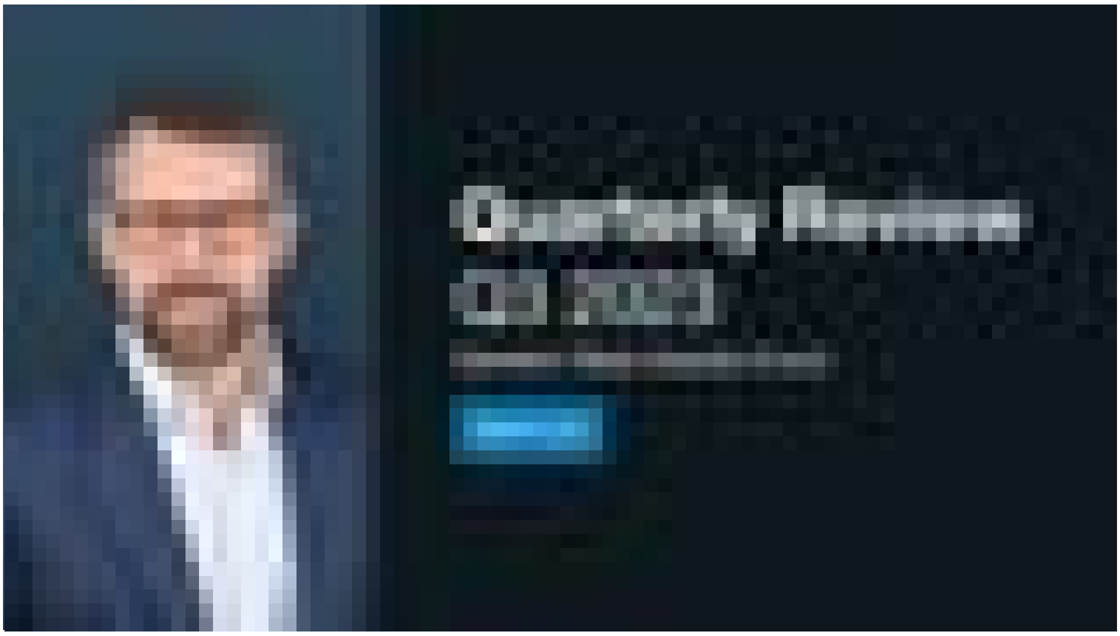
Sanlam Real Assets Fund Quarterly Review - Q3 2023

Chris Rodgers is joined by Head of Multi Asset, **Mike Pinggera**, who provides an overview of the Sanlam Real Assets Fund's performance, current market trends, and an outlook for the future.



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Full transcript

Chris Rodgers
Good morning. My name is Chris Rodgers. I'm head of investments at Sanlam Investments UK here in London. And with me this morning is Mike Pinggera. Mike is head of the alternatives team and the lead manager on the Sanlam Real Assets Fund, which is the fund we're going to talk about this morning. Looking in particular at the third quarter that was just finished.

Morning, Mike. Can we start by just helping us understand the background? Has it been a difficult quarter, challenging quarter? There's been a lot of change in interest rate expectations. What's been going on?

Mike Pinggera
Yeah, I mean, it most certainly was a challenging quarter. As you say, the interest rate expectations have shifted to a higher for longer narrative, which put a lot of pressure on, you know, on bond markets, on equity markets in particular areas such as utilities came under a lot of pressure. Global equities were down in the region of 3.5% over the quarter.

The US utility index was down closer to ten. So some of those bond proxies for want of a better word. Some of those bond proxies really took the heat in terms of that that shifting narrative. We also had a couple of stock specific issues, you know, announcements: Orsted, NextEra Energy Partners, really just making negative announcements regarding some of their project values.

Chris Rodgers
And perhaps we'll come onto that in a minute.

Mike Pinggera
Yeah. But those effectively had a fairly tough market backdrop and some individual pressure points. Yeah.

Chris Rodgers
So it's really the shift in the yield curve with long yields rising up again, they sort of undermined the valuation of some of these real assets I think.

Mike Pinggera
Yeah, it seems it's a very, very strange situation because of the fact that inflation remains elevated.

Chris Rodgers
This is the conundrum for investors I think.

Mike Pinggera
Yeah. Yeah. So you've got revenues which are inflation linked and so these companies are benefiting from higher inflation at the operational level so their revenues are increasing. But, but your capital values are effectively being punished because of higher rates. So it does create a fairly frustrating environment. I mean, we spend a lot of time engaging with the management teams of the businesses that we're invested with.

And all of those meetings are positive. You know, the companies themselves, you feel very confident about how they are navigating this environment. And from an operational perspective, that is being evidenced. From a share price perspective, you'd think we don't need schools, roads and hospitals ever again, which is clearly not the case.

Chris Rodgers
Has the environment and the weakness presented any good new opportunities for the fund?

Mike Pinggera
So, I mean, we've been rotating the portfolio, so everything in the portfolio we like and I daresay everything in the portfolio looks better, looks much, much better value today than it did eight months ago. So, so effectively, you're making relative calls. It's really looking at businesses where you have sort of highest degree of confidence in the management team and their ability to navigate their way forward. We've got quite a lot of the names trading at discounts to net assets which will mean that raising fresh capital for new opportunities might be quite difficult.

But at the same time we've got quite a lot of businesses with a proven track record of recycling, so selling assets to fund new projects and they're the businesses that we've been tilting towards for quite some time. They're the businesses most likely to take advantage of the current opportunities. Okay.

Chris Rodgers
Well, let's talk about performance. As we said, it's been a difficult quarter. What are the numbers looking like?

