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SEISMIC SHIFTS POWER INFRASTRUCTURE ASSETS

Nearly three years after the Infrastructure Investment and Jobs Act was signed into law, infrastructure remains top of mind for institutional investors. And for good reason. The asset class is powered by at least three global mega-trends: the need for upgraded transportation infrastructure and power grids; technological advancements, such as artificial intelligence; and the transition to renewable energy sources. In addition, infrastructure not only delivers risk-adjusted returns comparable to traditional assets, but also diversification and resiliency in the face of inflation and higher interest rates.

Yet as investors explore the vast opportunity set, some questions have arisen amid last year's slowdown in deal activity and shifting macro conditions. Is it time to pause on allocating to infrastructure? Are the recent valuation concerns expected to persist? Leading managers in infrastructure investing — abrdn, I Squared Capital and Igneo Infrastructure Partners — cut through the complexities, share their investment approach and highlight the macro and market tailwinds that underpin the asset class.

P&I: Is this an opportune time to invest in infrastructure?

"We believe that increased rates have presented a long overdue repricing of risk, increasing the appetite and attraction of infrastructure as an asset class," said Ivan Wong, partner of concession infrastructure at abrdn. Over the last several years, from the start of the pandemic to the supply shocks and the sharp rise in inflation that led central banks to combat it with higher rates, the relatively consistent performance of infrastructure assets has reassured investors that the sector is resilient and thus a good place to be invested in for the long term, he said.

"The appetite for this asset class remains very high," Wong said. "Even with fundraising markets tight as they are, investors do intend to increase their allocations across the board to infrastructure." Additional reasons that investors like the asset class today are its long-dated, predictable cash flows and liability matching with very low volatility, even during periods of high interest rates.

What's more, the sector has suffered from massive underinvestment, according to Michael Ryder, partner and co-head of North America at Igneo Infrastructure Partners, a specialist in middle-market infrastructure investing. It "has been systematically under-invested in for decades, and so there is significant opportunity for new capital to invest in infrastructure development and infrastructure build-out," he said.

"This is a much better time to invest than when rates were zero," said Gautam Bhandari, co-founder, managing partner and global chief investment officer at I Squared Capital. "Current mid- and long-term rates are reflective of a somewhat more normalized environment and higher inflation. So now is a great time to come in and lock those rates in for a long period of time. Infrastructure assets offer the unique ability to lock in higher rates in the next 10 to 20 years."

In fact, Bhandari sees the beginning of what he calls an infrastructure super-cycle that he expects will keep dollars flowing and investor interest high for decades. This super-cycle is characterized by "a few trends that have converged: climate change, the use of artificial intelligence, society's desire to have modern infrastructure immediately, and governments' desire to create jobs and have a productive economy."

Sameer Amin, global head of concession infrastructure at abrdn, said infrastructure is well positioned relative to other private market investment options. "One has to look at the challenges that both real estate and private equity are currently experiencing to understand why infrastructure is standing head and shoulders above some of our peers," he said. "Allocations are awarded to private markets because they can genuinely deliver the diversification that people are seeking from a private markets allocation."

P&I: Which thematic trends will drive infrastructure assets over the next few years?

Amin highlighted three trends: decarbonization, urbanization and digitization. All told, up to $94 trillion over the next 15 years would be needed to meet the infrastructure requirements borne out of the three trends, he estimated. "When you take the three mega-trends together, you start to get a sense of what, ultimately, we're facing as an industry," said Amin. "And that translates into very explicit opportunities."

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"We believe private capital has a pivotal role in funding all this," Wong added. "It's a broad opportunity set to work in partnership with government to meet these challenges." Abrdn has identified a number of subsectors that are ripe for investment in each of the three global trends. They range from healthcare, education facilities, housing, water and waste treatment to transportation areas, such as mass transit systems, roads and ports, as well as renewable energy generation.

