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Infrastructure Secondaries in Today's Market

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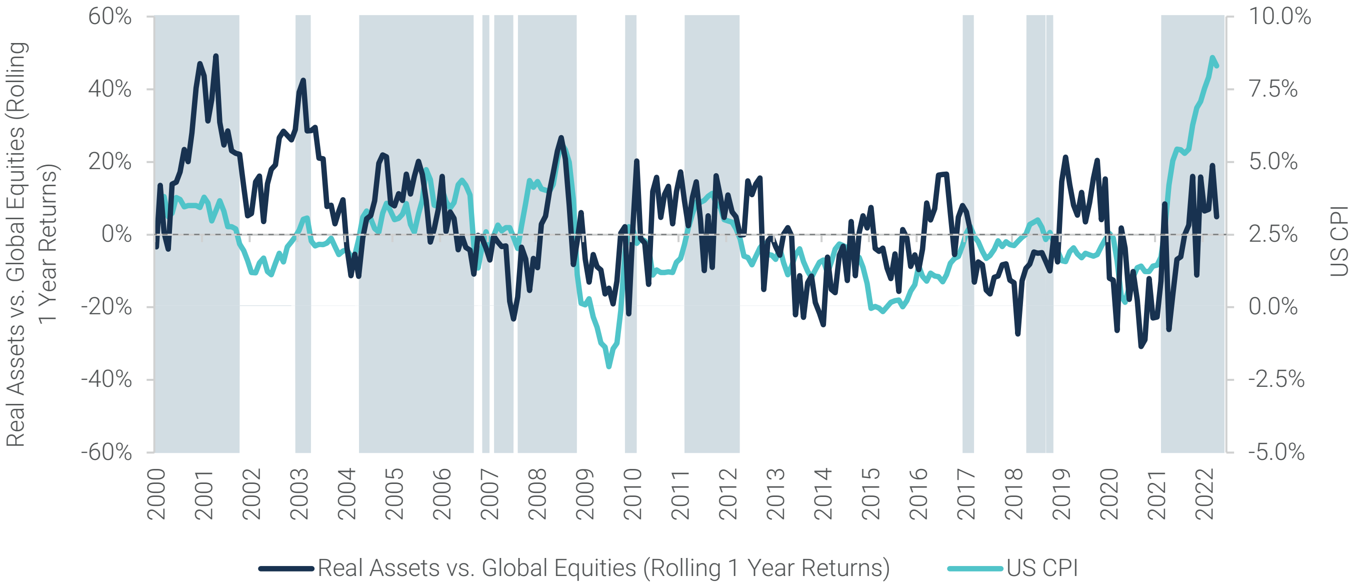
Introduction

Today's macro environment is characterized by record-breaking levels of inflation, central bank policy tightening, and slowing economic growth across developing and advanced economies. This backdrop has had wide-ranging implications for individuals and businesses, as well as financial markets. Amid the continuing macro and rate uncertainty, public markets have become increasingly volatile, with many investors searching for new opportunities and/or grappling with how to reallocate their portfolios.

During periods of elevated inflation, investments in real assets, including infrastructure, are seen to offer both "the opportunity for uncorrelated returns and competitive real return potential"[1] For example, in public real asset securities, such as listed infrastructure companies, listed real estate companies (REITs), and commodities, the rise in inflation has positively impacted returns compared to global equities. This is shown in Figure 1, which shows the positive and negative movement of listed real assets returns versus global equities, highlighting periods where the US inflation rate (US CPI) is above 2.5%[2].

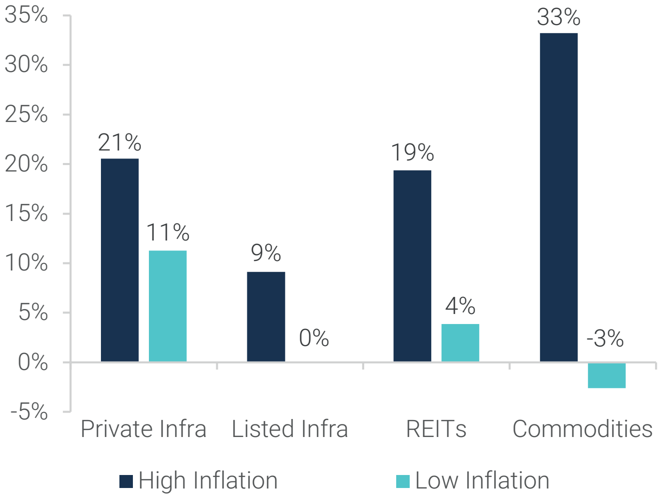
Looking at each asset class separately and with the addition of private infrastructure, Figure 2 takes the quarterly returns (annualized) for real assets relative to global equities and averages these across the periods of high inflation shown in the previous chart to showcase the outperformance of each asset class during historical inflationary regimes.

