INFRASTRUCTURE – OUR ASSET CLASS ASSESSMENT

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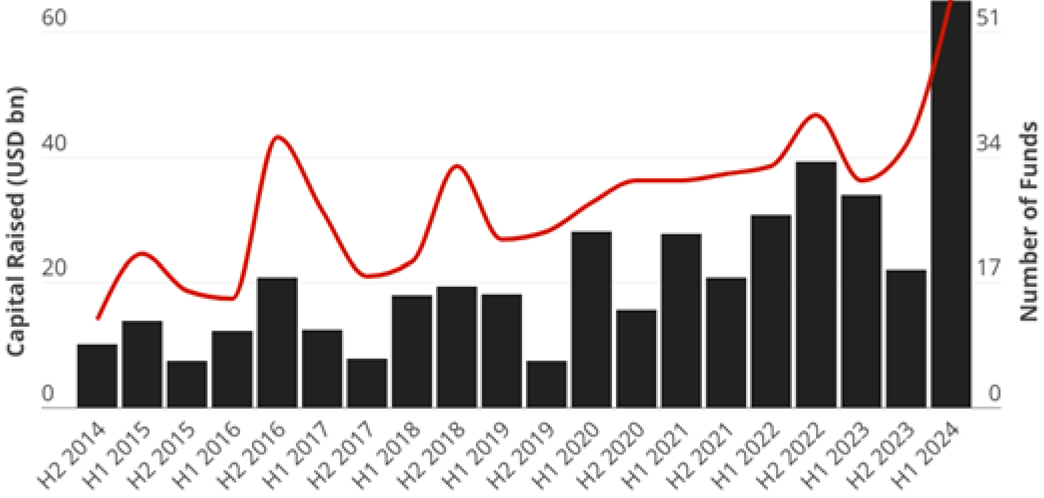
RML Advisory

Investors pour record capital into core infrastructure funds

Capital raising by core private infrastructure funds has jumped significantly as investors have rewarded managers pitching safer strategies with an almost doubling in commitments in H1 2024, according to global real assets data specialist Realfin (September 12, 2024).

The surge in interest among investors in the fund style prompted a 91.3% year-on-year increase in commitments at various stages (interim and final closes) to USD 65.10 billion in H1 2024, compared to USD 34.02 billion in the year-ago period, provoking a record high for the strategy.

The revival in demand for core strategies comes after two consecutive half-years of declines. It appears to corroborate the position that the desire for resilience amid continuing macro headwinds, as well as progress made in valuations among core assets, is persuading investors back to the style.



The Appeal of Infrastructure

Infrastructure plays a vital role in supporting the economy and societal progress. It can produce consistent and reliable cash flows with attractive returns that can safeguard against inflation and provide stability in different economic conditions. Investments in infrastructure typically exhibit low volatility and are not strongly correlated with other types of assets, making them a valuable addition to an institutional investor's portfolio.

Rethinking Manager Selection: The Importance of Strategic Fund Choices

During the previous period of low interest rates, rising valuations, and strong exit activity, institutions could rely on private markets to deliver, without closely scrutinizing liquidity management, portfolio construction, fund strategy, and value creation approach. However, in today’s environment, thoughtful manager selection is essential to achieve consistency of returns.

Smaller Funds and Niche Managers: An Untapped Opportunity

In recent years, there has been a noticeable trend towards consolidation within the infrastructure fund market, leading to a more centralized focus on a select few major players.

With the increasing demand for investments in infrastructure, the funds allocated to this asset category have also seen significant growth, often surpassing 10-20 billion euros per fund, averaging around 2 billion euros (see Realfin data).

At the same time, the number of attractive infrastructure opportunities (projects and companies) coming to market are scarce, further exacerbated by a slowdown in M&A activity.

With more than 300 billion euros of infrastructure dry powder, there is increasing urgency to deploy capital.

This leads to an increase in prices, resulting in lower returns, while also causing a concentration of larger and more intricate assets. These bigger and more complicated investments are prone to various points of vulnerability.