The move to electrification and renewable energy is a "massive societal trend" that will help drive long-term interest and investment into infrastructure, Ryder said. It dovetails nicely with two other trends favorable to the asset class: digitization and reshoring. "That includes the move away from hydrocarbon-emitting fuels toward greater electrification and renewable energy," he said. "That is a significant area of investment on a global scale."

Beyond energy generation, Igneo Infrastructure Partners also sees opportunities in transmission and storage. In addition, digitization, highlighted recently by the rapid development of AI, has driven investment into cell towers, fiber networks and data centers, Ryder said. "We've seen a massive increase in investment and velocity around artificial intelligence, but that is just a continuation of a significant trend of considerable investment that has gone into macro cell towers, fiber and data centers to provide the computing power, the storage and

low-latency access to information and data that is necessary for our society to run," he said.

"If you look at societal needs globally, they all imply a monumental buildup of infrastructure," said Bhandari of I Squared Capital. "You can see it globally in how rapidly people want to make the grid green and how quickly we are adopting technology and data centers — all of which has massive implications for the consumption of power."

P&I: For investors considering an infrastructure allocation, what key attributes and risks should be top of mind?

"Leverage. When you're operating an infrastructure asset, what's the level of leverage you've taken on?" Bhandari said. "If you take a very safe asset but put a lot of leverage on it, then it's no longer safe." Other key attributes to watch for in an infrastructure investment include recurring revenues, how an asset performs through the stages of a business cycle and how a company performs through inflation different scenarios as well as how efficiently the company manages its day-to-day operations, he said.

"It's important to buy infrastructure businesses with a strategic approach," Ryder said. "It involves building and maintaining broad networks to identify opportunities for investment and then doing the hard work to understand those businesses and to carefully negotiate structures of acquisitions or partnerships in order to make investments. Once you own the business, it's all about actively managing that business, putting the right leadership team in place that is appropriate for the asset."

At abrdn, which operates in the public-private partnership, or P3, space, Amin and Wong pay particular attention to government policy. Amin pointed out that upwards of 70 countries around the world are going to the polls this year. "Understanding whether a change in government will lead to a change in strategy or policy on how public procurement programs are enacted and mobilized is incredibly important because that really determines the speed at which we can respond to that requirement," he said.

As far as regulations are concerned, Bhandari noted, investors need to monitor "how consistent the regulator has been, regardless of the country." Besides regulations, investors also need to keep an eye on liquidity and changing market conditions, he said. Depending on the size of their investment, exiting a position could be difficult. "If you're a $300 million to $1 billion investor in an infrastructure asset, it's easy to get in and out. But if you have written a $2-to-$3 billion equity check, then $4-to-$6 billion exits are harder," he said. "So liquidity is one of these risk factors" that you need to closely watch.

Successful infrastructure investing requires active management, Ryder emphasized. It involves "identifying and watching out for any future changes in the market environment in which you operate — the customer environment, the supplier environment, the value chain, the technology — any changes that would manifest themselves as risks that could impact upon the long-term value of the business that you're running," he said. "Active management is key to what we do."

Institutional investors should also consider infrastructure in a global context. "We're keen to explore and continue to take advantage of the opportunity set in South America and targeted geographies, such as the Andean regions of Colombia, Chile, Peru and Uruguay, where there are established legal frameworks and a good track record in utilizing P3," Amin said, adding that rapid population growth is fueling the need for additional infrastructure. "That presents a very compelling opportunity."

P&I: With subdued performance in the past couple of years, are valuations more compelling today?

"Broadly, asset values are more specific to the situations and the opportunities around certain companies," Ryder said, referring to private infrastructure assets versus publicly traded ones. For example, with so much demand for AI, companies developing data centers and other industries that cater to AI are richly valued, he said. But even in some segments enjoying high investor demand, high valuations don't necessarily mean investors should stay away.

