ROUNDTABLE

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North American infrastructure: 2020 and beyond

Six infrastructure experts tell Jordan Stutts about the opportunities and challenges that lie ahead in the US, Canada and Mexico

The US has not seen a major government infrastructure package since President Dwight Eisenhower's administration in the 1950s, so excitement surrounding a much-touted federal commitment to overhauling the country's ageing infrastructure was palpable when President Donald Trump took office in 2017. However, this year, enthusiasm was notably tempered by caution at a gathering of six North American infrastructure experts hosted in New York last month.

"There was a period of euphoria on the back of a federal infrastructure bill in the US infrastructure market as people imagined a massive federal infrastructure build, which never really had much hope of becoming reality, at least in the medium term," explains Mark McComiskey, partner at AVAIO Capital.

"That is because the majority of decision-making around infrastructure is handled at a state and local level. There is little the federal government can do beyond financial incentives, and these do not streamline the permitting and stakeholder issues that delay infrastructure projects. The sense of euphoria now seems to have deflated and it is back to business as usual."

David Williams, managing director and head of global infrastructure and power at CIBC Capital Markets, however, is slightly more optimistic. "Action at a federal level has meant that decision-makers, at a local level, can no longer just kick the can down the road though," he says. "They are taking it upon themselves to advance projects, so it does seem like there is more going on."

George So, managing partner at InstarAGF Asset Management, meanwhile, reinforces the idea that a local approach is, in any case, best. "Municipalities are responsible ... for around 60 to 70 percent of infrastructure, but from a tax perspective, they only get 10 cents on the dollar. That creates a real opportunity for the private sector to fill that void. The local level is where you can get the best bang for your buck while adding value to the community."

> **3%**
>
> **Proportion of deals of more than $1.5 billion over the past five years**

High energy

And, of course, even without a meaningful federal injection, the US, as the largest country in North America, offers myriad investment opportunities. It does, however, continue to be a heavily energy-focused market. Three-quarters of deals completed by the top 10 infrastructure funds over the past five years involved energy of one form or another, according to McComiskey, with Brent Tasugi, investment director at AMP

PHOTOGRAPHY: **BRIAN SHUMWAY**

Brent Tasugi

Investment director, AMP Capital

Tasugi joined AMP in 2017. He was previously a senior vice-president with Oaktree Capital Management, and focuses on origination in the North American infrastructure markets, including the transport sector, where he has particular expertise.

Chris Beall

Founder and managing partner, NOVA Infrastructure

Beall has more than 20 years' experience in private equity, investment banking and infrastructure operations and engineering. He was previously a managing director and co-portfolio manager for Oaktree Capital's infrastructure strategy.

Mark McComiskey

Partner, AVAIO Capital

McComiskey is involved in all aspects of investment and operational activities at AVAIO. He has over 20 years' experience in private equity and infrastructure, and has invested more than $4 billion of equity in energy, infrastructure, transport and manufacturing projects.

David Williams

Managing director and head of global infrastructure and power, CIBC Capital Markets

Having joined CIBC's merchant banking group in 1990, before working in M&A, Williams joined the infrastructure group in 1999 and has led more than 300 transactions in the power, pipeline and infrastructure sectors globally.

George So

Managing Partner, InstarAGF Asset Management

So is responsible for strategic and business development, transactions and asset management. He was founder of Kindle Capital Group and a member of the Canada Pension Plan Investment Board's private investment infrastructure team.

Bruce Chapman

Partner and co-founder, Threadmark

Chapman has more than 18 years' experience of capital raising and corporate finance. He was previously a partner at CP Eaton Partners and Continental Capital Partners and was an officer in the British Army's Royal Green Jackets.

"Many managers that historically inhabited the mid-market space have been sucked up into the mega-market and left deal sizes of $50 million to $200 million relatively underserved"

BRUCE CHAPMAN
Threadmark

Capital, adding that over half of all transactions his firm sees contain an energy component.

"But, if you take a step back and consider the macro challenges hanging over North America – climate change, urbanisation, demographic shifts – you start to see the breadth of need for infrastructure investment," Tasugi says. "That need reaches down, at a local level, to utilities, transportation and telecoms."

Indeed, some elements of the US energy industry appear to have lost their shine – most notably midstream. While huge amounts of capital poured into opportunities, particularly between 2010 and 2013, in order to capture the shale revolution, the dynamics have now shifted, and this explosive growth is no longer the low-hanging fruit it once represented.

