Alternative Investments – Brief Look at Infrastructure as an Asset Class – July 2024

Private Equity firms have greatly expanded their exposure to Infrastructure assets over the past 15 years. Despite higher interest rates materially reducing "exits" and new capital raises for PE firms, there has been no let-up in the launch of additional Infrastructure funds. A large number of recent transactions have seen PE firms, perhaps feeling under-sized in the hot Infrastructure space, buying independent Infrastructure fund managers.

This article discusses Infrastructure -- increasingly seen as a stand-alone asset class by institutional investors and Family Offices. We believe there are reasons to be cautious currently, despite strong institutional interest in the asset class.

Emergence as an Asset Class

Infrastructure investments began to attract significant attention in the mid-1990's, despite having been around as a small asset class for over 30 years. Early transactions were driven by cash-strapped governments seeking to avoid required expansions or upgrading while monetizing existing assets. Sales to Infrastructure funds focused on toll highways and bridges and local utilities with regulated returns.

As more dedicated capital was raised post 2009, sponsors diversified across additional assets and geographies. Sought-after assets in the early years had revenues and/or volumes protected by contract and were often the primary transportation link or water supplier or power generator / distributor in a particular region. Growth could come from increases in the rate base to meet growing demand. Returns could also be enhanced through the higher leverage achievable due to perceived safety or defensiveness of the underlying cash flows.

This rationale was then applied to other assets with similar attributes, such as parking lots, pipelines, airports, air traffic control agencies, broadband networks and cell towers.

Investment funds also realized that they could separate infrastructure assets from associated cyclical businesses and thereby surface value. Examples included power islands carved out of pulp mills or midstream assets (e.g., gathering and transmission pipelines, gas plants) separated from larger energy companies funded with a lower cost of capital than was available to the prior parent company.

More recently, the asset class has expanded to include *energy transition* and *electrification* themes, including renewable power generation and related storage assets, data centres and EV charging networks.

Assets owned by dedicated Infrastructure funds have grown at greater than a 15% average annual rate since 2012 to above $1 trillion. Given the perception of lower risk, investors have been comfortable with lower IRRs than are expected from traditional Buy-out funds, with industry commentators suggesting that Infrastructure funds have earned approximately 10% IRRs, about one-third lower than Buy-out funds.

It has been suggested that returns from "long term" investing (meaning, holding assets that have very limited liquidity over the short to medium term) may enjoy a "illiquidity premium" over more liquid or publicly-traded assets. Owners are rewarded for holding an asset that many investors do not want to,

or cannot, hold. Some institutions, particularly insurance and pension funds that seek i) to match assets with long-term cash flows to long-term liabilities, and ii) lower-risk assets that may still have equity characteristics, include this *illiquidity premium* as a rationale to increase exposure to Infrastructure assets.

There are a number of investment themes that support ambitious expectations for Infrastructure spending. Blackrock, the world's largest asset manager, suggests that the decarbonization aspirations expressed by governments will require investments that those governments will never be able to fund. McKinsey estimated meeting zero-emissions will require a $3.5 trillion annual spend. Letko, Brosseau and Assoc ("LBA") have suggested that the electrification of the United States' energy system would lead to a doubling of electricity demand by 2050, following two decades of <1%/year growth.

Within the Alternative investments space, Blackrock believes that infrastructure is second only to private credit in terms of where institutional clients intend to increase their allocations in 2024/2025. Blackrock enlarged its Infrastructure business recently, acquiring Global Infrastructure Partners for $12.5 billion.

Brookfield, a $900 billion AUM Canadian alternative asset manager, raised a record amount for their Infrastructure fund in Q4 2023. They see renewable power and energy transition as one of the fastest growing areas amongst Alternative assets. They identify infrastructure as possessing factors that investors seek: market growth, principle-safety in uncertain times, inflation protected revenues and long-term capital appreciation.

In terms of fund raising, Asia Pacific kept pace with North American and Europe in terms of growth in the middle of the last decade, but has fallen behind of late. However, KKR just closed a $6.5 bn Asian infrastructure fund. The fund's mandate includes power and utilities including renewable, water, digital infrastructure and transportation.

Caution May be Warranted

There is historically a strong relationship between real interest rates and infrastructure sector performance. There is more than $300 billion in dry powder available, following two years of above average fund-raising and reduced investments.

Commentators are beginning to ask whether rising rates and the large increase in uninvested capital allocated to the asset class might result in funds overpaying or stretching the definition of Infrastructure in order to put capital to work.

The *higher-for-longer* interest rate sentiment put pressure on infrastructure asset valuations in 2023, highly-levered utilities in particular. Renewable energy was also hard-hit in 2022 and 2023, as supply chains bottlenecks drove input inflation and higher interest rates made many projects difficult to finance at levels that could generate attractive returns on capital.

We may need a few years to see what higher interest rates will do to the returns generated by traditional infrastructure assets.

Access for Retail Investors

Blackstone introduced new structures that provide *high-net-worth* individuals access to Private Equity products. Funds that provided longer-term capital (no wind-up dates) for real estate and private credit were their focus. Their success motivated competitors to follow suit and we expect similar structures for Infrastructure assets are coming.

However, individual investors can also gain infrastructure exposure through public markets with more modest investments and without the fees charged by private equity. Publicly-held infrastructure enjoys the same tailwinds as do privately-funded, including to the structural growth drivers of energy transition, electrification and digitization. Many of these companies pay attractive dividends as well as offering growth through expansion driven by demographics.

For example, our client portfolios contain electricity utilities with substantial renewables exposure (*EdP from Portugal,* Copel - *Brazil)*, water management utilities (Veolia - *France,* Saneamento Basico - *Brazil,* China Water), airports (Fraport - *Germany,* Aeroportuario del Centro Norte - *Mexico)* and natural gas distribution (Beijing Enterprises).

As another example, 35% of First Pacific's net asset value is attributed to infrastructure assets located in the Philippines, Indonesia and Singapore, including electricity generation, water utilities and toll roads.

LBA's Emerging Markets Fund has a 20% allocation to infrastructure assets (including telco companies), to take advantage of the enormous spending on even basic infrastructure required in many emerging markets.

If you would like to know more about these allocations or investment rationale, please let us know.

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