"Companies that have strong positions with existing generation capacity in operation and a clear pipeline of opportunities in development are demanding strong valuations because that sector is in such high demand, and there are significant growth opportunities," Ryder said. "These are in areas where there's more demand for growth and investment than we necessarily have opportunities today. That situation drives valuations to be at strong levels."

"So rather than asking whether valuations are high or low, you need to look at the specifics around individual sectors and ask whether the forces in play are driving valuations to fair levels, even with numbers that may look elevated. I think the answer is yes," he said.

Abrdn, which is seeing public sector projects utilizing private sector skills to deliver infrastructure, also sees valuations readjusting to higher interest rates, Wong said. "Given the increased underlying cost of government debt, there's diminishing dry powder in the market with respect to liquidity," he explained. "Those two features have implied a repricing of risk. And as such, valuations are adjusting accordingly and setting more value for buyers."

Bhandari said it's actually been a good year for infrastructure. "Investors are still allocating to the sector and private infrastructure continues to consistently outperform any of its listed peers with lower volatility. If you look at, for instance, private investments in wind farms, renewable energy or data centers, those are all up 20+ % as an asset class because there is fundamentally good value creation and these assets meet a real societal need."

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— MICHAEL RYDER, IGNEO INFRASTRUCTURE PARTNERS

I Squared's ability to allocate capital globally and across sub-sectors, combined with a prudent underwriting approach, is essential to identifying the most compelling opportunities, Bhandari said. Datacenters are one example "with potential for more attractive valuations outside the OECD markets. Our local insights combined with an ability to build platforms has meant we've been able to pick up businesses cheaply and build them. And, with buyers placing a premium on late-stage development capacity, a subdued market can create better entry points for those looking to capitalize on future growth."

P&I: Will 2024 see a turnaround in fundraising and deal volumes in private infrastructure?

"While it's difficult to predict near-term allocation trends, investors broadly recognize the need the grow their allocation to the asset class. We think 2024 and 2025 are promising investment years for fundraising and deal activity," Bhandari said. "These are very good vintages because if you believe that rates will come down — whether six months from now or three years from now — you would have captured elevated rates for a very long term."

"Deal volume has slowly been picking up," Ryder said. "Fundraising will improve as monetization accelerates. As funds sell assets, exits occur and capital flows back to institutional investors, they will then need to reallocate that capital. That's when we will really see fundraising start to improve."

Amin said he doesn't expect a "material" improvement in fundraising this year "because the effects of what's taken place macroeconomically over the last 18 months has left a number of allocators with disproportionate allocations, and with disproportionate return requirements to their clients," he said. "Do we see it improving thereafter? Absolutely."

P&I: How will infrastructure exposure continue to benefit institutional portfolios?

"Infrastructure is a great diversifier for your portfolio because, generally, infrastructure assets are low-beta assets," Bhandari said. "Also, it has explicit, often contractual inflation protection; so infrastructure companies do very well when inflation is high. And it adds a defensive element to your portfolio." Investors are attracted to all its pos-

itive characteristics for an institutional portfolio: low correlation, liability-matching and linkage to inflation, he said.

"Over the past few years, infrastructure investing has demonstrated inflation resiliency," Ryder said. "And as interest rates have gone up, we've seen that many owners of infrastructure assets have been able to pass on some of that inflation and maintain strong cash flows and margins."

"Infrastructure is an alternative asset class that gives institutional investors the opportunity to add diversification in their portfolios," he added. "It has different correlation levels with other alternative asset classes, such as private equity, real estate and private credit, and often is a meaningful addition to an institutional portfolio to reduce risk and provide uncorrelated returns."

Diversification within a private market allocation is increasingly important in a tight market, Amin said. "Infrastructure forms one of many private market options for investors," he said. "One has to look at the challenges that both real estate and private equity are currently experiencing to understand why infrastructure is really standing head and shoulders above some of our peers. With infrastructure, we can genuinely deliver the diversification that people are seeking from a private market allocation." His colleague Wong added that three benefits of infrastructure continue to stand out today for institutional portfolios: current income in the form of yield, capital appreciation and capital gains.

