

# No Cracks in Canadian Infrastructure Stocks

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Global infrastructure stocks continue to shine—surging by almost 20% since we last highlighted the sector in early 2007. How do Canadian infrastructure stocks fit into this picture? Evidently, very well. Not only did the Canadian infrastructure index outperform the TSX during the past year, but it also topped its global and American counterparts by healthy margins. Valuations of construction and engineering firms are reflecting the huge potential of the current unprecedented infrastructure boom in Canada. And that’s just the beginning.

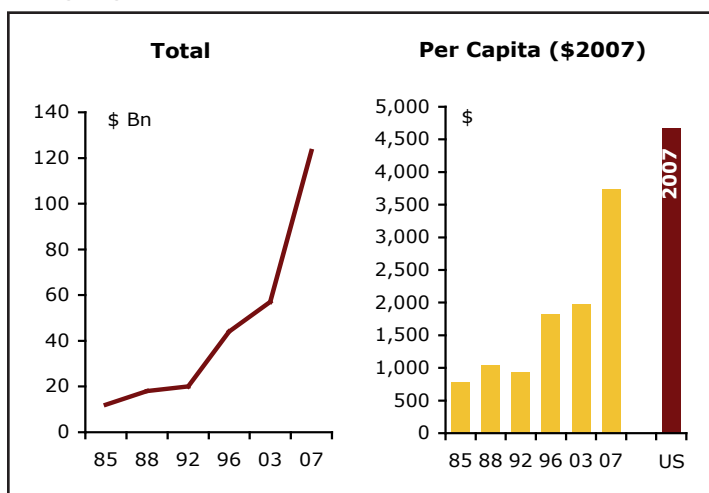
## The Problem

Recent estimates suggest that the infrastructure-related funding shortfall in Canada is much larger than was assumed until recently. The consensus is that the total additional investment needed to repair and prevent deterioration in existing municipally owned infrastructure assets stands currently at roughly C\$125 billion. That is up from C\$60 billion in 2003—a dazzling C\$15 billion of deterioration per year. As a share of GDP, this deficit has ballooned from 3% in the early 1990s, to the current 8%. And per capita, at just under \$4,000, the deficit is now four times larger than it was 15 years ago (Chart 1). In fact, on a comparative basis, the Canadian infrastructure gap is not much smaller than in the US, where the situation is often described as a looming crisis, and where Washington has already taken decisive steps to deal with the infrastructure funding shortfall.

And these estimates reflect only the most urgent infrastructure requirements, without taking into account additional needs for expansion due to demographics and environmental issues. Take Ontario for example; the pledge to shut down its coal plants by 2014 cannot be achieved without the refurbishment of existing nuclear plants and the development of new ones, as well as a massive investment in grid infrastructure. Such requirements are not included in current estimates of the infrastructure deficit. Add them to the equation and the required infrastructure funding in Canada almost doubles to C\$240 billion or 15% of GDP. Two-thirds of this amount is required to fix, maintain, update and expand the country’s water and transportation systems (Chart 2.)

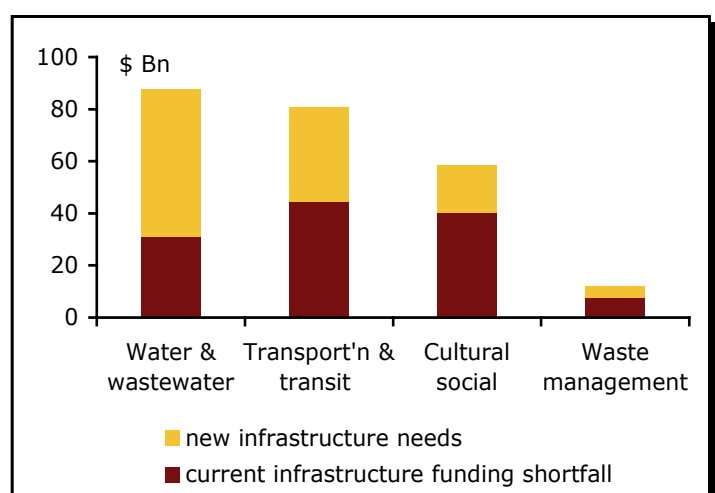
The rapid acceleration in the value of the infrastructure deficit in Canada reflects the fact that more than half of the nation’s civil infrastructure is more than 50 years old (Chart 3, left) and the system has used almost 80% of its life expectancy. And this life expectancy gets shorter with every year of delayed maintenance. As illustrated in Chart 3 (right) the service life of a typical infrastructure asset can be reduced dramatically due to insufficient maintenance. Note that moving from 2% maintenance cost (% of construction cost) to 1% can reduce the service life of the assets by 15 years. Given the rapid widening of the infrastructure gap in recent years, we estimate that the current maintenance rate is probably

