Analysis

KEYNOTE INTERVIEW

Global view, local execution

The mid-market offers a diverse range of benefits for infrastructure investors, says I Squared Capital's Gautam Bhandari

A mid-market emphasis can give investors an attractive entry point into infrastructure, providing access to assets with the potential to scale and transform. However, only managers combining global capabilities with local talent can ensure diversification, seize opportunities in fields like artificial intelligence, and avoid the trap of too narrow a geographic or sectoral focus, explains Gautam Bhandari, co-founder, managing partner and global CIO at I Squared Capital.

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Q What's the attraction of the mid-market today for infrastructure investors?

The infrastructure market has thousands of young companies with the potential to transition from small-cap to mid-cap, and from mid-cap to large-cap. And linked to this is the potential to build platforms; about half of our investments are platforms, and the vast majority of those are self-built.

From an investor perspective, that means being able to come in at cost, or close to cost, without paying a big premium for a large existing asset. That gives you a margin of safety on your investment. And because of that cost advantage, you get very attractive dividend yields. It's the place to be if you want stability and cashflows.

But it's only when you transition from small-cap to mid-cap – or mid-cap to large-cap – that you actually de-risk an asset and create value. Mid-cap entry multiples can be 20-30 percent lower than in large-cap. But if your company is still mid-cap when you sell, then you'll get the same multiple on exit. There's no free lunch. You only get a premium when you de-risk and stabilise an asset.

Q What are the benefits of platform building versus acquiring standing assets?

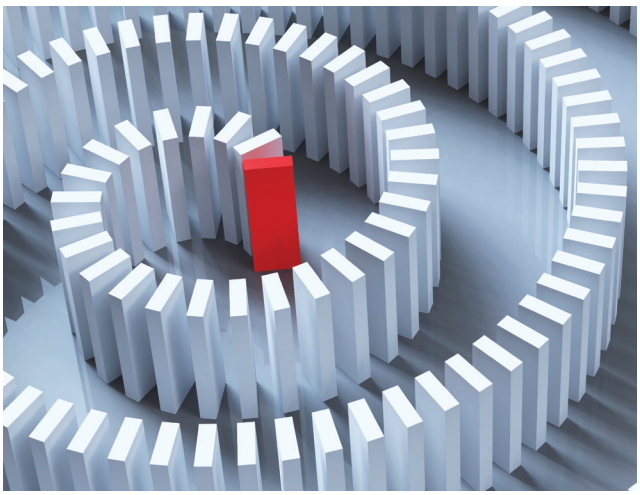
In addition to coming in at cost, you don't have any legacy assets that might be a drag when building a platform. Instead, you're building with the

future in mind. And by virtue of that, you own younger, long-lived assets with the latest technology – creating a forward-facing company.

It takes time and a lot of GP resources, but the ultimate advantage is the returns. Time and time again, for the same risk, mid-cap funds tend to outperform large-cap.

Take the example of Energia, the Irish utility we bought in 2016. As the Irish economy grew, we expanded the renewable portfolio to 408MW, investing more than €2 billion of capital at cost. EBITDA increased from around €133 million to about €325 million at exit, at a time when many large European utilities were actually declining in profitability. It's a good example of using the mid-market approach of building assets for the future to make a modern utility, rather than being straddled with legacy plants. The result was that we exited at a record multiple and consistently compounded capital at a gross IRR exceeding 20 percent over nine years.

"Supplying the picks and shovels to the big data centre boom can still produce mid-teen returns"



Q What risks do you need to be aware of when bringing together assets into a mid-market platform?

You need to be very good at handling operational risk. You're not taking on leverage as the driver of value creation; you're taking on a set of operations. As a mid-cap specialist, you really need to be into the details of every company and how to scale it.

You also need to be able to do this globally. As a consequence of the size of their funds, mid-cap operators tend to be focused on a single country or sector. In today's world, that might mean raising a $3 billion fund for a North American digital strategy. While that sounds very exciting, it's also a sector that's fully priced, if not overpriced. It was a similar story in midstream energy when shale gas emerged. A lot of investments that went in at the peak of the cycle didn't do well.

