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Calm in the Storm: Investing in Infrastructure

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Infrastructure assets have provided stability and protection for investors, helping to sustain private equity (PE) deal activity and fundraising through a period of macroeconomic uncertainty. We examine what is driving growth in the PE infrastructure space and how fund managers are expanding beyond the traditional infrastructure categories to unlock new opportunities.

These are challenging times for PE, as rising inflation and interest rates dampen deal flow and fundraising. Global buyout deal value slid 41% year-over-year in 2022, according to Mergermarket data, and this trend is continuing in Q1 2023, with global buyout deal value having contracted by 57% since Q1 2022. Buyout fundraising was down 16% during the same period, as reported by Bain & Company.[1]

One area that has held firm, however, is infrastructure. The long-term revenue streams of infrastructure assets have provided a natural hedge against inflation and positioned the sector as a haven in times of uncertainty.

Increasingly risk-averse investors have pivoted their allocations decisively toward infrastructure strategies, which are typically less cyclical. A Nuveen survey of investors found that 58% plan to increase their allocations to infrastructure strategies over the next two years.[2] These investors have continued to deploy capital into infrastructure funds, even though fundraising for buyout and venture capital strategies has contracted.

Bain & Company analysis of Preqin data shows that, in 2022, year-over-year infrastructure fundraising climbed by 22% (as compared to a 16% fall in buyout fundraising and a 14% drop in venture capital fundraising).[3] Infrastructure fundraising highlights included Stonepeak closing its fourth infrastructure fund on US$14 billion,[4] I Squared Capital raising US$15 billion for its third and largest ever global infrastructure fund[5] and KKR raising US$17 billion for its fourth global infrastructure vehicle.[6]

Returns have also been impressive. Infrastructure was the second strongest performing private markets asset class in 2022, according to McKinsey, with only the cyclical natural resources space showing stronger performance.[7] Between 2008 and 2021, infrastructure delivered a track record of steady long-term returns relative to other private markets strategies.[8]

"Infrastructure is in the spotlight and is likely to remain center stage," says Ropes & Gray asset management partner **Amanda Persaud**. "There is huge demand to improve not just brick and mortar assets, but also digital connectivity. This is turbocharging infrastructure investment globally."

Infrastructure's resilient characteristics and robust investor support have given fund managers the confidence to continue deploying capital despite the uncertainty and dislocation in wider M&A markets—global M&A deal value (excluding global PE deal value) contracted by 27% year-over-year in 2022, according to Mergermarket data, and it is down by 38% in Q1 2023 as compared to Q1 2022.

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>
> *— Marko Zatylny, M&A*

Big-ticket infrastructure transactions in the past 12 months include Carlyle Group's US$1 billion investment in cell tower platform business Tillman Infrastructure,[9] UBS's acquisition of a portfolio of Texas energy storage assets from Black Mountain Energy Storage[10] and Blackstone's investment in Italian infrastructure group Atlantia.[11]

These deals have underscored the sector's resilience, with infrastructure's predictable, non-discretionary revenue streams giving dealmakers the confidence to invest despite wider macroeconomic uncertainty.

"Infrastructure-linked M&A has held up strongly in the past year. Strategics and PE investors have remained active, and auction processes have been competitive. The buyer universe has expanded, and there have been attractive opportunities on the sell-side to secure good multiples for assets," says Ropes & Gray M&A partner **Marko Zatylny**.

Debt for deals

The stability of the infrastructure sector through recent market dislocation has also meant that lenders remain willing to finance infrastructure deals, even as overall financing for M&A deals (including PE deals) has contracted steeply in the face of rising interest rates. According to Debtwire data, high-yield and leveraged loan financing for corporate and buyout M&A in the United States slid approximately 40% in 2022 year-over-year, from US$541.64 billion in 2021 to US$328.17 billion in 2022.

According to Fitch, infrastructure and project finance assets recorded the lowest proportion of deteriorating outlooks when compared to other global industries, with only 13.3% of the assets tracked by Fitch showing a deteriorating outlook.[12]

The essential nature of infrastructure has shielded the sector from drops in demand, and lenders have taken comfort in the protection offered by high levels of contract-based, inflation-linked revenues. According to S&P, this has seen infrastructure default rates come in materially below the default levels recorded by other corporates.[13]

"Infrastructure dealmakers can access different pools of capital, backed by lenders and institutions with long-term investment horizons. Lenders in the leveraged buyout space have hit the brakes due to choppier markets, but we continue to see banks willing to underwrite with a view to syndicating multibillion-dollar infrastructure debt packages," says Ropes & Gray finance partner **Michael Kazakevich.**