Chart 1  
Surging Canadian Infrastructure Shortfall



Source: Federation of Cdn Municipalities (FCM), CIBCWM

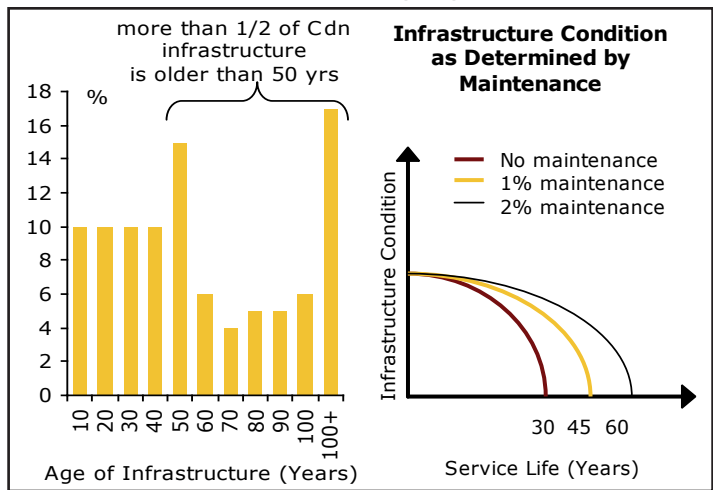
Chart 2  
Required Infrastructure Investment by Sector



Source: FCM, CIBCWM

Chart 3

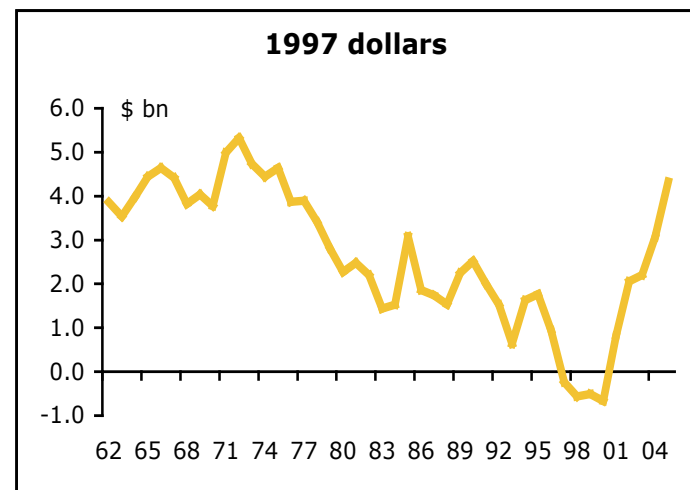
**Canadian Infrastructure Aging Fast**



Source: FCM, CIBCWM

Chart 4

**Government Net Spending on Infrastructure\***



\*Net of depreciation. Source: Statistics Canada

lower than 1%—a fact that worked to accelerate the aging process of Canadian infrastructure.

**The Solution**

The tragic collapse of a Laval bridge near Montreal last fall captured all these statistics in one gloomy image. But in many ways it worked as a catalyst for governments across Canada to start moving on the infrastructure front. And the difference is that now they can afford it, with the federal government celebrating 10 years of being in the black. As illustrated in Chart 4, the worst is over for public sector infrastructure investment in Canada. After years of under spending, which saw the share of the federal government in total infrastructure capital falling from

40% in the 1960s to less than 7% in 2002 (and municipal governments' share rising from 40% to 60%), the tide is turning. In fact, in its last budget, Ottawa made its largest single commitment to public infrastructure in the country's history—\$37 billion in investment over seven years—of which less than \$2 billion has been spent so far (Table 1).

The federal government is also directing some of the tax power to municipalities—mainly via the gas tax. Today, 36% of the gas tax is spent on infrastructure—five times the amount spent only three years ago.

Provincial governments are also stepping up to the plate. Alberta has recently announced a record \$18 billion over

Table 1

**Federal Government Long-Term Infrastructure Plan**

Long-Term Infrastructure Plan (\$ millions)	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Base funding								
Gas tax funding	800	1,000	2,000	2,000	2,000	2,000	2,000	11,800
GST rebate	715	750	790	830	875	915	960	5,835
Building Canada Fund	572	926	1,186	1,401	1,427	1,636	1,655	8,801
Fund for gateways and border crossings	137	221	283	335	341	391	396	2,105
Fund for P3 projects	82	132	169	200	204	234	236	1,257
Equal per jurisdiction funding	325	325	325	325	325	325	325	2,275
Asia-Pacific Gateway and Corridor Initiative	108	158	118	144	172	170	108	977
Sunsetting infrastructure initiatives	1,597	1,141	571	362	326	26	0	4,023
<b>Grand Total</b>	<b>4,335</b>	<b>4,653</b>	<b>5,442</b>	<b>5,597</b>	<b>5,669</b>	<b>5,698</b>	<b>5,680</b>	<b>37,073</b>

