Starlight Capital Global Infrastructure 2024 Outlook

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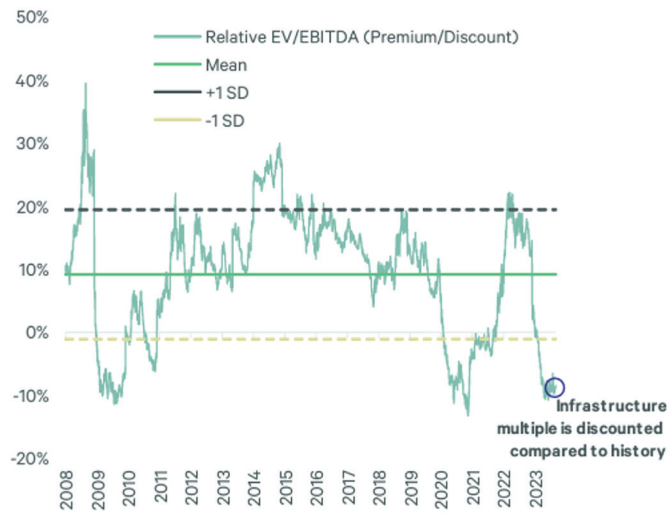
Infrastructure

Last year was a difficult year for infrastructure investors. Rising central bank rates, treasury yield volatility, supply chain constraints and capital cost inflation caused investors to adopt a defensive posture and turn away from typically stable infrastructure assets. Owing to its essential nature and economically resilient characteristics, infrastructure historically trades at a ~10.0% premium to global equities. However, in 2023 the asset class experienced severe multiple compression and declined from a 20.0% premium vs global equities to a 10.0% discount **(Exhibit 1)**.

Reaching for Yield

After more than a decade of low interest rate policy, coordinated central bank action to fight global inflation resulted in the sharpest increase in overnight lending rates in 50 years. In response, investors rotated out of utilities and other infrastructure subsectors into cash and fixed income, which finally provided a decent yield compared to yield-focused equities **(Exhibit 2)**. While we understand investors' rationale for the rotation, we believe the action is overly myopic because it underweights the reinvestment risk in bonds. We also believe the emphasis on yield may cause investors to miss out on greater total returns in infrastructure driven by above-trend growth arising from investment in decarbonization, infrastructure renewal and digital connectivity.[1]

Exhibit 1 - Relative Valuation Multiple Global Infrastructure vs. Global Equities

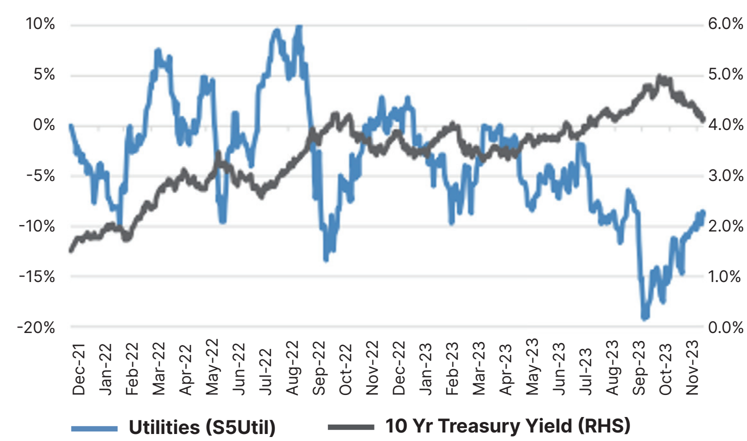


Source: CBRE Investment Management.

Rising funding costs were a significant headwind

Renewable energy developers were the hardest hit segment within infrastructure in 2023. Despite generous government tax credits and continued strong demand for renewables, 2023 saw share price declines across the sector as the S&P Clean Energy Index fell 20.1% in 2023 **(Exhibit 3)**. Over the course of three years, we've gone from euphoric sentiment and peak valuations at the start of 2021 to overly discounted conditions today. Despite the negative sentiment, most management teams in the sector have never been more bullish and some even delivered record fundamental progress in 2023, as measured by revenue and EBITDA growth.

Exhibit 2 - Utilities Performance (LHS) vs. 10-year Yield (RHS)



Source: Bloomberg Finance L.P.

[1] Reinvestment risk in this context implies rolling over capital at similar rates upon maturity.

