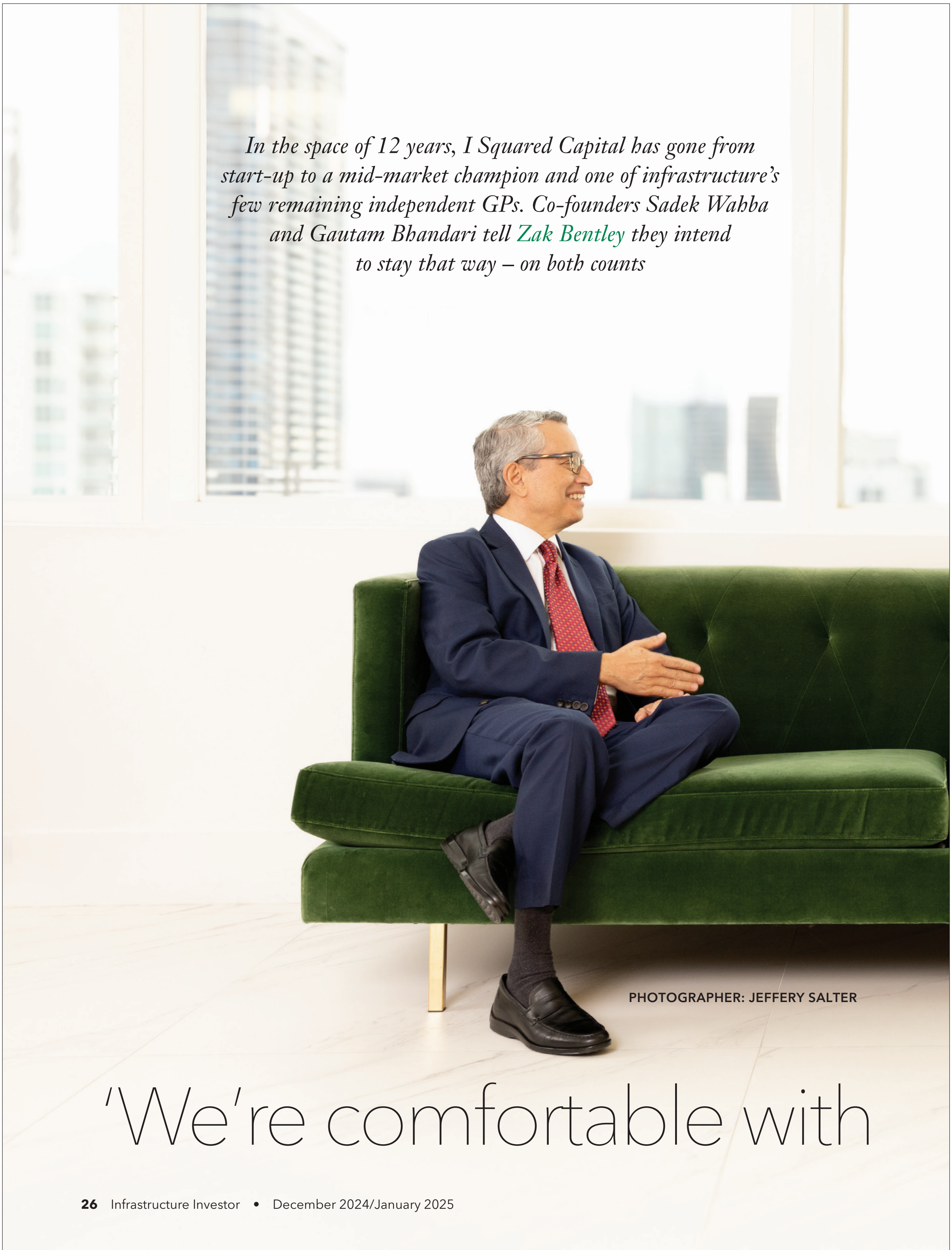
Infrastructure Investor

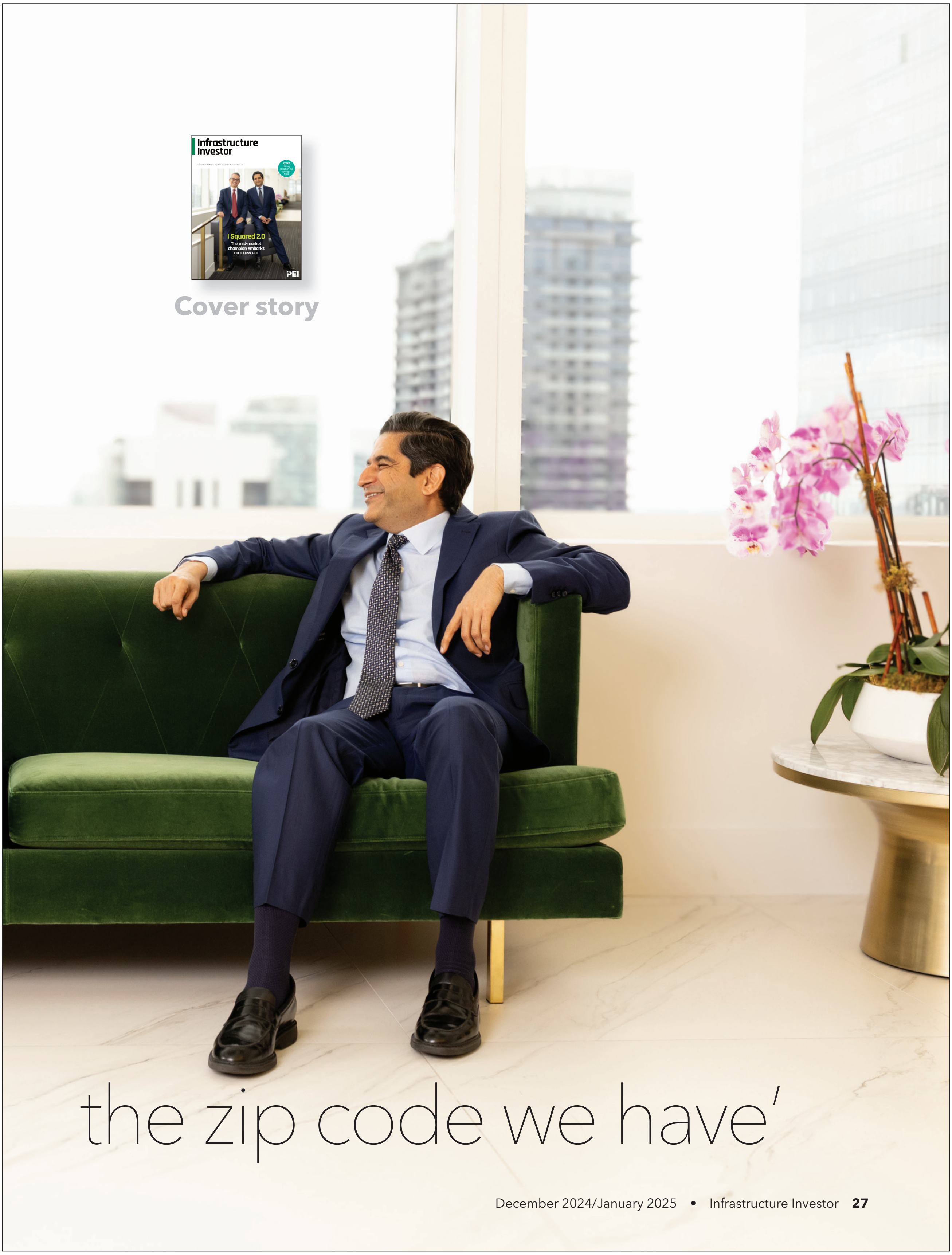


In the space of 12 years, I Squared Capital has gone from start-up to a mid-market champion and one of infrastructure's few remaining independent GPs. Co-founders Sadek Wahba and Gautam Bhandari tell Zak Bentley they intend to stay that way – on both counts

PHOTOGRAPHER: JEFFERY SALTER

'We're comfortable with

Infrastructure Investor



It's 13 years ago this month that *Infrastructure Investor* reported that Sadek Wahba, the global head of infrastructure at Morgan Stanley Infrastructure, was leaving his role.

