ROUNDTABLE

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Making sense of a packed mid-market

With no shortage of funds to choose from, infrastructure's mid-market is booming. However, size, discipline and maturity are among the issues our five industry experts are having to contend with. By Zak Bentley

Four years ago, when analysing our H1 2015 fundraising statistics (see p.48 of our Decade anniversary issue), we pointed to "the emergence of mid-market muscle" and asked if investors were shifting to what we called "the neglected middle".

Fast forward to 2019 and we're holding our first mid-market roundtable at the London offices of Antin Infrastructure Partners. There are five managers around the table – although, were it not for reasons of practicality, there could have been five times as many.

This segment has grown so much and so rapidly that one of the advantages highlighted in 2015 – that the mid-market did not exhibit the "supply/demand imbalance" seen at the higher end – is now a concern for some managers, even if there isn't a unanimous view on the issue.

"I wouldn't say it's too saturated," argues Angelika Schöchlin, senior partner at Antin. "Infrastructure, by definition, has fewer small-cap deals than other asset classes, so the mid-market is where it makes most sense to position yourself in terms of dealflow."

This view is echoed by Spence Clunie, managing partner at Ancala Partners, who has taken heart from the greater number of assets and market participants.

"We like the mid-market because there are more opportunities where we can buy in at a sensible price and do a lot with the asset," he explains. "We can improve it, increase it in scale and, over time, have a large business with strong cashflow. In infrastructure, there are a whole raft of investors who want assets which are larger and delivering a strong cash yield, and they are willing to invest in these at a lower discount rate."

Although Rob Gregor, managing partner of Basalt Infrastructure Partners, agrees with these viewpoints, he highlights the mid-market's fluidity. "We've seen an evolution in the market," he says. "Some GPs have moved up to the large-cap space – say $5 billion – leading to what I'd call the hollowing out of the mid-market.

"At the same time, you've had new entrants coming in, looking to raise around $1 billion to $2 billion. They're getting involved because of the weight of numbers, where 90 percent of the dealflow is in the mid-market."

One such entrant is AVAIO Capital, a spin-out from US engineering company AECOM, which targets mid-market construction and redevelopment projects. "We're looking to build long-term real assets and related infrastructure through the creation of platforms, single-asset transactions and carve-outs or build-outs," says Anthony Gordon, a partner at the firm. "There's a surfeit of opportunities with enterprise values lower than $1 billion – the key is spending the time and effort to originate those opportunities."

Oliver Schubert, partner at Vantage Infrastructure – the former European arm of Hastings Fund Management – also sees

$1.9bn

Average infrastructure fund size as at the end of H1 2019

PHOTOGRAPHY: **PETER SEARLE**

Rob Gregor

Managing partner, Basalt Infrastructure

Gregor has been at Basalt Infrastructure since 2010 and is responsible for its overall management of the company. He has more than 25 years' experience in infrastructure and joined Basalt from AMP Capital, where he founded the European infrastructure business and oversaw management of its European infrastructure funds, sitting on the boards of portfolio companies Alpha Trains and Thames Water.

Spence Clunie

Managing partner, Ancala Partners

Clunie founded Ancala in 2010 following five years as a senior managing director at Macquarie. He previously held roles at Dresdner Kleinwort Wasserstein and the Royal Bank of Scotland. He has more than 25 years' experience of investing in and managing infrastructure assets. He has led Ancala on transactions in sectors such as utilities, bioenergy, hydropower and gas pipelines.

Angelika Schöchlin

Senior partner, Antin Infrastructure Partners

Schöchlin is a member of Antin's investment committee. She joined the firm in 2010 after nearly eight years as a director at Terra Firma. She previously worked in Goldman Sachs' investment banking division. She has experience in both principal investment and mergers and acquisitions.

Oliver Schubert

Senior partner, Vantage Infrastructure

Schubert leads Vantage's equity investments origination and execution team. He has been with the firm since April 2018, when Hastings Fund Management's European team was bought by Northill Capital. He joined Hastings as an executive director in 2012 and was a member of its executive and investment committees. He was previously a senior vice-president with Macquarie in Germany.