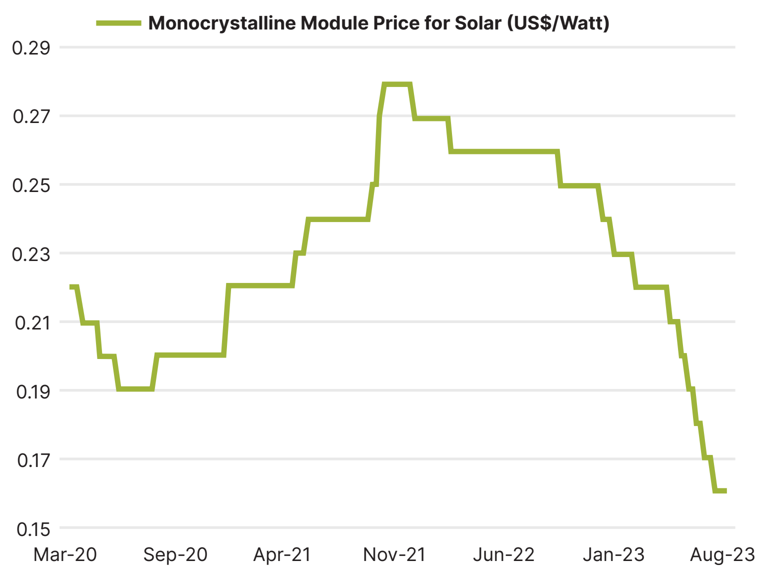
COVID-induced supply chain constraints caused renewable power component price increases heading into 2023, but prices have since eased and the trend has reverted to secular decline across most technologies **(Exhibit 4)**. New build utility-scale solar and wind are cheaper than existing coal or gas plants in countries that account for ~82.0% of global electricity generation. This is true even with a higher cost of capital and despite the gap between fossil fuel costs and renewables declining as gas prices have fallen from 2022 peaks.

While a rising cost of capital presents an incremental challenge to renewable energy developments, steadily declining input costs, load growth, strong utility/corporate demand for renewable electricity, and steadily increasing utility rates present long-term tailwinds across renewable technologies. To be clear, renewable energy developers do not need low interest rates to bring projects online. Funding costs are a passthrough and get priced into power purchase agreements. The well-publicized blow-ups in renewables were discrete issues where companies took on significant development risk on long-duration projects without first securing engineering and procurement, funding and offtake agreements. Other companies managed risk prudently and were able to stick-handle through the challenges and were able to get their projects funded and are now running downhill. One such example is Northland Power, our top holding, which got not one but two large projects across the line to financial close despite the difficult environment. With macroeconomic trends increasingly shifting to renewable power's advantage, investor flows should come back to the sector and drive improved sentiment and valuation expansion.

Exhibit 3 - S&P Global Clean Energy Index

Source: Bloomberg.

Exhibit 4 - PV Modules Price Evolution (USD/MW)



Source: Solaria 2023 Investor Day Presentation.

Looking more broadly at utilities, they now trade at a price-to-earnings ratio of 15.7x, which is a 17% discount to the S&P 500, whereas they have traded at average premiums of +0.4% and +2.1% over the last five- and ten-year periods. With long-term electrification/green tailwinds once again coming into view, there appears to be valuation disconnect that is still pricing in continued weakness. We expect the mean reversion to play in the utilities space in 2024.

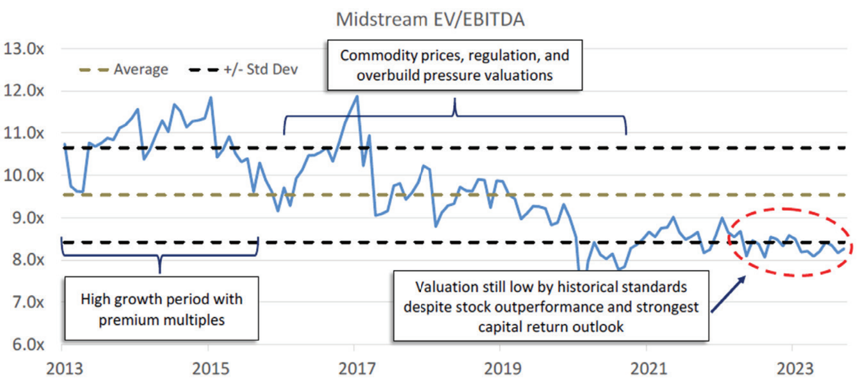
Midstream is well-positioned to continue to outperform

Midstream has been the standout performer within infrastructure. The sector was up 11.6% last year and has returned 24.0% over the last three years.[2] While performance has been rewarding for investors, the sector is still trading at a below average historical valuation **(Exhibit 5)**. On average, current stock valuations imply ~1.2% cash flow declines into perpetuity. While crude oil infrastructure is challenged by electrification, energy security and decarbonization continue to drive natural gas demand, and more infrastructure is needed to process, store and transport it from where it is produced to where it will ultimately be consumed. There is a growing valuation gap

[2] Alerian Midstream USD Total Return Index.

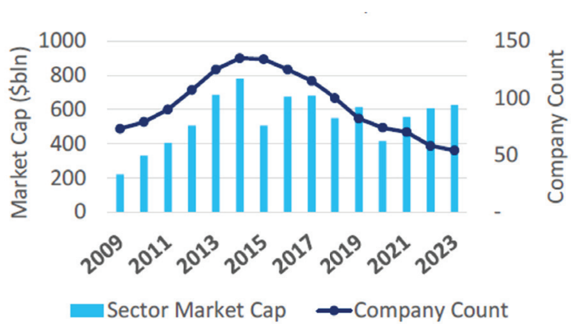
between oil and natural gas focused companies, but in neither case are investors willing to pay up for growth. In terms of capitalization, companies are very well positioned. Almost all midstream operators are at or below leverage targets and capex budgets are largely flat to lower in 2024. All of this adds up to an environment that is ripe for capital return and M&A, which is exactly what has been driving returns over the past three years **(Exhibit 6)**. The midstream sector is consolidating at a pace of ~10.0% per year, a trend that is likely to continue. The midstream industry is trending toward fewer, more well-capitalized companies with larger networks and greater economies of scale. This will enable companies to accelerate capital return. Industry analysts project that midstream companies will return half of operating cash flow through rising dividends and buybacks in 2024.