Two other lines in that story in late December 2011 stand out. First, that "it is not yet known where Wahba will go to next", and second, that the rest of the team, including then head of Asia Gautam Bhandari, "remain in their respective roles".

It wouldn't take long for the latter to change, with Bhandari exiting Morgan Stanley about six months later. As for where they would go next, in 2012 it emerged that alongside Morgan Stanley's Americas dealmaking head for infrastructure Adil Rahmathulla, the trio had formed I Squared Capital.

With the manager now at more than $40 billion in AUM – Morgan Stanley Infrastructure, incidentally, has $16 billion – they clearly exceeded their ambitions. Wahba, though, tells *Infrastructure Investor* "I don't think I had any particular expectations", while Bhandari characterises himself as "by nature, a pessimist", so the duo is no doubt buoyed by the progress made in 12 years.

Three founders became two in June, when Rahmathulla's tenure ended, having originally announced plans to step down in May 2023. Bhandari subsequently took on the firm's chief investment officer role, while Wahba remains as chairman and managing partner.

"I think it's I Squared 2.0," Wahba says. "Two years ago, we said that we wanted to institutionalise the firm and when I look back at what has happened in the rest of the market, I'm very happy with the outcome. People have taken the decisions to merge or to sell. We took the decision to recharge and institutionalise the firm in a way that I think very few have done and we've been able to do it very successfully."

The institutionalising has meant a partner ownership scheme and a broadened investor relations team following the departure of IR head Andreas Moon in April 2023. What the broader dynamic Wahba is referring to is, of course, the wave of consolidation in the market that leaves I Squared as one of the few high-profile independent asset managers in the asset class. So, will I Squared be sold off to a large PE shop in the coming years?

"I really don't see the rationale for us. We're extremely comfortable in the strategy that we've adopted. We're extremely confident in our growth opportunities," says Wahba. "We think that this is the right model and it's a model that LPs and investors truly appreciate.

"It takes two to tango and we're not interested in dancing right now."

If anything, it is I Squared who will be acquisitive, according to Wahba.

"I see ourselves partnering with people who are complementary to us. There's a lot of opportunities in the specialised credit area. We invested in climate-related technology that I think is very interesting, so there's a lot of ancillary businesses and sectors that I think will complement very well."

Mid-market mega-fund

I Squared is at an intriguing moment in time. It is understood to now have four different funds in market: its fourth flagship, second growth markets vehicle, second credit fund and debut energy transition strategy.

Its previous flagship – ISQ Global Infrastructure Fund III – closed on $15 billion in 2022, with the successor thought to be targeting the same amount. That puts it in the realm of other infrastructure mega-fund managers such as Stonepeak or Brookfield's transition series. But fund size aside, I Squared has typically favoured a more mid-market approach for deals, with ticket sizes, often up to $400 million and $500 million, with some larger exceptions going up to $1 billion, as the group looks to build platforms.

There were, according to Bhandari, intense discussions about this before launching Fund III and after closing Fund II on $7 billion in September 2018.

"When we raised Fund III, a lot of LPs said, 'You're going to more than double your fund size, will there be style drift?' We thought about it very carefully and decided that as this industry migrates to larger and larger cheque

