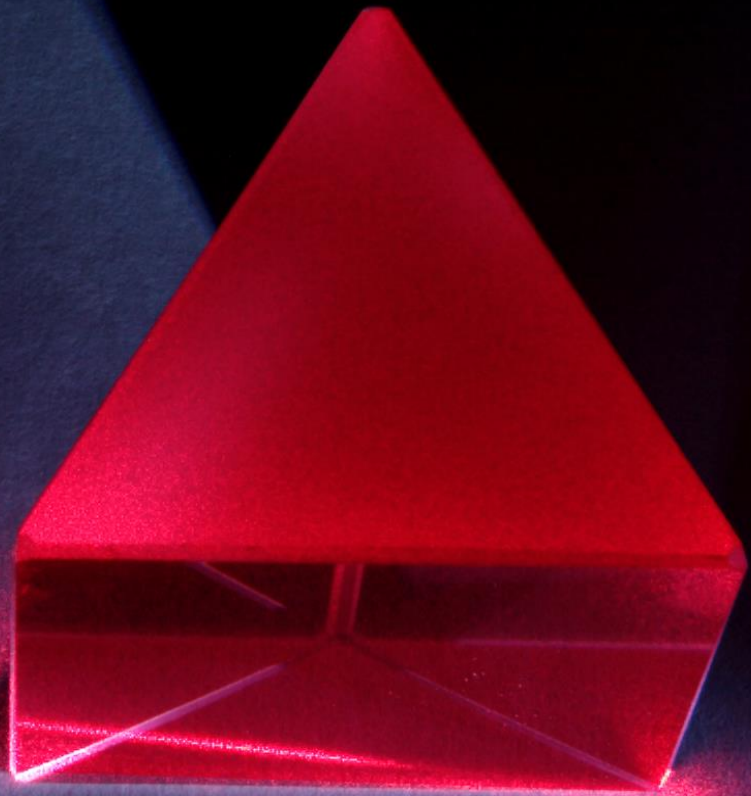


Energy Transition Infrastructure The Size Factor

August 2024

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HSBC Asset Management

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Long term horizon: Investors should expect to be locked-in for the full term of the investment

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Introduction

Over the past 10 years, capital raised for private market infrastructure funds has increased markedly. Investors have been attracted to infrastructure assets due to a number of favourable attributes. These can include, but are not limited to: the ability of some assets to offer inflation protection, potentially stable cash yields, defensive growth, and low correlation with other asset classes. In addition, some assets can offer benefits to portfolios in all economic conditions, particularly during periods of high inflation. This is evident for assets that benefit from long-term contracts, with revenues linked to inflation.

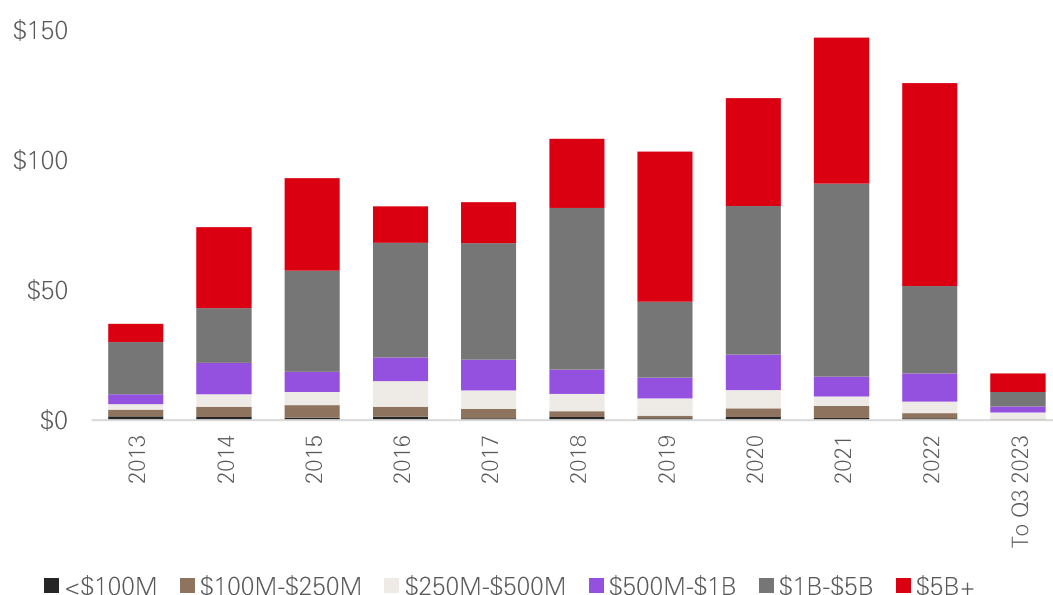
As the infrastructure asset class has matured, it has taken on some of the characteristics of other maturing asset classes. One of these traits is the concentration of capital being raised in large-scale funds. This has created a situation where smaller funds tend to have less competition for assets if they focus on smaller deals (smaller deals may not move the dial on returns for larger vehicles). As a result, in our view, mid-market investments present a significant opportunity, with more attractive entry valuations, historically stronger realized returns, solid growth prospects, and the potential for more varied exit options.