Exhibit 5 - Midstream Sector Valuation



Source: Citi.

Exhibit 6 - Midstream Sector Market Cap

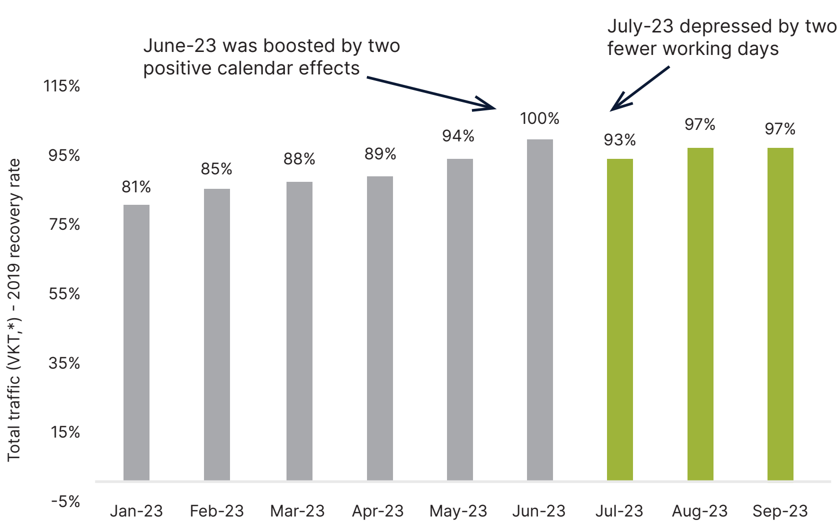


Source: Citi.

Post-COVID Normalization in Transport

Toll roads, rail, and airports continue to capture normalized traffic post-COVID, allowing them to raise tariffs to catch-up with inflation and expand margins. In Toronto, tolls on the 407ETR will increase 18.0% on average (across vehicle types, zones and times of day) this year compared to 2020, exceeding Canada's rate of inflation in the 2020-23 period by 4.0%. Traffic increased from 81.0% of 2019 levels at the beginning of the year to 97.0% by September 2023, driven by improving office occupancy levels levels **(Exhibit 7)**.[3] The tariff increase is a clear indicator that traffic improvements experienced to date are expected to be sustained.

Exhibit 7 - 407ETR Traffic vs. 2019 Levels



Source: Company data and Santander.
(*) VKT = Total Vehicle Kilometers Traveled.

[3]Measured in Vehicle Kilometers Travelled as shown in Figure 7.

From 'Higher for Longer' to …

There is significant uncertainty associated with the current transition as we go from a 'higher for longer' environment to one that is widely expected to produce below trend growth. The conventional playbook dictates that hiding out in regulated utilities and other defensive assets is the preferred positioning to ride out economic weakness. However, no two cycles are ever exactly alike. COVID was a 100-year flood that led to all kinds of dislocations that are slowly correcting themselves. We believe the interest rate volatility last year has already led to a 'flight to safety', driving up the valuation of defensive assets (i.e. consumer staples, telecoms). Expected returns from here are unattractive. Conversely, our fund positions are already priced to reflect expectations that, we believe, are far too low. As the above examples in renewable energy, midstream and toll roads illustrate, the pendulum of market sentiment often swings too far and the market eventually self-corrects. Using valuation as our guide, we remain focused on high-quality infrastructure businesses that generate above-average returns across the economic cycle, exhibit capital discipline and are driven by secular growth tailwinds along the long-term investment themes of decarbonization, infrastructure renewal and digital connectivity.

The Starlight Global Infrastructure Fund is a concentrated portfolio of 44 high-quality global infrastructure companies with a track record of increasing their cash flows and distributions annually. In 2023 the portfolio generated 29 distribution increases with an average increase of 10.5%. The Fund currently yields 5.6%, payable monthly, which has historically been taxed primarily as return of capital. In 2022, 65.6% was taxed as return of capital.

We invite you to partner with us.

Starlight Capital

Investment Management Team

Hisham Yakub, CFA
Senior Portfolio Manager, Infrastructure

Hisham Yakub joined Starlight Capital in February 2023 as Senior Portfolio Manager. He has over 10 years of experience in the investment industry.

Mr. Yakub most recently held a position with a boutique Toronto-based investment management firm as an Investment Analyst and Portfolio Manager. He also spent the first six years of his business career focused on developing software tools for portfolio management applications. He progressed through several roles across the industry and finished his pre-MBA career at CPP Investment Board.

Mr. Yakub holds the Chartered Financial Analyst and Financial Risk Manager designations and earned a Master of Business Administration from the Rotman School of Management at the University of Toronto in 2013 and an Honours Bachelor of Business Administration degree with a specialization in Information Systems from York University.

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