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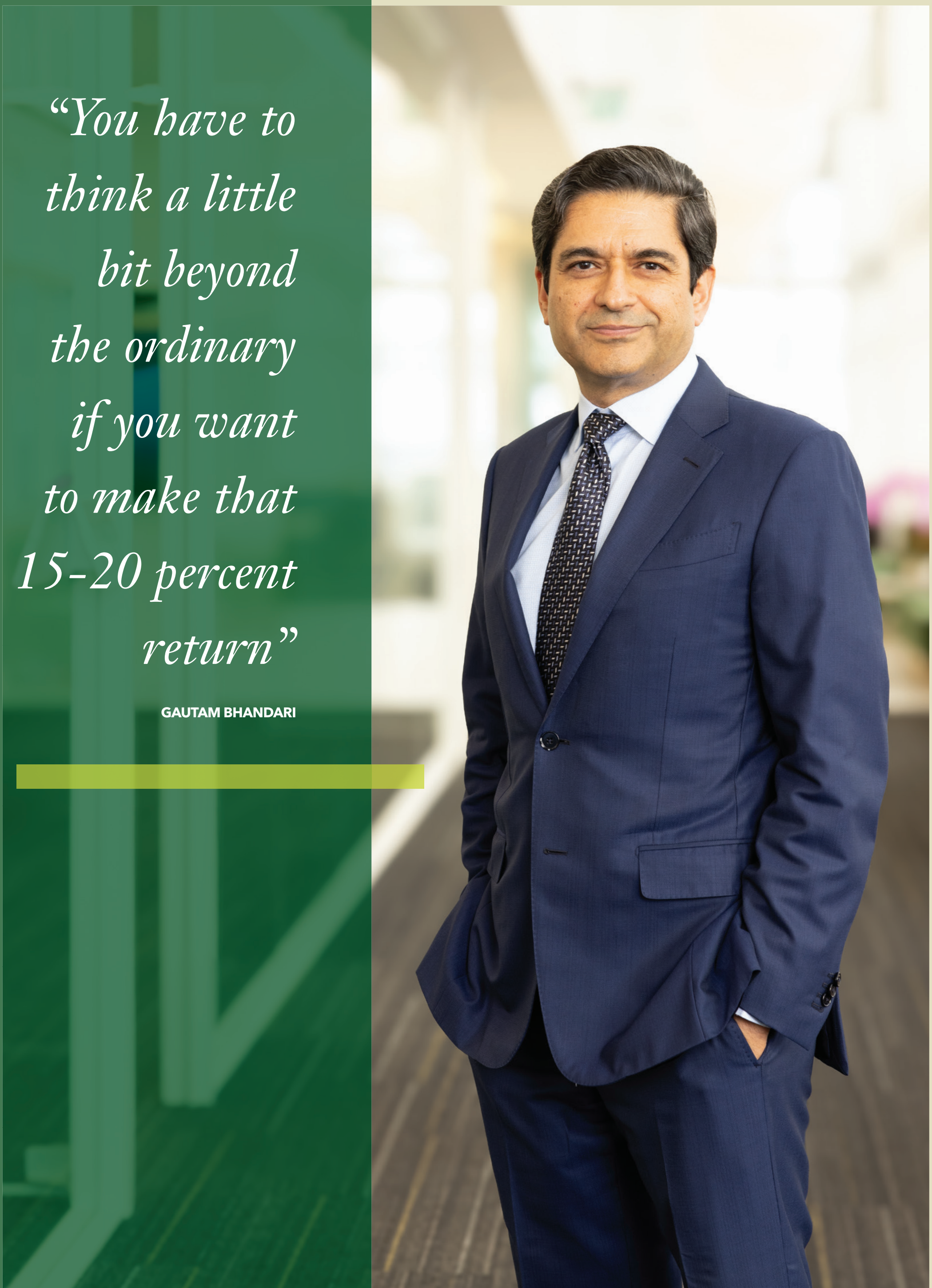
"You have to think a little bit beyond the ordinary if you want to make that 15-20 percent return"

GAUTAM BHANDARI



Cover story

"If we go into the $20 billion mark, then you start having a strategy drift"

SADEK WAHBA

sizes, we don't want to be competing in that herd. We'd rather be the champion of mid-market," explains Bhandari. "It's a very unique combination where we thought we could add value and be complementary to other people's portfolios. That was a conscious choice and to stay the course."

Bhandari says that to outsiders, "one of the most misunderstood things about I Squared" is the perception of being a large-cap fund manager. However, he says that once Fund III is fully invested, it will have close to 30 investments in the fund.

This is certainly a point appreciated by Australia's Brighter Super, an LP with I Squared since 2015.

