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Accessing the Private Infrastructure Asset Class in a Rapidly Changing Environment

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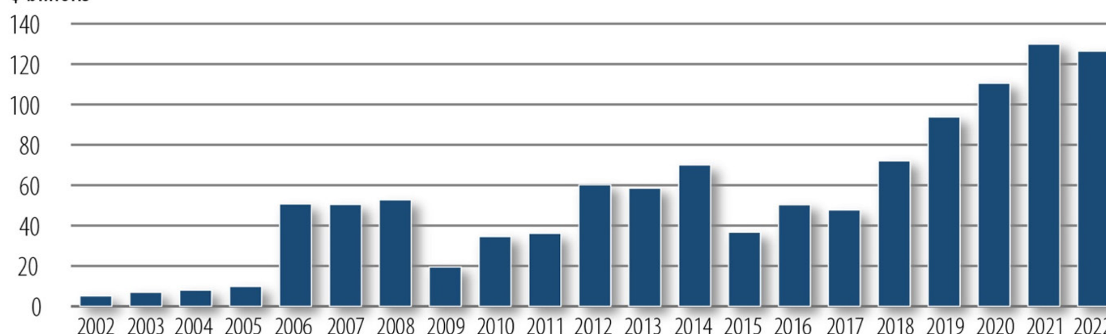
Overview

Private Infrastructure has been a growing area of interest for investors for more than two decades, and the capital raised to pursue the strategy has increased significantly in recent years. From 2020 to 2022, an annual average of $122 billion was raised for private infrastructure funds—a 71% increase from the average over the prior three years and a 180% increase from average fundraising totals one decade prior (2010 to 2012).[1] The appeals of investing in infrastructure are readily apparent: essential assets with inelastic demand profiles; high barriers to entry; stable, long-term cash flows; and inflation-adjusted revenue streams that generate substantial cash yield. These characteristics create a highly downside-protected asset that has the potential to generate attractive risk-adjusted returns. In 2022—a period characterized by the continued impacts of the COVID-19 pandemic, rising inflation, supply chain disruption, and the European energy crisis—global private infrastructure funds generated an average return of 9.5%,[2] outperforming both the S&P 500 and Bloomberg US Aggregate Bond Index by more than 20 percentage points.[3]

Figure 1. Global Infrastructure Fundraising



SOURCE: PitchBook Data, Inc.

[1] PitchBook Data, Inc...... [2] The Burgiss return is based on a composite of the investment funds that constitute the Burgiss Private i global all infrastructure pooled benchmark for all vintage years, as December 31, 2022, as produced using Burgiss data, in the strategy category of infrastructure and was calculated using Burgiss data available as of Friday, September 22, 2023. The Burgiss Pooled IRR was calculated by Burgiss as an annualized effective compounded rate of return using daily cash flows and annual/quarterly valuations sourced from limited partner transaction data of Burgiss clients, which were not independently verified by Burgiss. The Burgiss Pooled IRRs are presented net of fees, expenses, and the general partner's profit participation of the underlying investment funds...... [3] S&P 500 and Bloomberg US Aggregate Bond Index data sourced from Bloomberg.

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With approximately 48% of all private investors below their target infrastructure allocations and 88% of all investors seeking to maintain or increase their infrastructure exposure in 2023,[4] growth in the sector is expected to continue. As a result, it is fair to ask what impact this current and future growth will have on returns and what options are available to investors who may be seeking to adapt their investment approach to adjust to the rapidly changing market.

Infrastructure Investment Strategies & Vehicles

Infrastructure assets vary widely on a risk/return basis, from stable, cash-generative operating assets to opportunistic investments that possess characteristics similar to private equity. Although formal strategy definitions continue to evolve, investors most commonly divide infrastructure into the following categories: super-core, core, core-plus, value-add, and opportunistic (see table 1). Further, there are many options for investors looking to gain exposure to private infrastructure, including open-ended, or evergreen, private funds and closed-ended funds, each of which has its own set of benefits and detriments.

Open-Ended Infrastructure Funds

Open-ended infrastructure vehicles have risen in popularity in recent years, especially by investors drawn to the turnkey solution they offer: diversified exposure, current yield, and the potential for liquidity. As a result, fundraising in the open-ended market has increased rapidly. At the end of 2017, just 15 open-ended infrastructure funds had been launched. As of October 31, 2022, that number had increased to 51, including 20 funds that launched in 2022 alone. With the growing number of funds comes increasing dry powder seeking new investments, which stands at over $20 billion.[5]

By buying into an existing portfolio of assets, investors in open-ended funds can eliminate the blind-pool risk inherent in closed-ended vehicles and gain immediate exposure to a diversified portfolio of assets. Further, the