This has allowed infrastructure dealmakers to continue tapping loan and bond markets for financing at reasonable rates, with limited syndication risk. In Germany, for example, joint venture partners Vodafone and Altice were able to place a €4.6 billion loan to invest in fiber-to-the-home broadband infrastructure in March 2023 with little trouble.[14]

Sponsors investing in infrastructure have also benefitted from the emergence of infrastructure financing in the private debt space, which has provided yet another source of capital for deals. Although still relatively new, private infrastructure debt strategies have gained traction in the market and secured increasing levels of investor support. Ares Management, for example, closed is fifth infrastructure debt fund on US$5 billion at the start of 2023.[15]

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— *Michael Kazakevich, Finance*

The expanding infrastructure investment scope

Infrastructure, however, has become a more complex asset class to understand and navigate as it has grown over the past decade.[16]

Infrastructure managers have had to differentiate their offers as the market has become more competitive, which has seen PE firms look beyond traditional infrastructure definitions to stand out from the crowd.

"Across all private market asset classes, we have seen fund managers become more specialized as competition increases. This is also playing out in infrastructure, and we see fund managers and investors looking at infrastructure sub-sectors in ways that they were not doing previously," Ropes & Gray asset management partner **Eric Requenez** says.

Digitalization, energy transition, and new approaches to mobility and transport, meanwhile, have trans-

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formed broader thinking around the core services people and organizations require.

"If you think of infrastructure assets as facilities that support the economy, the expansion of the infrastructure category has been a natural response to how the world is shifting. Digital infrastructure didn't really exist 20 years ago, but now it is a service you can't manage without," adds Ropes & Gray real estate transactions partner **Richard Gordet.** "The way we conceptualize infrastructure has changed, with ever greater crossover between real estate, infrastructure and technology."

New categories of infrastructure investments still offer similar characteristics to classic infrastructure plays, such as stable revenue streams in defensible markets in which infrastructure owners can negotiate long-term contracts. At the same time, however, new areas require significant up-front investment, a tolerance for initial negative cashflows as new projects are built out, and a higher risk appetite.[17] Different branches of infrastructure offering a wider mix of risk-reward dynamics have emerged in response to these trends.

Super-core infrastructure plays encompass the classic infrastructure assets in areas like power or water, in which tariffs are regulated and demand is predictable. Core infrastructure offers similar low-risk, low-return dynamics and includes assets like toll roads, airports and pipelines, in which cash flows are stable but more exposed to shifts in demand. Core-plus strategies, which typically target more "operational" assets like motorway service stations, hospitals and data centers, offer higher return profiles but higher risks. Core-plus assets present similar characteristics to pure-play infrastructure but without the same levels of downside protection.[18]

"Infrastructure by its nature has had lower fees and lower carry, but that is changing as the nature of infrastructure evolves and we see greater convergence between infrastructure, real estate, tech and buyout strategies," says Persaud.

This shift has seen infrastructure become more than simply a safe asset class in times of uncertainty. Infrastructure still offers stability, but fund investors and managers have become more nuanced, pursuing different pockets of infrastructure that provide various levels of risk and reward.

"Investors are taking a much more granular approach and will split out infrastructure allocations across super-core, core and core-plus strategies," says Ropes & Gray asset management partner **Debra Lussier.** "Infrastructure investors are drilling down into the risk-return profiles and bucketing their investments accordingly."

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> *— Richard Gordet, Real Estate*

The dash for data

The growing consumption of data—driven in part by the digitization of virtually all industries—is a prime example that the lines between infrastructure, real estate and buyout strategies have blurred.

According to UBS, telecom assets—which include data centers, telecom towers and fiber networks—accounted for a fraction of overall infrastructure deal flow as recently as five years ago. By 2022, however, telecom M&A deals (including PE deals) represented close to one-fifth of infrastructure deal volumes.[19]

Data creation, capture and consumption have seen huge growth in the past decade, with Statista figures showing a more than tenfold increase from just nine zettabytes in 2013 to a forecast of 120 zettabytes in 2023 and more than 180 zettabytes by 2025.[20]

This has produced a frenzy of investment activity in areas such as data centers as private markets managers move to invest in assets in this space and capture growth. According to Synergy Research, data center-focused M&A deal value (including PE deal value) reached US$48 billion in 2022—only slightly behind the US$49 billion posted in 2021, a blowout year for global M&A, and the second highest annual total going back to 2015. PE firms led 10 of the 12 largest data center deals in 2022, including KKR and Global Investment Partners' US$15 billion takeover of CyrusOne.[21]

"PE firms have moved into the data center space in force over time. Strategics also remain highly active. The large cloud service providers, such as Amazon Web Services, Microsoft Azure and Google Cloud, continue to invest aggressively, and other businesses are also investing in their own data centers. It is a very hot market," says Ropes & Gray private equity transactions partner **Brandon Howald.**

The surge in data center growth and corresponding M&A activity, including PE activity, reflects how data provision has become an essential service for consumers and businesses, and presents "infrastructure-like" characteristics, including high margins, non-discretionary spending and highly defensible market positions, according to UBS.[22]

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— Brandon Howald, Private Equity

At the same time, however, the huge interest in data center assets has driven up entry multiples, even though data center investments are characterized by lower initial cashflows. This shows how fund investors and managers have had to rethink traditional assumptions around what infrastructure involves and take a more flexible approach.

