Low base rates – an issue infrastructure equity investors can't ignore

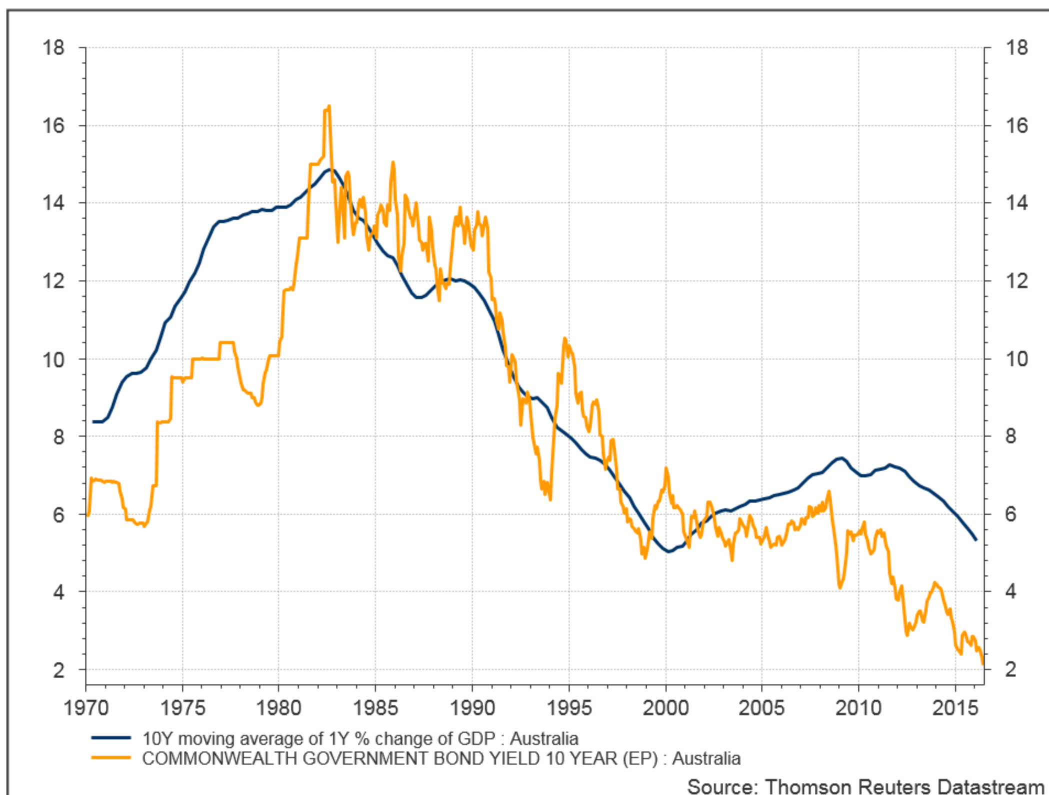
Base rates are very low and likely to stay low for some time. There are mixed views on what the long-term brings. Will rates revert to longer term averages – ie 5%+ for Australia – or is the new normal permanently lower rates?

This is an issue that investors can't really ignore.

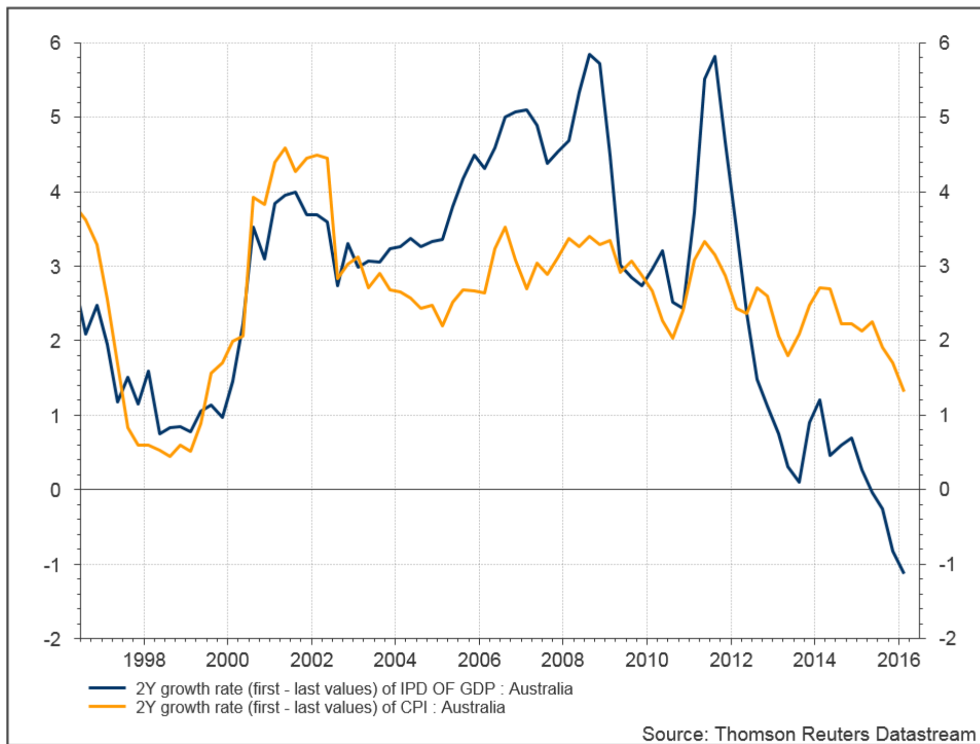
Questions investors should be asking:

