identified within the 'social' factor of ESG and four within the 'governance' factor. BBGI will be reporting against all of these over time, providing ESG investors with plenty of information on how well their investment is progressing in ESG terms.

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