Infrastructure holds firm

Infrastructure fund values are holding up well and the future growth of the secondaries market looks guaranteed. Florence Chong reports

Seemingly insatiable demand for infrastructure is propping up valuations – even in the secondaries market – at a time when pricing for other private market assets has weakened.

So far, the value of secondaries from core infrastructure funds with inflation-hedging assets and first-tier sponsors, are holding firm. But some discounts to net asset value (NAV) have appeared in core-plus and value-add infrastructure secondaries.

Will ongoing volatility and global economic uncertainty test the resilience of core infrastructure assets in coming months – especially with a wave of infrastructure secondaries expected to hit the market?

Evan Corley, partner in global infrastructure and real assets investment team at Pantheon, says: "Trends in the market point to a significant flow of secondary opportunities over the next 12-24 months or more. This is partially a result of portfolio management by investors in response to the denominator effect.

"Generally, infrastructure valuations have remained stable over the last two or three quarters, despite a more volatile market environment," says Corley. Because infrastructure is not as mature as the private equity secondaries market, prices can be a bit more disconnected. "You may see more of a spread relative to private equity secondaries. There is also a waiting game; sellers are holding out for better prices or clarity on valuations," he says.

Edward Keith III, partner and head of infrastructure secondaries at Ares Management, says: "We've seen discounts increase significantly over the past 12 months. It's not uncommon to see discounts of 20% or more on infrastructure assets. One important consideration is the intrinsic value of the assets we buy. For the assets we purchase, NAV is inevitably dated, one to two quarters behind. We factor all of this in when we buy assets and we buy at larger discounts in periods of volatility.

"If the discount becomes very wide, you can see a decline in volume, given the bid-ask spread. Over time, NAV catches up to reality and we see our purchase price stay the same – but the nominal discount shrinks. That's when volume increases significantly.

"For example, immediately after the COVID shock, in financial markets we saw a large bid-ask spread. Buyers pulled back and sellers, other than the most distressed, were in a holding pattern. Once valuations started to correct downward, all of that pent-up volume came to market and there was a material uptick in transactions."

David Perrin, partner at Campbell Lutyens, says: "We have seen some softening in infrastructure pricing for LP [limited partner] portfolio transactions. Over the past five years, on average, we have achieved in transactions a slight premium to NAV across every type of risk profile – from low-risk, low-return assets, through to value-add funds. Over the past six months, we have seen pricing for LP transactions come off on average 5% to 7%."

But this level of discount is still lower than in private equity or real estate, Perrin says. "Par pricing is still achievable from funds of more recent vintage with a blue-chip name or funds investments with high-inflation correlation."

Depending on what you buy, says Mark Benedetti, co-head of Ardian US and a member of the Ardian Secondary Fund management committee, infrastructure is trading at a 5-15% discount. By comparison, the firm has achieved discounts in "the high teens" in recent private equity secondaries transactions.

Ardian has, to date, committed 40% of the US$5.25bn (€4.90bn) raised for its Ardian Secondary Fund VIII, currently the largest secondaries fund in the series. "If you look at how we've built our fund so far, we have done transactions at pretty significant discounts," Benedetti says.

William Greene, managing partner for the infrastructure business of Stafford Capital Partners, says: "Looking back 12 to 18 months, the discount to NAV might have been 1% or 2%. These days, the conversation starts at 5-10%."

Discounts are not new, says Greene. "On the types of transactions we do, we averaged 14% discount in our last fund."

Greene says Stafford has achieved better discounts with each successive fund – from an 8% discount in his first fund up to 14% in Stafford Infrastructure Secondaries Fund IV. He expects the fifth fund in the series, which has a €1.3bn capital-raising target, to benefit from a similar discounting environment.

Changes in seller composition

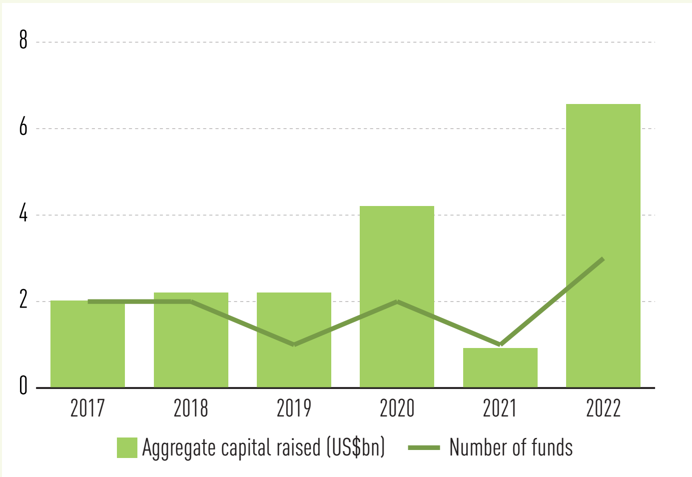
Many in the industry are anticipating a change in the composition of secondaries sellers in 2023. "In the last year we did start to see more LP-led deals," says Corley. "While certainly there were secondaries completed in the second half of 2022, we believe that many groups were sitting on the sidelines to see how pricing and portfolio valuations would develop, given market volatility. Once they have conviction over their valuations, they will review their overall asset allocations.