Figure 1: Real assets outperformed global equities during periods of high inflation



Source: Bloomberg as of June 30, 2022; Real assets is an average of S&P GSCI (Commodities), FTSE NAREIT, and S&P Global Infra (from 2001 on); Global equities: MSCI World.

Figure 2: Real assets outperformed global equities during periods of high inflation

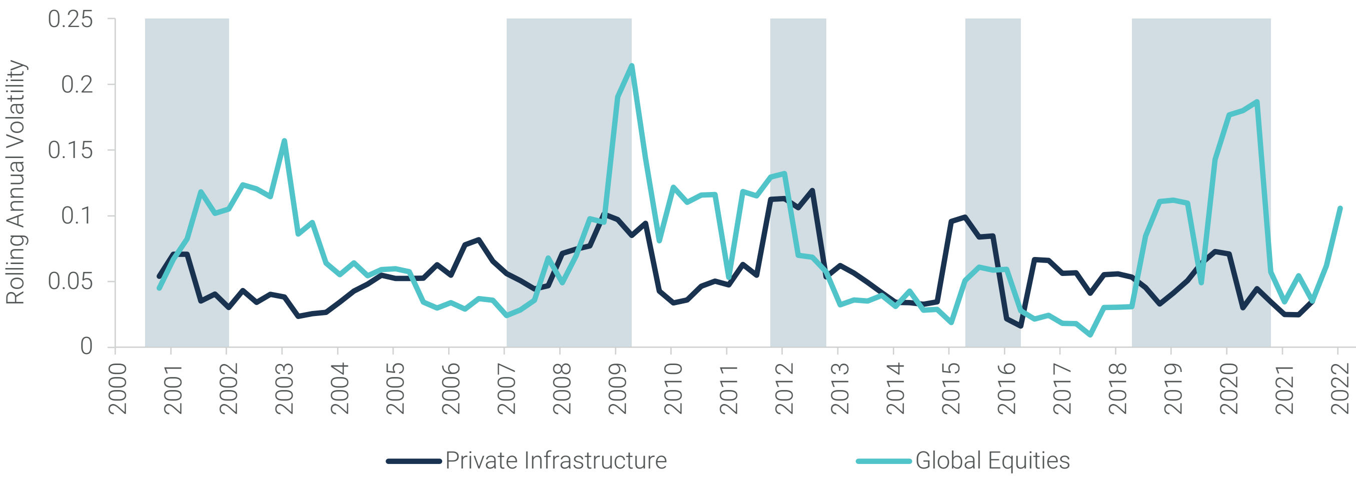


Source: Pantheon analysis of Bloomberg data to 30 June 2022.

Figure 2 demonstrates that private infrastructure has historically been among the most consistent in return profile, with among the strongest excess returns compared to global equities during inflationary periods. In addition, there is strong evidence that private infrastructure investments are particularly attractive during periods of market stress, as they can (i) provide downside protection and (ii) improve diversification[3]. Figure 3 shows that the volatility of returns from private infrastructure has been noticeably lower than global equities over the past two decades.

In this paper we seek to address how gaining access to private infrastructure through secondary transactions has become even more attractive for CIOs and portfolio managers looking to capture the benefits of investing in infrastructure, especially as it enables shorter duration exposure to this lower correlation and lower volatility asset class.

Figure 3: Private infrastructure investments are stable during periods of market uncertainty



Source: Periods of market uncertainty defined by EDHEC Infra as: July 2000 to April 2003, January 2007 to May 2009, December 2011 to January 2013, July 2015 to July 2016, April 2018 to May 2020.

KEY TAKEAWAYS

Infrastructure can offer returns that benefit, or are at least insulated, from rising inflation

There is evidence of infrastructure investing offering strong downside protection in times of macro distress

