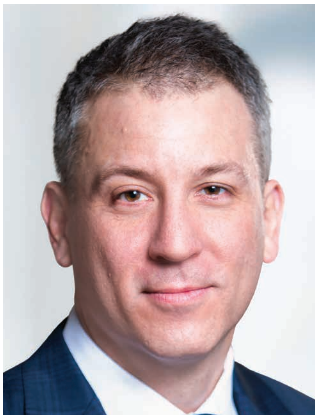
KEYNOTE INTERVIEW

Diversification is key in volatile times



Diversified portfolios with minimal leverage are well-placed to thrive amid market volatility, says Northleaf's Jamie Storrow

Infrastructure managers face a mixed picture in 2023. Most segments of the asset class have demonstrated resilience to inflation over the past year – and yet fundraising has suffered a dramatic dip.

Despite the downturn, Jamie Storrow, managing director and head of infrastructure at Northleaf Capital Partners, is bullish about the future of the asset class. He is particularly excited about opportunities to invest in new types of assets that support the energy transition and help maintain a diversified portfolio.

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Q Which infrastructure assets do you currently find most attractive?

We look for investment opportunities that are smaller and below the radar – it is very uncommon that you would see us in an auction process. We like fragmented markets where assets are less observable, as it lowers the competitive intensity when we make acquisitions. We try to take the investments on a journey where we grow and de-risk them through active asset management and then sell through a visible, patient auction process.

One of our main investment themes is in energy transition. Right now, we are most active in renewables, biofuels storage and sub-metering. We are also reviewing district energy and contracted electric vehicle charging, which benefit from a lot of similar tailwinds. The maturity of traditional renewables makes it more difficult to find risk-adjusted returns that meet our requirements, but we do continue to review this sector, often on a platform basis and alongside battery storage investments.

We are also active in communications infrastructure. We own and manage towers, data centres and fibre networks. We are currently most active in contracted or subsidised fibre, and our main target areas are less populated communities that do not have fibre today.

On the transportation side, our recent focus has been on short-line rail infrastructure in the US. That is a very large sector with many opportunities for small investments that are not particularly visible. We also look for opportunities with other types of contracted infrastructure, such as chemical storage tanks – this is an area where we have a lot of expertise, and we expect we will continue to make investments.

Q What benefits does such a diversified portfolio bring, especially in the current macroeconomic environment?

We actively look for diversification in our portfolios. As part of our portfolio construction criteria, we aim for diversification in the underlying physical infrastructure, the sectors that we are investing into, the types of revenue frameworks that we deal with, and the counterparties on the other side of the revenue framework.

We look for inflationary linkage in the revenue line, as we have historically done, which has been beneficial in the current market environment.

We also try to find situations where we can minimise leverage. Currently, debt is expensive and is much harder to get. We have been looking for opportunities where we can acquire un-levered assets or take on a very modest amount of debt. That has been a very deliberate strategy in the past for us, and it is benefitting our current portfolios – we do not have a lot of debt across our investments.

Q On balance, are you benefiting from the higher interest rate environment?

There are pros and cons to higher interest rates. We are now in a very different market than we have had over the last decade. Debt is more expensive, and acquisition processes can be

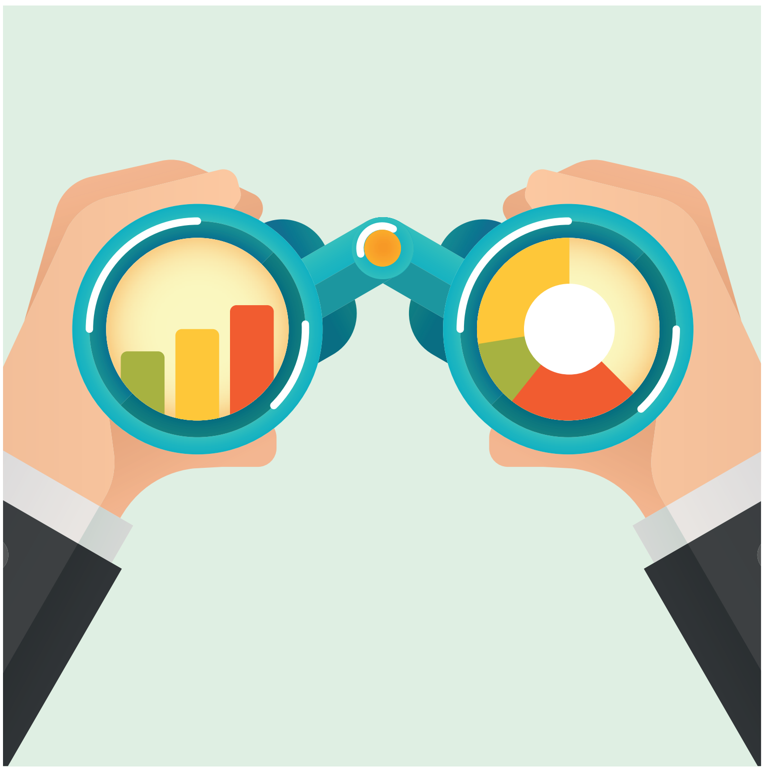
Q How optimistic are you feeling about the medium and long-term outlook for the asset class?