In some cases, different players will even target different parts of the data center value chain, as Ropes & Gray private equity transactions partner **Taylor Hart** points out: "There is significant joint venture activity in the data center space. Strategic, private and real estate investors will combine resources and capabilities to spread the upfront development costs and activities."

Going green

Energy transition is another area where infrastructure players are having to adjust strategies and risk-reward expectations. Looming climate change risk has seen governments and businesses around the world prior-

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itize weaning the global economy off hydrocarbons and transitioning to net-zero energy systems.

Energy transition presents a huge opportunity for infrastructure investors, with McKinsey estimating that an investment of US$275 trillion will be required to achieve net-zero emissions targets by 2050.[23]

Much of this will be allocated to familiar areas for infrastructure players, such as power distribution networks, power generation, water utilities and transport. As in the case of data centers, however, scaling up the provision of onshore and offshore wind, green hydrogen, electric vehicle charging, and electric battery storage will likely require infrastructure stakeholders to refresh their approaches and risk appetites.

As seen in the data center space, joint ventures have also proven popular for energy transition deals, as they allow dealmakers to spread out up-front capital expenditures.

"In industries like wind or solar energy, big checks have to be cut to develop new projects. Strategics don't want to carry all of that financing risk on their balance sheets, so they will partner with financial sponsors to take some of the load in return for a share of the cash flows at the back end once the project is complete," says Zatylny.

Investors and dealmakers will have to accept that remaining relevant in the infrastructure space will involve a different, more creative approach to dealmaking, one that requires betting more on growth, accepting more commercial risk, and coping with high levels of investment and weaker cashflows up front.

Despite these hurdles, firms are taking advantage of the vast opportunity that energy transition represents. For example, Brookfield is preparing to raise US$20 billion for its sophomore energy transition fund this year, only a year after banking US$15 billion for its debut energy transition vehicle in 2022,[24] while Blackstone is on track to secure up to $13 billion for energy transition as its wraps up its green energy credit and equity funds.[25]

Paris-based fund manager Ardian, meanwhile, has partnered with FiveT Hydrogen to raise €2 billion for the largest infrastructure fund focused on clean hydrogen, which will crowdfund public sector, debt and co-investment capital to unlock up to €20 billion for green hydrogen projects.[26]

Energy transition M&A deals (including PE deals) have proven equally robust, with Infralogic recording US$76.32 billion in energy transition deal value in the first quarter of 2023, up from US$69.39 billion recorded in Q1 2022.[27]

Infrastructure investors that are adapting to energy transition are seizing the chance to benefit from the growth trajectory and compelling long-term value green infrastructure assets offer.

"Environmental, social and governance factors such as climate change are a key piece of the investor lens. Investors want to see returns, but also put dollars to work in areas that are going to improve the environment and health. That overlays nicely with infrastructure, where fund managers are at the forefront of decarbonizing energy and green development," Lussier says.

Infrastructure fundraising and deal activity have proven remarkably resilient in the face of rising interest rates, inflation and economic uncertainty. In uncertain markets, investors have actively sought out infrastructure strategies that provide exposure to assets offering essential, non-discretionary services that generate stable, non-cyclical revenue streams.

While infrastructure remains a natural hedge against inflation and a steady option in choppy markets, the nature of the asset class has changed and requires a more sophisticated approach from investors.

The crucial importance of data provision and internet connectivity to businesses and consumers has seen telecom and data center assets converge with classic infrastructure plays in utilities and transport. Energy transition, meanwhile, has obliged investors to take on more technology and commercial risk to remain relevant as the global economy switches from legacy hydrocarbon infrastructure to renewables and still nascent areas like battery storage and green hydrogen.

The rapid change in what constitutes a core infrastructure service and how it is delivered has seen the definition of infrastructure widen and the emergence of a much broader set of strategies and risk-return metrics.

This presents unique challenges for infrastructure investors, who are having to get used to managing periods of negative cash flows and higher risks for certain assets. For investors and dealmakers who can adapt, however, the rapid growth of new infrastructure categories present significant potential in the long-term.

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> *— Debra Lussier, Asset Management*

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ENDNOTES

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