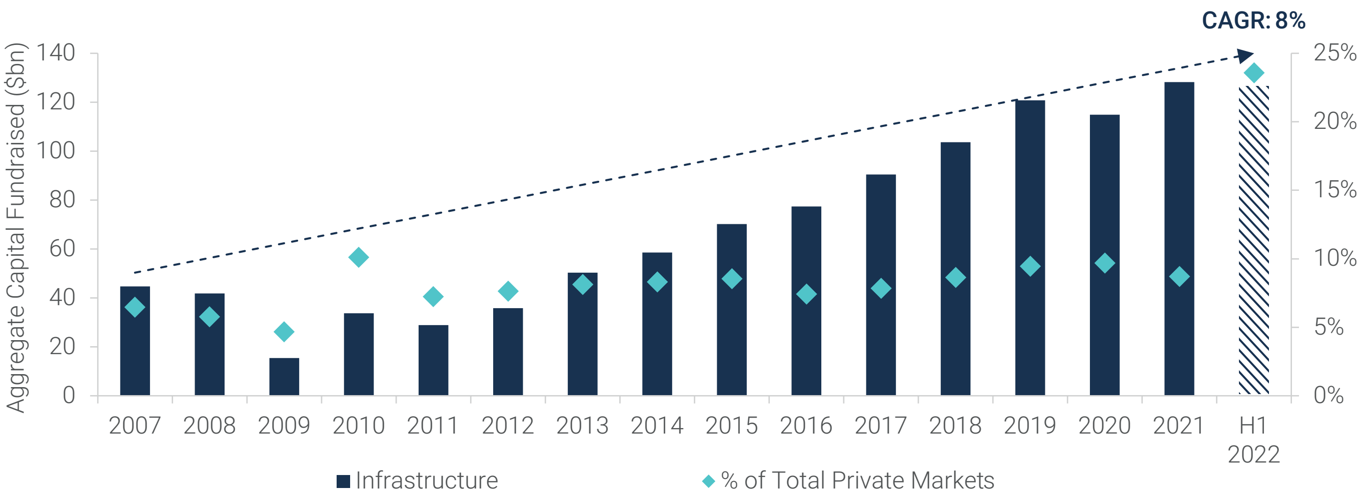
Infrastructure secondaries are an attractive way to invest – purchasing the assets at a later stage in their development provides greater visibility over their future potential, with a shorter time horizon to liquidation

Infrastructure Market

Since the 2008-09 Global Financial Crisis (the "GFC"), private infrastructure capital formation has grown by over 8x, reaching its highest point of $128 billion in 2021, relative to around 4x growth in private markets more broadly over the same period, as shown in Figure 4. This positive fundraising momentum continued in the first half of 2022, with $126bn raised by private infrastructure and real assets investors, a 2x growth over the same period the prior year[4].

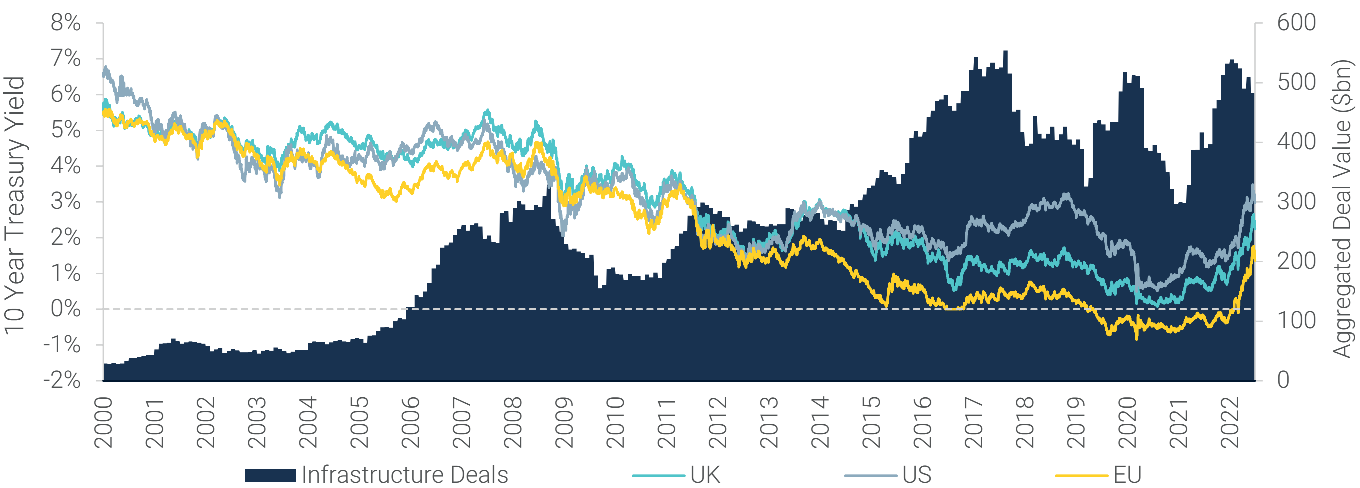
The increased allocation to infrastructure funds since the GFC can be attributed to the low-interest rate market environment, which led many investors to allocate towards infrastructure as a fixed-income alternative; infrastructure investments provide the portfolio benefit of matching longer duration liabilities, similar to fixed income, through a stable yield profile. This is supported by Figure 5, which shows the increase in infrastructure investment activity relative to declining treasury yields since 2000.

Figure 4: Fundraising of private infrastructure has seen strong growth following the GFC



Source: Preqin as of August 2022.

Figure 5: As the treasury yield has decreased, the deal flow in infrastructure increased



Source: Preqin as of August 2022.