Given the above characteristics of mid-market assets, in our view it is not particularly surprising that these assets can have the potential to deliver outsized returns. While there are nuances to various data sources, EDHEC¹ data shows that mid-markets have outperformed Core assets and the broader market over a number of time periods. We believe infrastructure investors can benefit from the opportunities to be found in the mid-market space to achieve potentially higher returns. In our previous publication, [Asian Infrastructure: Filling in the Gaps](#), we explored this in greater detail.

Middle-market infrastructure funds – a favourable gap to target

The bulk of infrastructure capital raising is focused on large-scale funds (>\$1bn in size): an average of 76% of capital raised was secured by these funds between 2013 and the end of Q3 2023.

Infrastructure capital raised by fund size (\$bn)



Any views expressed were held at the time of preparation and are subject to change without notice.

Source: Preqin Pro, data as of 3 April 2024

1. École des Hautes Etudes Commerciales du Nord

This has created an environment of competition among large-scale funds for large-scale investment opportunities. As a result of this competition, entry valuations have been driven higher over time. Arguably, the large-cap market is increasingly becoming saturated, with the main differentiator between investors simply their cost of capital, as they often compete for the same deals. While larger infrastructure funds can bring some benefits for investors, such as: a market position, perceived quality, economies of scale, and potential stability, they can also come with some constraints. These can include: the need for larger deals, competition at the top of the market increasing the price paid for assets and reducing returns. Each of these can be a limiting factor for some investors, leading them towards a mid-market alternative.

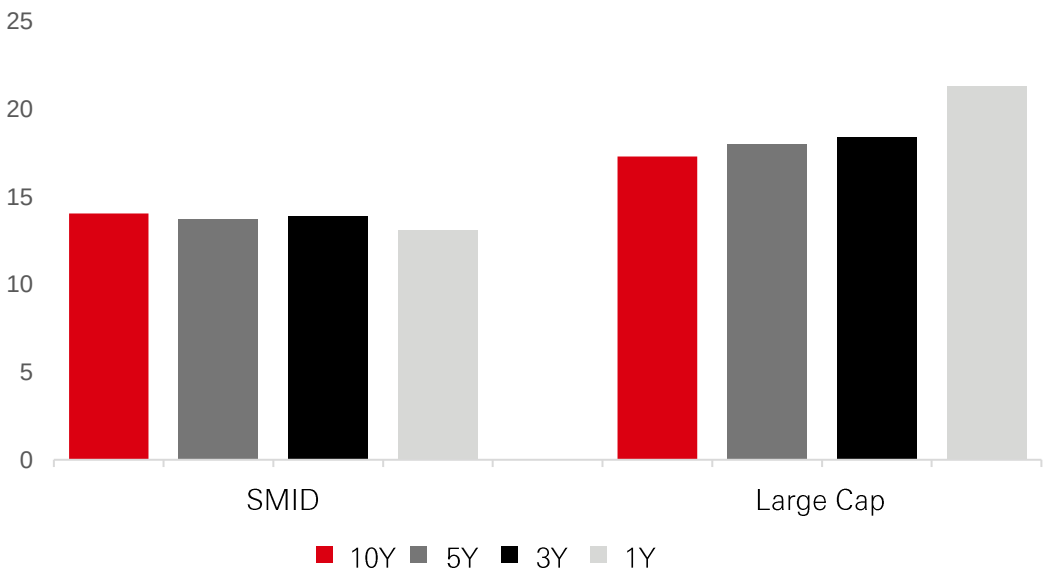
Liquidity is important too. There is a significantly higher volume of transactions in the mid-market versus the large-cap segment. Of 1,368 transactions recorded in 2023, the middle market and lower middle market accounted for 95% of transaction volume, according to data from Inframation. This higher relative supply is met with less competition on the demand side, due to fewer investors focusing on the mid-market. As a result, we believe mid-market funds offer stronger prospects for alpha generation.

Middle-market deals can potentially offer more compelling entry multiples

In the last five to ten years, infrastructure deals in the small/mid-cap range have transacted at around a 23% average discount to large and mega-cap transaction multiples, contributing to their relative outperformance.¹

There are other benefits to focusing on small and mid-market opportunities. Often, small and mid-sized deals are sourced through proprietary networks instead of competitive auctions.² This is a key point of differentiation, which has a potentially large impact upon returns. When there are auctions for assets, the price can be bid-up quite significantly in some instances. But a wide network of contacts within the infrastructure industry can mean that assets are marketed ‘under the radar’ and without the competition associated with an auction. In these instances, a solid network is vitally important.

