Igneo Infrastructure Partners

Fragmentation, competition, growth and politics: How these factors influence opportunities

A Q&A with John Ma and Michael Ryder, partners and co-heads of North America for Igneo Infrastructure Partners

Characteristics of North America's infrastructure market

John Ma: Fragmentation and substantial growth are defining characteristics of the North American infrastructure market. During the past five years, this market has doubled in size to $7.8 trillion in assets.

One of the surprising things about the North American market is just how fragmented it is, in both the United States and Canada. While there are large companies operating nationally and internationally, the continent has 50 states, 10 provinces, and hundreds of cities and municipalities of significant size, each with its own set of regulations and codes that create a patchwork of markets in which many regional and local companies compete. Federal policies are important, but there are also many meaningful variations at the state, province, local and municipal levels resulting in market fragmentation. The fragmentation also means there are significant opportunities in the middle market.

Middle-market focus

Michael Ryder: In infrastructure today, investors tend to define the middle market as transactions between $100 million and up to $1 billion in equity value. We're seeing interesting opportunities across that size range from the lower end to the upper end of the middle market.

The market has changed a lot during the past decade. A number of funds have now transitioned into the large-cap or mega-cap space, launching funds with goals of raising $5 billion, $10 billion or even $20 billion. As a result, the universe of investors competing for middle-market assets is smaller, particularly in the lower middle market.

For Igneo, it's not just taking advantage of lower competition to make investments. In many middle-market businesses, we think there are numerous levers to pull to create sustainable value through proactive asset management.

Target sectors within infrastructure in North America

Ma: Significant tailwinds continue to drive development and activity in renewables and energy transition. Obviously, there's a large amount of policy support for energy transition, starting at the federal level. And at the state and local levels, there is tremendous underlying demand for reliable green power. The higher interest-rate environment is making projects more expensive, and supply-chain constraints also affect the renewable sector in the United States.

One tailwind is the Inflation Reduction Act (IRA), which supports growth in infrastructure investment and helps offset some of the macro challenges in a higher interest-rate environment. Supported by the incentives in the IRA, the energy transition and renewable generation sector continues to be attractive, and we are finding good assets and attractive companies to invest in.

Another interesting sector is transportation. We haven't heard as much about transportation in recent years, but since the pandemic, we've seen a lot of movement in the industry. Many companies and parties are still trying to recover from the nightmare of the supply-chain constraints they experienced during the peak of the pandemic. No company wants to find itself back in that position.

Shippers want more reliable, more resilient supply chains. Onshoring and nearshoring are major and ongoing trends. We're seeing demand for investment into transportation infrastructure and logistics. There's also a broad, longer-term macro theme – decarbonization – within the transportation infrastructure value chain, as companies seek to decarbonize their footprints, whether it's through renewable-fuel projects, electric-vehicle charging or other similar projects.

IRA and the Infrastructure Investment and Jobs Act

Ryder: Passed in 2021 and 2022, respectively, the Infrastructure Investment and Jobs Act and the IRA together have provided incredible stimulus to investment in renewables, particularly from the IRA, and also across transportation and other infrastructure spending – likely north of $2 trillion in total infrastructure incentives. So those two acts, combined with the Chips Act, have created strong tailwinds for investing in infrastructure in North America.

Transportation infrastructure assets in the United States, for example, are typically under public-sector ownership and control, and underinvestment has taken its toll. Airports and roads are almost exclusively controlled by local cities and municipalities. While we don't see that changing in the near term, the 2021 Infrastructure Jobs Act money will flow to local governments, and it's a way of distributing economic benefits, boosting investment, creating jobs and driving economic stimulus.

There are some niche sectors we think will benefit from federal government money incentivizing private investments. One good example is the freight-rail sector, where we have an investment in a leading short-line freight-rail operator, Patriot Rail. In the freight-rail sector, the Christie Grant program was funded by the federal government at around $400 million a year. Since 2021, the level of funding has more than tripled. The Christie Grant program is competitive and has opened up a significantly enhanced level of federal funding that goes directly into rail capital projects industry participants can access. That federal money often gets paired with individual, state and local grant funds, which are also attractive because states and municipalities like to see investment in job-creating infrastructure projects.

