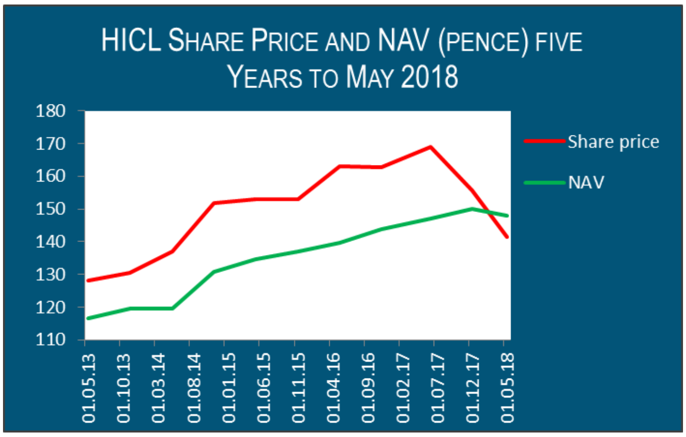
Published Date: 01.06.18

HICL Infrastructure – too good to be true?

By David Liddell

What's not to like about HICL? At the current price of 141p it stands at a discount of 4.6% and has a prospective yield of 5.7% based on a reaffirmed dividend of 8.05p for the year to March 2019; it claims both a 0.8 correlation of portfolio returns to inflation and good cash flow longevity with a 29.5 years weighted average asset life. The dividend increased by a reasonably healthy 10.6% between March 2014 (7.1p) and March 2018 (7.85p). Is it not the perfect asset to put into a pension fund or ISA for income and forget about?

The chart below shows how the market largely thought it was (the perfect asset), driving the share price to a significant premium until the latter part of 2017.



Two circumstances then intervened to heighten investors' perception of the risk surrounding HICL such that the share price has fallen to a discount: political risk rose considerably as private finance initiatives (PFIs) in general came under an unfavourable media spotlight, with labour leader Jeremy Corbyn threatening to cancel concessions without compensation. Public Private Partnerships (PPPs) make up 74% of the portfolio at March 2018 (down from 88% at March 2017, as the managers have sought to diversify). Secondly, the well publicised problems of Carillion, culminating in its liquidation in January this year, had a particular impact on HICL where Carillion was the largest facilities management and operations counterparty; ie Carillion was doing the work on a lot of HICL assets.

Ten projects had facilities management subcontracts with Carillion subsidiaries, approximately 14% of the portfolio by value; these projects included acute hospitals, defence accommodation, several emergency services projects (police and fire services) and primary healthcare accommodation. In a stock exchange announcement of 26th January 2018, HICL stated: 'Based on current information, the (negative) impact is estimated at approximately £50m of NAV (equivalent to 2.8p of NAV per share, or 1.8% of NAV per share as at 30 September 2017), which is incremental to a provision of £9.4m that was taken at the time of the Company's Interim Results in respect of counterparty exposure.' This financial impact (£59m) was reiterated in the company's annual results announcement of 23 May 2018.

The company acknowledges that future deal flow in UK PPP is likely to be limited but is the market now overdoing the risks associated with HICL? We look at the portfolio in detail, the factors contributing to investment performance and the calculation of NAV.

1. Under the bonnet – the portfolio

What actually are we buying if we invest in HICL? As we have seen, the portfolio is 74% PPPs – the provision of infrastructure and services to public sector clients (schools, hospitals, the emergency services etc); the balance is 18% demand – based assets (rail transport and road tolls) and 8% regulated assets – the investment in Affinity Water (a water utility covering an area to the north and west of London, stretching from Saffron Walden down to Guildford, and including parts of Essex and Kent.)

Another way of looking at the portfolio is by sector: Education (18%), Fire, Law and Order (7%), Transport (26%),

Cont. page 2

01.06.18: This research has been produced by David Liddell, chief executive and major shareholder in IpsoFacto investor.com Limited which has approved this research. David may have equity holdings in any or all of the stocks listed.

The information contained in this research has been obtained from sources that IpsoFacto investor.com Limited believes to be reliable and accurate. However, it has not been independently verified and no representation or warranty, express or implied, is made as to the accuracy or completeness of any information obtained from third parties.

IpsoFacto investor.com Limited is authorised and regulated by the Financial Services Authority. ***Investors should be aware that past performance is not necessarily a guide to the future and that the price of shares and other investments, and the income derived from them, may fall as well as rise and the amount realised may be less than the original sum invested.***

