Infracapital

Delivering value in European mid-market Infrastructure

Recently, **Chase McWhorter,** managing director of infrastructure at Institutional Real Estate, Inc., spoke with **Martin Lennon** of Infracapital. The following is an excerpt of that conversation.

Is politics in Europe a key concern for the infrastructure market?

Europe has certainly experienced a turbulent few years when it comes to politics: a series of national elections has seen the rise of populist parties on both sides of the political spectrum; the United Kingdom's post-Brexit future appears no clearer after more than a year of negotiations; and more recently, Catalan secession seems a possibility following impassioned demonstrations across Catalonia.

> *"Europe requires €2 trillion of investment in infrastructure by 2020…."*

Despite this volatility, the infrastructure market has remained resilient. In fact, increased infrastructure spending appears one of the few policy areas politicians can agree on. Infrastructure investment is widely understood as pivotal to Europe's continued economic growth and competitiveness on the global stage, especially during a period of prolonged uncertainty. This is underpinned by national and international infrastructure policy, notably the Investment Plan for Europe (the "Juncker Plan"), which the European Commission recently agreed in principle to extend and reinforce, seeking to mobilize €500 billion of investment in the real economy by 2020. With the European Commission estimating that Europe requires €2 trillion of investment in infrastructure by 2020, well beyond the means of constrained government and corporate budgets, the market continues to attract significant private capital.

How have investors responded to this?

In some ways the Brexit referendum result has seen increased interest in the perceived "safe haven" of infrastructure. Investors recognize that infrastructure can provide attractive returns when the market is unpredictable. This has been evidenced through the strong performance of infrastructure sectors during the global financial crisis and subsequent recession. Institutional investors continue to increase their allocation to the asset class, attracted by its defensive characteristics, low correlation to the wider market and potential to deliver steady cash yields. We note that in a recent Preqin study, some 53 percent of investors indicated that they are looking to commit more capital to infrastructure in the next 12 months than in the previous 12 months.

Martin Lennon has been Head of Infracapital since its inception in 2001, and has over 25 years of infrastructure, project finance and investment experience. Prior to founding Infracapital, Martin led the Project & Infrastructure Finance business at M&G, having joined the company in 1998.

Infracapital has invested in over 40 significant European infrastructure businesses or projects since its inception.

Can the market cope with this influx of capital?

This steep rise in demand has undoubtedly resulted in prices tightening in certain sectors and/or deal types. Dry powder has increased markedly and more managers are competing for large trophy assets. These competitive auction processes can attract lower cost of capital bidders that contribute to driving purchase prices higher and returns lower. Though record breaking sums of capital have been raised in recent years, it's increasingly concentrated in an ever smaller pool of mega-funds that necessarily are targeting big ticket deals.

Conversely, deal flow in the European mid-market remains strong and compelling value can still be found by experienced and well-resourced managers capable of originating lowly competed deals. Of the near €65 billion capital that was raised in 2016 focused on infrastructure, only 5 percent will target the European mid-market, according to Preqin. By focusing on mid-market assets with an EV of less than €1 billion, it is still possible for experienced managers to leverage non-price factors to secure bilateral deals.

Where can you find these less competed deals?

There's no simple formula for sourcing bilateral deals, but it tends to come down to relationships, experience and a focused proactive approach to deal sourcing. It's crucial to have a strong network covering all target geographies and sectors. In our experience, a transaction team should be predominately on the ground meeting with local banks, specialist advisers, asset owners and key stakeholders. If your first activity on a deal is opening the pitch book that a major investment bank has sent you, then it is probably already too late to secure that asset at a good price.

A number of our recent investments were originated through such direct relationships with vendors, including family owners, entrepreneurs and larger corporates. In all instances, a local footprint and reputation as a trusted partner were critical factors to secure the deal. In addition, the relationship with management prior to financial commitment allows for more comprehensive due diligence, and the lack of bid deadline enables the development of bespoke transaction structuring.

Value can also be extracted by targeting complex deals that can only be sourced by a manger with considerable execution expertise. This could include transacting on assets that require

Calvin Capital: A utility company division transformed into a standalone business through a platform approach

Sourced bilaterally, the business was grown from an initial £35 million investment in 2007 into a leading national provider of smart electricity meters. By applying an active management approach and executing a number of follow-on investments, Calvin Capital's meter base was more than tripled during 10 years of ownership, achieving a 17 percent compounded annual EBITDA growth.

The asset management team played a key role developing the business.

- Drove transition to a standalone business, assembling a strong management team
- Maximized market potential, diversified customer base and added new contracts with "Big Six" suppliers
- Delivered on smart meter growth opportunity by capturing greater market share
- Implemented an advantageous capital structure

separation from a parent company, consolidation under a new management structure, or the establishment of a new executive team. Typically these deals aren't pre-packaged and require a lot of support and guidance in the transition to a strong standalone business, therefore having a dedicated team of active asset managers with credible commercial experience is vital.

Another way in which managers can differentiate themselves is through targeting platform assets in sectors that demonstrate opportunities for growth or fragmented markets requiring consolidation. The initial investment may be unlikely to attract attention, but by scaling a business through follow-on investments, either by organic or inorganic growth, a significant value arbitrage can be achieved. In doing so, a business can benefit from scale efficiencies and network synergies, deliver co-investment opportunities and attract a large buyer set at exit.

How do you navigate the uncertainty and opportunities available in a changing market?

Infrastructure used to have a reputation for being slow moving, but with the advent of smart cities, autonomous vehicles and a changing energy mix, it's become anything but. Managers must innovate to deliver value, recognizing that yesterday's strategies are no longer sufficient to tackle the challenges of the future. However, that does not mean rushing to invest in the latest technology that grabs the headlines. As new opportunities arise, manager's must be disciplined and avoid taking undue risk in any unproven industries.

Infrastructure investments should first and foremost demonstrate proven essentiality. Fledgling sectors may offer attractive returns in the short term, but to deliver long-term value a manager should consider the asset's value over at least a 20-year time horizon. Infrastructure investing should never involve taking technological bets on sectors at risk of redundancy. Investors allocate to the asset class precisely to protect themselves from short-term volatility and should be wary of manager's stretching the definition of infrastructure.

> *"5 percent of capital raised in 2016 will target the European mid-market."*

How does ESG fit in this?

Environmental, Social and Governance factors must be recognized as value levers in their own right and should be a key consideration for any investor in today's market. Failure to take ESG seriously can result in underperformance at the portfolio company level and can expose managers to serious reputational risk. We don't see this trend changing as LPs continue to demand more sophisticated ESG reporting. When realizing our first fund, we also found that clear ESG policies and processes implemented by our portfolio companies proved a big selling point to prospective buyers.

Thankfully strong corporate governance has long been central to infrastructure businesses because of the essentiality of their service, large customer base and close scrutiny from regulators. However, increasingly we see the European ESG agenda driving investment opportunities too, resulting from national and supranational commitments to decarbonization, as well as the continued drive toward sustainable cities in accordance with the 2015 Paris Climate Agreement. A manager's ability to identify and capitalize on these trends can differentiate them in today's competitive market.

CORPORATE OVERVIEW

Infracapital is a European infrastructure investor based in London, with significant experience in mid-market investing, having raised and managed over £3 billion of funds since 2001. Infracapital invests in essential infrastructure assets across sectors including utilities, transport, renewables, telecommunications and social infrastructure assets.

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