I am optimistic about the future for infrastructure. I certainly don't feel there will be any long-term decline in the asset class. The value proposition is clear, infrastructure provides essential services. The performance of the industry as a whole in 2022 was a great example of why investors continue to allocate to infrastructure. Inflation protections and monopolistic characteristics really played out in a positive way last year, in the face of volatile capital markets with high inflation and high interest rates, alongside geopolitical shocks.

The biggest challenge we always face is finding risk-appropriate investments. Risks change year-to-year, sector-to-sector, and so continually staying in front of those risks is always something that we focus on.

The infrastructure industry looks different than it did 10 or 20 years ago, and communities demand different essential services over time. We are now spending time on investments that, five years ago, were difficult to imagine having risk-appropriate revenue frameworks for an infrastructure portfolio. A sector such as contracted EV charging infrastructure, which did not even exist until recently, is an example of something we're currently reviewing. In other words, the industry continues to adapt to societal needs and is therefore always going to have a home. Society's demands will change, and the industry will be there to support them.

From a portfolio perspective, infrastructure continues to provide excellent diversification and correlation properties, and generally speaking we expect investors to continue to deploy capital in the asset class over the medium and long term.



more difficult because the cost of capital is higher. But we are seeing some benefits to the current interest rate environment when it comes to new acquisitions.

In our sourcing strategy, we typically focus on undercapitalised developers and industrials that are open to collaborating outside of formal auctions. These kinds of companies are currently under a lot of pressure because their ability to raise debt is very limited. We have found acquiring assets that can deliver strong risk-adjusted returns with very little debt has been possible because of the current market dynamics.

Q In terms of your geographic focus, which markets are most appealing?

The bulk of our investment activities are in the United States – and we expect that to remain our primary focus. The US market has the largest opportunity set for our strategy and it is where we have the largest pipeline of investments. Since the US market is so large, there is a lot of fragmentation and we are able to find numerous smaller, undercapitalised developer and industrial groups that are open to collaborating on transactions.

"As the market normalises, investors will have an increasing amount of choice. This is a maturing market, with multiple managers covering numerous strategies"

In addition, the Inflation Reduction Act in the United States has certainly benefitted the asset class. It's a large programme that is creating significant interest in the sector, including in certain energy transition assets that were more difficult to finance before the legislation was passed. Currently, the US economy is among the top performers across developed markets – there are tailwinds around GDP and population growth that are beneficial to many of the investments that we make.

We are also active in Canada, some Western European countries – particularly the United Kingdom – and Australia and New Zealand, but those markets account for a smaller proportion of our pipeline.

Q Does core infrastructure now look less attractive?

There is no question that in the current environment, higher returning infrastructure strategies are more in favour. With interest rates high, you would naturally expect some of the core managers to look to take more risk to get higher returns, because in many cases, they are effectively competing against the cost of debt.

However, there is always going to be investor interest in the lowest risk assets – investments that are generating more income than capital gain, investments with very limited business plans, with very long-term contracts or transparent regulatory frameworks. I think there is always going to be room for that category.

Saying that, the industry has found, over the last 20 years, that sometimes it is very difficult to measure risk. Some of the so-called core assets have actually underperformed, but we usually find that those cases are in the minority – most core assets have performed as expected.

"Infrastructure continues to provide excellent diversification and correlation properties"

Q There has been a clear downturn in fundraising in 2023. Are LPs losing appetite for infrastructure?

The fundraising market is slow right now. I feel it is gradually starting to pick up, but I think we will be well into 2024 before a sense of normality returns. It usually takes a couple of years for the fundraising cycle to return following market shocks.

Saying that, the downturn in fundraising does not have anything to do with infrastructure specifically. The main cause is the denominator effect – portfolio weightings between public and private market allocations are out of sync. Investors that are overweight in private markets find it more difficult to deploy additional capital, despite the strong performance.

As the market normalises, investors will have an increasing amount of choice. This is a maturing market, with multiple managers covering numerous strategies. There are both open and closed-ended fund options, regional funds, global funds, sector-focused funds, and funds offering a varying range of risk-return profiles. LPs that have been investing in this sector for many years typically have multiple managers solving for different investment goals. ■