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A head scratcher

BBGI's high yield looks secure but the trust continues to trade at a wide discount...

Update
19 March 2024

A widening of discounts across the infrastructure sector over the past two years can leave you with the impression that rate hikes have impacted – or are likely to impact – all trusts equally. The reality is that some are much less susceptible to the risks higher rates create than others.

BBGI Global Infrastructure (BBGI) is a prime example of this. The trust has a globally diversified portfolio of availability-style assets, with government or government-backed counterparties and inflation-linked contracts. All of the trust's holdings are in AA/AAA-rated investment grade economies.

The result of this set up is that BBGI's investments produce highly predictable cash flows from reliable public sector counterparties, regardless of economic cycles or market volatility. The pandemic provided a great example of the strength of this model as the trust continued to generate its usual cash flows, despite the global economy grinding to a halt.

From these secure, predictable cash flows, BBGI has been able to deliver annual increases to dividend payouts, and BBGI has met or exceeded all its dividend targets since its IPO in 2011. Indeed, the trust is targeting an annualised increase to dividends of 6% for 2024, following a 6% dividend increase for 2023, these are sector leading dividend increases. These are likely to be fully covered as BBGI aims to have dividend coverage of 1.3x over the long-term.

The inflation-linkage in the trust's contracts also means that it has been more immune from the impact that rising prices have had elsewhere over the last two years. The inflation-linkage in BBGI's contracts is index-linked and works in a mechanical way, with mark ups to contracts made and passed directly on to clients, in some instances on a monthly basis.

BBGI also mirrors these contracts with the management companies it pays to ensure the trust's holdings remain fit for use. This limits the degree to which there can end up being a mismatch between revenue the portfolio generates and the amount that must be paid to these contractors.

What this has meant in practice over the past two years is that BBGI has seen an increase in revenues, as it has been able to mark up contracts with its counterparties to reflect higher rates of inflation. At the same time, equivalent agreements with the trust's contractors mean that costs have been kept under control and not increased to the detriment of the trust's earnings.

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Secure, increasing revenue is important but it has arguably been fears around debt that have prompted reratings in the broader investment companies market. However, here too BBGI's managers have structured the trust to shield it from the impact that higher rates could have.

The majority of BBGI's debt is on the portfolio level, with no structural gearing at the trust level. What is particularly significant here is that 55 of the trust's 56 holdings have fully amortizing fixed rate borrowing costs, with no refinancing obligation. This means that higher rates have had no impact on the borrowing costs for these investments.

The one remaining portfolio company does face a refinancing obligation for a tranche of debt in Q3 of next year. However, the managers have hedged out the risk of a change in base rates for this amount, meaning the risk only pertains to the lender's margin in excess of the base rate.

BBGI did use its revolving credit facility (RCF) to make two investments in 2022. However, this was expected to have been fully repaid by the close of last year from excess cash BBGI has generated from its portfolio. Assuming that was the case – BBGI's

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results are out later this month – it illustrates the trust's ability to grow organically and the fact it does not need to go and raise funds from the market.

Another key and related point is the fact that the trust does not have any obligations to invest, meaning it is not in a position where it will become a forced seller to meet such obligations. In fact, the trust is in a position whereby it could make no more investments and still pay a rising dividend for the next 15 years.

This is a reflection of the fact that BBGI pursues disciplined growth that builds shareholder value first, encouraged by an internal management structure, and not growth in assets under management for its own sake.

Taken as a whole, we think this means BBGI offers attractive defensive features, which mean the trust can continue to pay a sustainable, rising dividend over the long-term, that is heavily protected from the risks of an economic downturn or higher refinancing costs.

The trust is also shielded from inflation due to the inflation-linkage in its contracts. Indeed, if inflation does continue to run higher then BBGI can actually benefit from an increase in its underlying revenues.

At the same time, the trust enjoys potential upside from lower inflation and potential rate cuts. If we do see these later this year, it's plausible the trust would see a tightening of its discount – currently at 13.3% - as investors start to find the nearly 7% forward yield more attractive than it already is.

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