KEYNOTE INTERVIEW

Time to be selective in infrastructure

The mid-market infrastructure space is facing a shortage of capital, creating an opportunity-rich environment for GPs with dry powder, says Northleaf's Jared Waldron

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A difficult fundraising environment and a risk-off approach by the banks is causing difficulties for many mid-sized infrastructure assets seeking capital. Infrastructure funds raised just $27.3 billion of capital in the first three quarters of 2023, down from $136.2 billion over the same period in 2022, according to Infrastructure Investor figures. And while this year may see the start of a recovery, many of the funds in the market are some of infrastructure's largest players.

So, where does this leave assets in the mid-market infrastructure space? Jared Waldron, managing director and head of North America at Northleaf, offers his thoughts on what is happening in the market and where he sees both opportunity and risk.

Q How would you describe the current environment in the mid-sized infrastructure asset space?

We see a very clear dynamic in this space. Both debt and equity capital are becoming increasingly scarce in the mid-market. At the same time, returns are increasing. This is partly because of the rise in interest rates, but it is also the result of constrained capital availability for investment. Because of these two factors, capital formation, in particular, is very challenging and we are seeing that affect both industrial companies and developers.

Nowhere is this more apparent than in the mid-market and as a result, there is a healthy return premium over the large-cap and mega-deal infrastructure space. There are increasing investment opportunities for those with capital to deploy as competition for assets in the $150 million to $200 million deal size bracket has fallen away. In today's market, there are many undercapitalised developers and industry players looking for alternative capital sources.

Q What is causing the dearth of capital in this space in particular?

There are some supply-side challenges. These include banks pulling back their origination activity for new loans. Until recently, the market was still working through the liquidity injected into the system during the covid-19 pandemic, but the environment has now changed; banks are having to manage risk against a backdrop of economic uncertainty and are increasing their loan provisions. They are taking a more conservative approach and pulling back on origination.

This is compounded by the challenging fundraising market, and the difficulty that a number of publicly listed infrastructure companies are viewed as interest-rate sensitive, and are also struggling to raise money. In the private markets, as the denominator effect has created headwinds for LPs in making allocations to private markets in general, many infrastructure funds have struggled to raise capital. This is making GPs highly selective with the dry powder they currently have.

Q Where are the most attractive opportunities in such a capital-constrained environment?

GPs with capital to deploy are seeing significant opportunity in today's market; it is one of the best markets to be investing into that I have seen. Many of the projects we invest in provide essential services to society and so slowing down development is not an option – these have to reach completion.

Also, many of the development platforms have business models that require them to continue developing projects regardless of the market environment. So, the supply of investment opportunities is strong. Our dealflow is up 30 percent today from last year and so we can be even more selective than we have been previously.

We are also seeing a return to normality for returns in pockets of the market that were previously over-valued, including in operational contracted renewables. Here, valuations have fallen to a level where we can start to see risk-appropriate value.

Even in areas such as clean energy, auctions are sometimes failing because there are fewer participants in those processes than there used to be. As a result, we are now getting call-backs from bankers after we have passed on an auction because they have had limited interest. I suspect we will see more failed auctions and these will create interesting opportunities to reshape deals and their structures in bilateral processes.

Q How is the interest rate environment and increased cost of debt affecting

Q How is government policy supporting investments in the areas you target?

Infrastructure in America is clearly a major beneficiary of government policy. The US Inflation Reduction Act in particular is a major initiative for renewables – for both businesses and producers – and more broadly for the energy transition in areas such as carbon capture and sequestration, green hydrogen and electric vehicle charging. The tax and other incentives under the IRA are accelerating development in some of these sectors.

That development or maturation is also allowing for contract profiles that bring certain assets' risk profiles down to the core-plus level, where previously they were more value-add opportunities with a private equity-style risk profile. We view medium to long-term contracts as a key differentiator for the core-plus space, as compared to value-add.

