KEYNOTE INTERVIEW

# Out with the old, in with the new?

*Infrastructure has changed considerably over the past two decades, bringing significant opportunities for investors. But while this has transformed the way managers assess risk, many of the principles remain, says Infracapital's Peter Mitchev*

The nature of infrastructure is changing rapidly as societal needs shift. No longer just a set of discrete physical assets, infrastructure has broadened and the boundaries between sectors are dissolving and becoming increasingly interconnected.

This brings a massive investment opportunity. McKinsey & Co recently estimated that cumulative investment in infrastructure will reach $106 trillion by 2040 across transport and logistics, energy, digital infrastructure, agriculture, waste and water.

There is clearly a lot to go for. But these changes also bring new potential pitfalls for infrastructure investors.

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Peter Mitchev, managing director at Infracapital, outlines some of these transformative trends as well as what it takes to capture today's infrastructure opportunities while carefully managing the risks.

**Q How is the definition of infrastructure shifting, and what's driving that?**

At its simplest, infrastructure is defined as assets that are critical to the functioning of society. As society's needs and priorities change over time, so does the infrastructure that underpins those needs. If we look back 10 to 20 years, there's been a significant shift in priorities. Clearly, technology wasn't such a massive part of our day-to-day lives 20 years ago. And, also, the drive for decarbonisation was still an aspiration rather than a reality.

There are so many new opportunities that didn't previously exist. Not so long ago, infrastructure was mainly regulated utilities, some wind and solar power generation, ports, airports and roads. Today, the landscape of potential investments is much broader, but the fundamental principles of infra

### What are the big trends for the future of infrastructure?

In the UK, heating needs to be decarbonised and so we'll see more investment in heat pumps. That's still a relatively nascent market. Further ahead, sustainable aviation fuel and hydrogen have been talked about for some time. The issue has been that the contractual arrangements and protections for infrastructure investors are not there just yet. But this will change over time, and you'll see more capital put to work in those areas.

And then there's the trend for democratisation of the asset class. It's a testament to how secure and essential infrastructure is that we're now seeing a shift to give access to individuals as well as institutional investors.

Overall, infrastructure is a fascinating space. It's evolving fast and one of the big attractions is that it's about making returns for investors as well as contributing to society.

investing – visibility of cashflow, barriers to entry and an asset base – remain.

### As infrastructure has broadened, how has the opportunity and risk landscape changed?

The type of risks infrastructure investors manage has changed markedly. That's true right across the spectrum of core, core-plus and even value-add. One area we have to consider carefully today is the interconnected nature of infrastructure. In the past, there was relatively little overlap between different sectors. You'd have a water company, wind farm, port and so on. These assets had limited to no interaction with one another.

In today's world, a single asset class or theme can generate multiple investment opportunities. If you take data centres as an example, an infrastructure fund can invest directly in a data centre. But there's also an opportunity to invest in decentralised energy generation and/or fibre connectivity. This creates an opportunity for synergies across portfolios. Of course, if pursuing this type of strategy, it's important not to be over-exposed to a single asset.

### How can potential risk be mitigated?

There's clearly been a shift towards lesser-known asset classes with a larger development component. When pursuing these opportunities, it's key to stick to the fundamental principles of infrastructure, which I mentioned earlier. You need a model that avoids 'build it and they'll come' as much as possible. Your capital needs to be secured by revenue before you invest.

Inevitably, there can be bumps along the way, such as labour shortages, delays in grid connections or less secure revenue streams. It's vital that you have downside protection and sufficient levers within the business plan to absorb such potential shocks.

Our investment in Neos illustrates this well. The firm recently signed a contract in the UK with Network Rail, Project Reach, to lay brand new fibre along railways and create a digital backbone for new data centres as they build out. We've achieved a win-win for both parties – we have strong capital protections in the contract, while providing a commitment to roll out a significant amount of fibre to support the UK's digital ambition.

### What is the attractiveness of new business models?

The energy transition is a huge, long-running trend, with shifting business models playing out for some time. My first investment at Infracapital in 2015 was a district heating and industrial energy solutions platform called Adven. The investment theme we backed through the acquisition was the decarbonisation of industrial energy generation.

When we bought the business, many people questioned whether it was infrastructure because of the potential for contract renewal risk. That's a risk we see in a lot of assets today. But if you look at the model, the business was providing heating solutions to a diverse client base, none of whom were energy experts. These clients want to focus on their core activity and de-risk energy generation through outsourcing. The projects that we bid on delivered double-digit unlevered return with a large fixed-fee component, and through active and early engagement with customers there was a strong track record of renewal.

I'd also point to EV charging, where we were an early investor. This sector has seen massive inflows of capital over the years, much of it in the growth stage. However, before we made our first acquisition, we spent a lot of time screening opportunities across Europe. We didn't invest in any of these because we couldn't get comfortable with the plans to turn these businesses from capital-intensive growth platforms into cash-generating businesses.

Ultimately, we acquired a 70 percent stake in Fortum's Nordic EV charging business because we were comfortable with the fact that it had an early-mover advantage. The company could secure attractive sites, it already had an operating asset base and Norway, where it predominantly operated, has one of the most developed EV charging markets in the world. We've been able to de-risk with fleet agreements, too. The business is now EBITDA positive, and we've been able to de-risk the revenue stream through fleet agreements. Recharge is now well positioned to be a consolidator in a market that's seen a lot of capital in a short space of time.

And finally, in our investment in battery storage business Zenobē, we reshaped the business model. It was a front-of-the-meter BESS provider when we invested. While that can be lucrative, it's also exposed to revenue volatility. Since the acquisition, we've focused more on behind-the-meter solutions with more capacity-based revenues. It's important to tap into the opportunities new concepts and technologies bring. But you have to stick to the fundamental principles I mentioned earlier: having an asset base with steady and visible cashflows.

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**Q Beyond decarbonisation, what other macro themes are important today?**

One key macro theme that's emerged since the war in Ukraine is energy security. That's playing out, alongside decarbonisation, in Europe today. But the macro picture is also important in financing our investments.

Previously, we were living in a low-interest-rate environment. That's no longer the case and so infrastructure investors need to think carefully about how they mitigate financing risks, especially when considering assets that were bought when the cost of debt was lower. Active asset management and driving operational excellence across portfolios are now more important than ever.

**Q What are some examples of how to achieve this?**

Interest costs have gone up, but now we have artificial intelligence to help manage costs. One example in our portfolio is UK rail freight company GB Railfreight (GBRf). We have a big fleet of locomotives and a significant workforce. We're now using AI to optimise the scheduling of this workforce and becoming more efficient and driving margin improvement. We have to think creatively. And if we have a negative impact in one area of our investment case, how can we roll up our sleeves and make up the value elsewhere?

There's also a decarbonisation story here that improves GBRf's revenue prospects. Rail freight is already less carbon-intensive than road. We're introducing the first new locomotive to the UK market in 25 years, and they're hybrids, using electricity and biofuels. This feeds into reducing the Scope 3 emissions for GBRf's clients, so that's a massive positive for the business and the world. ■