Cont. from page 1

Project	Valuation %	Short description of concession arrangements	End date	Number of years	Project Capex	Key Subcontractors
Affinity Water	8%	Ownership and management of water treatment and supply covering an area of 4,515 square kilometres.	N/A	N/A	N/A	In house
High Speed 1	7%	Finance, operate, and maintain a high-speed rail link for the UK Department of Transport.	2040	30	£5,793m	Network Rail
Northwest Parkway	5%	Operate, manage, maintain, rehabilitate and toll a 14km four-lane road under an agreement with the Northwest Parkway Public Highway Authority.	2106	99	NA	In House
Home Office Headquarters	4%	Build, finance, operate and maintain a new headquarters building to replace the Home Office's existing London office accommodation with purpose-built serviced offices.	2031	29	£200m	Bouygues
Southmead Hospital	4%	Design, construct, finance, operate and maintain an 800-bed acute hospital on a single site at Southmead in North Bristol, on behalf of the North Bristol NHS Trust.	2045	36	£431m	Interim arrangement
Pinderfields and Pontefract Hospitals	4%	Design, construct, manage, finance and operate a new 708 bed acute hospital in Pinderfields, West Yorks and a new diagnostic and treatment hospital in Pontefract, West Yorks for the Mid Yorkshire NHS Trust.	2042	35	£311m	Engie
A63 Motorway	4%	Design, build, finance, operate and maintain an upgrade to the A63 highway between Salles and Saint Geours de Maremne in France.	2051	40	€1,130m	Egis
AquaSure Desalination	3%	Design, build, finance and operate a 150GL/year desalination plant and associated infrastructure.	2039	30	A$3,512m	SUEZ Environmental
Dutch High Speed Rail Link	3%	Design, construct, finance, operate and maintain power, track and signalling for the high speed railway between Schiphol Airport and Belgian border in the Netherlands.	2031	30	€890m	Siemens
Allenby & Connaught MoD	3%	Design, build and finance new and refurbished MoD accommodation across four garrisons on Salisbury Plain and in Aldershot, comprising working, leisure and living quarters as well as ancillary buildings.	2041	35	£1,557m	KBR
	45%					

Percentages are of the gross directors' valuation.

In total there are 116 projects/ investments and the managers claim the portfolio is well diversified.

2. Performance

In the following table we analyse the contribution of various factors to the growth in net asset value (NAV) over the last five years.

NAV movements in pence per share	2018	2017	2016	2015	2014	Total	% contribution
Valuation movements							
Reduction in discount rates		2.8	4.6	4.5	3.2	15.1	48.2%
Revaluation				1.7		1.7	5.4%
Change in economic assumptions	0.9	-0.5	-1.4	-0.9	1	-0.9	-2.9%
Forex movement	-0.7		0.4	-0.6		-0.9	-2.9%
Portfolio performance							
Expected NAV growth	0.6	0.8	0.7	0.7	0.7	3.5	11.2%
Project outperformance	1.9	1.6	0.2	1.8	1.1	6.6	21.1%
Sale				4.1		4.1	13.1%
Carillion liquidation	-3.4					-3.4	-10.9%
Accretive issuance of shares	1.3	2.1	1	0.4	0.7	5.5	17.6%
B/f	147.1	140.3	134.8	123.1	116.4		
C/f	147.7	147.1	140.3	134.8	123.1	31.3	100.00%

Cont. from page 2

Discount rates

The directors' valuation of £2,836.5m at 31 March 2018 is based on summing all the cash flows from the projects over their lives and discounting the results at rates of interest to reflect risks in the differing projects. The higher this discount rate is, the lower the value of the portfolio. Hence, the biggest positive impact on the value is the reduction in the weighted average discount rate from 8.4% in 2012 to 7.4% currently – this has added 15.1p, or 48% of the total movement in NAV. The discount rate has fallen largely because of the decline in long term bond yields from 2.9% to 1.7%. The risk premium – the riskiness of the cash flows – has actually increased, from 5.5% to 5.7%. The mangers argue that this means that if bond yields rise this does not necessarily mean that the discount rate would rise – ie have a negative effect on NAV – because, for example, a rise in bond yields might be associated with a stronger global economy which might reduce the riskiness of some of the projects.

Project outperformance

The next biggest positive contribution to NAV of 6.6p or 21% of the total has come from 'project outperformance'. This refers mainly to cost or financing savings in the underlying projects which have been achieved ahead of those originally budgeted.

Accretive issue of shares

This is where, with the shares trading at a premium to NAV, shares could be issued at a price which enhanced NAV. This contributed 5.5 p of NAV enhancement, 17.6% of the total. This will not be possible going forward, if the shares continue to trade at a discount.

Portfolio management

Sale of a project in excess of the valuation added 4.1p or 13% of the total gain.

Expected NAV growth

This represents the effect of the discount unwinding each year less running costs and the amount distributed as dividends. So looking at 2018 it appears that the discount rate for year ending March 2018 cash flows would have been approx. 6.95%, since the discount unwind less costs was expected to be 8.5p; with dividends of 7.9p, the expected NAV growth was 0.6p.

Other factors affecting performance

The major other factor affecting performance in this period was the liquidation of Carillion which cost 3.4p of NAV.

3. How real is the NAV?

The concept of NAV in this company is slightly difficult since it is an amalgam of so many different cash flows discounted back over a large number of years. This is perhaps best illustrated by the company's own presentation, produced in February 2018 (see graph below).

The gross cash flows that are implied by the NAV calculation are something approaching £7bn and spread out over a large number of years, stretching beyond 2053. Cash flows are a mixture of distributions from the underlying companies formed for each project, interest on debt and directors' fees and, towards the end of a projects' life, repayment of debt. It can be seen that there is scope for considerable change in NAV should cash flows not turn out as expected.

Conclusion

The biggest risk would appear to be political – although operational risk is always present – but, to some extent at least, Mr. Corbyn's Labour party represents a risk to quite a number of tradeable investments. You don't get something for nothing and a forward yield of 5.7%, partially inflation protected, is telling us that there are risks around the cash flows. NAV enhancement may be limited from here – at least from discount reduction – but if the cash flows keep coming and the dividend rises then we should get some share price appreciation. We would suggest holding a relatively small allocation of HICL in an income portfolio such as a SIPP, as long as it is accompanied by assets with greater growth potential. We hold the stock in our Balanced portfolio.

HICL YEAR ENDING 31 MARCH 2018