"That capital was supported by high volume growth rate, as domestic production supplanted imports," explains Chris Beall, managing partner and founder of NOVA Infrastructure. "Now, those imports have largely been displaced and so growth rates have moderated. Today, the US is trying to take a global share from sovereigns with non-economic reasons to maintain production, and that is a much harder game to play."

There is now also considerably more black swan risk associated with midstream investment, including a leading Democratic presidential candidate who says she is willing to ban all fracking, one participant points out while asking not to be quoted. "That has got to have an impact on midstream. Some niches may benefit as activity is diverted, but as a whole, it is a big negative. There is real political risk, at least for the next year."

Digital dealflow

Elsewhere, digital infrastructure remains critically underinvested, according to Tasugi. "As digital devices proliferate and as corporates continue to outsource their data handling, significantly more data centre infrastructure will be required," he says. "The deployment of 5G will also require more fibre and tower investment and there will certainly be a role for private capital to play."

So adds that the digital space is becoming more interesting as an investment proposition as it transitions from a consumer sector towards essential infrastructure. "A mobile mast for banking communications is as necessary as a fixed line telephone was back in the sixties and seventies," he says.

"What were once luxury items are now

serving an everyday need. That creates massive demand for infrastructure as well."

As infrastructure investors continue to expand their parameters, the question of the level of associated risk becomes increasingly relevant. Our roundtable participants are not afraid to challenge each other on the question of whether digital infrastructure could ever be considered core.

"I don't think it is possible to generalise," says Beall. "Is a road core? What if you leverage it 25 times and put an accreting swap on it? You have to analyse downside protection asset by asset and contract by contract."

McComiskey, however, notes that there is risk inherent in certain components of digital infrastructure. "What happens to fibre-to-home projects that have just been paid for if 5G delivers on what it promises? The impact of what is happening in the digital world on traditional infrastructure is meaningful," he says. "Just look at parking lot investments which were considered core at the time they were made. What ridesharing has done to demand, particularly in New York, has been brutal."

In addition to digital risk, dramatically escalating fund sizes are a notable element of today's market. But does the opportunity set match the amount of money being raised?

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CHRIS BEALL
NOVA Infrastructure

"We are seeing $20 billion-plus funds being raised and while there is no doubt that there are assets large enough to absorb those funds, it does require a shift away from where those managers have historically deployed," says Bruce Chapman, partner and co-founder of Threadmark.

McComiskey also questions whether there are enough mega deals to go around. "Over the past five years, 4,900 infrastructure deals were completed at below $1.5 billion in North America. Over the same period, there were only circa 150 deals done at more than $1.5 billion."

He continues: "In today's market, there are a fair number of infrastructure investors whose minimum equity cheque is approaching $1.5 billion. Combine that with the pension funds and SWFs that are increasingly active in direct investment, and it is hard to see that there is enough dealflow in this size range to feed everyone with that kind of appetite."

Deficit spending required

So, however, points out that there is still a vast infrastructure deficit in North America. "Trillions of dollars need to be invested over the next 25 years and 75 percent of the infrastructure required over the next 30 years has not actually been built yet. The need is definitely there, and so I think there will be room for everyone to play within their specific areas of focus, whether that's bulge bracket or mid-market, specialised or diversified."

Beall, meanwhile, believes that growth in capital under management creates a lot of opportunities downstream, at the smaller end of the market. The key to capitalising on that, he says, is relationships. "If you are only looking at banked transactions or are focused on PPPs, I think dealflow will be a concern. But the US economy is massive and there are lots of smaller projects looking for capital, for those prepared to put in the elbow grease."

Chapman agrees that growth in fund size has made the mid-market a more attractive space to play in. "Many managers that historically inhabited the mid-market space have been sucked up into the mega-market and left deal sizes of $50 million to $200 million relatively underserved."

Furthermore, new entrants to the infrastructure industry, including direct pension funds and sovereign wealth funds, are not set up to take advantage of mid-market

opportunities, which has a positive impact on mid-market returns. "The new entrants that have come in are predominately large dollar players," says McComiskey. "These new entrants often have lower overall return hurdles than traditional funds. Focusing on the middle market, where these new players are less likely to operate, means you do not have the same pressure on returns."