"I think the trend in 2023 will be portfolio management and perhaps LPs selling strips of their portfolios or certain names to reduce their overall exposure."

This is because many LPs have started to reach their target allocations, says Corley. Now, especially with the denominator impact, they are more willing to look to the secondaries markets for portfolio management. "So while most LPs have seen their overall assets under management decrease, their infrastructure portfolio has been stable, which means they may be at or above the weighting for the asset class," he says.

Perrin agrees that there certainly has been an uptake of LPs selling infrastructure funds, but he thinks

INFRA SECONDARIES FUNDRAISING



Source: Preqin

this wave of LP portfolio sales will build "over the next three years as LP portfolios continue to mature". He says many factors drive LP-led deals. LPs are selling due to the denominator effect, because of over-exposure to a single manager, or when there is a need to recycle the balance sheet so that they can "re-up" and participate in new funds.

"For LP portfolio management, we are likely to see a divergence in approach from different regions," Perrin says. "For example, US investors are generally still building their infrastructure programmes, but European investors have more mature programmes and will generate sellers."

Perrin says the volume of infrastructure secondaries traded last year was between US$7bn and US$8bn – down from around US$13bn in 2021. Stafford's records show transactions led by LPs totalling US$7bn in 2022, with deals led by general partners [GPs] at US$8bn, but Greene believes some GP-led transactions did not close last year.

Perrin believes GP-led deals, by volume, if not by number, will continue to make up 60% of the market in the near term. And he expects to see expanded use of the secondaries market, with the potential for multiple mid-market large-scale GP-led transactions over the coming 12 months. "I think 2024 or 2025 could certainly see a US$20bn market," he says.

Corley says: "GP-led deals have accounted for a significant portion of secondaries deal flow over the past two to three years. And this will continue to be a key theme over the coming year, if not longer."

Benedetti says a "host of GPs" want to carry out transactions so they can hold quality assets for longer in continuation funds (see The rise of the continuation funds). But they are likely to run into buyer resistance on pricing when they can bid on similar assets at better pricing from LP-led transactions.

"Buyers are asking why they should do a deal if it is at or near par [to NAV] when, for example, they have access to an LP portfolio that includes the same assets for a 10%-plus discount," Benedetti says.

Growth in 2023 and beyond

History may judge 2022 and 2023 as years in which infrastructure secondaries hit a roadblock, but market players are convinced that the sector will grow over the long term. "Typically, it takes four to five years

The rise of the continuation funds

The COVID-19 crisis drew attention to the liquidity advantages of these fund

Boston-based ArcLight Capital Partners has become the first mover in what is expected to be a busy year for continuation funds in the secondaries market.

In January, the mid-market sustainable infrastructure fund manager completed the final close of Arclight 3C SPV, its new continuation fund, raising US$407m (€381m).

Continuation funds are created when one or more assets in a legacy fund is transferred into a new vehicle, typically managed by the same sponsor. It is a so-called liquidity event for limited partners, who can roll-over their interest into the fund or cash in their investment.

The capital raised by Arclight 3C SPV was used to purchase the remaining 25.1% interest in Third Coast Super Holdings from an affiliate of ArcLight Energy Partners Fund V.

Third Coast is the privately-owned US Gulf Coast and Gulf of Mexico midstream infrastructure platform, focused primarily on providing eastern deep-water and shallow-water Gulf of Mexico producers with access to gulf coast markets.

The continuation fund gave investors in ArcLight Energy Partners Fund V the choice of monetising their interests in Third Coast or remaining invested in the business.

More continuation funds are expected to emerge in the infrastructure market in the coming months and years. They are one of three approaches commonly used by general partners [GPs] to create liquidity. The other two are asset-strip sales – where a percentage of a fund's portfolio is sold to a new vehicle – or tender offers, where the GP organises a competitive process to identify a secondary buyer to provide liquidity for all or a portion of the funds' limited partners [LPs].

In a note published last year, alternative asset manager GCM Grosvenor said continuation vehicles seemed to offer "perfect" solutions, since they allowed investors the option of taking liquidity if they

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needed it or retaining their investments if liquidity was not a priority.

The firm said that during the COVID-19 pandemic, continuation vehicles were successful because sponsors recognised that, in addition to solving liquidity issues for their LPs, they offered GPs the ability to retain assets under management.