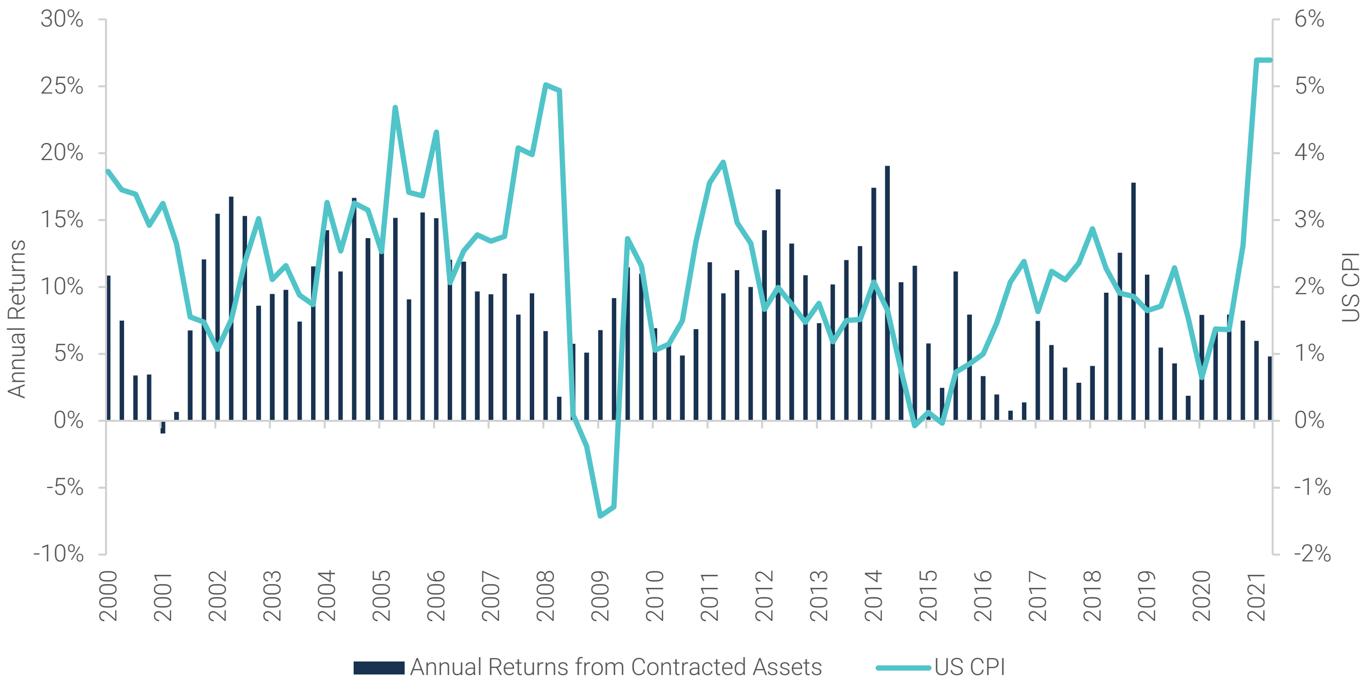
Infrastructure investing as a mitigant to rising inflation and interest rates

Since the start of 2022, investors appear to have continued to seek out benefits of infrastructure assets' defensive, lower volatility nature and cash yielding/liability matching characteristics. Investors may also have been quick to appreciate the inherent benefits of investing in infrastructure including: (i) providing an effective inflation hedge, (ii) contracted and stable cash flows, and (iii) decreased interest rate risk from refinancing.

Infrastructure investing is generally focused on gaining exposure to assets in a monopolistic or duopolistic market that provide essential services, typically have long-term contracts with price escalators/inflation-linked revenue escalators, and that are supported by contracts or concessions with high-quality corporate and government counterparties. Inflation-linked revenues act as a natural hedge to rising inflation and enable attractive inflation debt financing with fixed rates and long-term tenors. Debt providers gain comfort in cash flow visibility and asset stability and can provide longer term maturities corresponding to existing customer contract durations.

In Figure 6, we can see that infrastructure assets with contracted cashflows[5] have historically continued to generate positive returns during periods of rising inflation, shown on a 1-year lag[6]. In addition, the availability of longer-term fixed debt for infrastructure shields these investments from interest rate risk that can arise during a refinancing in a rising rate environment.

Figure 6: Assets with contracted cash flows remain positive through periods of high inflation



Source: Preqin, as of June 2022; Deals are completed as of Q2 2022.