Source: Federal Government

three years of infrastructure projects—that is three times the amount spent in previous years. In fact, based on inventories of ongoing and planned infrastructure projects by 2013, cumulative spending in the province will climb to a dazzling \$18,400 per person—an amount matched only by infrastructure investment in oil-rich countries such as Dubai. British Columbia will see roughly \$20 billion worth of infrastructure investment in the coming five years, while the booming Saskatchewan economy will see an infrastructure cash injection of \$5.5 billion or \$5,600 per person during that period. While the economic fundamentals of Atlantic Canada are not as favourable as in the west, infrastructure investment in the region is gathering momentum at a pace second only to Alberta (Chart 5).

Instead of simply writing a cheque, governments are now willing to utilize more effective ways to finance infrastructure investment. Chief among them is the growing role of Public-Private Partnerships (P3) in Canada. Many of these projects involve the participation of the private sector in designing and building infrastructure to meet public sector performance specifications, often for a fixed price, so the risk of cost overruns is transferred to the private sector. While Canada has been slow to adopt this concept, this reality is changing quickly with no less than 50 P3 projects currently in process nation wide. And Ottawa’s recent commitment to creating a federal P3 office is a clear indication of the direction the government is aiming. Chart 6 indicates that the combination of the current volume of P3 activity and its level of sophistication, put Canada in the same league as countries such as the

US, France and Spain, but still below countries such as Australia and the UK, where P3 projects play much more prominent roles in infrastructure investment.

What makes investment in infrastructure particularly attractive at this time is that the rising supply of infrastructure projects coincides with a rapidly growing demand for that kind of investment—particularly among pension funds, given their growing need to match long-term liabilities with stable long-term cash flows. Infrastructure investment typically carries greater duration than 30-year government bonds, and in addition to having bond-like characteristics, it has equity-like features, since revenues grow over time with demographic changes, providing pension funds an attractive hedge against inflation.

And that’s precisely why in the coming years, pension funds will become major players in the Canadian infrastructure space. With more than \$700 billion to play with, even a minor change to their asset allocation can dramatically change the mathematics of infrastructure funding. And it’s already happening. We estimate that currently roughly 5% of pension funds’ assets are allocated to global infrastructure investment—up from only 2% earlier in the decade. And this allocation is rising. Look for pension funds to allocate between 10% and 15% of their assets to infrastructure investment by 2015—adding more than \$200 billion of fresh money to this capital intensive sector. And given that much of this investment is likely to be leveraged—the actual amount of cash infusion coming from pension funds will be much larger.