The US government policy around rural fibre is also generating tailwinds. The Rural Digital Opportunity Fund, for example, is injecting $20 billion of federal funds into the construction and operation of broadband in rural America, while the Broadband Equity Access and Deployment Program has over $40 billion to deploy.

Covid-19 highlighted the importance of high-speed broadband and these initiatives are designed to eliminate the digital divide. They are incentivising internet service providers and developers to build out high-speed broadband connectivity in areas that might otherwise be unviable.

new and existing infrastructure investments?
In core and core-plus infrastructure, managers have largely been highly disciplined in the amount of leverage they have used and so they tend to have balance sheet flexibility. That means we are unlikely to see a wave of bankruptcies in this space. Overall, investors have done a good job of keeping leverage low, managing short-term maturities and hedging rate exposures.

We have always been conservative in our use of leverage – typically our deals have leverage in the range of 20 to 30 percent of the acquisition price. This is indicative of a value creation strategy where the objective is not to use financial engineering, but to drive return through growing EBITDA and free cashflow. Where we have used leverage, we have either used long-term, fixed-price bonds or we have otherwise hedged out our interest rate exposure. As a result, we have been insulated from the increased cost of debt.

In new investments, we are looking at opportunities to keep assets unlevered. So, for example, that could mean looking at platform deals where the returns on capital deployed are strong enough that we can scale them without leverage.

We are in a position to be patient and see where interest rates are in, say, three-to-four-years' time and, if value maximising, introduce leverage then. Of the three investments we completed in 2023, two were all-equity.

Q Where do you see operational risks in mid-sized infrastructure investments and how do you manage them?
In core infrastructure, where assets tend to be fully contracted, the most prevalent risks concern operations and maintenance. It is about the availability and upkeep of assets. With supply chain disruptions and elevated inflation, the primary risk has been cost containment.

"There are increasing investment opportunities for those with capital to deploy as competition… has fallen away"

However, you can mitigate these using contracts leading to efficient risk allocation. If you have a wind farm, for example, you can arrange a 10-year fixed operations and maintenance contract where the responsibility resides with the contract counterparty. There may be some refinancing risk, but usually, these assets have long-term, fixed-rate financing arrangements.

In core-plus, the profile is different. You might have medium-term contracts that need to be renewed or a construction or network build-out during your investment horizon. This could be the case in a fibre business, for example, where you have to build the network and there might be staffing, labour and availability risks. Or, there may be growth risks embedded in a platform investment, where there is risk they don't grow as planned.

Management team strength is the vital component to managing these risks – and that is not always straightforward to find or build in smaller companies. However, that creates an opportunity for mid-market managers to infuse themselves into these companies to drive value creation opportunities.

In value-add, we are seeing some investors take on risks that are hard to delineate between infrastructure and private equity. They are targeting assets with short or no contracts and there is a much broader fan of investment outcomes here – there is a real risk of experiencing capital impairment.

Q What trends do you see playing out in mid-market infrastructure over the coming period?
The energy transition will remain a prominent driver of investment and will be an active subsector. It will increase in maturity, featuring more medium and long-term contracts that allow infrastructure investors to lean in.

There is also a trend apparent in our portfolio that speaks to wider developments: the demand for data centres as businesses increasingly explore and apply AI capability and other high performance compute applications. Data centres provide a once-in-a-generation opportunity as the sheer amount of capital needed to support that demand will make for attractive investments.

Core-plus managers are demonstrating strong risk management capability in the core-plus space, but I would expect them to get better at managing and packaging up risks in a way that further broadens the scope of infrastructure investment.

Finally, I would highlight two key market factors. One is capital availability: if you invest in a platform that will require further capital for growth, you need to be certain in your ability to access that capital in an efficient way.

The other is economic uncertainty: GPs need to build diversified and resilient portfolios that will perform well in any economic environment. This reinforces the attractions of core and core-plus infrastructure, which have remained stable even through covid and a high inflationary environment. ■