Anthony Gordon

Partner, AVAIO Capital

Gordon joined AVAIO in October 2018 following its spin-out from AECOM, which he joined following 14 years as managing director for energy and infrastructure at hedge fund manager Och-Ziff Capital Management. He has concluded numerous transactions across the energy value chain and invested in energy technologies at varying stages of marketplace adoption. He was also vice-president and managing director at Goldman Sachs' energy and power division from 1996 to 2002.

deals in the larger end of the market as a reason to remain in the middle.

"The core, large-cap space has become extremely competitive," he says. "But the competition is very much based on the lowest cost of equity and the most aggressive capital structures, while underpricing certain risks. In the mid-market, you get better risk-adjusted returns and have more opportunities to invest in deals on a bilateral basis, which is almost impossible in the large-cap space."

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> **OLIVER SCHUBERT**
> **Vantage Infrastructure**

Growing pains

The question nevertheless remains about when a mid-sized manager becomes a large-cap one. Is this solely down to fund size, or is it about how the manager invests its capital?

"The mid-market is quite a vast way of looking at things," says Schöchlin. "We can do buy-and-build strategies, where you can start quite small; we can build things up over time; and we can go into growth stories where we deploy a lot of additional capital. So, we feel comfortable in this range, where we play across the mid-market spectrum from the lower end to the higher end."

Platforms are the favoured method for many in the space, including Basalt, although Gregor says there is a limit to this.

"If you look at the definition of mid-market, it hasn't changed in over 10 years," he says. "We would look at asset size rather than fund size. In our view, mid-market is where assets have an enterprise value of less than $1 billion.

"With fund size now an average of $1.9 billion, when it was previously about $1 billion, you can see that migration to the larger fund sizes in action. But we still want to make sure Basalt remains dedicated to that mid-market space. If you have a $10 billion fund, you're going to have to write out a lot of cheques to take advantage of that $1 billion EV."

At this point we are reminded that infrastructure is still very much the younger cousin of private equity, with plenty of room to mature.

"Private equity mid-market firms will actually raise a €4 billion fund and do 20 investments. There's no infrastructure manager that is currently doing that," says Clunie. "Infrastructure managers haven't had to yet, but logically it should evolve towards that. You can have a larger fund and do more investments. Just stick to the thesis. The investors in infrastructure have allowed people to raise larger funds and gravitate out of that."

Of all the managers around the table, Antin comes closest to testing that theory. *Infrastructure Investor* understands that the French manager is raising a fund of up to €6 billion, although it has never commented on this.

Schubert adds the onus is on investors to both understand and assert what they want from their investments.

"The differentiations in strategies and consolidation among managers hasn't really happened in infrastructure yet as it has in private equity," he says. "At the same time, infrastructure is the only alternative asset class which has such a broad range of risk/return strategies. You can go for 'super-core', bond-like, regulated assets with single-digit returns; or private equity-like investments with double-digit returns and a completely different risk profile.

"As an investor, understanding where in infrastructure you want to invest is quite important. Investors capable of allocating more and more to the larger managers will do so. At the same time, some investors will see they're less relevant in a larger fund and will want to be more relevant." However, Schubert believes it will be some time before the mid-market as a whole reaches this level of maturity.

Calling in to question

Those LPs that have already reached this level of maturity are increasingly inquisitive of managers. Whether our participants believe the mid-market is saturated or not, LPs have a wealth of strategies to choose from, meaning any concerns they have will need to be thoroughly addressed.

Clunie, like many around the table, says track record is important in these discussions, though it is an issue that still needs to be handled carefully.

"We've walked into meetings with investors and shown our track record," he says. "Because it's good, they said we must have taken more risk – where we haven't been. Some investors also feel infrastructure

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ANGELIKA SCHÖCHLIN
Antin Infrastructure Partners

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ROB GREGOR
Basalt Infrastructure

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> **SPENCE CLUNIE**
> **Ancala Partners**

should be like investing in a bond-like product. However, the reality is that, through the financial crisis, a lot of those assets were shown not to be bond-like.

