

Lazard Global Listed Infrastructure/May 2010

# An Investment for **Uncertain Times**

While the investment outlook is generally always uncertain, it seems more uncertain today than at any time since the 1970s. In this climate, a subset of the infrastructure market, which we describe as Preferred Infrastructure (more details later), offers investment characteristics that can provide the security of real capital and attractive returns. Unlisted, or private equity, infrastructure investments may also look attractive, but our research shows that there is an overhang of uninvested capital in private equity funds that will take an estimated 20 years to drawdown.<sup>1</sup> In our opinion, a portfolio of listed, Preferred Infrastructure companies offers better value per dollar invested, at current market prices, than private equity infrastructure; in addition, it also offers the benefits of liquidity, diversification, transparency, and increased allocation flexibility.

In this commentary, we present Lazard's Global Listed Infrastructure strategy as "an investment for uncertain times." Our view is that, as patient investors in Preferred Infrastructure assets trading at compelling valuations, we can reasonably expect to earn attractive real rates of return during the current uncertain economic time. More than a year after the depths reached during the financial crisis of 2007-2008, we believe that our argument is still sound, and we can point to several events that have supported it.

The Lazard Global Listed Infrastructure strategy holds between 25 and 50 listed infrastructure securities with assets located predominantly in OECD countries that meet our criteria for Preferred Infrastructure. The portfolios are diversified across infrastructure sectors and countries, with currency exposures hedged into the investor's home currency. The strategy performed strongly in 2009 and in the first quarter of 2010; nevertheless, as we write this note, the underlying investment value in the strategy is still attractive.

## Recent Events

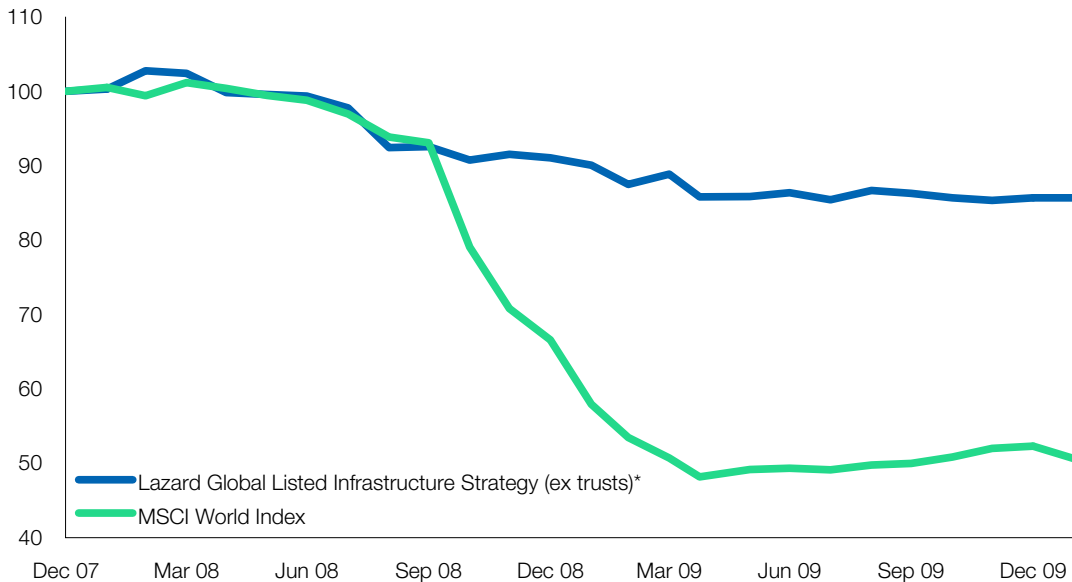
In 2009, the Lazard Global Listed Infrastructure strategy returned 22.2% (hedged in U.S. dollars) compared to 14.9% for the UBS Global 50/50 Infrastructures & Utilities Index (in local currency). Apart from the general recovery in equity markets, the main contributors to our strategy's strong returns in 2009 were takeover bids for two stocks—Macquarie Communications Group (an owner of communication towers) and Transurban (a tollroad operator)—and strong rallies in the shares of Italian tollroad operators. Tollroad operators in Italy had fallen particularly heavily in 2008 and into 2009 because, as part of its political response to the financial crisis, the Italian Government suspended the regulated toll increases that were due on 1 January 2009. The reality is that the road system has bottlenecks, the tollroad operators are in the best position to fix them, and they must have an incentive to do so; therefore, the suspended increases were allowed from May 1 and the share prices began to recover. The 2010 toll increases took effect, as scheduled, from January 1, and the government has agreed to above-inflation toll increases and concession extensions as incentives to reward operators for the capital expenditures they are making. The resulting strong earnings growth that we expect over the next few years puts our valuations well above current share prices. This episode illustrates the mean-reverting nature of regulatory risk, as well as the opportunities for patient investors that can appear if the market overreacts to negative short-term news.

During 2009, tollroads in our Preferred Infrastructure universe generally proved their worth as low-risk assets that are not sensitive to oil prices and economic shocks. Of the 57 tollroads held indirectly in the strategy as of December 2009, only two (M6 Toll in the United Kingdom and APRR in France) reported lower EBITDA (earnings before interest, tax, depreciation, and amortization) compared with the previous 12 months.

In 2009 we also saw practical responses by airport operators to reductions in traffic. Management deferred capital expenditures at Frankfurt and Vienna airports and reduced operating costs in Sydney, Copenhagen, Brussels, and Frankfurt. Grupo Aeroportuario del Centro Norte (OMAB) and Grupo Aeroportuario del Pacifico (GAP), both in Mexico, took similar operating cost-reduction measures. These actions improved free cash flow.