- What does it mean for MIC returns and risk objectives?
- What does it mean for investments in government bonds?
- What about other long duration assets – such as infrastructure?

Our view is that interest rates will remain below long-term averages for some time. We use long-term nominal GDP growth as a yard-stick for assessing long-term interest rates. This approach suggests a long-term outlook in the 4-5% range for Australia – based on 2-3% economic growth and around 2% inflation.

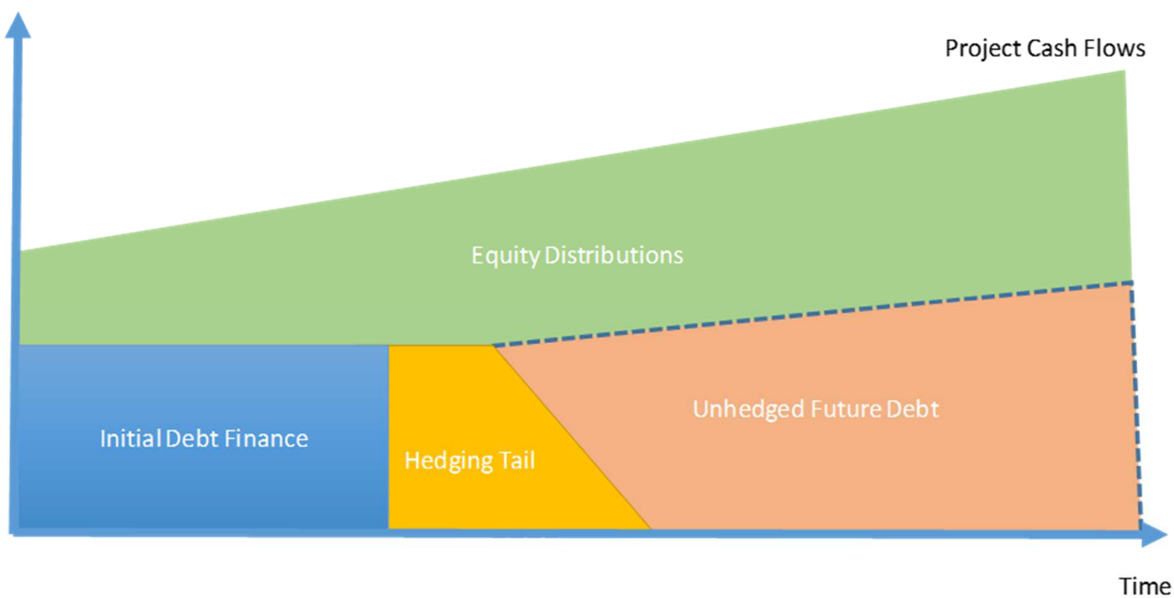


It is worth noting that GDP weighted inflation is running substantially below consumer price inflation (see chart below) as falls in commodity prices hurts export earnings. This is likely to see real interest rates (measured on a CPI basis) somewhat lower than you might otherwise expect.



For infrastructure investors, there is a big difference between infrastructure equity and infrastructure debt. Infrastructure equity returns are inevitably dominated by back-end cash flows. For example, it is not uncommon for equity distributions after year 10 to account for half to two thirds of the net present value of equity.

While most transactions have some level of interest rate hedging – with the exception of PPPs – most transactions are much longer than their hedges. This means long term base rate movements have a significant impact on equity returns. This is illustrated in the diagram below.



Equity investors are effectively exposed to the impact of base rates on their distributions (the green area in the diagram) as well as the unhedged portion of debt (the orange area). Importantly, the gross exposure to base rates will be larger than the value of equity – that is, equity is leveraged to long-term base rates.

For infrastructure equity investors – particularly at today's extremely high multiples - you have to believe in low long term rates. With debt you can be agnostic. You can choose between fixed and floating. The debt maturity ends your direct exposure to base rates.

www.infradebt.com.au 02 6172 0222 info@infradebt.com.au Level 1/99 Northbourne Avenue Turner ACT 2612