

Global Listed Infrastructure

Infrastructure is more defensive with ESG consideration

May 2010

Infrastructure can offer investors inflation-protected income and sustainable growth over the long – term. The income component benefits from assets providing essential services, enjoying high barriers to entry and strong pricing power. The growth component reflects structural drivers like urbanisation, globalisation, mobility, energy security and the shift in assets from public to private. Global listed infrastructure has shown over the last 15 years (and the last 3 years through the Global Financial Crisis) that these attributes can translate to higher returns with lower risk than general equities. While it seems logical to match long-dated liabilities with long-term assets, investors need to be confident that their companies are being managed for the next decade, not just the next quarter.

Tackling sustainability is not easy and companies have to do more than tick a few disclosure boxes and place a wind farm on the cover of the annual report. Management need to take practical steps towards best practice or potentially suffer a higher cost of equity than peers. Sustainability issues are more important for infrastructure companies than many other sectors. For example, Environmental issues present risks for coal-fired power stations but present opportunities for electricity transmission extending to renewable energies. Social awareness can maintain customer satisfaction at airports and reduce political risk in regulatory outcomes. Governance is critical if toll road companies want to avoid trading below intrinsic value.

We believe Environmental, Social and Governance (ESG) issues impact infrastructure stock performance and should be fully integrated into an investment process. We do not screen companies on ESG criteria but seek to understand the risks and capture them in a proprietary quality ranking. In practice we require a higher return for companies that fall short. This process has proved valuable as infrastructure companies which have ranked higher on ESG criteria have been more defensive.

Infrastructure and ESG issues

Sustainability issues are important for many infrastructure companies. Mismanagement of these issues can clearly impact the sentiment towards a company, but may also have a direct impact on profits through customer losses, regulatory outcomes or political intervention.

Environment

The potential impact of infrastructure companies on the environment is varied. Electricity generation is responsible for 30-40% of the world's carbon emissions. Generation fleets biased towards nuclear, hydro and wind offer a significant cost advantage to coal, oil and gas generation, particularly as countries implement carbon pricing schemes. Some companies are taking active steps to replace coal-fired power stations with renewable energy and invest in research and development of carbon capture and storage technologies. Others are waiting for governments to force the change or are trying to deflect the issue through financial contracts - short-term responses to a problem that is unlikely to go away. Other areas of environment risk for infrastructure companies include fuel spills from storage tanks, access for pipelines through protected wilderness areas and dredging to improve port access.

We have also seen some positive outcomes for infrastructure companies on the environment front. Replacement capex to improve electricity losses and water leaks has underwritten solid earnings growth for utility networks. Subsidies offered on renewable energy investments have cushioned the declines in wholesale power prices. A new generation of aircraft like the A380 use airport runways and terminals more efficiently. Investments in new motorway and rail infrastructure are significantly reducing congestion on some routes.

Social

Most infrastructure assets are in privileged positions. Provision of an essential service with limited competition means they are also likely to face a high level of public scrutiny, particularly if they abuse this privilege. It is important for infrastructure companies to consider all stakeholders – staff, community, customers, suppliers, regulators, - if they want to maximise long-term returns to shareholders. Social issues that impact infrastructure companies include: staff turnover and injuries, community impacts from noise or pollution, customer satisfaction and engagement, meeting suppliers' needs for access and efficiency, and maintaining healthy relationships with regulators. Mismanagement of just one of these issues could impact another, for example where poor customer satisfaction leads to significant political pressure on regulatory outcomes.

Governance

Infrastructure assets can deliver strong free cash flow to investors with relative certainty. But this certainty at the asset level can be offset by high financial leverage or aggressive acquisitions at the company level. This in turn may lead to stocks trading at significant discounts to intrinsic value. The Board plays a critical role in ensuring that certainty translates from the asset to the stock. Boards must set a clear strategic direction, align management incentives and maintain transparency.

