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The march of the mid-market

Promising proprietary origination, value creation and reliable exits against a volatile macroeconomic backdrop are the reasons why the mid-market has come into its own, five infrastructure investors tell Amy Carroll and Kalliope Gourntis

The mid-market is soaring in popularity as investors look to minimise the negative impacts of a punishing economic environment and access some of the most disruptive and transformative infrastructure trends.

"Investors are proactively looking to increase their mid-market exposure. Part of that is driven by a more sophisticated approach to portfolio construction," says Tom Maher, managing director, infrastructure at PATRIZIA.

"If you are already invested with three mega-managers, investing in a fourth is not going to add anything different to your portfolio. Investors are also looking at the drivers of the infrastructure of tomorrow and recognising that themes such as decarbonisation are going to result in smaller, distributed assets, best suited to a mid-market approach."

Furthermore, investors are looking more closely at how value is created, given persisting high interest rates.

"Large-cap core infrastructure is likely to command a return of around 6 to 7 percent. You are better off buying government bonds," says Maher. "The mid-market offers a much better risk-adjusted return. Whether you are looking at core-plus, value-add or opportunistic strategies, the return you get for the risk you take in the mid-market is always going to be better than in the mega-cap space and investors increasingly understand that."

Latifa Tefridj-Gaillard, head of capital formation and investor relations at Infracapital, agrees that the potential for value creation is key to the mid-market's appeal. "LPs understand that there are more levers to be pulled with small and mid-cap assets. They also recognise that there is an easier route to exit, while in the mega-market you are largely reliant on the IPO window being open."

Laurent Chatelin, partner and head of infrastructure at Eurazeol, adds: "In the mid-market, we are not simply relying on leverage, we are providing growth capital to create and develop platforms, we are building to core and generating value when we sell to larger GPs."

In addition, dealflow for smaller ticket sizes is also more robust. "The opportunity set is simply much larger, while at the same time, many managers have drifted away from the mid-market over the past five to 10 years, raising ever bigger funds, which has resulted in attractive supply-demand dynamics," Tefridj-Gaillard explains.

A further benefit provided by the mid-market is the ability to source opportunities on a bilateral basis, according to Roger Pim, senior investment director at abrdn. "The majority of deals that we look at are also primary

Roger Pim
Senior investment director and head of strategy, business development, abrdn

Roger Pim has over 20 years' experience in private markets and been involved in abrdn's infrastructure business since its inception. He is a member of the investment and management committees. Prior to joining in 2002, Pim worked in Goldman Sachs' corporate finance team.

Latifa Tefridj-Gaillard
Head of capital formation and investor relations, Infracapital

Latifa Tefridj-Gaillard joined Infracapital in 2022. She is a member of the firm's investment and responsible investment committees. Tefridj-Gaillard was previously head of European capital formation at DigitalBridge. She also spent more than 16 years at Goldman Sachs International in global markets and investment banking, managing the formation of over $40 billion in funds across the capital structure.

Tom Maher
Managing director, infrastructure, PATRIZIA

Tom Maher is a member of the investment committee for PATRIZIA's mid-market European infrastructure fund series as well as serving on a number of investee company boards. Maher joined PATRIZIA in 2022 as part of the acquisition of Whitehelm Capital. Maher previously led Whitehelm's business development and capital raising initiatives globally across the infrastructure equity, high-yield infrastructure debt and listed infrastructure markets.

Laurent Chatelin
Partner and head of infrastructure, Eurazeo

Prior to joining Eurazeo as partner and head of infrastructure, Laurent Chatelin was a partner at Marguerite where he originated principal investments, primarily in the digital and energy space. Chatelin also spent seven years as a principal investor in the European greenfield and brownfield infrastructure space at ABN Amro and Macquarie Capital. He began his career at Nokia (formerly known as Alcatel-Lucent).

Ian Harding
Managing partner, Arcus Infrastructure Partners

Ian Harding was part of the team that founded Arcus in 2009. Prior to joining Arcus, Harding was part of Babcock & Brown's European infrastructure team and also worked with Citigroup's infrastructure advisory group and NM Rothschild & Sons' natural resources team.

transactions and are typically priced much more attractively than large-cap deals."

Investor appetite for the mid-market does vary by region, however. "Many of the large Middle Eastern, Japanese and South Korean investors still appear to favour global mega-funds. They find scale benefits given the large tickets they have to put to work," says Ian Harding, managing partner at Arcus Infrastructure Partners.