"It is not only the amount of capital they have to put to work that precludes the mid-market for many direct investors," says Chapman. "Mid-market transactions are generally delivered through relationships developed over a very long gestation period. It is not something these pension funds are set up to do. They just do not have the headcount."

Some investors operating in the large-cap space would deny that those inhibitors exist, because they have portfolio companies that can come down into the mid-market. "But entrepreneurial businesses are not indifferent to whether you are a financial or strategic investor," says Beall. "A strategic investor looking to synergise a management team is much less attractive than a financial partner which can provide capital and support to help them grow."

Beyond the main risks that are being

Canada and Mexico

The US may be the biggest market in North America but what opportunities do Canada and Mexico currently represent?

"Canada has led the way in the PPP so, in addition to new projects, there will be opportunities to sell PPP assets that are up and running," says David Williams, managing director and head of global infrastructure and power at CIBC.

However, Williams adds that the political situation in Mexico is making it a less attractive market than it was even a year ago. "Mexico is in North America but has some of the same political turmoil that we are seeing in some countries in South America. A number of managers have not done well there. While returns can be higher than you can earn in the US, the risk/return trade-off has made the market less attractive to many investors."

George So, managing partner at InstarAGF Asset Management, agrees that the scale of demand for infrastructure investment in the US is so great that you simply do not need to venture south. "Given the scale and quality of the opportunity that is available here, we do not see the need to take the emerging market risk, the political risk or the currency risk."

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CIBC Capital Markets

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AVAIO Capital

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BRENT TASUGI
AMP Capital

identified and discussed, Beall is quick to point to rate-based risk as a significant danger. "We are seeing that play out on a massive scale in California. People are talking about the political repercussions, but at the end of the day, it was at least partially caused by underinvested infrastructure."

"The starkest example of that is in the UK, where the rates of return allowable to water utility and electricity grid investors was slashed after privatisation," adds McComiskey. "This may deprive them of investment just when it is needed most to support the transition to renewables. The US water industry has seen underinvestment also, as around 3,700 systems do not meet minimum clean water standards and that is largely because it is politically impossible to raise rates."

But for So, the most significant threat facing the infrastructure market right now is the macroeconomic backdrop. "I think the potential for market contraction should be one of our highest priorities – whether that is a full blown recession or mild correction. What will that do to our assets? What will it do to our capital position and how do we weather that storm?"

Rising values

The situation is exacerbated by sometimes dizzying valuations. Fully contracted data centres are regularly pricing at north of 20x EBITDA, says McComiskey. Ports, meanwhile, are again pricing in the high teens and low twenties. "There isn't a sector out there for operating infrastructure assets for the faint of heart right now," he adds. "What impact will that have when the tide goes out?"

The situation clearly differs depending on whether you are planning to hold assets as bond substitutes for a long period – where interest rates will have a potentially profound effect – or if you are planning to build value through a growth strategy where you can proactively increase value.

"In a downturn, I think you are much better off with a more lightly levered business with operating leverage, rather than a long-dated bond approach," says Beall. "I am of the view it is only possible to look about five years into the future easily; 10 years feels almost impossible – 30 years, no way."

He continues: "If you are buying assets you intend to hold for 30 years, you had better have a very robust internal policy around aggressively re-evaluating market conditions every four to five years. Whereas, if before exiting you have a strong management team and a very good five-year plan, you reduce the exposure to something unexpected that may happen 30 years down the line."

"For me, the discipline provided by a defined exit horizon is a compelling reason to stay in the closed-end market."

Chapman, however, says that there are assets that fit neatly within an open-ended structure, with PPPs being an obvious example. "It is fine to develop those assets in shorter-dated funds, but once up and running, I think they fit more naturally in an open-ended vehicle."

However, he cautions that there does need to be a recognition that not all assets are suited to those structures. "We are now seeing managers that have been heavily focused on the PPP space, many of which are now, frankly, starved of dealflow. Some of those firms are expanding their definition of core and I question whether those assets really belong in longer-duration funds."

And that, says McComiskey, is a risk to everyone. "In an economic downturn, those assets are not going to respond like long-term contracted assets. People who thought they were invested in core infrastructure will find out that was not always the case. That could cause a reputational problem for the sector as a whole."

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GEORGE SO
InstarAGF Asset Management