OPPORTUNITIES IN EUROPEAN MID-MARKET INFRASTRUCTURE
- Martin Lennon, **Infracapital**

What do you see as the most important change taking place in the European infrastructure market today?
We see an ongoing need for managers to seek to develop distinct strategies and/or innovate to drive value in the sector, as it continues to experience large inflows of capital from investors seeking protection from wider market volatility.

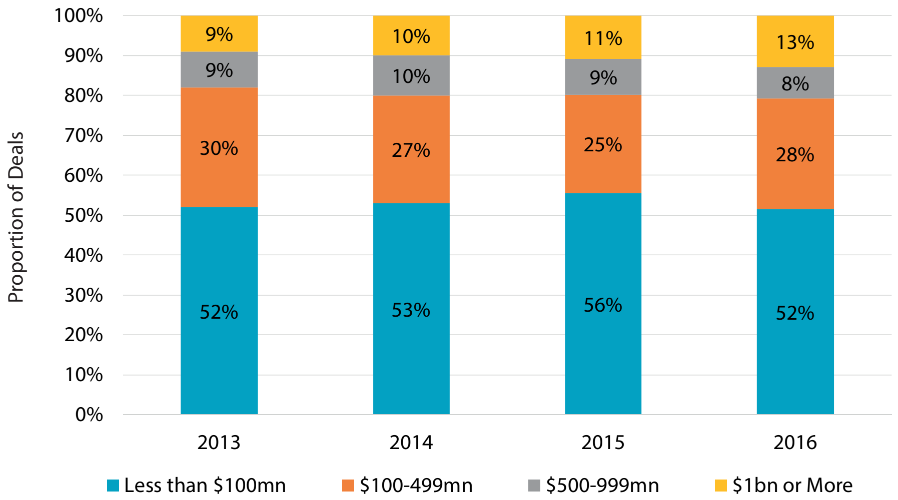
It is really no surprise that institutional investors, faced with uncertainty across global markets and a prolonged low yield environment, are increasingly attracted to the infrastructure asset class and its apparent ability to consistently generate strong returns. We continue to see new investors recognizing infrastructure as an attractive and valuable addition to their portfolios. This is undoubtedly good news for the industry but the resulting capital inflow represents a challenge for managers that are encountering more competition for deals.

As a result, we are now seeing more and more managers specializing, and trying to find their place in the market. Those who cannot differentiate themselves are going to struggle to secure commitments from increasingly sophisticated investors and that is a big difference from a few years ago.

Where can you still find good opportunities?
While pricing has undoubtedly tightened in general terms, the mid-market deal flow remains strong. According to Preqin, in 2016, the majority of all infrastructure deals related to assets valued at less than $500m. In contrast, deals worth over $1bn, which often grab the headlines, represented less than a seventh of transactions.

Increasing capital inflows into the asset class have certainly contributed to record-breaking prices for larger trophy assets, but in our experience the mid-market is still offering compelling value. Transactions in this space can be complex; they might require separation from a parent company, or the establishment of a new management team for instance, but they can provide superior relative returns as a consequence and give well-resourced expert asset managers an opportunity to add real value.

Fig. 1: Infrastructure Deals by Value Band, 2013 - 2016



Source: Preqin Infrastructure Online

We also see an interesting value proposition and less competition for assets that are at earlier stages of the investment lifecycle, particularly the pre-construction phase where few managers have the necessary skills and depth of experience to manage the related risks effectively. It is important that managers stay disciplined in their fundraising efforts, and that the size of the fund matches the specific market opportunity to ensure it can be deployed efficiently and in line with its strategy. Investing at this stage requires comprehensive risk mitigation expertise, but presents an opportunity for strong value accretion through delivery of projects on time and on budget (or better), and potential for premium yields in the operational phase.

What are the key things you look for in the projects in which you invest?
Our investors want to gain specific exposure to mid-market European core infrastructure, so we make sure to only target assets in line with this strategy that play to our specialist expertise where we know we can add value. We offer traditional infrastructure, but seek to invest in opportunities where we have an angle – either through origination and the relationships of the team and Group, or by leveraging our expertise to complete complex transactions. With a commitment to an active asset management capability, we have the confidence to acquire assets that stand to benefit from improved efficiency or have growth potential.

When assessing greenfield opportunities we will only invest in projects that are at a later stage in the development cycle and/or are reaching financial close, nearing the commencement of the construction stage. At this point we have greater certainty over revenues and cost streams, plus business economics are substantially defined making future yield more predictable, in some cases more so than certain operating infrastructure assets with non-contracted revenues.