Meanwhile, European mid-market infrastructure, in particular, holds most appeal among European investors, adds Harding. "North American investors' appetite has declined as a result of the crowding-in effect caused by the Inflation Reduction Act. Many US investors are keen to get money back into North American infrastructure as a result of Biden's regulatory programme."

Tefridj-Gaillard, however, says that while historically most investors in infrastructure funds have tended to stay close to home, a shift has been taking place over the past 18-24 months. "Some of those large Middle Eastern LPs, for example, are starting to reach capital allocation restraints and so are not as focused on getting big tickets out of the door. As a result, they are starting to see more value in mid-market strategies. We have also observed Asian and North American investors gaining appetite for Europe in recognition that the region is leading the way in certain fields such as decarbonisation."

Maher found himself in Texas meeting with a large American LP recently that has made a specific commitment to European mid-market infrastructure. "Some of these investors are unable to invest in the mid-market themselves because of their minimum cheque sizes and concentration limits but are working with funds of funds and consultants instead in order to build a mid-market portfolio."

Meanwhile, an emphasis on building relationships with counterparties in the pre-deal phase is helping bridge the gaps between buyers and sellers that have been pervasive in private markets over the past year. "It may take six to 12 months to develop a transaction in the mid-market. It can even take multiple years," says Pim.

"In a typical large-cap auction process, a buyer will be presented with information and then asked to submit a bid according to a pre-determined timeline. That can result in a disconnect in terms of information and relationships. In contrast in proprietary, mid-market transactions you have the opportunity to build a relationship with the other party which means that issues get discussed and expectations can be managed. This includes developing a relationship with the management

"It isn't always about getting the last euro out of the buyer. Deliverability and credibility become more important than ever in an uncertain environment"

IAN HARDING
Arcus Infrastructure Partners

Greenfield vs brownfield…

… or maybe olive or yellow. Which plan works best for you?

Greenfield investing in the mid-market has inevitably been impacted by soaring inflation, but appropriate structuring can mitigate many of these risks.

"We have a separate greenfield infrastructure platform run by a team with project finance and construction finance backgrounds. That team spends a lot of time drilling into the detail of the cost component of construction and negotiating with suppliers to ensure additional protections in contracts," says Infracapital's Latifa Tefridj-Gaillard. "Innovative structures such as earn outs, where contingency payments are made to sellers when projects come to fruition and hedging around energy costs and FX are important as well."

Eurazeo's Laurent Chatelin adds that greenfield investing has always been about how you hedge yourself against what could go wrong. "Today, the emphasis on mitigating the risk of capex overrun and delays through structuring is higher given the macro environment. However, in my experience, that risk is more perceived than real when you have the right mitigants and structure in place and is counterbalanced by the value that can be captured once an asset becomes operational."

Others believe a blend of brownfield and greenfield provides the optimal risk/reward profile. "There are a number of ways in which you can add value. You can buy cashflow through M&A or you can build cashflow through greenfield," says Ian Harding of Arcus Infrastructure Partners. "In a low-cost environment, building the cashflow through greenfield adds more value because you are not having to pay a premium for buying an existing business. But, in an inflationary environment, at some point it will become cheaper to buy than to build. We have what we call an olivefield strategy – a combination of brown and green. We buy operational brownfield but then grow those assets either organically or through M&A."

Roger Pim of abrdn says: "It can be quite difficult to discern what proportion of our portfolio is brownfield and what proportion is greenfield given that we are always looking for accretive opportunities."

"We refer to the blend of brownfield and greenfield as yellowfield," adds Tom Maher of PATRIZIA. "We often supplement brownfield investing with bolt-ons or growth capex. That means you get all the benefits of greenfield investing but with downside protection. You have something there to fall back on."

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TOM MAHER
PATRIZIA

team and ensuring you fully understand and diligence any issues."

The quality of the relationship is increasingly a key determinant of deal-making success. "Sellers are starting to adjust their price expectations in recognition that buyers have a higher cost of debt to factor into their financial models. However, over the past six to nine months we have observed that deliverability and credibility are almost as important as price," says Harding.

"Family-owned businesses and entrepreneurs want to know they are working with someone they can trust to look after their people and who will deliver on what they have promised. It isn't always about getting the last euro out of the buyer. Deliverability and credibility become more important than ever in an uncertain environment."

"Relationships are key in the mid-market," agrees Chatelin. "We

were involved in a management buyout process recently where we didn't proceed to the next round because our bid was too low. But six weeks down the line the company called us to say that the other parties didn't understand what they were trying to achieve, and they wanted to work with us as we shared a common vision in developing the business. Within a day we had come to an agreement based not only on value but also on the way the investment was to be structured to enhance downside protection.