Chart 5

**Planned Infrastructure Spending by Province (2007-2013)**

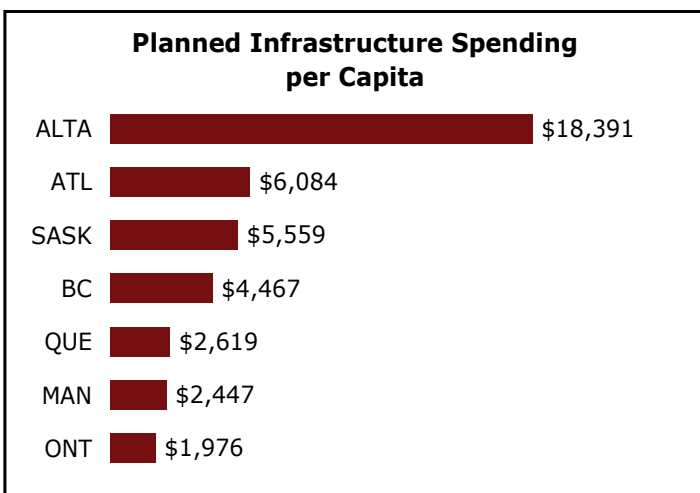


Chart 6

**P3 Market Maturity Curve**

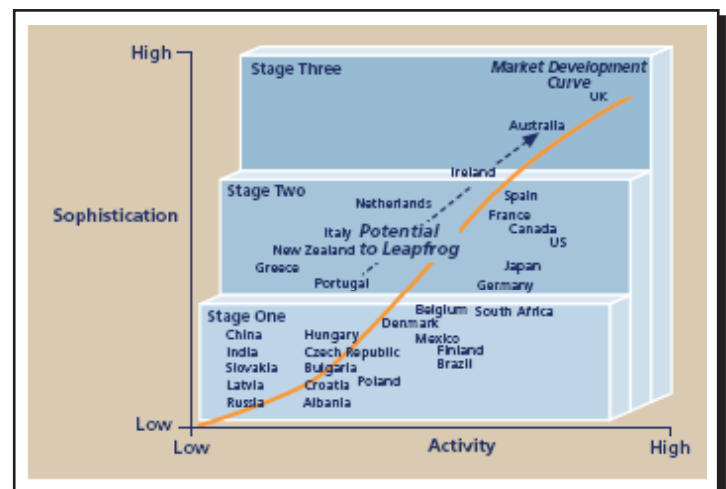
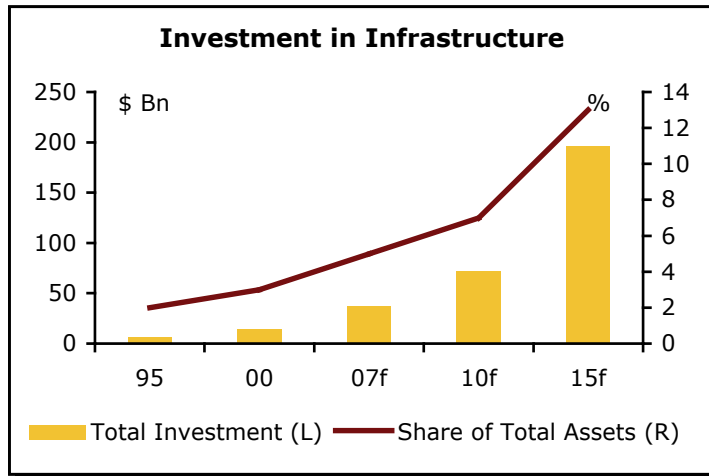


Chart 7  
**Pension Fund Infrastructure Investment Will Grow Rapidly**



Source: Statistics Canada, CIBCWM

and in the past year alone the index topped the S&P/TSX by 20%-points (Chart 8, left). And even more impressive is the fact that the Canadian index outshined both global and American infrastructure indexes over the past year by roughly five percentage points (Chart 8, right).

By sub-sector, stocks of engineering companies, which constitutes close to 40% of our index have seen the largest appreciation over the past year, followed by equipment distribution (Chart 9).

Years of under spending in Canada’s infrastructure assets have created a huge funding gap, but also a great investment opportunity. With both public and private money now pouring into the sector at an unprecedented pace, Canadian infrastructure companies are entering a golden era, with growing pricing power largely offsetting any cost pressures. Profit margins and valuations will continue to respond accordingly.

**The Investment**

With surging demand for infrastructure investment, and more money available to finance it, the balance has shifted in favour of Canadian construction and engineering firms. And it’s already evident, not only in their rising profit margins, but also in their valuations. Over the past two years our Canadian Infrastructure Index<sup>1</sup> has outperformed the TSX by a cumulative 37%-points

Note:

1. The index is based on 18 publicly-listed Canadian firms with pure or significant infrastructure exposure. We focused only on companies that are listed in the S&P/TSX and with available stock price history going back at least to mid-2004. Individual stock prices are weighted by their market cap. Total market cap of our index is C\$25bn. Company names are available upon request.

Chart 8  
**Canadian Infrastructure Stocks Outperform**

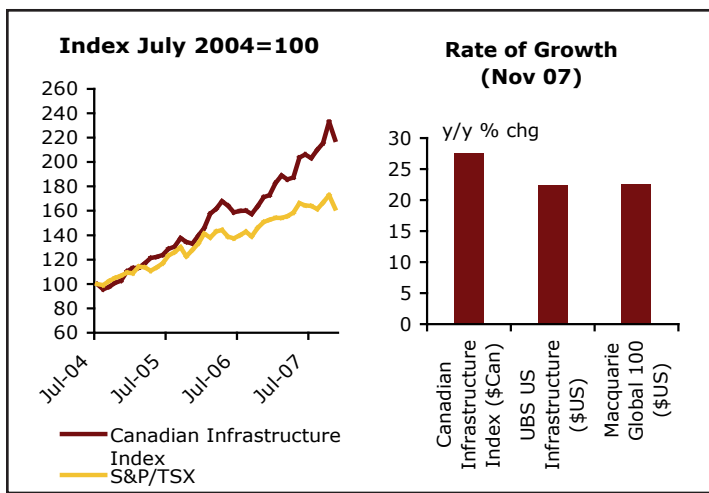


Chart 9  
**Canadian Infrastructure Index—By Subcomponent**