Table 1. Infrastructure Investment Characteristics

	Super-Core	Core	Core-Plus	Value-Add	Opportunistic
Typical Target Net Return	5%–7%	7%–9%	10%–12%	12%–15%	>15%
Key Risks	Counterparty Risk, Financial Leverage	Operating Risk, Financial Leverage	Operating Risk, Strategy Implementation	Contract Risk, Strategy Implementation	Market Risk, Technology Risk
Main Return Driver	Income	Income	Income & Appreciation	Primarily Capital Appreciation	Capital Appreciation
GDP Sensitivity	Low	Low	Low/Medium	Medium	Medium/High
Greenfield/Brownfield	Brownfield	Brownfield	Predominantly Brownfield	Both	Both
Operating Complexity	Low	Low/Medium	Medium	Medium/High	High

NOTES: Target net returns are presented for illustrative purposes only and reflect typical stated target returns to limited partners in the named strategies from infrastructure fund managers, net of manager fees, expenses, and carried interest over the life cycle of an infrastructure fund. Given the anticipated risks of each infrastructure strategy, actual returns will vary and could differ significantly from the target net returns shown.

[4] Infrastructure Investor, "H1 2023 Investor Report." [5]bfinance, as published in Infrastructure Investor, "The Explosive Growth of Open-End Funds", December 8, 2022.

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existing yield generated from the portfolio and the existing asset base diminishes or removes the J-curve effect (a characteristic common in closed-ended funds, in which returns early in a fund's life are negative as a result management fees being high in relation to assets during the ramp-up of investment activity). As a result, an investment in an open-ended vehicle can have an immediate positive impact on investment returns and portfolio construction. The permanent-capital aspect of such evergreen vehicles can also present an attractive component for investors, particularly for those with smaller investment staffs and a desire to maintain an infrastructure allocation without having to consistently underwrite new commitments.

While there are many benefits associated with open-ended fund structures, there are also several factors that potential investors should consider. To accommodate investor inflows and outflows and the associated mark-to-market requirements, open-ended funds are limited in the types of investments they can pursue. Generally, open-ended funds must invest in mature, stabilized assets, commonly referred to in the industry as core or super-core. These assets can deliver attractive current yield but have limited opportunity for the capital appreciation commonly associated with non-core strategies (i.e., core-plus, value-add, and opportunistic). Additionally, record-high fundraising, combined with the buy-and-hold nature of assets in open-ended funds, have created a scarcity of core assets in the space, thereby increasing competition.

"Record-high fundraising, combined with the buy-and-hold nature of assets in open-ended funds, have created a scarcity of core assets in the space, thereby increasing competition."

Investors in evergreen structures also often face queue times, and with all capital invested at once, the time-diversification benefits of investing across market cycles—an aspect associated with closed-ended funds—is limited. Once investors are in a fund, there is also often a lock-up period associated with their position, and even after its expiration, liquidity is not always readily available to investors. For example, in troubled markets, where investors seek redemptions in unison, it may take an extended period to ultimately see a return of capital.

Investors in open-ended funds also face potential key issues with asset valuations, both in how they acquire or redeem their positions and how the underlying managers are compensated. Unlike closed-ended funds, where entry points are dependent on dollars paid for the underlying holdings and exit points are based on actual sales proceeds, open-ended infrastructure funds are reliant on interim asset valuations, which are inherently subjective.

Closed-Ended Private Infrastructure

Closed-ended vehicles typically possess a 10- to 14-year initial life divided roughly into thirds: an initial investment period, a period of strategy implementation and execution, and a divestment period (where managers crystallize their value creation through sales processes). While these structures can encapsulate the lowest-risk infrastructure strategies, they are particularly well-suited for non-core. Typically in these strategies, investors are seeking to acquire an asset, implement a series of operational changes and business model enhancements to de-risk the asset, and then ultimately sell the improved asset at a higher valuation than purchased. Without having to account for the possibility of redemptions, a manager of a closed-ended vehicle is able to transform complex assets that would not otherwise be possible.

These closed-ended funds, however, do possess blind-pool risk. They are invested over a 3- to 6-year time horizon and have a 10- to 12-year fund life, over which net asset values rise and fall. As a result, portfolios built through closed-ended fund commitments require consistent monitoring and re-investment of distributions.

Economic expenses in closed-ended funds also tend to be toward the upper end of the spectrum, often with management fee and carried interest structures substantially similar to those seen in private equity (1% to 2% annual management fees, 20% carried interest).

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This can cause a J-curve effect for the first one to two years of a fund's life. However, investors have tools at their disposal to minimize the impact of the J curve and overall economic expenses through consistent commitments to economics-free co-investments and fund investments in the secondary market.

Where are Today's Infrastructure Market Opportunities?

With private infrastructure managers flush with dry powder from investors seeking to find assets to deploy capital into, the sector has become more competitive, bringing into question infrastructure's ability to deliver the attractive risk-adjusted returns it promises.

