US Investors Move to "Higher Alpha Infra"

Opportunities at the lower end of the middle market are catching investors' attention in the evolving US infrastructure scene, where responsible investing is also on the rise

Brian DeFee
Managing Director, Capstone Partners

What's the current state of play with the US fundraising market, and is there a bifurcation in the market for infrastructure?
Global infrastructure fundraising numbers have been off the charts the past few years. Preqin data shows that $98bn was raised across 88 funds in 2019. While the number of funds closed was down approximately 7% from the prior year, the aggregate capital raised was up approximately 4%. North America was a considerable benefactor in 2019 as almost $50bn of capital was invested in funds focused on the region. And at the start of 2020 we are witnessing the highest number of funds in market with the highest aggregate capital target. So, we expect to see a continuation of this growing trend in fundraising.

The current state of the US fundraising market is interesting for most infrastructure funds. In general, the universe of US-based LPs interested in infrastructure is not nearly as deep as those in other geographies; however, the interest level continues to grow annually. For the past several years we have heard from LPs and/or consultants that they backed a couple of very large, global infrastructure players so their portfolio is fully allocated in this sector. However, as interest grows and LPs' portfolios evolve, we are slowly hearing less of this. In fact, many US LPs are beginning to focus on adding to their infrastructure allocation for diversification reasons as well as outperformance. We are in the early innings in the US, but we believe over time there will be more interest in the US lower middle market, but also a move away from core strategies to value-added strategies or, as we say, "higher alpha infra."

Where do US investors' interests lie?
Well, I can tell you where the interest does not lie – and that's anything near the wellhead. For better or worse, energy is a four-letter word in most investment committee meetings across the US. And one must remember that much of the reason that US LPs have younger, less diversified infrastructure portfolios is the longstanding prevalence of natural resources investments. Many of these LPs deployed considerable amounts of capital during or immediately following the 2015 slide in oil prices and, to be quite frank, many if not most of these LPs simply have not seen capital returned – i.e. capital calls are still outpacing distributions. Even high-profile LP stalwarts are announcing that commitments to natural resources investments have been the greatest drag on their portfolios as of late. And, of course, this also creates a drag on US LPs' appetite for new infrastructure commitments.

The infrastructure market can be one of the most difficult for LPs to find unique strategies as we often hear that "everything tastes like chicken." We've seen steadily growing interest in the lower middle market where there are ample opportunities and far fewer players. Additionally, we've not seen the windfall of capital investment in the US infrastructure landscape that was promised in the 2016 presidential elections, so there remains a lot of investment opportunities.

The shift in strategy away from core to core-plus or value added is becoming more and more interesting for US LPs. In fact, in a survey of investors, Preqin reported that value-added strategies are perceived as the best opportunities. Much of this is due to the expected return profile of these deals being more attractive, but also the fact that at the lower end of the market there are simply more of these opportunities. Energy midstream and even downstream are both continuing to see interest from US LPs, as well as adjacent sub-verticals, e.g. wastewater removal, water treatment facilities, and new downstream processing assets. The area that is seeing the most attention as of late is renewable and/or sustainable investments. Solar energy is nothing new to LPs, but water treatment facilities and/or e-recycling are attracting more attention. In fact, many LPs have pivoted away from carbon-producing investments near the wellhead to focus on more environmentally friendly opportunities. And many infrastructure funds focused on the lower middle market should be in a prime position to provide these types of opportunities to investors.

How has the rise of responsible investing and ESG impacted infrastructure fundraising?
This is an interesting and timely topic; we are finally starting to see private capital managers, in general, address responsible investing and implement ESG guidelines and protocols. Fact of the matter is that many of the natural resources and infrastructure managers have been required by LPs to adhere to strict ESG policies for years. This has been a lead topic of conversation by LPs with metals & mining managers, for example, for quite some time. But we are finally starting to see the implementation more broadly across private equity, venture capital, and other strategies. When I began my career in private equity in 2006 there was no discussion of this in private equity & venture capital, but fast-forward to today and it's a top-of-mind topic.

In the infrastructure sector, it is very important that GPs have robust, well-defined ESG policies and protocols that are more than merely pieces of paper dusted off for fundraising. GPs need to enforce these policies, but also nurture a culture of accountability and adherence. It's an unfortunate reality that there are a few bad actors in the investment community, and always will be, but what LPs find unacceptable are poor investment practices and/or corrupt management practices which are not monitored, identified, and addressed properly.

So, while the UN PRI standards, as an example, are helpful and provide comfort to investors, the focus should be on implementation and execution of these policies. I think we're seeing progress on this front – considerable progress from when I started my career in private equity. However, it will take several years of GPs implementing, administering, and adhering to responsible investment policies before we can claim success in changing attitudes within private markets.

Capstone Partners

Founded in 2001, Capstone Partners is a leading independent placement agent focused on raising capital for private equity, credit, real assets, and infrastructure firms from around the world.

Brian is responsible for distribution and business development in the Northeastern and Eastern US and leads the firm's energy/real assets advisory efforts.

www.csplp.com