"As the manager of an Article 9 fund, we were also able to provide a lot of expertise in the area of ESG, which the management team valued. In the mid-market, what you bring to the table is more than just capital."

Meanwhile, in terms of closing the bid/ask spread that has inhibited dealflow in many markets, relationship building provides the opportunity to create structural solutions that work for all parties, according to Maher. "Over the course of the relationship building period, it is usually possible to find mutually beneficial outcomes including earn outs and long-term incentive arrangements that ensure our risk on entry is minimised while value created collectively on the journey is shared, thereby maximising alignment of interest."

As a result, mid-market dealflow remains robust. "Rather than experiencing any slowdown, for us the bigger challenge is being sufficiently selective given the number of opportunities we are seeing in the market," says Pim. "Furthermore, we have not seen a material shift in valuations. The reality is that valuations of our existing investments are typically based on discounted cashflows and most financing is fixed for the long-term and fully hedged.

"Yes, rising rates have had an impact on the pricing of new investments but this can be factored into the price and given our long-term horizon has been relatively modest. In contrast, rising inflation has had a positive effect for many assets offsetting some of the increased financing costs. Some less experienced investors seem to believe that this has suddenly become a buyer's market and that we should be able to buy assets on the cheap. In reality, if you are buying high-quality businesses, that is definitely not the case and the impact is more nuanced."

Harding adds: "Public markets react quickly to shocks but we are long-term investors. Macro factors tend to

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LAURENT CHATELIN
Eurazeo

"In a volatile market, lenders are likely to reprice risk and place greater scrutiny on business plans, just like buyers are, but financing is still there"

LATIFA TEFRIDJ-GAILLARD
Infracapital

average out over the cycles. Interest rates and inflation will normalise, so there is no pressure to adjust valuations on a knee-jerk basis."

Increases in the cost of debt also take longer to flow through to mid-market valuations because there is typically less leverage in these businesses. "For existing assets, debt is based on long-term fixed rates and for new assets, leverage is still a relatively small component of the capital stack and so the cost of financing has not materially impacted mid-market valuations," says Maher.

Tefridj-Gaillard, meanwhile, comments that while rates have increased, credit spreads have not changed significantly. "In sectors such as energy transition, it is still easy to access financing, and while in other sectors such as fibre it has become more challenging, overall, there is still appetite for mid-market infrastructure amongst debt funds, institutions and banks. Processes can take longer. In a volatile market, lenders are likely to reprice risk and place greater scrutiny on business plans, just like buyers are, but financing is still there."

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ROGER PIM
abrdn

Hot opportunities

Inevitably, the energy transition and digital infrastructure are among the most popular sectors with stubborn valuations for the most hotly contested assets. But mid-market investors see pockets of opportunity, nonetheless.

"The electrification of transport is a sector we really love, whether that involves EV charging or shifting the movement of merchandise from road to rail and electrifying fleets of trains," says Tefridj-Gaillard. "Digitisation is obviously another hot theme. Given our target returns, we are not focused on towers or hyperscale data centres, but we do see regional co-location data centres as an attractive space. A lot of businesses are moving data storage and computing power off premises but are not willing to fully rely on public cloud solutions and regional co-location is poised to pick up some of that demand. We are also seeing MNOs [mobile network operators] struggling with the capex required to invest in 5G roll-out, for example, which is creating opportunities to invest in neutral host providers."

Harding agrees that demand for digital assets has grown to such an extent that the prices being paid for hyperscale data centres have become astronomical. "We have therefore changed our approach and are looking to build a platform of regional colocation data centres, while adding a bit of greenfield in a modular fashion. We are building cashflow rather than buying."

Chatelin adds: "The mid-market is all about creating value through expanding platforms and building out your assets so that in five to seven years' time they will have reached a scale where the big funds are competing for them in auctions.

"That is particularly true of all the transitioning themes including the decarbonisation of energy generation, the electrification of transport and industrial processes and energy efficiency. There is also a lot that can be done around the transition of waste management from incineration to recycling and the circular economy. The big incumbents are making lots of money out of the old ways of doing things. It is small and medium-sized businesses that are leading the transition. We can provide capital to support their growth and deliver value for our investors."

Pim agrees: "The transition space is providing a lot of opportunities whether that's around waste, new alternative fuels or associated storage services. There are also some really interesting consolidation plays – rolling up subscale assets into sizeable platforms. Almost irrespective of geography or sector, we believe you can find more attractive risk-return profiles in the mid-market than you can in the large-cap space. The mid-market really does have it all." ■