Average EV/EBITDA Multiple for Infrastructure Transactions



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Source: Hamilton Lane Analysis, DWS proprietary database of European unlisted infrastructure deals, including publicly available transaction information from Infrastructure Journal, InfraNews, Pitchbook, Bloomberg, Preqin, Inframation as of June 2024

1. Hamilton Lane, The Infrastructure Middle Market is Ripe with Opportunity
2. Schroders, The attractions of the small-mid private equity segment as of 6 June 2024

Mechanisms

We believe reduced competition for small and mid-cap assets, asset class characteristics and difficulty with sourcing deals can explain some of the differences in returns between fund sizes. At the same time, risk is, obviously, also a key factor.

Larger funds are typically constrained by mandate and resource towards a minimum deal size that precludes assessing and investing in mid-sized firms. They also typically compete at that size alongside non-financial, or “strategic” investors, such as large utility, energy or infrastructure companies, who are also searching for scale. With larger funds competing for fewer larger deals, mid-sized firms are the preserve of smaller funds, which can often be acquired on more favorable terms.

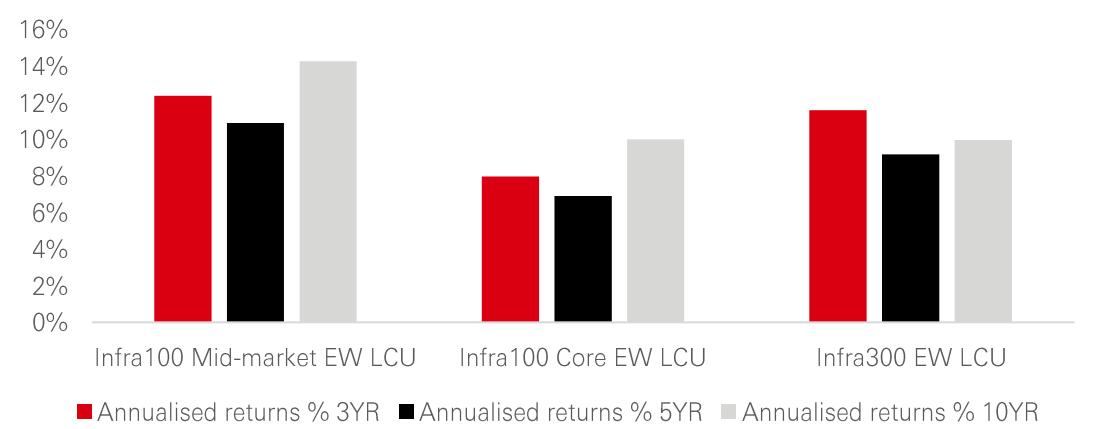
Mid-market deals can also offer access to market segment that is relatively inaccessible to large-cap funds, including platform buildouts, roll-up, or aggregation strategies that cannot be executed on a scale large enough for large-cap infrastructure funds.

Smaller funds can take advantage of proprietary sourcing capabilities and platform scale-up opportunities (both organic and inorganic). Small and mid-market assets can also offer more routes to valuation uplift. For example, if a manager can acquire a mid-market asset and successfully grow it into a large-cap asset by the time of sale, it is likely to experience a valuation uplift, as it could become an acquisition target for larger funds or strategic investors.

Performance in perspective

With a prudent approach to manager selection and disciplined execution, mid-market funds can potentially outperform large-cap funds. One way in which to see the opportunity is to look at the assets that would form the investments of small or mid-market funds, compared to assets that might sit within large-scale funds. While a generalisation, we believe larger assets are likely to be bigger, lower risk and potentially generating stable cash flows. This might put many assets within the Core ‘bucket’.

Infrastructure returns



We can see that mid-market assets have generated significant returns over the long-term, particularly when compared to Core assets and the broader index of assets. This backs-up the assumption that smaller assets can outperform their larger counterparts. In our view, while the performance highlighted is at the asset level, it is sensible to assume that the assets which would sit in mid-market or large-scale funds would comprise similar assets to those in the respective indices. This gives us some comfort in our preference towards mid-market assets.

Past performance is not indicative of future performance. Any views expressed were held at the time of preparation and are subject to change without notice. Source: EDHEC, data as of July 2024

Bigger is not always better

Size can often have a more significant effect in private markets than public markets. We believe this is particularly true in the infrastructure asset class. And within that, in our view, the infrastructure middle market offers a particularly interesting opportunity. While returns from mid-market assets are greater than Core assets over the long-term, we believe they also offer additional diversification benefits, through providing access to parts of the market off-limits to those which invest only in larger funds.

Within the infrastructure middle market, we believe the opportunity in energy transition infrastructure stands out. If net zero targets are to be delivered, energy transition investment will need to increase significantly from present levels. This will not be delivered by governments alone, so private capital markets have an important role to play. No single asset will deliver on the net zero target, and a broad composition of large and smaller-scale projects will have to be utilized. This is a key driver of our belief in the mid-market and our area of focus.

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