Digitization and energy transition are driving infrastructure investing

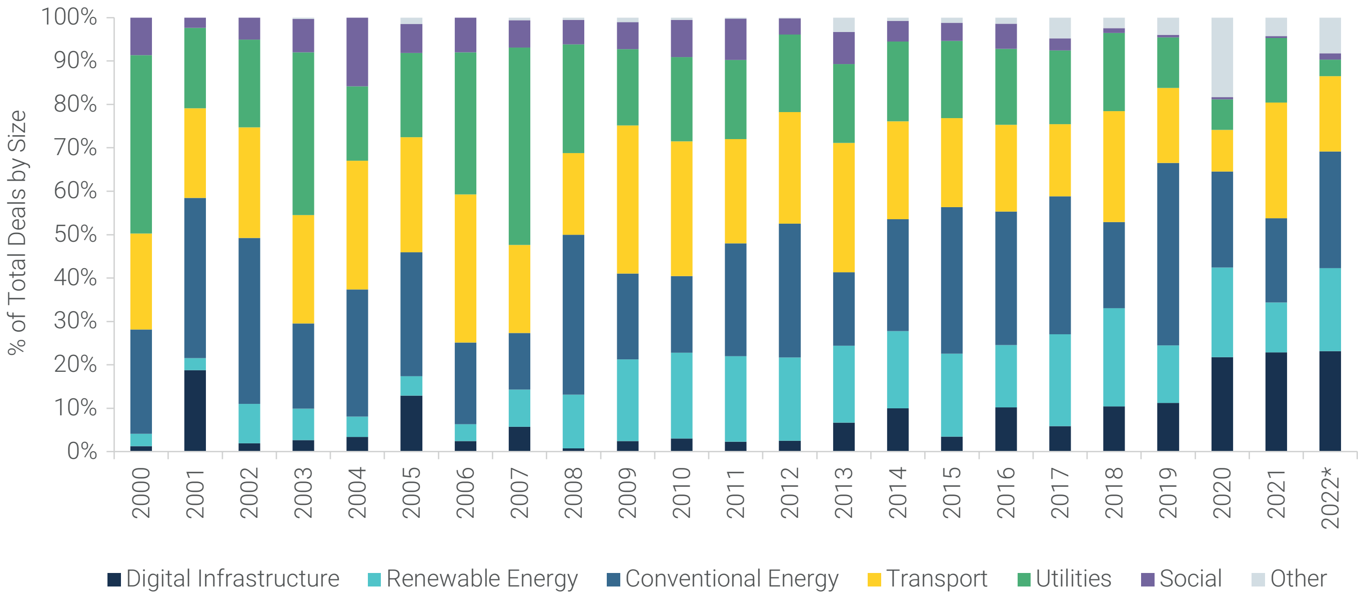
In addition to infrastructure's inherent defensive characteristics, many investors are keen to play offense and invest behind market themes such as digitization and the global energy transition. The Covid pandemic has only accelerated these trends. Through the pandemic investors flocked to digital infrastructure and renewables as two key sub-sectors that stand to benefit from these tailwinds and structural shifts.

Digital infrastructure assets such as towers, fiber and datacenters have become the 21st century utility assets, as data and connectivity have become more essential than ever before for a functioning economy and social ecosystem.

Furthermore, investment into renewables, accelerated as the volatility of the energy markets and the ongoing decarbonization of electric grids took hold over the past five years. The Russia/ Ukraine crisis and renewed concerns over energy security have only strengthened the case for renewables and energy independence for governments and their associated economies.

As showcased in Figure 7, digital infrastructure and renewable energy investments showcased the largest growth in overall infrastructure deal flow over the past three years. We believe that this trend is here to stay as the need for these assets continues to increase over time.

Figure 7: Proportion of deals in digital infrastructure and renewable energy increasing over time



Source: EDHEC Infra, Refinitiv as of June 30, 2022.

Secondaries as a mainstream investment product in alternatives investing

Since 2009, investors have increased allocations to secondary funds at a 24% CAGR, reaching $282bn of available dry powder in 2021. These growing allocations have been matched by deal activity, with secondary transaction volume in 2021 reaching $134bn, setting a new annual record[7].

Potential rationales for portfolio managers growing their allocations to the secondary strategy include:

- J-curve mitigation
- Access "not-for-sale" investments
- Enhanced diversification: GP/asset/geography/vintage
- Lower volatility in returns
- Ability to buy at discounts to NAV
- Having a tool to invest during periods of market dislocations (by providing liquidity to LPs).