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P&I: What specific attributes of an infrastructure asset manager are important to navigating today's market?

"It's important to identify a private manager who has demonstrated over a long track record an ability to identify opportunities to invest in true infrastructure businesses," Ryder said. "If you're looking at and comparing managers, and then looking at the deals that those managers have done and their track records, make sure that they're sticking to what they have said they will do."

I Squared Capital sees the middle-market, which Bhandari defined as deals between $300 million and $1 billion, as presenting the best opportunity for infrastructure asset managers to generate returns. "The segment where there is real alpha, real value, tends to be in that middle-market segment," he said.

From there, investors need to understand a manager's risk process. "A lot of managers use a bucket approach to classify risk in terms of core, core plus, etc. But at I Squared, we use a ground-up, numerical, methodical and consistent 10-factor risk model," Bhandari said. "One key to creating value is selecting the right assets. And key to selecting assets is measuring risk consistently, not just in broad buckets but focusing on granular risk and measuring it," he said. Using its 10-factor risk model, the firm monitors those risks and attempts to lower them over the course of its ownership, he noted. "And as you lower the risk, you create value."

For abrdn, it is key to be able to articulate the infrastructure investment strategy and then implement it with a well-seasoned team of professionals. In addition, differentiation is critical. "Being differentiated and niche, we believe, plays well" with institutional investors, Amin said, pointing to its approach with public-private partnerships globally.

P&I: How does the uncertainty over the Federal Reserve's next moves, given the expected rate-easing cycle, impact infrastructure?

For infrastructure investors, a long-term view is critical to success, but how critical interest rate policy is to an infrastructure strategy depends on the strategy itself.

Wong said that as a P3 manager, abrdn keeps a close eye on Fed policy. "Often, we enter into long-dated contracts funded by our public activity bonds, usually with a 10-year call option to effectively refinance those bonds, delivering a cheaper capital solution," he explained. "However, with the slight delay or continued uncertainty around the Fed's easing of interest rates, that's just been pushed out a bit longer."

But that also means that in some cases the current market environment is beneficial, Amin added. "The cost at which private-sector capital can be procured is intrinsically linked to where the Fed chooses to move its interest rates," he said. "So it's an incredibly timely moment."

While uncertainty around the Fed's next move is not hampering deal activity, its next move will fuel it, said Ryder at Igneo Infrastructure Partners. "Once we see actual tangible easing, and the Fed moving to a more accommodative monetary policy, we'll probably see transaction activity accelerate further," he said.

Investors need to think about the impact of interest rates on different aspects of infrastructure assets, said Bhandari at I Squared Capital. "If rates do come down, the assets that you would have bought during this period will be worth more," he said. "But because these assets are not like real estate, you need to finance them on the longer end of the spectrum, so investors also need to think about long-term interest rate equilibrium. Fortunately, now, long-term interest rates have also moved up and are therefore more normalized today."

P&I: Will the U.S. election impact infrastructure?

"We believe that in some ways, it transcends either party that may come into government and their priorities; infrastructure will be a priority regardless," Amin said.

Bhandari agreed. "The common theme for any presidential campaign globally has been infrastructure. It's generally jobs and infrastructure are the top two items in any election," he said. "It's very hard to argue that one side wants good infrastructure and the opposing party doesn't."

"If you look at the support for infrastructure investing, significant capital has flowed into the infrastructure sector in the U.S. through Republican administrations and through Democratic administrations," Ryder said. "We are carefully monitoring the election outlook, but we remain confident that regardless of who is in the White House and who is on Capitol Hill, there remains a significant need for infrastructure investment. The federal government and, importantly, state, regional and municipal city leaders will work to encourage and support further infrastructure investment," he said, "because it goes to the core of supporting and growing U.S. competitiveness on a global scale." ■

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