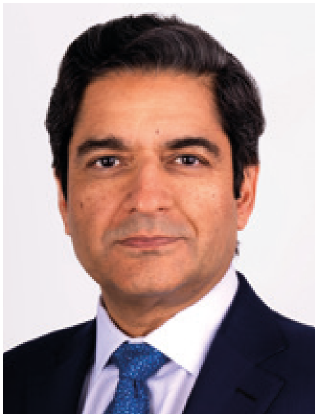
KEYNOTE INTERVIEW

Finding the sweet spot



New mid-market opportunities are emerging as governments increasingly seek modern, high-quality infrastructure assets, says I Squared Capital's Gautam Bhandari

Opportunities for global mid-market players have grown rapidly in recent years, particularly as infrastructure investment needs the world over have expanded to include services such as clean energy, data centres and e-mobility, alongside more traditional assets such as ports and bridges.

Gautam Bhandari, co-founder, global chief investment officer and managing partner at I Squared Capital, gives his take on how the infrastructure landscape is evolving, where the most attractive opportunities can be found and why the industry needs to embrace innovation.

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Q Why is the mid-market such an attractive area for investment?

The mid-market is far less crowded than the larger end of the deal spectrum as there are far fewer global players that focus on it. Societies are demanding more advanced infrastructure, such as green energy and data centres, and they need people with the skills and capital to develop and build those assets and businesses.

The mid-market also has some attractive inherent features. It is much more liquid for exits than at the larger end of the market. For example, it's much harder to find buyers for a $4 billion to $5 billion equity position, than it is for $500 million.

It's also efficient to borrow at competitive rates in that part of the market. It is much harder and expensive when you are targeting smaller loans because there are fewer lenders. Operationally, it is also challenging to benefit from operating synergies when dealing with smaller investments, say under $300 million. Overhead costs can be high for what are sub-scale developing and complicated assets. It is for this reason that for many of our ab-initio platforms, we do not use much debt and invest a lot of GP resources until the company achieves that $400 million to $500 million of equity deployed milestone.

Q How has the space evolved in recent years?

We started out 12 years ago and the market has become far more global than I ever expected. Today, people all over the world use data centres, ports, airports, or renewable energy in much the same way. The gap between the quality of infrastructure found in developed and emerging markets is very slim. For us, this means that you can take strategies and models that work well in one market and replicate them in another. It helps to have a truly global outlook to capitalise on this shift.

The size of mid-market businesses has also grown. Data centres and wind farms are now much larger scale than when we started out 12 years ago. They are more capital intensive than they used to be, and as inflationary pressures have come to bear, equity cheques have also grown. Previously, we might have called something like $300 million mid-market, but today that bar is at least $400 million to $500 million.

Q Where do you see the most attractive opportunities in the mid-market?

Stepping back, we see potential in creating assets from scratch, rolling up smaller companies, growing somewhat larger assets organically or a combination of the three. The vital point is that you need to be following a strong global investment theme. That means building local teams that understand regulatory frameworks, get to know those local management teams and importantly, have a strong sense of timing. While models may be the same or similar across different markets, the timing may not necessarily be.

We, as a society, are far more global and homogenous in our needs today than we were a decade ago. There will be at least 64 elections across the world this year, and building infrastructure is a key vote issue in all countries as voters demand more renewable energy, access to clean water and green, efficient transport.

Q What are the lessons you have taken from replicating different markets and strategies?

There are many, but a particularly important one is to move with conviction and speed when you see an opportunity. For that, you need the muscle and firepower at the GP level because you want to be able to fund an investment with a 100 percent equity cheque to begin with. Often, at this stage, you need the scale to write that 100 percent equity cheque as it can take too long and become too complicated to attract lenders.

Another is to build relationships with manufacturers and OEMs. This means getting to know their schedules and best pricing. You need to be able to source the right materials in scale at the right time at the lowest cost; this requires global scale. Good relationships and agreements with the key suppliers

Q How does innovation fit into the evolution of infrastructure?