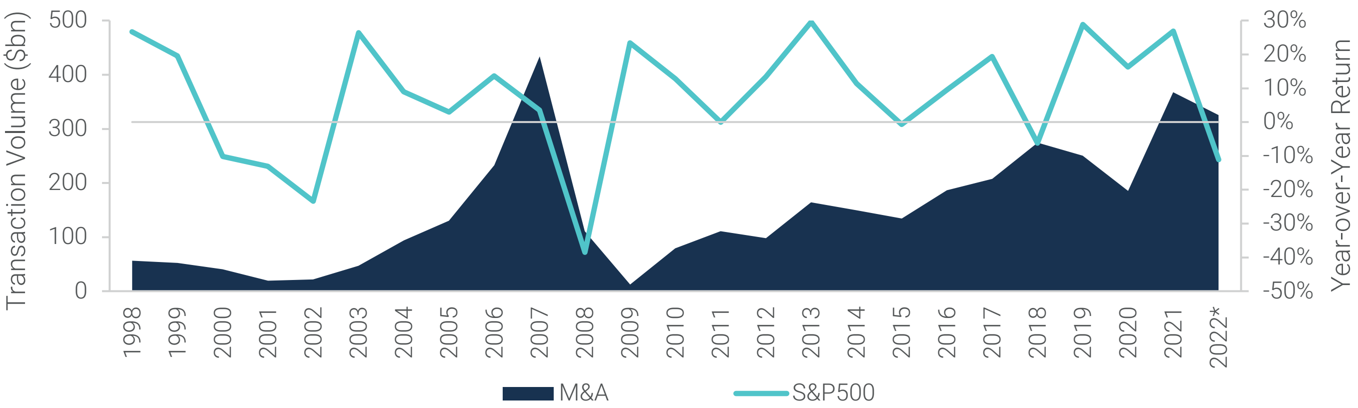
Secondary investors invest via two entry points: LP-stake and GP-led secondaries. LP-stake/portfolio secondary investments enable quick diversification into older vintage investments, while mitigating blind pool risk. The secondary investor steps into an existing LP portfolio at a price or valuation that is determined by the underwriting of future cash flows for the fund.

GP-led transactions on the other hand allow secondary investors to access selected assets or concentrated asset portfolios through continuation vehicles, minority investments, preferred equity structures, and strip sales. GP-led transactions typically exclude majority ownership premiums and mitigate operating risks associated with a new investor in a change of control. In some scenarios, secondary buyers can also provide unfunded capital to these assets to be invested into accretive add-ons or de-risked development opportunities, making it even more attractive to GPs who avoid cross-fund investments and whose older vintage funds are fully drawn.

Secondaries during periods of market dislocation

Over the past 12 years, the market has experienced a few dislocation events, where the M&A transaction volume declined alongside the S&P500, as seen in Figure 8. For example, during the GFC in 2007-2008, M&A transactions volume declined 74% YoY compared to a 38% decline in the S&P500.

Figure 8: M&A transaction volumes are correlated with S&P 500



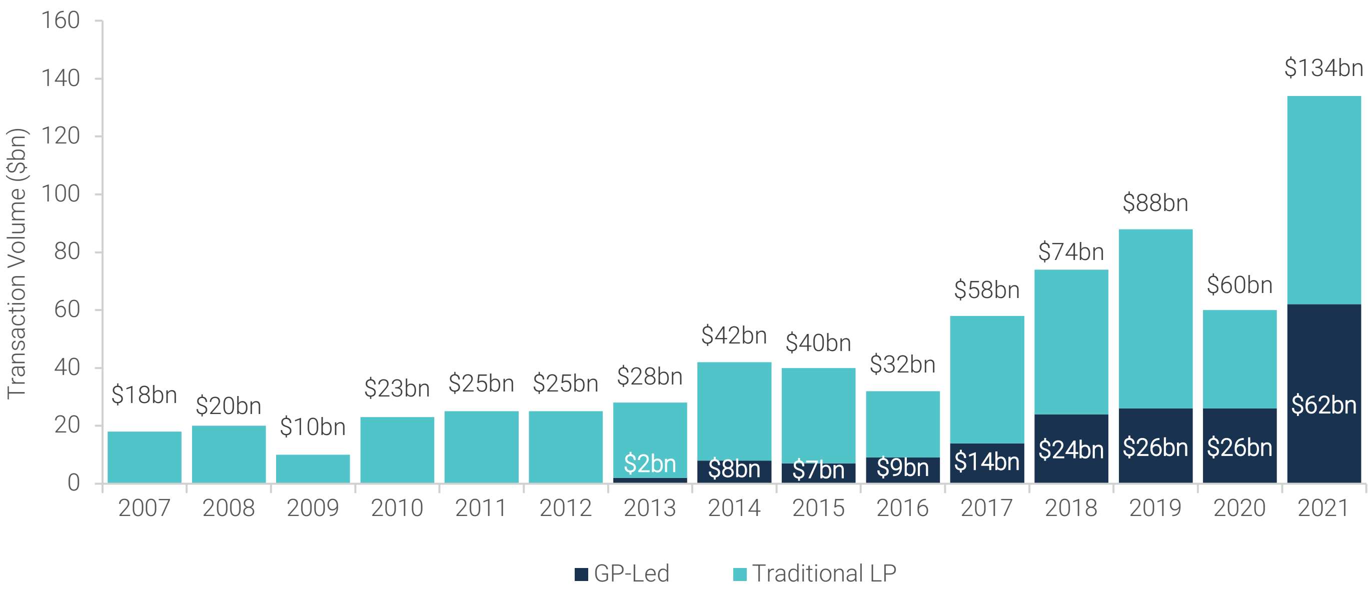
Source: LCD and Refinitiv as of June 30, 2022; 2022 represents transaction volume and S&P500 return as of Q2 2022.

