STEPSTONE

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Unlocking Infrastructure's Middle Market

Michael Venne: Today we're talking about infrastructure. One of the most interesting developments in the short history of private markets is the emergence of infrastructure as an investable asset class. The growth has been staggering. Consider that in the year 2000, seven fund managers raised just over $1 billion. Fast forward to 2022, and 156 funds raised $176 billion, according to Preqin. And in that time, infrastructure has followed a similar trajectory as other private market asset classes. A robust primary market? check. Burgeoning secondary market? check. Co-investment opportunities? Check. Fundraising being dominated by roughly a handful of larger firms? Check.

Because much of the capital raised is concentrated at the upper end of the market, that is, large cap or large market managers raising funds larger than $5 billion, when we think of infrastructure investments, many of us think of big pools of capital and massive works of civil engineering. And while that is true, it is not the rule. The fact is that eight out of every ten funds raised over the last few years fall into what we call the middle market. Joining me today to discuss this opportunity are Todd Lapenna and Sean Ebsary, a partner and vice president, respectively, on our infrastructure team. Todd and Sean, welcome to our PM.

Todd Lapenna: Thank you, Michael.

Sean Ebsary: Thanks, Michael. Pleasure to be here.

MV: Todd let's start with you. The amount of capital LPs have been allocating to infra has been rising steadily since the first infra managers came to market some 20 years ago. And over that time, a lot has been written about the portfolio protection infrastructure provides relative to inflation and market volatility. The current market environment is particularly relevant in this regard. To kick things off, Todd, could you briefly discuss the secular trends that are responsible for the growth of the asset class?

TL: Of course, LPs are interested in infrastructure because it's an area of investment focused on essential assets, which have some combination of regulatory protections, inflation linkage, high quality contracts and relatively high barriers to entry. These include sectors like power and renewables, energy and energy transition, transport, digital communications, and social infrastructure. Some LPs choose infrastructure for asset liability matching or inflation hedging, others for portfolio diversification given low historical correlations with global equities or as an alternative to fixed income and real estate. Infrastructure can really be seen in some ways as defensive or lower beta private equity, and as LPs have increased their allocations to private markets, the infrastructure asset class has presented an attractive option on a risk adjusted return basis. More recently, the emergence of energy transition, which is intrinsically linked to infrastructure rollout, has turbocharged growth in the asset class to meet the significant need for capital in support of technology changes, climate change and policy requirements.

MV: So most, if not all the things that you mentioned are very much long-term trends woven into the very fabric of society, thus making a strong case for allocating long-term capital to infrastructure. To keep things topical, the theory has long posited that infrastructure can protect investors during periods of inflation, and to paraphrase Doctor Ernest Lawrence, at least as portrayed in the film *Oppenheimer*, theory will only take you so far; we need real world examples. But now that we have a couple years of data since the beginning of the inflationary post-pandemic world, can we say definitively whether infrastructure has made good on its promise?

TL: Yes, we we've seen a few years where the performance here of private infrastructure as an asset class continues to be strong. This was through the pandemic and in this recent higher inflation period, consistent with past inflationary periods for the asset class as well. We've analyzed the MSCI Private Infrastructure Index performance during the pandemic and during this recent high inflationary period, and note that Infrastructure Sharpe ratio, its return per unit of risk, far exceeds that of the S&P 500 and the MSCI ACWI, and with performance that closely tracks G7 inflation since 2020. So intuitively, a couple of examples here that you can think of, that might help make the point one toll roads. These are long term concession assets with inflation linked tolls put in place for essential commercial and commuter transportation routes. For traditional toll roads that face traffic risk, many of these saw short term impacts to their volumes during the pandemic, but this was offset by the positive impact that inflation had on toll rate increases. Also, the impact from interest rate increases were typically muted by the long-term project financing that these assets, you know, typically have in place. Another example are cell towers. These assets have long-term contracts with mobile network operators. They have seen continued steady demand growth for a new tower lease up, as network operators try to keep up with customer needs. The demand for data and mobility accelerated through the pandemic and continues to be reflective of the essentiality of this type of asset. In terms of inflation linkage, while European towers tend to have this feature more prominently in their contracts than the US towers, in both cases, new contract pricing reflects increased inflation impact on CapEx costs and annual pricing increases that are either fixed or inflation linked on both sides of the pond. And so, what we've seen is remarkably stable performance throughout this recent period, and when you combine this with yield generation, inflation linkage and the ability to pass through fixed costs or costs generally input through price increases, which is present across many sectors and subsectors within the asset class, this explains why all sorts of LPs have looked to increase their allocations to infrastructure.

MV: Todd, that was excellent. I'd like to quickly check my understanding. Investors have been allocating more capital to infrastructure for a variety of reasons: stable returns, inflation protection, exposure to assets that mitigate climate change, a desire to maintain exposure to essential assets which is constantly evolving, among other reasons. Theoretically, an investor could tap into some of these benefits via the public markets. But why should investors access infrastructure through private markets?

TL: Yes, theoretically via public markets. But the reason you want to allocate via private markets is lower volatility. Many investors turn to infrastructure for its stability, and private market infrastructure performance has seen much lower volatility and returns. The second is the nimbleness and operational value add associated with private market strategies, much the same as private equity. In infrastructure, we see the benefits associated with GP's expertise and direct control come through in the alpha they're able to generate, whether it's buy and build strategy, the pursuit of growth or cost optimization, or simply improved access to capital given their strong sponsors in this asset class. These advantages help GPS drive enhanced risk adjusted returns versus public market comparables.