"They tend to have more deals per portfolio compared to their competitors, so you're getting somewhat better diversification," says chief investment officer Mark Rider. "They're avoiding writing the big mega-cheques as well, so you're getting better diversification."

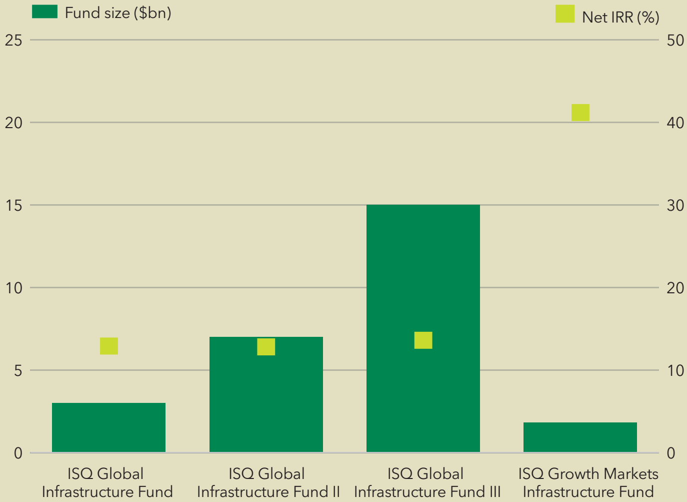
Rider says that over the years, I Squared has demonstrated "great discipline" in pricing, acquiring assets below comparable multiples Brighter sees elsewhere.

"It gives us an unfair advantage in terms of scale," Bhandari says. "We compete in a globally diversified, mid-market way and with enough firepower that we can make a small company to mid-cap or a mid-cap company into large-cap and then sell stabilised assets to people."

It's clear that Wahba and Bhandari think about the debate of what constitutes mid-market through the lens of deal size rather than fund size. That being said, Wahba remains wary.

"Of course, at some point, if you raise $20 billion to $25 billion, it becomes very difficult to think of [yourself] as mid-market," he says. "I think a sweet spot is around $15 billion and we've been very happy with the pace of deployment, the type of investment and the mix of larger investments and platform investments."

I Squared flagship fund series performance



Performance figures for flagship funds as of March 2024; for Growth Markets as of Dec 2023
Source: Infrastructure Investor

Surely, though, the fund size will inevitably get larger?

"I don't think that's the case," Wahba says. "If we go into the $20 billion mark, then you start having a strategy drift. We're very comfortable in the zip code that we have today."

The investment approach is summed up by Bhandari, who says "there's no $2 billion blind cheque that we write upfront to anybody to grow these platforms. We drip capital in a disciplined manner."

"We drip a little bit of money and then project by project, more equity is supplied to the company. As a result, the winners get oversized," he outlines. "The teams that have delivered and the teams that are working naturally grow to be large and of course, have higher returns."

There are also assets that exist across the funds, with Bhandari bringing the example of Indian roads platform Cube Highways.

"We pioneered this along with our LPs, where we would have portfolio companies like Cube Highways I, Cube Highways II and Cube Highways III. These are across funds, no asset is sold between funds. [The] management team is shared and every asset is an SPV," he explains. "The first 10 projects may belong to Fund I, the next 15 belong to Fund II, the next 30 belong to Fund III. The management just simply bills its time like they fill out timesheets. It's re-using the management team for the same investment thesis."

Growth premium

India is just one of the developing markets in which I Squared has found success. In Asia, led by another Morgan Stanley alumnus, Harsh Agrawal, strides have also been made in the Philippines, Japan and Taiwan. I Squared has also been a significant investor in Latin America since its launch, deploying in the likes of Brazil, Peru and Colombia.

The breadth the firm has reached geographically since inception is Wahba's main surprise outcome, a sentiment echoed by Bhandari.

"Twelve years ago, the common wisdom was infrastructure is defensive therefore should only be in safe geographies, and safe geography means my backyard," he says. "We started off saying a third of capital will be in growth markets and that was very controversial. We had a lot of 'nos', because people felt diversifying geographically is risky."