According to GCM Grosvenor, single-asset continuation funds now represent about 50% of total GP-led deal volume.

Wandy Hoh, managing director at Macquarie Asset Management, says: "We have been seeing more single-asset continuation funds over the past year or two. There are definitely multiple reasons why GPs will look to them. Perhaps it is an asset that they want to keep, or they have a business plan to continue to improve the asset. You will see these funds becoming a permanent part of the secondaries market."

A year ago, Global Infrastructure Partners (GIP) launched a continuation fund to hold a remaining interest in Gatwick Airport in the UK after selling a 50.1% stake to French company VINCI Airports. More recently, GIP moved Switzerland-based TIL Group out of its 2011 vintage Fund II into a continuation vehicle worth around €3bn.

Long-dated prime infrastructure assets lend themselves to continuation funds, says David Perrin, partner at Campbell Lutyens. "Once these large assets are sold to a strategic or financial institution, it may be a long time before they come back to the market."

Continuation funds appeal to both GPs and LPs. "We certainly see institutions come into the continuation funds on the buy side," says Perrin. "They are single-asset deals, and a good number of investors have an underwriting capability – either from a direct or co-investment standpoint – which allows them to participate.

"What we have seen in infrastructure is that we can bring participation from institutional investors, such as sovereign funds, pension plans and insurance companies, into these deals, more so than perhaps in private equity."

Campbell Lutyens works with infrastructure funds to raise capital. It also advises GPs in raising liquidity to recapitalise and roll over funds. It also works with LPs in selling fund portfolios. The firm's secondaries team has closed on around US$10bn of infrastructure transactions in the past two years.

Campbell Lutyens estimates that more than 50 infrastructure managers with funds over US$500m have already sought to use the secondaries market with some type of GP-led transactions.

"A key theme we are seeing is that GPs are seeking to raise follow-on capital for assets in older funds that no longer have reserves, but require follow-on investment for growth and development opportunities," says Perrin.

"The secondary market, through structures such as annex funds, can provide a solution here. As part of this trend, we have also advised GPs on using continuation fund structures to help them greenify the assets and, with the follow-on capital, put in place an energy-transition plan."

for what is being raised in the primary market to come to the secondaries market," says Perrin. As a rule of thumb, he says, 1.5-2% of assets under management are sold as secondaries each year.

Infrastructure funds raised US$173bn in the primary market in 2022, according to Preqin, up from US$133bn in 2021.

Stafford's own estimates – US$160bn in 2022 and US$120bn in 2021 – paint a similar picture. "This is a huge 30% increase, and some of this investment will find its way into the LP secondaries markets, starting as soon as 2025," says Greene.

Benedetti also points to the large volume of capital raised in the past three years by megafunds, launched by the likes of Global Infrastructure Partners and KKR. He says capital raised over this period is three times the amount raised in the previous five years. "And for those five years, it was three times the amount raised in the five years previous to that," he says.

"What we are finding is that whenever you have a market that has grown so quickly – and people have invested a lot of money into these funds – it is normal at some point that they will want to actively manage their portfolios. This year will see a meaningful deal flow pick-up compared with last year. It won't surprise me if we have a $20bn-plus year for the infrastructure secondaries market."

That number, he says, could reflect a desire to sell. "The buying capacity out there might only be US$10bn to US$15bn, so not all these groups are going to put their money to work in one year."

Corley says the universe for infrastructure secondaries is less competitive relative to private equity. "There are fewer than 10 fund managers of reasonable scale in the infrastructure secondaries markets, so historically we see more sellers relative to buyers."

What the secondaries market can do is provide an avenue for investors that are under-allocated to infrastructure to backfill portfolios. Benedetti says Asian institutions are definitely net buyers and investors in infrastructure and they are therefore unlikely to be sellers, unless for portfolio management reasons. Those investors that are selling tend to be heavily exposed to the private market, he says.

Another anticipated trend this year is a shift in focus from continental Europe to the US. Ardian's latest fund is likely to channel up to 60% of the capital raised to the US – a reversal of the 60% European bias in its previous fund.

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"The European secondaries market has been a key element of the overall secondaries market over many years, and in certain years we have invested more capital in Europe relative to North America," says Corley. "But generally I would say we tend to be roughly even-weighted between Europe and North America."

Greene says Stafford's "slant towards core" has meant Europe has always formed the largest geographical area of its focus. "We hadn't invested as much in North America in the past, because infrastructure tended to be less core and focused on energy," he says.

"That is changing now with more core assets available, including in the telecommunications, digital infrastructure and renewables space. Our latest fund has both a euro and a US-dollar sleeve, and we now have more freedom to go where the best opportunities are. As such, we will be looking to invest more in the US."