MV: Sean, turning to you now. We've just released a paper on infrastructures middle market. Why should investors have this tranche of the market on their radar?

SE: Thanks, Michael. There's a few important reasons that we can walk through performance diversification and enhanced relationships. Stepping back first, though, if we think about the development of infrastructure as an asset class, it really took off in the last 10 to 15 years, as you mentioned earlier. A small number of well-known successful managers grew their fund sizes quickly alongside LPs. As the asset class grew, investors naturally look to deploy with more established GPS

when moving into a new asset class, and this reinforced the growth of the largest GPS. We see that story having played out in the fundraising numbers. About half of the total capital from 2020 to 2022 was raised by only 15% of the number of funds that were raised. This means that LPs have portfolios that are concentrated with a small number of larger GPS. But on the flip side, there's a wide universe of mid-market managers to choose from. Turning to why it's beneficial to invest in the middle market, we think there are a lot of portfolio benefits, which ultimately boil down to adding diversification in terms of sectors and strategies. For example, where a larger GP might focus on corporate carve outs or take privates, in the middle market, we see a lot more deal flow, driven by proprietary acquisitions of platforms with scale up opportunities. From a relationship standpoint, LPs can also benefit from an enhanced partnership that comes with establishing an early relationship with a GP. Those benefits can include greater influence on fund terms, fee discounts, and priority co-investment opportunities benefits that can carry across fund vintages. Another interesting aspect of the infrastructure asset class is we're in the middle of a period of industry consolidation with several large headlines in the news recently. Part of the driver here is that fairly few funds in infrastructure are past their fourth or fifth vintage, and these firms are trying to move from founder led and owned platforms to institutions. All of this highlights what we see as an additional benefit to investing in the middle market, which is really diversifying your relationships into names, which wouldn't be in direct competition with these larger managers.

MV: Sean, that's, uh, that's really interesting, and, you know, I immediately drawn to the fact that there's a lot of overlap with the reasons that a private equity investor might want to invest at the lower end of that market. It's different, but not that different. What do we see when it when it comes to looking at historical performance?

SE: We tend to see performance of mid-market managers in the top quartile exceeding the returns of larger funds. This is reinforced by data we see from realized deals over the last decade, which highlights a correlation between higher returns for smaller deals, as well as lower entry and leverage multiples for smaller companies. These benefits come, however, with an increase in the volatility of return outcomes, both in terms of deals and fund returns, as well as a slightly higher loss ratio experienced by middle market funds. These drawbacks highlight, frankly, how important we think manager selection is, particularly in the middle market.

MV: My final question for you Sean relates to tactical opportunities, i.e. secondary and co-investments. Walk us through our house view on the deal flow and transaction volume in each of those strategies within the context of the middle market. Of course.

SE: Of course. Focusing on co-investments first, the largest managers in infrastructure often have programmatic co-investment models that may prioritize their largest investors. They may be able to warehouse and syndicate their deals to LPs. In the mid-market, on the other side, we see managers offering a lot of co-investments, both to existing LPs as well as new LPs looking to establish a relationship. However, being able to move quickly is crucial since these GPs can be more reliant on an LPs capital at a pre-bid stage or during exclusivity. Also, particularly for those LPs with capacity to invest in the emerging manager space, the ability to underwrite co-investments at the same time as fund commitments unlocks a lot of interesting opportunities that help reduce blind pool risk associated with backing a new GP relationship. On the secondary market you asked about Michael, we're in a really interesting time given the market and infrastructure is now maturing and we're seeing significant growth in transaction volume. A lot of large LP secondaries and even GP led secondaries have seen investors focused on liquidating positions in their largest funds, where the discount has tended to be

lower as there are a greater number of buyers. This, however, means for buyers of positions in the middle market, there's typically less competition and therefore we expect deal flow to continue growing.

MV: Thank you, Sean. Todd, I have another follow up question related to scale. Most LPs have the issue of figuring out how to invest at scale, and how can they overcome some of the challenges that arise when having to vet a greater quantity of smaller managers?

TL: Yeah, it's an excellent question and, you know, while many LPs express interest in investing in the middle market, many do lack the team capacity to effectively cover the market. Here at Stepstone, we focus on solutions for institutional clients, and we have over 70 professionals focused on infrastructure, holding over a thousand GP meetings every year in support of deploying in excess of 10 billion into funds each year. So, we think that size and that scale of our team affords the ability to effectively provide high quality market coverage. And so, LPs that have smaller investment teams or that may want to orient their teams towards, you know, larger cap strategies and performing diligence there, may want to consider separately managed accounts with us as an effective way to gain exposure to the middle market, while also benefiting from the aggregation of capital and resources that that we represent.

MV: Gentlemen, this has been excellent. Thank you both for joining me today.

TL: Thanks, Michael.

SE: Thank you.

MV: Thank you for listening. For more color on today's conversation, head to stepstonegroup.com where you can download a copy of the paper we discussed along with the rest of Stepstone Thought Leadership Library. Listen to RPM wherever you normally listen to podcasts.