Mike Pinggera
So we were down just over 5.5% for the quarter. As I say, against a backdrop of global equities down about 3.5%. Again, not that it's a benchmark, but you get utilities down closer to ten and that the big drivers year within that were the renewable names. I mean Orsted was the biggest detractor they wrote down the value of their US projects.

It's important to stress that those projects, they've got operational assets which are unaffected and they've got new projects which are unaffected, but some of those projects that were signed in the region of 18 months ago where you committed to a project, but then your construction costs, your supply chain issues, all of that have effectively meant that those projects may not be economically viable.

Chris Rodgers
There's no corresponding adjustment in the offtake for the rates they get for them.

Mike Pinggera
So yeah, so that's the conversation. And when we saw the UK auction where nobody bid and then subsequently at an Irish auction where the prices were higher and people were bidding. So there’s an adjustment phase, but there's a, there's a sliver of projects which have been affected by that sort of gap higher in costs.

But, it really should be noted that that doesn't affect your existing operational assets and it doesn't affect future projects where management teams will take those additional costs into account. So it's a transitional sort of period of pain rather than a permanent period of pain.

Chris Rodgers
Am I right in thinking that some of the weakness in the price of units of the fund reflects the fact that these funds themselves, the underlying funds that you hold trade at quite sizable discounts to net asset value?

Mike Pinggera
Yeah, Yeah. So effectively there's this sort of three valuation metrics that we monitor. We have the net asset value provided by the company in many cases independently verified. So that's the valuation metric that they're using. We then have the market implied valuation, so discount or premium and at the moment the market is employing around about a 25% discount to the company's valuation.

So effectively the market's saying, you know, we, we don't believe the company valuation.

Chris Rodgers
And is there anything that the companies can do to justify the valuations?

Mike Pinggera
Yeah, I mean, thankfully, yes. And we are seeing more and more management teams sort of engaging self-help practice, selling assets, in effect, to validate their valuation. So we've seen a number of transactions going through at the at the very least sort of at net asset value, but in a number of cases quite significantly above the recent company valuation.

So in 3i Infrastructure, I've owned since the IPO in 2007, they sold a project 31% above their March year valuation, but the shares trade at a 10% discount. HICL again another business I've owned since IPO in fact in 2006 in HICL's case sold a schools project 9% above net asset value at a point where the shares are trading at a 27% discount to net asset value.

So hard cash crossing the table is a pretty good indication of where values are. But at the moment there seems to be a very big disconnect between the demand and the valuations in private markets, which remain strong and high, and then the pricing we're seeing in the listed markets. And that probably has a lot to do with the fact that in listed markets quite often real assets have been used as bond proxies and people for the first time in a decade have been able to basically rebuild their bond allocation.

So I think it's got more to do with flows as opposed to valuations and fundamentals.

Chris Rodgers
Okay, we're looking to the future now and the current positioning. I mean, how are you split in the portfolio between the main categories of real assets?

Mike Pinggera
So infrastructure is the largest component of the portfolio. It's about 35% in infrastructure names. And currently those infrastructure names are trading off on average with about a 13%, just over a 13% discount rate. So you can read that as your implied implied future returns. Renewables comes in at the next level where you're looking at, again, about a 10% discount rate and property is at 20%.

Chris Rodgers
The revenue streams, cash flows discounted.

Mike Pinggera
Yes. Yeah.

Chris Rodgers
Not the price relative to its net debt.

Mike Pinggera
No, no, no. So you're looking at the dividend stream plus the growth in your capital on a steady state. So assuming that the discount rates stay stable. If they tighten, and if bond markets improve, then there should be further capital upside. But the largest weighting is to infrastructure. Again, you've got a high degree of contractual inflation linkage, so very good visibility around earnings.

The renewable energy space, which is a very diverse sector, you know, the pressures that we've seen in offshore wind, it should be noted, are not new. It's not the same everywhere. I mean, onshore wind is still doing quite well. You have storage, hydro - It's a very broad sector. And then in the property space weighting around about 20% in in specialist property, we don't own office blocks, we don't own shopping malls.

This is your mission-critical property, your private rental housing, your logistics facilities, data centres, etc.. Okay.

Chris Rodgers

You mentioned dividends. What's the current dividend yield on the overall portfolio?
Well, I mean, I think they're very well covered aren't they, but actually what we're receiving.

Mike Pinggera
Yeah. So the yield on the fund is about 5.2%. So it's been increasing steadily, just reflecting those revenues do tend to come through those inflation linked revenues with a lag. So we've got dividend growth of in the region of 5 - 5.5% forecast for this year and next, off a relatively attractive starting yield of just over 5%.

It should also be noted that while there has been some switching into fixed income and again within the Multi-Strategy Fund. I mean I've been doing this myself so I can't be too negative about it. But, but you should make a distinction between getting your 5% off a 30 year government bond, which is a fixed nominal return and 5% off an inflation linked to your real asset, which will grow over time.

So in the short term, your income stream is the same. But, but over a sort of 5 to 10 year holding window the two are not comparable. So it's a real five as opposed to a nominal five.

Chris Rodgers
Okay. I think we'll leave it there. It sounds as though it's been tough, but the valuation now is very compelling. And as you point out, the majority of it is index linked. So it should offer decent, decent returns going forwards. Yeah. Okay. Thank you very much, Mike.

So thank you for listening. If you have any questions that you'd like to put to Mike, please contact in the first instance, your Sanlam representative. They will pass them on and we'll get back to you. Thanks very much.