A further example of the resilience, relative to other companies, of Preferred Infrastructure to economic shocks is provided in Exhibit 1, which compares analysts' earnings downgrades for the stocks held in the Lazard Global Listed Infrastructure strategy to the stocks in the MSCI World Index.

### Exhibit 1 - Consensus Earnings Per Share 2009E



As of 31 December 2009

Source: Bloomberg, Reuters, UBS, IBES and Lazard Asset Management.

Rebased to 100 as of 31 December 2007.

Estimates based on historical financial accounts of companies held in the Lazard Global Listed Infrastructure strategy. All estimates are based on current information and are subject to change.

\*Relates to the Global Listed Infrastructure strategy using current market cap weights, and excluding trusts (CEU, MAP, MCG, MIG, TCL).

Overall, the Preferred Infrastructure universe was tested by particularly difficult conditions in 2009 and met our expectations. Since its inception, the Lazard Global Listed Infrastructure strategy has outperformed the generally accepted infrastructure and developed world equity indices by approximately 200 basis points; importantly, it has done so with lower volatility.

Our valuation methodology incorporates conservative assumptions about the future and is similar to that used by very large investors who take direct interests in infrastructure projects. Based on our calculations, the stocks in the strategy as of 31 March 2010 were trading at a weighted average discount of 30% (compared to 36% in December 2008) to what we estimate are their fair values. We always invest in stocks at prices lower than our valuations, but a 30% discount is a strong signal that the strategy is materially underpriced.

## Uncertain times...Still

Most banking systems that were in peril at the beginning of 2009 have been "saved," for the time being at least, though the cost of doing so is not at all clear. Near-zero interest rates in many developed economies and large government stimulus programs worldwide may have staved off the second "global depression" that many feared over a year ago, but some still unanswerable questions remain: How are economies to be weaned off monetary easing and fiscal deficits? What will be the ultimate cost for each country, who will pay it, and how? Does deflation or inflation lie along the path?

We still do not know the answers to these important questions, but we do know that the global financial crisis could have major impacts on the values of investments like bonds, equities, and property.

## Desirable Investment Features

Given the uncertainties we have described, is it possible to find an investment that can survive inflation and deflation and provide a reasonable return in the interim? In our view, such an investment would feature:

- **Ownership of real assets.** If there were a period of high inflation, rising replacement costs would sustain the real, long-term value of those assets.
- **Stable demand.** The more stable the demand for a company's product or service, the less vulnerable it is to deflation or slow economic growth.
- **Pricing power.** Similarly, the ability to maintain prices during deflation, or increase them in inflationary times, is an important stabilizer for profitability in turbulent economic conditions.
- **Generous operating margins.** For a typical industrial company, EBITDA averages around 15% of revenue. The equivalent for a fully operational tollroad can be 90% or higher, and regulated utilities often earn a 60% margin or more. The higher this margin, the less geared the business is to a fall in revenue, whether from declining volumes, prices, or both.
- **Manageable debt.** In inflationary times, equity holders in a company with real assets and plenty of debt can benefit at the expense of the debt holders, who are repaid in nominal dollars. However, the reverse is true in times of deflation; if debt cannot be rolled over, or comes due when interest rates are high, shareholders can sometimes lose control of the business to the creditors. In uncertain times, it is important for companies to be able to manage their debt and for it not to dominate them.

These features describe the listed companies that we call "Preferred Infrastructure" and have selected for the Lazard Global Listed Infrastructure strategy. These companies own real assets that have monopoly-like positions providing services that are essential to the normal operation of the economy.

The strong pricing power that these businesses have usually involves some degree of regulatory control over pricing or investment returns. The role of the regulators is to set these to balance the short- and long-term interests of consumers, keeping prices low while allowing the asset owner sufficient incentive to spend capital on maintenance and, where necessary, expansion. A regulator who does not strike the right balance will make a new attempt at the next regulatory review, so regulatory risk is inherently mean reverting.

Today, the Lazard Global Listed Infrastructure strategy invests in 42 companies that own over 170 distinct underlying assets located in 22 countries (predominantly in OECD countries) and in 10 infrastructure sectors. The Lazard Global Listed Infrastructure strategy is well diversified and passively hedges foreign currency exposure to the investor's home currency. As mentioned earlier, as of 31 March 2010 we believe these 42 companies trade at a 30% average discount to the intrinsic value of the underlying assets, offering long-term investors an attractive investment opportunity.

## Conclusion

In summary, we believe that the Lazard Global Listed Infrastructure strategy remains a compelling investment for uncertain times.

- The search for stability of demand, pricing power, and wide operating margins produce an investment that is relatively stable, even in fairly weak economic conditions. This idea stood up well to the tests of 2008 and 2009.
- The ownership of monopoly-like real assets that are difficult and expensive to replace is likely a protection against inflation. This is yet to be tested, but is difficult to refute unless one assumes extreme anti-capital measures.
- Finally, we believe that the large discounts to fair value we currently observe in our strategy offer an attractive entry point by historical standards.

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**Notes**

1 Source: Refer to Lazard's Letter from the Manager "Listed versus Private Equity Infrastructure," February 2010

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**Important Information**

Published on 13 May 2010.

Past performance is not a reliable indicator of future results.

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Securities and instruments of infrastructure companies are more susceptible to adverse economic or regulatory occurrences affecting their industries. Infrastructure companies may be subject to a variety of factors that may adversely affect their business or operations, including additional costs, competition, regulatory implications and certain other factors.

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