Politics and implications for infrastructure

Ma: It's an election year in the United States, and like everyone, we're watching this topic closely. It's important to note,

however, that infrastructure has been an area both Republican and Democrat administrations have tended to support. Infrastructure initiatives generate jobs, stimulate the economy and contribute to America's competitiveness in the global market. Both Democrats and Republicans in Congress see improved infrastructure benefitting their local markets and their constituents.

Ryder: Infrastructure has proved to be quite resilient during the past several years, through the high-inflation environment post-pandemic and in a higher interest-rate environment. While the geopolitical environment is uncertain, debt markets are open and functional, albeit coping with higher base rates than two years ago.

Inflation is certainly much tamer than it was 18 months ago. With capital markets open and good performance through the sector, we're generally optimistic about opportunities in 2024 and beyond. In our target sectors, lower middle-market companies have more limited options for accessing debt markets than larger competitors. We come across many businesses that don't have the appropriate capital structure in the current environment. These businesses often rely on legacy regional banking relationships, and regional banks have their own challenges.

There's significant opportunity to help institutionalize some of these businesses in our target sectors, and that's a key part of Igneo's value-creation approach and investment thesis.

Competition for infrastructure assets

Ma: With significant growth in the North American infrastructure market during the past decade, funds that earlier sought to deploy up to $500 million of equity value in deals are now looking for much larger transactions. There's more opportunity in Igneo's sweet spot — the middle market. With many funds now focused on $1 billion-plus transactions, there's a huge number of business owners, founders and families with middle-market infrastructure businesses that are looking for opportunities to exit.

Today, we're seeing more midsize companies come to market. We expect this to create a robust and interesting opportunity, as we have the capital and expertise in the middle market.

Dry powder

Ryder: There is less dry powder focused on the middle market today. Our analysis indicates, as of the end of 2022, about 6 percent of the dry powder in the North American market was in funds that were $1 billion or less. About 60 percent of all infrastructure deals are for $250 million of equity investment or less. Based on availability of capital versus the opportunity to invest, there is just less competition in this space.

Unique nature of infrastructure assets

Ma: We think about business plans on a long-term basis because many of the capital investments we're making are in long-lived assets. Our disciplined approach includes thinking about how we would exit an investment attractively within a certain time frame. That's not to say we necessarily will, but it creates accountability around time frames for achieving our long-term asset-management plan.

Ryder: At the time of acquisition, we create plans for what a successful exit would look like. That can include looking at who the potential buyers could be and what characteristics the company needs to demonstrate its attractiveness as a future investment. And then on an annual basis, as we go through our business reviews, we ask: Is this a company we should continue to hold during the course of the next year, or is this a company we should be evaluating for exit? It's a proactive approach to thinking through whether we continue to be the best owner or whether, because of market conditions or appetite of potential buyers, now is the right time for us to think about monetizing the business in a way that's most advantageous for our clients.

Outlook for 2024 and beyond

Ryder: As we look at 2024 from an infrastructure investing standpoint, we need to remind ourselves and our clients that the Trump administration in 2016 was pushing a $1 trillion infrastructure investment bill, and when the Biden administration came into office, we saw the passage of both the Infrastructure Investment and Jobs and the Inflation Reduction acts.

The markets have been through a 24-month period where inflation has spiked, interest rates have run up, and now we are seeing what looks to be a soft landing for the U.S. economy. Through all this, infrastructure as an asset class has remained resilient. As a result, we anticipate more transaction activity in the middle market in 2024 compared with 2023. At Igneo, we see this as an opportunity to take advantage of a stabilizing and more secure economy to leverage our 30 years of experience to carefully invest our investors' capital in this attractive asset class.

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CORPORATE OVERVIEW

Igneo Infrastructure Partners is the direct infrastructure investment team of the First Sentier Investors Group. Igneo seeks to deliver superior risk-adjusted returns by acquiring and managing high-quality, mature, mid-market infrastructure companies operating in the renewables, digital infrastructure, waste-management, water utilities and transportation/logistics sectors across the United Kingdom, Europe, North America, Australia and New Zealand. Operating since 1994, with one of the longest-established teams in the market, Igneo creates sustainable long-term value through innovation and proactive asset management.

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