Building on Infrastructure

Investors in search of yield increasingly are turning to infrastructure, where private markets investment firm Pantheon has nearly three decades of experience. *Chief Investment Officer* spoke with Pantheon Partner **Kathryn Leaf Wilmes**, head of global infrastructure and real assets, to find out where the opportunities are and how Pantheon is taking advantage of them.

***CIO*: What's driving the intense interest in infrastructure? Is it all low interest rates?**

Kathryn Leaf Wilmes: With record low interest rates, many investors are looking for defensive strategies that also have the potential to produce yield. Infrastructure fits that bill perfectly. There is also a longer-term trend at play where investors are looking to establish, and increase, allocations to infrastructure as a stand-alone asset class for diversification purposes and as an inflation hedge. The combination of these two trends is leading to the robust fundraising environment. To put numbers around it, Preqin found private infrastructure fund managers raised $131 billion from 2013 to 2015, and a one-year record of $52 billion in 2016 year-to-date.

***CIO*: Your approach to the infrastructure market differs from that of many of your peers. What's the key difference, and how does it benefit investors?**

Wilmes: What differentiates us is how we access the asset class on behalf of our investors. Our strategy focuses on secondaries and co-investments. These are less competitive markets where deal flow continues to be robust and relationships are key to unlocking opportunity. The potential benefit to our clients is that we have a lot of deal flow to choose from, which can be a critical differentiator in today's market. We currently invest in less than 10% of the co-investments we see. There can also be significant portfolio benefits in terms of vintage year and asset and manager diversification, which may add additional resilience to our client programs. Lastly, we work very collaboratively with our clients. We do not apply a "one-size-fits-all" approach, so we can tailor programs to a client's specific needs.

***CIO*: What's the appeal of the secondary market?**

Wilmes: We view secondaries as a differentiated access point to the same high-quality infrastructure assets other investors may be investing in directly. The key distinction is that we typically invest several years later. A big advantage of this is that, in many cases, the companies have been de-risked at our entry point; leverage has been paid down and there is clear visibility on operating and financial performance. And because of market inefficiencies, we're often able to buy in at a lower price point than the original investors.

***CIO*: With all the money flowing into infrastructure, what do valuations look like?**

Wilmes: In the direct market, it's 2007 all over again. We are seeing record pricing, particularly for core trophy assets which have significant scarcity value. It has become very challenging for core fund managers to compete with aggressive direct buyers, and this may only get worse as the new owners look to hold these core assets long-term. As a result, core managers are increasingly being pushed up the risk-return spectrum. We see some managers looking to do more greenfield deals, focusing on assets that have more operational complexity, and pursuing opportunities in "stretch infrastructure"—assets that have infrastructure-like characteristics but aren't what people traditionally think of as infrastructure. There are still attractive areas to invest, but we believe investors need to be strategic about how they get exposure.

***CIO*: Given these valuation levels, how are you positioning yourself for success?**

Wilmes: We are trying to build resilience in our client programs. First, we are being highly selective, focusing on reasonably valued assets we believe can withstand market cycles. We're also diversifying by asset type, vintage year and sector. Secondaries are powerful in this respect because they can allow you to invest across multiple vintage years and access deals that may have been completed in a very different valuation environment. Lastly, we are focused on investments with conservative capital structures.

***CIO*: Where are you finding the most interesting opportunities?**

Wilmes: In our view, energy infrastructure, particularly in North America, offers deep value today. The collapse in commodity pricing has impacted valuations of assets that transport, process, and store natural gas and oil. A number of these companies have needed to raise capital to de-lever and fund future projects, and there was a window in the first quarter of this year when many of them were unable to access public debt and equity markets. Through our market relationships, we were able to take advantage by investing in the preferred equity of a couple of midstream companies, gaining what we believed to be strong downside protection through the security along with significant equity upside. We anticipate a second wave of opportunity as challenged exploration and production companies look to divest midstream assets. We've also been investing in de-risked greenfield projects where all key permits and contracts have been secured but where we can earn a return premium for investing at an earlier stage in the life-cycle of the asset.

***CIO*: Are valuations challenging in the secondary market, too?**

Wilmes: We continue to see good value in the infrastructure secondary market, thanks in part to favorable supply-demand dynamics. This market has grown from just over $1 billion of deal flow back in 2010, when Pantheon did its first infrastructure secondary, to $9.7 billion in 2015. Meanwhile, this is still a niche market where the universe of buyers remains very limited. The supply-demand imbalance typically translates to favorable pricing. ■

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REPRINTED FROM CIO December 2016

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