The interests of numerous stakeholders can lead to poor governance of infrastructure companies. Boards of a number of European utilities are dominated by government or employee representatives and provisions exist to defend takeovers. China infrastructure companies tend to be controlled by a provincial government or entrepreneur, with shareholder returns tending to be higher for the latter. A number of Australian infrastructure companies were represented by the investment bank that also owned the management company, a clear conflict of interest and potential risk to investors.

Quality ranking

Capturing the impact of these varied ESG issues is an art not a science. But researching the key issues, identifying relevant measures of performance and forming a view, at least provides a framework for considering ESG issues within an investment process. We use a proprietary ranking system to identify issues that cannot easily be captured within a valuation model. We selected 25 criteria that we believe define the quality of an infrastructure company and rank each of these measures on a score of 1 to 5. Environment, Social and Governance are explicitly captured in 3 of the 25 criteria but are also present in other factors such as Board, Alignment of Interests, and Political & Legal Risks. Below we outline some examples of measures we have found insightful in assessing infrastructure company performance on ESG.

Environment

Carbon intensity – RWE produces more than 6 times the carbon per unit of energy compared to EDF

Water leakage – Pennon has met the UK water regulators leakage target every year since 1999

Oil spills – bulk liquid storage company Vopak reduced the number of spills from 102 in 2004 to 71 in 2009

Wilderness – construction of Vinci's A19 motorway included 116 animal crossings and 200,000 trees planted

Social

Customer satisfaction – Scottish & Southern tops the JD Power customer satisfaction survey for UK energy retailers

Lost time injury rate – US railway company CSX reduced its injury frequency index from 2.2 in 2003 to 1.2 in 2009

Noise complaints – Zurich Airport has established a CHF760m fund to insulate homes and compensate residents

Staff turnover – New Zealand's Port of Tauranga has reduced staff turnover from 10% in 2007 to 4% in 2009

Governance

Board independence – German utility RWE has 20 members, including 10 employee reps and 3 government officials

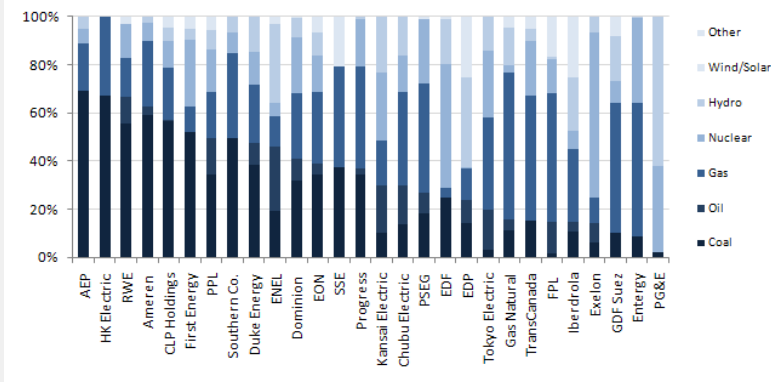
Equal voting rights – transmission company Red Electrica limits voting rights to 5%, excluding the State with 20%

Alignment of interests – infrastructure assets managed by investment banks led to significant conflicts in Australia

Takeover defence – the boards of Crown Castle and Magellan Midstream can issue new shares to block takeovers

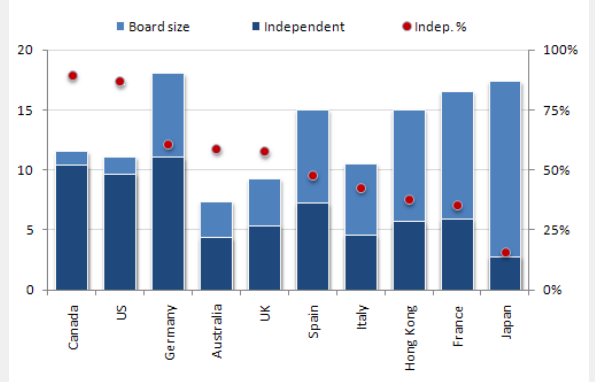
Examples of these measurements across companies and regions are captured in the charts below. These qualitative insights, together with our fundamental valuations, form the key steps in our stock selection process.