Within the core sector, where assets tend to be stabilized and de-risked at the time of acquisition, fund returns have declined since 2010. Looking at three-vintage-year cohorts (e.g., 2010–2012 funds, 2013–2015 funds), since-inception returns for core funds have consistently declined since 2010, falling from the low double-digits to the mid single-digits, whereas, value-add and opportunistic infrastructure funds have seen returns stay consistently in the low double-digits in each successive cohort.[6] The decline in performance for core funds has coincided with a general decline in fund return targets from core infrastructure managers.

Interestingly, the performance of value-add and opportunistic infrastructure strategies (as defined by Burgiss Private i) have not experienced a similar decline. Active management and value-add strategies provide a means for managers to generate additional alpha for their investors while managing the level of risk exposure in their portfolios. By acquiring an asset with some degree of risk (e.g., greenfield, contract, market) and de-risking the asset through value-creation methodologies, managers can create an asset that is of more interest to acquirers with a lower cost of capital. Many value-add managers are copying the techniques used by private equity peers for decades and applying them to infrastructure assets to create values, including the following:

> *"Active management and value-add strategies provide a means for managers to generate additional alpha for their investors while managing the level of risk exposure in their portfolios."*

- Transitioning a legacy business model to a future-proofed technology (e.g., rollout of fiber to upgrade an existing copper or cable broadband connection)
- Enhancing operational efficiency to improve profitability (e.g., improving turbine efficiency and start-up time and decreasing unscheduled downtime in a power plant)
- Growth through market consolidation and inorganic growth initiatives (e.g., acquiring new pipelines to increase covered acreage in a basin for a midstream company)
- De-risking through revenue expansion (e.g., parking structures providing ancillary services, such as car washes and valet parking)

As the supply of existing operational, de-risked core infrastructure assets shrinks from the expansion of long-term-hold open-ended funds, investors are turning to non-core infrastructure assets that have gone through value-creation initiatives and that have become de-risked. While non-core strategies provide the core infrastructure market with an ever-expanding opportunity set of de-risked assets, the core market provides a natural exit point for non-core managers who have a lower cost of capital and can also generate meaningful multiple expansion at exit. The value created during the holding period, combined with the

[6] Burgiss Private i. Returns are based on a composite of the investment funds that constitute the Burgiss Private i global infrastructure pooled benchmark for the defined vintage years, as June 30, 2023, in the strategy categories of core, value-add, and opportunistic infrastructure, as defined by Burgiss. Data was calculated using Burgiss data available as of Tuesday, September 26, 2023. The Burgiss Pooled IRR was calculated by Burgiss as an annualized effective compounded rate of return using daily cash flows and annual/quarterly valuations sourced from limited partner

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multiple expansion often seen at exit, has allowed the non-core infrastructure sector to continue to generate consistent returns despite a growing level of competition.

This non-core, value-add approach requires a greater degree of industry expertise to execute, given the varying complexities and market dynamics between infrastructure sectors. As a result, the infrastructure market is seeing an increase in specialization, including both a rise of industry-focused managers and funds and a larger number of industry specialists and siloed investment teams within generalist infrastructure managers. Investors focused on these value-add strategies in the non-core segments of the market need to consider the underlying sector expertise of managers in their targets industries, as well as the depth of the industry relationships necessary to source investments that are not broadly marketed.

Non-core infrastructure has also increased the number of available opportunities for infrastructure investors, given the strategy's ability to target assets with a greater degree of initial risk before implementing value-creation initiatives. As the competition for traditional infrastructure assets (e.g., roads/bridges/tunnels, airports, railways, regulated utilities, contracted power) that can be passively held has increased, managers have broadened the scope of assets that are considered for infrastructure mandates. These managers have shifted toward viewing infrastructure assets in terms of their characteristics rather than their appearance. Many of these industries (e.g., digital infrastructure, renewable energy, freight transportation, logistics services) have undergone a transition from private equity–focused industry subsectors to infrastructure mandates. Most recently, infrastructure managers have begun entering asset-light essential services, the broader energy transition markets, and telecommunications. These new sectors have gained the attention of value-add managers, who have identified their potential to deliver strong infrastructure returns.

Summary

The demand for private infrastructure investment to meet the needs of a modern global economy continues to grow. Infrastructure assets have proved their role within broader private market portfolios, and the downside-protection characteristics have translated into strong performance in tumultuous environments. As a result, institutional investors are allocating more capital to the asset class than ever before. Open-ended structures will continue to be a readily available option for investors, and the core infrastructure market is expected to continue to grow, partially as a result of the continued de-risking of new infrastructure industries by non-core managers through closed-ended structures. More than ever before, investors have the ability to customize a portfolio to achieve their desired degree of risk/return by appropriately diversifying by strategy and by fund structure, each of which has its own challenges and opportunities. Today's mature market enables investors of all sizes and risk appetites to enjoy the strong risk-adjusted returns available through investment in infrastructure assets.