During these market dislocations, we find that two patterns emerge that create additional opportunities in the secondary market. First, portfolio managers seek to rebalance their private and public exposure mix by divesting their stakes in private funds. This typically occurs when the public value of the portfolio declines quicker than the private assets in the portfolio due to mark-to-market impact of public value declines compared to lagged and smoothed private asset reporting. This is referred to as the "denominator effect" and can restrict LPs from funding capital call obligations or making new fund commitments. When the bid-ask spread on M&A transactions widens during dislocations, GPs can proactively turn to the secondary market to create liquidity alternatives for their fund investors, commonly through continuation funds and preferred equity structures.

Secondary investors can act as the bridge capital during these periods of stress by providing expedited liquidity solutions, as shown in Figure 9. After a slowdown in 2009 in the aftermath of the GFC, secondary market transaction volume grew consistently from 2010 to a new high of $42bn in 2014, representing a CAGR of 21.8%. Similarly, after the dip at the beginning of the pandemic in 2020, the secondary market rebounded strongly, reaching record H2 deal volume by the end of 2020; 2021 deal volume was 50% higher than pre-Covid levels, with GP-led transactions showing an especially strong rise of 2.3x[8]. Secondary investors in these transactions were able to partner with GPs and invest in the GP's top performing, "not for sale" assets that were shielded from direct Covid impact. These secondary transactions extended the GP's hold period of marquee assets for continued value appreciation.

Furthermore, with democratization of private markets over the past several years, non-traditional investors in private markets (i.e., private wealth, high net worth, 401K, etc.) have added meaningful exposure to private equity. According to a WSJ survey in early 2022, 80% of secondary buyers expect to see an increase in deal volume from those investors in the next 12 months, up from 55% in 2020 and 70% in 2021[9]. In times of stress such as the one that the market is experiencing now, we anticipate additional investment opportunities from this investor group seeking liquidity to potentially offset losses or to fund obligations in other parts of their portfolios.

Figure 9: GP-Led secondaries have increased market share over the last several years



Source: Greenhill as of January 2022.

Leveraging secondaries to gain exposure to infrastructure in a dislocated market

In today's dislocated market, secondary investments into infrastructure assets and funds provide a portfolio manager this dual-pronged access point to (i) a stable and resilient private asset class (ii) shorter duration investment proposition -- integrating the above-mentioned benefits of both infrastructure and secondary investing.

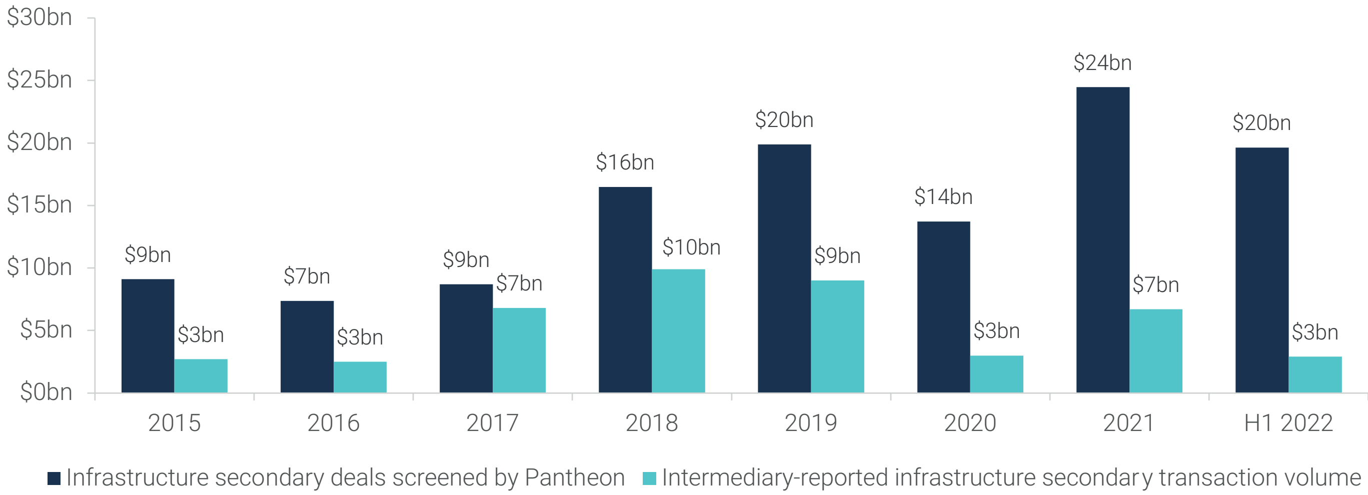
Secondaries, by definition, are investments in funded assets in older vintage funds – and they therefore have shorter durations relative to primary fund commitments. Secondary investors can invest into either older vintage funds or assets that are being carved out from existing funds and that have shorter exit horizons; secondary funds provide early distributions from mature portfolio assets. Other inherent mitigants to duration risk include infrastructure's focus on dividend yield, and structured GP-led solutions' rights to early distributions.