Bhandari adds: "People take a very simplistic approach of OECD or non-OECD. As a result, a lot of non-OECD assets don't get capital, but they're inherently good."

"Good" might be an understatement. As it launched Fund III, I Squared also launched its first Growth Markets Fund, seeking $2 billion. It ended up closing on $1.8 billion but has delivered a net IRR of 41.2 percent as at the end of 2023, according to *Infrastructure Investor* data, sourced from the State Board of Administration of Florida. By comparison, all of I Squared's flagship global funds are performing within the targeted 15-20 percent gross range.

"Governments and regulators are very keen on having foreign direct investment coming in," believes Wahba. "Toll roads in India have been a huge success, as have renewables in Southeast Asia and Latin America, where they've developed the regulatory framework to encourage people to come and invest. Like everything else, if you know how to invest in these regions, I think you can develop a very attractive portfolio."

There are, intriguingly, several LPs who have invested in the growth markets fund but have yet to invest in any other I Squared product, including the aforementioned Florida LP. Another of these is Denmark's Industriens Pension, which told *Infrastructure Investor* in June it struggled to find the right emerging markets GPs with a "convincing strategy and a sufficient premium compared to the good returns in developed markets". However, it is effusive when it comes to I Squared.

"We like their investment approach with thorough and solid risk management and – among other things – a strong focus on currency risks. After looking at I Squared and the people behind the fund, we were convinced by their solid track record in growth markets and their competent team," says Jan Østergaard, Industriens' head of real assets.

For Bhandari, there's been an additional factor in this success. "A lot of the issues of inflation and high interest rates [have] more to do with the US and Europe than many developing markets," he maintains.

"They were fiscally responsible through covid and as a result, they actually are not on the same fiscal economic cycle."

According to Wahba, it's been a case of replicating successes it's had in certain sectors and bringing that to countries elsewhere. "The strength of a global approach is the ability to arbitrage across different regions and different sectors. You can quickly pivot if you see opportunities in the renewable sector and the storage sector in Japan that didn't exist before. But more importantly, when things happen in the market that you can't control, then you're able to pivot one way or another."

I Squared, though, can still be subject to the question many other GPs face at times: is it infrastructure? A take-private earlier this year in Spain saw the firm, alongside TDR Capital, acquire Applus, a vehicle testing, inspection and certifications services company, in a deal valuing the company at €1.65 billion and on the larger end of its ticket sizes.

"Testing and verification is required by law. It's a concession, it's contracted and you're the only provider," Bhandari says. "A lot of these businesses have been overlooked and I think at the prices that we enter, we find them super attractive. You have to think a little bit beyond the ordinary if you want to make that 15-20 percent return."

The road ahead

When I Squared last launched a flagship fund in pandemic-ridden 2020, it was the group's sole focus. Now, at the nascent stages of Fund IV, Growth, Credit and Energy Transition are all strategies in the mix.

It's a rapid expansion in terms of new verticals, although Bhandari and Wahba don't envisage any radical additions to the menu.

"I always say five or six flavours of ice cream, but only ice cream, that's all we sell," muses Bhandari.

However, where he might see additions is within the transition space. The group's ISQ Energy Transition Fund, targeting $2 billion, is positioned to offer lower returns than the global fund series, targeting 15 percent gross returns and in proven technologies, such as renewable power and batteries.

"We put a dedicated team just to [focus on] very classical energy transition that unfortunately, you cannot make 25 percent off [of]," Bhandari reasons. "On the other hand, I think there is a space for a fund that takes more market risk than either the global fund would ever take or the energy transition would ever take, but I think that will take us some work to assemble the right team and convince the right investors."

And for those LPs wondering – as has been asked – whether Wahba's journey into regular commentary on the politics of infrastructure will see him go into public office, he remains committed.

"I think it's important, especially in the context of the US, to be able to really have a voice and encourage governments, states, municipalities to really rethink infrastructure," he argues. "While my primary role is to work for our investors, I also want to ensure success in the long run. That means having sound policy."

For readers in late 2024 and early 2025, that seems perfectly pertinent. ■