How often do you compete directly with institutional investors for assets?
It is relatively rare for us to compete directly with institutional investors, largely down to the nature of transactions that appeal to their apparent lower cost of capital model.

Direct institutional investors tend to target large-ticket operational assets, so we are less likely to come up against them in more complex mid-market deals, or pre-construction deals. Many institutional investors typically do not have or are still building up the requisite expertise and resource to invest in assets requiring significant hands-on asset management, or requiring development and construction input and oversight. This can sometimes be mitigated by working with partners that do have these capabilities. The relative lack of direct institutional investors in the greenfield space serves to further enhance the appeal of this particular area of the market.

Everyone talks about 'active' asset management; what is your take on this?
Most infrastructure investors speak of actively managing their assets, but there is clearly a broad range of approaches in this regard. I think what sets our team apart is the depth of their commercial experience working in the industry, which is applied in a hands-on but collaborative way with the executive management teams in the businesses we own. Unlike our transaction professionals, our senior asset managers come from operational, strategic and regulatory roles in industry.

Asset management value-add can sometimes be hard to quantify given much of the job involves working closely with the management of investee companies, but it is absolutely critical when it comes to maximizing returns and enhancing yield for investors. Active asset management is not just about making gains through developing operational efficiencies and implementing new business strategies; it plays a vital role in mitigating risk through volatile periods to protect capital and stabilize returns.

Increasingly political sentiment is generating a focus on customer affordability and on regulatory reform. That is why it is important to have an asset management team with extensive commercial experience that can provide management with a challenging yet supportive environment, as well as a clear and aligned culture of stakeholder management throughout the entire investment period.

With your current strategy exclusively targeting greenfield opportunities, is there greater demand from investors for this type of offering?
We are seeing significant interest in the greenfield strategy from long-term investors attracted to the higher returns on offer relative to core brownfield, and the complementary role it has from a risk/return point of view in a brownfield portfolio.

Greenfield should not be considered as divorced from brownfield infrastructure, but rather as a connected stage in an asset's project lifecycle. Greenfield investments provide early access to opportunities that will ultimately develop into brownfield. Accessing projects earlier in the lifecycle can present a compelling risk-return proposition for investors if they are confident a manager is able to successfully manage construction and commission risk, ultimately providing investors with a core operational portfolio with favourable returns.

Another benefit is that by investing earlier in the lifecycle, investors typically buy in at cost rather than paying a multiple of cost. This means the J-curve is not as deep, which to many is surprising, and yield is coming at a lower price.

Are you seeing changes in the way institutional investors want to access the asset class, and greater demand for co-investment in your funds?
Yes, the market continues to develop and institutional investors are becoming more sophisticated, focusing on infrastructure managers with particular skills to deliver specialist strategies that are attractive to their portfolio. Investors want to allocate to managers in each segment of the market that can meet their specific return requirements. Managers that offer specialist products responding to their clients' needs stand to benefit from this trend.

In terms of co-investment, appetite for brownfield is consistent with previous years, but we find that a significant number of investors wishing to pursue a co-invest strategy have limited capacity to pursue typical process transaction timelines. We are, however, seeing increased interest for co-investment on the greenfield side where the platform structure gives investors time to more fully review and due diligence these exclusive opportunities, with the added bonus that they typically incur no bid or abort costs in the process. This is proving especially popular with investors wishing to allocate greater investment to assets that provide 'impact' as they can more easily acquire relatively large stakes in their target areas.

Where do you expect to see the best infrastructure investment opportunities in Europe over the next few years?
As one of the world's largest infrastructure markets, Europe remains a very good place to invest. It benefits from a number of well-established regulatory regimes, as well as a supportive investment environment backed by ambitious infrastructure plans at both national and EU level. Europe is unique in its diversity which certainly contributes to a range of attractive investment opportunities in all core geographies and sectors. Furthermore, it is exciting to see the continent leading the way in certain new high-growth sectors such as broadband, infrastructure services and smart technologies.

INFRACAPITAL
Infracapital is a leading European infrastructure investor based in London, with significant experience in mid-market investing, currently managing over £2.4bn of funds. Infracapital's platform offers investors multiple ways to access European infrastructure with a manager uniquely positioned as an experienced aligned boutique with the 'weight' of a large Parent Group, Prudential plc, behind it. Infracapital's focus is to build and actively manage a diverse and stable portfolio of core infrastructure businesses.

The team brings over 350 years of relevant experience and has developed a proven track record since 2001 having successfully invested across a range of sectors, geographies and strategies in the European infrastructure market.

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