Historically, infrastructure has been somewhat resistant to change and focused on more traditional, regulated assets. Technology and innovation have quite often been seen as risky, but we don't see it that way. This is why we created our infratech fund that targets disruptive technology in the infrastructure space. We have an operating team that studies businesses with the objective of improving their operating efficiencies. For example, we have invested in software that prevents hacking at power plants or linear generators that could help solve the problem of intermittent power from renewable energy.

Many of the innovations we back could be used by ISQ companies across our other strategy portfolios. In many ways, it's akin to a lab where innovative companies see us as a quasi-strategic investor. Over time, the infrastructure sector will have to accept and embrace innovation because it makes assets more efficient, resilient, sustainable and, therefore, more valuable.

allow you to build projects on time and to consolidate purchasing across the portfolio. That gives you a strong competitive edge.

Q How should managers approach platform-building?

We start by studying a theme or an existing or future need from the outside in and either find a small business already in the space or build one from scratch. In the UK, for example, six years ago we could see that there would be a need to solve the issue of intermittent power from renewable sources. Fossil fuel plants were being phased out and the future of nuclear looked uncertain or would take too long to build. That's why we decided to create Conrad Energy, which provides flexible power, energy storage and grid stability services. It's also a business model we have since backed in Texas with an investment last year in RPower and now more broadly with Aggreko.

It's important to identify a management team with a strong conviction and experience base across the same theme, and then incentivise them to build the business. At the same time, you must keep a careful eye on the risks as you build because it's easy to get carried away. As an investor, you need to deliver a dedicated action team that can hold the management team's hands and keep a close watch on value at risk and the dollars spent.

It can take years to get a platform going, but it's an attractive strategy because you invest at cost rather than paying a premium. You can cherry-pick assets rather than taking on a portfolio of legacy assets, some of which you may not want, and there are no bad legacy assets to manage. You can start with a clean sheet and design a modern infrastructure company. It's also one thing to build, but another to operate. To make the platform successful, you need strong operating partners at the GP level to get the business going and growing profitably.

Q The private capital infrastructure industry is undergoing some major shifts. How should managers think about this to best prepare for the next decade and beyond?

We are an infrastructure specialist, and we want to provide our LPs and the market with a comprehensive suite of solutions. This means different risk and return profiles, spanning from 10 to 25 percent. Some players have opted for M&A or to go for an IPO, but we decided to remain independent and created our own succession plan. Last year, we welcomed 27 new equity owners in the business – they are the future generation of our firm – and we opened two new offices in Sydney and Sao Paulo.

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I Squared has evolved and will continue to evolve so that we are able to take advantage of the global, human desire for better infrastructure and the global policy shift of governments inviting the private sector to invest in infrastructure. Private capital has demonstrated its capacity to build assets on time and manage them more efficiently. LPs have also realised that a diversified portfolio should include exposure to infrastructure – they are looking to specialists to help them gain the right exposure.

Q How do you see infrastructure investment developing over the coming years?

Infrastructure has done remarkably well as an asset class over the past decade or so. It has navigated a series of challenges: from covid and supply chain disruption to energy and inflation shocks. It has also been a defensive asset class that has done better relative to others.

I am extremely optimistic about the infrastructure asset class as allocations shift this way. At the same time, our definitions of core, core-plus and so on are somewhat dated – we've borrowed from real estate, which is a very different asset class. Investors need to understand risk and I think we'll reach some more infrastructure-specific definitions. Other segmentations are obvious, such as large-cap, mid-cap, etc.

The globalisation of infrastructure is also a theme that will continue. Ten to 15 years ago, there was a strong belief that the infrastructure asset class was of relevance in OECD countries, but that has proven to be misplaced. The supply chain for infrastructure is global, as are societal needs for improved infrastructure.

Finally, societal, and generational needs will continue to shape our industry and where it invests. Not just regulations. Meeting the global demand for decarbonisation involves investment figures that are almost beyond human comprehension. The need for capital to be raised and deployed in infrastructure will increase rapidly and this will be the case across the risk-return spectrum of infrastructure. ■