OPPORTUNITIES & CHALLENGES IN EUROPEAN INFRASTRUCTURE

- Martin Lennon, **Infracapital**

Tom Carr: Does Europe still represent an attractive region for infrastructure investors?

Martin Lennon: In spite of continued interest in the space, the European opportunity set for infrastructure remains as broad as ever both in terms of sectors and geographies. Infrastructure investment has not just been supported, but actively promoted, through national and international infrastructure policy, affirming its power to boost Europe's continued economic growth and competitiveness at a global level.

Few people dispute the need for new infrastructure investment across the continent. The European Commission estimates that Europe needs €2tn of investment in new infrastructure by 2020, which is likely to require significant private sector involvement. However, there is still a substantial need to expand, strengthen and reinvigorate the existing infrastructure base, providing an ideal opportunity for institutional investors.

TC: How has the market responded to this growing opportunity?

ML: Continued growth in investor demand has undoubtedly resulted in more competition in certain sectors and/or deal types. Having realized a number of investments over the previous year, it is clear that the breadth of potential buyers for infrastructure assets has expanded markedly since we acquired those businesses approximately a decade ago. This demand has also led to many managers altering their investment strategies. Some GPs have increased their fund size in order to accommodate more capital, targeting larger deals. Conversely, others have moved up the risk spectrum, targeting a wider set of investment opportunities, or seeking to differentiate themselves by specializing in specific sectors, geographies or technologies.

TC: What has been Infracapital's approach?

ML: We see value in pursuing two distinct but complementary strategies. A greenfield strategy may target the same essential infrastructure assets as a brownfield approach, but invests earlier in the project lifecycle during the late development or early construction phase. It has been very satisfying to see investors buy in to this new strategy. We see it as a less competed market segment yielding significant opportunities for a skilled manager.

In the brownfield space we see potential in smaller, more complex opportunities that offer stable returns but the prospect to improve performance through active management or growth. Also, by focusing on the mid-market, well-connected managers can find bilateral deals or opportunities with limited competition.

TC: How can you find these lowly competed opportunities?

ML: Achieving this usually simply comes down to a strong network of relationships, experience and a focused proactive approach to deal sourcing. In our experience, a transaction team should be proactively on the ground meeting with local banks, specialist advisers, asset owners, key stakeholders, etc.

A number of our recent investments were originated through such direct relationships with vendors including family owners, entrepreneurs and larger corporates. A reputation as a trusted partner can also play a vital role. In addition, building a close relationship with a target's management team prior to financial commitment, typically outside of a rigid bid deadline, allows for more comprehensive due diligence.

Value can also be extracted by targeting complex deals that require considerable execution expertise. This could include transacting on assets in need of separation from a parent company, consolidation under a new management structure, or the establishment of a new executive team. Typically these deals demand a hands-on approach led by a dedicated asset management team that can support the transition into a strong standalone business.

Another way to potentially create value and avoid competition is by gradually building scale and value over time in sectors that demonstrate opportunities for organic growth or in fragmented markets ripe for consolidation. An initial small investment may be unlikely to attract wider market attention, but by scaling a business through follow-on investments a considerable value arbitrage can be achieved at exit.

TC: Are platform investments not more of a private equity play?

ML: When it comes to platform investing, prudent managers must not rely on growth to support the initial investment, that is the key difference. Risks can be mitigated by targeting strong operating assets that should deliver in line with investment remit irrespective of growth. However, by identifying macro trends and leveraging asset management expertise, experienced managers can develop broader platforms.

As our experience with Calvin Capital shows, platform investments can deliver a number of benefits to LPs. Entering at a smaller size often allows for an attractive entry multiple: as the business grows, capital can be deployed prudently through tranche investments in an efficient, low-cost manner, often on a bilateral basis. Plus, as the platform develops, investors can benefit further from economies of scale as our asset management team seek to capture operational synergies. Further to this, platforms can also deliver co-investment opportunities with more transparent timelines that suit potential co-investors.

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CASE STUDY: CALVIN CAPITAL

The business was sourced bilaterally using our relationship network, and from an initial investment in 2007, it was grown into a leading national provider of smart electricity meters. Through active management and follow-on investments Calvin Capital's meter base was tripled under Infracapital's ownership, achieving a 17% compounded annual EBITDA growth. The asset management team played a key role developing the business, culminating in a strong 2017 sale outcome by:

- Providing assistance in the transition to a standalone business through a hands-on approach
- Maximizing market potential, diversifying the customer base and adding new contracts
- Delivering on the growth opportunity by capturing greater market share in a new technology
- Implementing an advantageous capital structure

TC: What about the risks of this kind of active asset management approach?

ML: In our view, asset management teams should comprise individuals with a significant amount of industry experience, to ensure they possess the skills required in managing carve-outs, implementing new systems, optimizing businesses and, should the need ever arise, the ability to step into a management role. However, we also place considerable importance on developing high-quality executive management teams within portfolio companies with the appropriate level of empowerment to deliver our strategic aims.

In many instances, it can be possible to optimize performance without taking undue risk, indeed in some regulated businesses major shifts in strategy are simply not feasible. This does not however limit the ability to realize material upside. By working closely with management, asset managers can provide the necessary support and incentives to drive business improvements. This may include relatively subtle changes such as initiating a culture shift, enhancing governance processes or placing an emphasis on customer service, yet together we have seen that these factors can compound to deliver superior risk-adjusted returns to clients.

TC: Technology is the latest buzzword in infrastructure. Should investors be wary?

ML: We understand the importance of keeping abreast of new technologies in the sector, recognizing that it poses both threats and opportunities to the asset class. However, before investing it is important to ensure that any new innovations truly meet the definition of infrastructure. Classic infrastructure assets usually come with high barriers to entry and limited exposure to technological change. They provide essential services, therefore experiencing relatively consistent demand throughout the economic cycle.

We must also satisfy ourselves that the risk of redundancy is minimal. As most infrastructure assets typically have useful lives of 20 years or more, managers should never rush into unproven sectors that run the risk of failing to deliver long-term value. One of the qualities that attracts LPs to the asset class is its relatively low short-term volatility; therefore, investors should be wary of managers that are willing to make technological bets and are liberal with the definition of infrastructure.

TC: How do ESG factors fit into your approach?

ML: We believe ESG should be fully incorporated across a manager's business, including through the full lifecycle of its funds and portfolio companies. Increasingly we now see the European ESG agenda becoming a growing driver of investment opportunity, underpinned by commitments to decarbonization and digitization at a national and supranational level. This can offer specific opportunities like Calvin Capital, which benefited from the policy-led transition to smart meters, or create opportunities for new strategies such as diversified greenfield investments.

With regards to asset management, robust corporate governance is critical to a successful approach. It has long been considered a key priority in the sector because infrastructure assets provide an essential service, possess a broad customer base and are closely scrutinized by regulators. We believe it is important for asset managers to spend considerable time engaging with all stakeholders to understand the role of assets in the communities they serve, which ultimately drives value for investors.

INFRACAPITAL

Infracapital is a leading European infrastructure investor based in London, with significant experience in mid-market investing, having raised and managed over £3.3bn of funds since 2001. Infracapital invests in essential infrastructure assets across sectors including utilities, transport, renewables, telecommunications and social infrastructure assets. Infracapital has invested in over 40 significant European infrastructure businesses or projects since its inception.

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