Infracapital

Finding solid infrastructure opportunities in uncertain times

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, real estate and infrastructure, recently spoke with **Mark Chladek,** head of brownfield at Infracapital, about where to find infrastructure opportunities in the current macro environment. The following is an excerpt of that conversation.

We are living in uncertain times. How do you think infrastructure strategies will perform in the next few years?

We are always in uncertain times, but this does seem to be a particularly heightened period, especially in the financial markets. In times like this, infrastructure is a very attractive asset class because its assets tend to be long term, with relatively low risk and a low correlation to financial markets. If we look at how correctly executed strategies match up against the individual macro uncertainties, we are confident that infrastructure can hold its own. For example, infrastructure typically has a strong resilience to inflation, which can give investors inflation protection. Looking at rising interest rates, which characteristically go hand in hand with inflation, every real asset has some exposure, but we use hedging strategies to protect our investments. Finally, infrastructure investments can have some linkage to GDP, but we focus on essentiality and resilience to mitigate this, in addition to diversification. So, overall, I think infrastructure is well placed, and the market uncertainty should only increase demand for the asset class as part of people's investment strategy. That doesn't mean that there aren't challenges, however.

What are the key challenges you think infrastructure investors could face?

There are several challenges, but I think the one that jumps to the top for investors is: What are appropriate returns for an infrastructure investment? And the corollary: How do we achieve those returns without undue risk? We've mentioned that we are in uncertain times. With a strong likelihood that we are moving into a recession, plus continued rising interest rates – plus continued fallout from the pandemic – valuing assets appropriately will take a skilled manager. As an experienced manager, we have been through previous challenging markets, including the GFC and COVID-19, and come out on the other side well. We focus on robust infrastructure characteristics and driving value from our portfolio companies, so we are not reliant on returns from market movements. We have also focused on macro trends and new infrastructure sectors for strong growth potential. We were early investors, for example, in the smart metering market, in rural fiber and sustainable energy solutions, to name just a few. To drive superior returns in this market, we believe you can't just stick with the status quo.

What are some of the macro trends you think will shape your future investments?

Climate change and environmental issues – and the required investment – are obviously massive areas for opportunity that shape both what we do with existing portfolio companies, as well as driving new investment sectors. To meet this challenge, we have a greenfield strategy, which is aimed at earlier stage and more developmental areas of the market, while still keeping the infrastructure discipline. We also have a long-established and successful brownfield strategy that acquires more mature businesses that may invest in new infrastructure, in addition to transitioning existing assets to cleaner energy solutions.

Infracapital has recently invested in two businesses – Recharge and Gridserve – which are well-positioned EV-charging providers in the Nordics and United Kingdom, respectively.

On the transport side, we have recently acquired BCTN and MCS, which provide barging solutions across the Netherlands and Belgium. These businesses are at the forefront of shifting freight from congested and carbon-heavy road transportation to a much cleaner solution. To drive further environmental benefits, we are investing to transition from fossil fuel–driven barges to electrified vessels.

We see this environmental drive across many of our portfolio investments in sectors including electricity- and heat-storage solutions and sustainable heating, and we are currently looking at even newer technologies, such as hydrogen, to determine if they are a fit for our funds as infrastructure investments.

Many believe we will not meet the 2050 net-zero targets on renewables alone, so how important is decarbonizing existing assets?

We think it's very important. We see a huge opportunity in transforming the legacy of existing businesses. In the United Kingdom, we own GB Railfreight, which is a large and growing rail-freight operator. We are investing a significant amount to transition from diesel locomotives to much cleaner bimodal or fully electrified rolling stock. We believe the macro trend for that business – getting freight from our congested roads onto rail – is a very positive step and contribution in the move toward net zero. So, we are not only cleaning up the rail business, but we are lowering the carbon footprint of the distribution network by reducing the number of trucks on the road and the congestion that often accompanies them.

Are you investing in sustainable energy sources?

More recently, we have not been investing significantly in the traditional wind and solar renewables spaces, due to lower expected returns as the sector has matured. We have been investing significantly in other sources and storage, however, such as sustainable heat, and thermal and electric batteries. We have significantly invested in a geothermal-heating solutions business in the Netherlands called Eteck, which is a market leader in installing and owning sustainable heat solutions in residential and commercial buildings. We also own a last-mile utility connections business in the United Kingdom called Last Mile Infrastructure. Historically, it has installed and owned the last mile of gas pipework to new housing developments. With the future ban on gas boilers, it is now offering a ground-source heat-pump solution to property developers. We have found these less-mainstream opportunities have provided high-growth opportunities with more attractive returns.

Are there challenges of being an early adopter?

There are, and it is critical for early adopters to do their homework. We invest significant time to make sure the investments and sectors fit our infrastructure criteria. It can be easy to stray into the venture capital category, especially when investing in companies using new technologies. But that drift can be avoided if you have strong discipline and due-diligence processes that underpin your infrastructure investment strategies.

Are there regions with more opportunity than others?

We are seeing a huge amount of private sector–driven investment in the energy transition in Europe. The number of countries, the different approaches and the entrepreneurship that has led to some of these businesses being developed are combining to create a huge amount of opportunity for infrastructure funds like ours. There are also larger corporates in Europe who, for varying reasons, need to raise money from infrastructure partners. We are seen as a strong partner on those sorts of opportunities, where we can grow the operations of a noncore area to become fully independent businesses. A recent Goldman Sachs analysis concluded that about $10 trillion of investment will be needed in European infrastructure by 2050 if it is to hit the net-zero target. So, we see huge opportunity for new investment, as well as strong political support to do that.

How important is ESG to your investors?

ESG is incredibly important to our investors; it is also incredibly important to us as the investor in the underlying infrastructure. We are seeing more and more investors who are very knowledgeable about ESG, and they are measuring our performance as a manager by their ESG requirements. We welcome that scrutiny. We have had ESG as part of our process for a long time, and we are keen to demonstrate to our investors how we are delivering ESG goals across our portfolios. ESG continues to be intrinsic to everything we, and our businesses, do. We are on board with an approach of total transparency and providing as much information to investors as we can to demonstrate what we are achieving. As part of our commitment to transparency, we have welcomed and encouraged a shift toward standardization, such as the SFDR classifications for funds, which will help our investors be able to measure and compare managers.

Does it provide inflation protection? What are the downside risks and upside potential, and have we priced it appropriately? If we can answer those questions to our satisfaction, as well as see the growth possibilities, then we are confident we can deliver attractive returns for our investors — as well as help the planet move toward net zero.

So many infrastructure managers have moved into the energy-transition space. How can you still aim to make premium returns for investors?

We have been in this space a long time, well before it attracted the attention it does today. We have been an investor in sectors such as smart meters, sustainable heating and renewables well before they became mainstream. We continue to look at the investment needed in emerging sectors that support the energy transition. It is not necessarily a congested market, given the scale of investment that is needed. The key things we have focused on when looking at a new investment revolve around answering the questions: Is it — and more importantly, will it be — essential and resilient in the long term? Does it provide inflation protection? What are the downside risks and upside potential, and have we priced it appropriately? If we can answer those questions to our satisfaction, as well as see the growth possibilities, then we are confident we can deliver attractive returns for our investors — as well as help the planet move toward net zero.

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CORPORATE OVERVIEW

Infracapital invests in, builds and manages a diverse range of essential infrastructure to meet the evolving needs of society and support sustainable long-term economic growth. Infracapital takes an active role in all of its investments to ensure they are adaptable and resilient, while working closely with local communities. Infracapital has raised and managed more than £6.8 billion ($7.8 billion) across six funds since 2001.

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