Dodge the recession with essential infrastructure

Politicians and a few eternally optimistic property spruikers are about the only ones still pretending we're not headed for recession. As increasingly dire unemployment numbers come out, more and more are joining me in the 'it's going to be bad' camp. It is coming, and you need to be prepared.

So what to do? You could take your money and put it in the bank. But that won't do much for you with deposit rates at less than 5%. You could buy Woolworths shares. Everyone needs food, right? Woolworths is indeed a wonderful business. But you're unlikely to do much better than the bank by paying 20 times earnings for a business with limited growth potential. And you could do much worse.

It's a perfect example of a defensive business that isn't necessarily a defensive stock – simply because the price is so high. But there is one sector of the market offering up juicy potential returns for what are genuinely recession-proof investments. It's called essential infrastructure and, like most investments that seem too good to be true, there are (mostly) good reasons for the seemingly low prices. It is, however, worth a look.

Assets we can't live without

Essential infrastructure assets are those which are essential to the functioning of modern society. Examples include toll roads, airports, power stations, pipelines and ports. Due to their monopolistic nature, these assets tend to be regulated by their respective governments.

Regulated or unregulated, though, the cash flow from these assets tends to be highly predictable and relatively immune to the economic cycle. People need water and electricity even in the worst of times. But that hasn't stopped the share prices of the listed players being pummelled over the past 12 months. In fact, some funds are close to insolvent, such as Babcock & Brown Power and Babcock & Brown Infrastructure (both have suspended distributions and are undertaking asset sales in order to keep the bankers at bay).

The reason is debt, and lots of it. Infrastructure funds were front and centre of the credit bubble of the past few years. Incredibly favourable borrowing terms enabled infrastructure funds and their inappropriately incentivised managers to pay exceptionally high prices for assets and to fund juicy but unsustainable distributions. Over the past five years, Macquarie Infrastructure Group returned $3.2bn to its owners – more than double the $1.6bn of cash flow it received from its underlying assets.

Ponzi scheme no more

Not only are the Ponzi-scheme days over, but several of the weaker players – mostly from the Babcock & Brown stable – are having trouble refinancing their debt. Those that can obtain funds are paying substantially higher margins. All of which explains why no one wants to touch infrastructure investments with a ten-foot barge pole.

Herein lies the potential opportunity. The underlying assets remain attractive – in fact they've become more attractive. With corporate profits disappearing faster than Bernie Madoff's friends, the relative stability and certainty provided by essential infrastructure is a safe haven. And the alternatives are offering very little in the way of returns.

The 'flight to safety' has pushed government bond yields to extraordinarily low levels. Lend your money to the US government for the next 30 years and you'll earn a return of 3% per annum; buy UK bonds and you'll earn 4% over the same period; and the 15-year Australian government bond is priced to yield 4.3%.

Low long-term interest rates make essential infrastructure offering returns of 8% and 9% an attractive alternative. There are endless opportunities to invest in the sector in Australia, spread across a wide range of asset types and regulatory regimes. At one end of the spectrum, there are those that look reasonably priced and have minimal need to refinance debt, such as Macquarie Airports and Challenger Infrastructure Fund. And, at the other, there are those, such as Babcock & Brown Infrastructure (BBI), with pressing refinancing requirements, which are trading for a small fraction of their underlying asset value – but that asset value may not do you much good if the fund doesn't survive.

Plenty of cash looking for a home

For those funds that desperately need to sell assets, there does seem to be an active market among unlisted funds. A recent article in Breaking Views highlighted some US$94bn sitting in infrastructure funds that's yet to find a home. Late last year, QIC bought 50% of Powerco, a New Zealand power company, from BBI. BBI also sold 20% of its Euroports business to Antin Infrastructure Partners, and, in December, troubled Spanish construction group Sacyr Vallehermoso sold its toll road business to Citigroup's infrastructure fund for €7.9bn. There are no guarantees. But for the reasons outlined earlier, there are buyers, which is more than can be said for most financial assets at the moment.

And not only have the assets become more attractive, but so have the funds. Until now, the likes of Macquarie and Babcock have made fortunes through their insidious management contracts, and no one else has made a cent. But plummeting share prices have forced managers to accept less. Some funds have completely internalised their management; others have dramatically cut fees and beefed up the independence of their boards; and the rest are moving in the right direction. Babcock & Brown Wind recently internalised its management and paid off its former manager, Babcock & Brown, to the tune of $40m – undoubtedly the best investment it's made.

It's a broad sector and, with complicated structures and frequent shuffling of assets, it's not easy to analyse. So far, at The Intelligent Investor, we've got positive recommendations on Southern Cross SKIES (a security issued by Sydney Airport trading under the ASX code SAKHA) and BBI EPS (ASX code BEPPA) but they're both income securities and suitable only for relatively sophisticated investors who understand such investments. But I'll be spending a lot of 2009 prospecting for further opportunities. For those looking to sidestep the recession, it might pay to do the same.