Global Electric Utilities generation capacity mix by fuel



Source: Company reports, CFSGAM

Infrastructure Board Independence



Source: Bloomberg, CFSGAM

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Relative performance

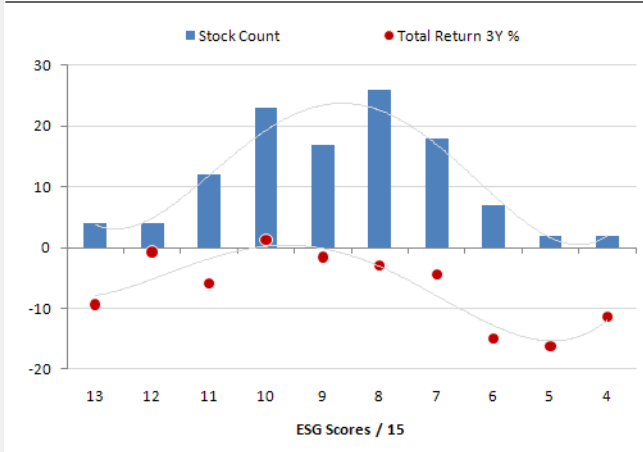
Infrastructure companies with a higher rating on ESG tended to be more defensive during the GFC. The first chart below captures the ESG score for 115 infrastructure companies under coverage. ESG scores out of a possible 15 range from 4 (worst) to 13 (best). We then overlay total returns for the 3 years to May 2010. In the second chart we extend the analysis to a time series of the 20 top and bottom rated companies on ESG. A number of observations can be made:

1. Infrastructure companies with the lowest ESG scores significantly underperformed over this period
2. Top ESG stocks outperformed Bottom ESG by more than 20% over 3 years
3. Top ESG stocks achieved this outperformance with almost half the volatility

We think it's important to note that ESG is only part of the equation. Some of the very highest rated companies on ESG also underperformed, typically because they were well loved stocks trading at premiums and offered high liquidity during the GFC. Further, at the height of the crisis in March 2009 stocks with low ESG scores simply offered too much value to ignore. Taking some calculated risks delivered impressive returns over the next six months.

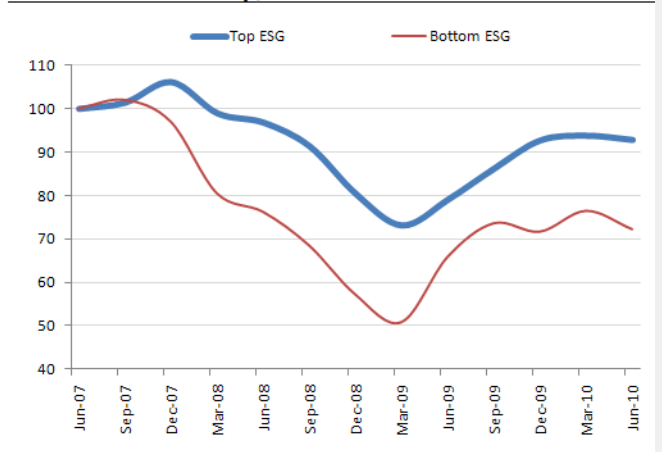
Overall, consideration of ESG issues as a fully integrated part of the investment process can deliver more defensive returns for infrastructure investors.

Infrastructure ESG Scores and Performance



Source: CFSGAM, Bloomberg

Infrastructure ESG Top/Bottom Performance



Source: CFSGAM, Bloomberg

For further information

Peter Meany Head of Global Infrastructure Securities +61 2 9303 2456 pmeany@colonialfirststate.com.au

cfsinstitutional@colonialfirststate.com.au

Regional Managing Director, Australia and New Zealand

Joanna Davison +61 2 9303 7007

Institutional Business Development and Consultant Relationships

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Tracey McNaughton +61 2 9303 2695

Institutional Relationship Management

Liz Krajewski +61 2 9303 2927

Daniel Bristow +61 2 9303 6311

Helen Squadrito +61 2 9303 6142

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Nadene Moore Maternity leave

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