"I feel like this is likely to happen again in another downturn, and hence active management of such assets is important to ensure the appropriate risk/return ratio is maintained."

Explanation required

Managers also have to answer questions on the perennial issue of high valuations, which is present across asset classes. This does not necessarily signal that something is wrong. But, as Schubert admits, it needs to be explained to LPs.

"People have different ways of bidding for assets, but you need to take into account your capital structure, your business plan risks and your expected return, which we do," he says. "On some transactions, you might be outbid by somebody, but at least you apply consistent methodology to all of your investments and protect the downside for your investors."

Schöchlin agrees valuations are "on everyone's minds", but she also finds that LPs are increasingly focusing on the macro end of the market.

"There's an element of regulatory and political risk more broadly," she says. "Given we don't invest in regulated assets, it's less of an issue for us. Having said that, infrastructure is always, to some extent, connected to political risk."

According to Gregor, managers are increasingly being quizzed on their exit records and strategies as the asset class matures.

"LPs are asking, 'What exits have you had?' We have to show how we originated the asset, what value we added to it, how we've de-risked it, who we've sold it to and the ultimate return," he says. "They want to see that lifecycle set out. They're also asking about team experience, retention and how you incentivise your teams."

With its focus on constructing assets, AVAIO faces slightly different challenges to some of its mid-market peers. However, Gordon says it still needs to take into account some of the issues these firms face.

"We need to think about what asset valuations are going to be like in the future, who's going to buy those assets from us," he says. "On fundamentals, we need to ask, 'Do these assets make sense? Will there be a market for these assets?'"

LPs have also been vocal about style

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> **ANTHONY GORDON**
> **AVAIO Capital**

drift, something several mid-market managers have fallen prey to, as they attempt to differentiate themselves in a crowded field.

In an ideal world, Gordon's belief – that "either it's in the box or it's not in the box; it's pretty clear what you should be doing and which opportunities one should pursue" – would hold true. Yet Schubert maintains that infrastructure lost its "boring" tag a long time ago and "there are more sub-sectors where we see an overlap with private equity".

So how do our panellists prevent style drift from happening? For some, it's about adapting the manager's focus, rather than changing it altogether.

"We're fortunate that we have quite a lot of diversity," says Gregor. "We can be looking across sectors and still satisfy the characteristics of infrastructure. We like utilities and we have the ability to look at the US market in a completely different way to how we look at Europe.

"For example, we're doing utility deals in the US, but we're not doing utility deals in Europe, given the pricing pressures." He says this ability to adapt enables the firm to construct portfolios, in terms of sectoral and geographical coverage, that provide attractive levels of risk and return.

A similar view is espoused by Schubert, who says Vantage adapts its strategy by excluding sectors, rather than risking style drift on the core-plus end. "There are highly regulated assets in Europe that we would be much more cautious on than we would have been five years ago, because there is more risk attributed to them and that is something we have explained to our clients," he says. "What we don't do is try something completely different and buy a business that has nothing to do with infrastructure."

For Antin, it is not strategy that prevents style drift, but the firm's relationship with its investors.

"You've raised a fund with a strategy and with a team, and that's the relationship you're building with your LPs," says Schöchlin. "You cannot work with your clients by doing something completely different to this."

However, Clunie points out that mid-market style drift isn't necessarily driven by managers in search of new assets.

"We need to be stringent to not be tempted to compete with some of the direct/PPP investors who are moving into more operational asset types," he says. "We have to stay true to our returns and our risk profile, and that may mean we've got to make more effort and stay diligent to what we're focusing on."

Gordon offers a different perspective: "We are constantly thinking about what valuations are going to be in the future and who's going to buy those assets from us. We're laser-focused on whether each opportunity makes sense."

This, of course, does not mean that new asset types, particularly in digital infrastructure, should be excluded. As managers increasingly move towards sector-specific strategies, it appears our packed mid-market is only going to become more crowded. ■