On top of talent to handle operational risks, diversification is what really helps avoid these "hot sector" traps. With our $15 billion fund, we execute around 30 transactions across geographies and sectors. Every time investors go against that core rule of finance – diversification – they lose.

Q What other skills do you need in the mid-market?

You need to know how and when to build, if buying is expensive. And when you have built an asset once, you know you can do it again. That keeps you price-disciplined – and that's an important quality to have.

Another key attribute is to have a global view, but local investment execution. A lot of technologies are simply transposed from one geography to another. Whether stabilising the grid or running a gas turbine – the technical solution is always the same. Procurement is also global and brings the advantage of scale, such as negotiating with suppliers for discounts.

But other activities like permitting and development are local. If you're going to get development done in Texas or Ireland, then I suggest you hire Texans and Irish engineers. We've had localised teams on the ground in our markets for 13 years, and our platforms are staffed by local management teams. Our Japanese platform, for example, is run by Japanese professionals and, as a result, is well integrated into society.

Q How does AI infrastructure fit into the mid-market, especially when investments are often on a huge scale?

Every day there are announcements about new $50 billion or $100 billion data centres. While that's great for society, I'm not so sure it's great for

investors. Many of those transactions are being done at cap rates in the low double digits. If you compare with other transformative technologies, like the creation of internet, a lot of telecoms infrastructure was built at very similarly aggressive assumptions. This was to the detriment of infrastructure investors at the time.

We think you can play the AI trend by investing in power and fibre, and many other things that don't require a $50 billion investment. Supplying the picks and shovels to the big data centre boom can still produce mid-teen returns. Sometimes, we also find better risk-adjusted returns in credit, because the equity returns are not much more than those of credit.

We currently own more than 50 data centres globally, and those are edge data centres where inference is taking place. People's interaction with ChatGPT is not occurring in the large language model data centre; it's happening in cities, so that the latency period is low.

At Energia in Ireland, we signed a contract to build a data centre for Microsoft right in the Huntstown power plant just outside Dublin. The investment is keeping an ageing power plant alive, and it adds brand new wind farms to meet the energy demand of the data centre. It's a win for all parties and it all comes in the form of a modern, integrated utility enabled by the transformation of a mid-sized asset.

Q How do concerns about an AI bubble affect data centres and other assets?

We think about this question every day. Along with attention comes cheap cost of capital and a lot of risk being thrown out of the window. We think there are sometimes better risk-adjusted returns in ancillary assets that aren't solely dependent on AI. For example, power consumption in the US is on the rise with or without AI because of re-industrialisation. Dual-use infrastructure assets have far better downside protection. However, we're big believers in AI – it's a transformative technology that will change society. Our only quibble is with the returns, so we can find different ways to play it.

"Nearly every government today welcomes private involvement in infrastructure in a way that hasn't always been the case"

Q How do geopolitical factors such as sovereignty and deglobalisation impact infrastructure?

Deglobalisation means re-industrialisation. Governments in the US, Europe and India want to re-industrialise, not only for security of supply, but also to create local jobs. For years, governments delayed capex. But that trend is now reversing and will lead to what we believe is an infrastructure supercycle, replacing ageing infrastructure and creating new infrastructure to cater for factors like AI or climate change. The desire to re-industrialise is a terrific tailwind for mid-market infrastructure.

Q How are governments making that possible and what's the role for private capital?

While there's a desire to build modern infrastructure, the balance sheet of almost every country is over-leveraged. Some sectors today are open to private investment, like telecoms, and others are still largely held as public goods. It remains to be seen whether some governments will choose to monetise existing infrastructure to free up investment for education, health and other essential services. However, nearly every government today welcomes private involvement in infrastructure in a way that hasn't always been the case.

The proof is in permitting reform. Typically, permitting activities have taken far too long and held back infrastructure. But we've seen permitting speeds accelerate in the US, and we're seeing efforts in Europe to allow faster permitting and quicker infrastructure builds. Many governments recognise that, frankly, they're an impediment to their citizens having good infrastructure, and so they're starting to shift. ■