The secondary market for infrastructure has demonstrated impressive volume growth and increased structuring sophistication in recent years. Over the past 10 years, transactions completed have grown from $1.2bn in 2011 to $6.7bn in 2021[10], a 19% CAGR; and now representing 5% of total secondary deal activity in 2021[11]. In addition, the volume of GP-led transactions in infrastructure increased to represent 10% of the market in H1 2022 compared to 2% in 2021[12], indicating a growing preference for infrastructure GPs to utilize the secondary market to create liquidity for their LPs in times of market stress.

Figure 10 compares the dollar value of the secondary transactions screened by Pantheon to the total deals closed in a given year, as reported by intermediaries. In the last two and a half years to (to H1 2022), Pantheon reviewed $57.8bn of secondary opportunities. This is comparable to the $61.5bn reviewed in the five years prior to this, reflecting the market opportunity growth in recent years.

Strong fundraising in the primary infrastructure market, as shown in Figure 4, continues to fuel the overall NAV (i.e., assets on the books of GPs' funds) of the asset class, with 2021 marking a record year for fundraising. Growth in primary fundraising seeds future opportunities in the secondary market, while the number of secondary infrastructure investors of scale remains limited.

Figure 10: Infrastructure secondaries is a growing asset class



Source: internal data provided by Pantheon, intermediary-reported transaction data from Campbell Lutyens for 2015-2019 and Greenhill for 2020-2022.

While there is substantial dry powder in the infrastructure market ($298bn as at the end of 2021), it is largely held by direct funds; and the dry powder associated with secondary strategies remains low. As of Q2 2022, secondary dry powder earmarked for infrastructure investments represents $8.5bn, with $4.4bn expected from fundraising over the next 12 months[13].

Conclusion

Over the past decade, CIOs and portfolio managers allocating to infrastructure secondaries have done so on the investment proposition's diversification, J-curve mitigation and yielding benefits. Amid the current disruption, infrastructure secondaries are finally having their "moment". Gaining exposure to the infrastructure asset class via this short-duration (swift deployment and early cash back) strategy to invest into hard to access opportunities has become paramount for portfolio managers, especially as they try to reallocate from the more volatile or higher beta investments such as public markets to more stable and resilient asset classes.

Furthermore, portfolio managers can use infrastructure allocations to further increase their exposure to investment themes such as digitization and energy transition. With continued market volatility, we forecast similar investment opportunity windows for investing in infrastructure secondaries as demonstrated in similar periods historically.

Allocation to infrastructure secondaries provides not only the benefits of inherent asset resilience, but also unique deployment opportunities resulting from dislocation.

Endnotes

[1] Goldman Sachs, June 2022, "Equity Bear Market: Paradigm Shift?" Goldman Sachs Research Newsletter

[2] The US Fed has a target inflation rate of 2.0%, year over year. https://www.federalreserve.gov/newsevents/pressreleases/monetary20120125c.htm

[3] EDHEC Infra, July 2022, "Is Infrastructure Shockproof? – The Resilience of Infrastructure Equity Investments During Market Downturns, 2000-2022".

[4] Pantheon analysis of Preqin data, as of June 30, 2002.

[5] EDHEC Infra defines contracted assets as "availability-payment schemes, by which a public- or private-sector client commits to paying a fixed income over a pre-agreed period, typically in excess of two decades".

[6] Pantheon analysis of EDHEC Infra data.

[7,8] Pantheon analysis of Greenhill data, as of January 2022.

[9] WSJ, September 2022, "Secondary Buyers Expect More Wealthy Investors to Seek Exits. https://www.wsj.com/articles/secondary-buyers-expect-more-wealthy-investors-to-seek-exits-11662026400

[10] Pantheon analysis of intermediary-reported transaction data from Campbell Lutyens for 2011 and Greenhill for 2021.

[11] Greenhill as of January 2022.

[12] Jefferies as of July 2022.

[13] Pantheon analysis of Evercore data as of July 2022.

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