Investing in smaller or specialized funds, however, can provide various advantages in terms of risk and return. These specialized fund types often grant access to unique deal flows and strategies, which can lead to improved economics and stronger governance. We believe that considering these factors can be beneficial for investors seeking diversified and potentially higher-performing investment opportunities.

Case study: The Offshore Wind Sector: Rising Competition and Profitability Challenges

The offshore wind sector has become highly competitive, with zero-subsidy bids and companies even paying for development rights. Extended lead times in development and lengthy construction phases (up to five years) further complicate projects, as locking in capital and contract structures early leaves little room to adapt to changing market conditions. This rigidity increases the risk of project profitability deteriorating, with limited options to renegotiate terms.

The timing of key decisions - such as when to finalize costs, secure financing, and lock in revenue structures - is crucial. Poorly timed commitments can severely impact a project's financial viability.

In response to these challenges, several industry leaders are scaling back. Ørsted, after announcing significant write-downs on delayed U.S. projects, is reviewing its portfolio, cutting jobs, and abandoning offshore wind plans in three European countries. The company also withdrew from two U.S. projects, Ocean Wind 1 and 2, citing unworkable fixed-cost agreements that failed to account for inflation, rising interest rates, permitting delays, and supply chain issues.

Equinor has decided to exit offshore wind development in Spain and Portugal, citing "significant headwinds" in the industry and a need to focus elsewhere to remain competitive.

Vattenfall has paused development of its 640MW Kriegers Flak offshore wind farm in Sweden, deeming current investment conditions "unviable." Danish pension fund Akademikerpension has also noted that market conditions must improve for the sector to regain profitability.

Anders Schelde, Chief Investment Officer at Danish fund Akademikerpension, echoed this sentiment, noting that the market conditions for offshore wind need to be reset to make the sector profitable again.

Case study – Strugles beyond renewables: The case of Thames Water

Thames Water, the UK's largest water supplier, has been facing significant financial and operational challenges. The company is struggling with around £14 billion in debt, exacerbated by rising interest rates, leading to concerns about its financial stability in 2023. There are even discussions about potential government intervention or nationalization. Much of Thames Water's financial troubles stem from its private equity ownership, which created a highly leveraged financial structure and prioritization of shareholder returns to justify its acquisition price. Critics argue that this has come at the expense of infrastructure investments, leaving the company vulnerable to long-term challenges.

Operationally, Thames Water has one of the worst leakage rates in the UK, losing around 600 million liters of water daily. Despite pledges to reduce this, the company has consistently failed to meet regulatory targets and has been fined multiple times for environmental violations.

Regulator Ofwat has placed the company under increased scrutiny for its failures in addressing leakage, pollution, and infrastructure investment.

In 2023, concerns over its financial health and failure to meet key operational targets led to talks of placing Thames Water into a special administration regime to ensure service continuity in case of insolvency.

One of its investors has already written down the value of its holding in Thames Water to zero.

CONCLUSION – WHY SMALLER FUNDS ARE CRUCIAL FOR PORTFOLIO DIVERSIFICATION AND OFFER MORE ATTRACTIVE RISK/RETURN PERSPECTIVES

For numerous LPs/investors new to or not yet active in the field, investing in smaller funds presents an opportunity to increase portfolio diversification by gaining access to unique deal opportunities and strategies. Prioritizing smaller or up-and-coming fund managers can also lead to better financial outcomes, improved chances for co-investing, stronger oversight, and the chance to cultivate long-lasting relationships.

This underscores the significance of not overlooking smaller funds in the investment landscape.

ABOUT RML ADVISORY

RML Advisory is an independent alternative investment advisor founded in 2017 that specializes in a diversified set of alternative investment strategies (Hedge Funds, Private Equity, Private Debt, Real Assets such as infrastructure, and Venture Capital).

Our team's extensive expertise in the field of asset management, broad industry connections, and commitment to understanding the specific needs of our clients enable us to offer a diverse range of services and present attractive investment opportunities to our clients.

RML Advisory is a fully regulated investment advisor according to FinSA (Financial Services Act) and a member of The Financial Services Ombudsman Association (OFD), a regulatory requirement according to FinSA, Section 74.

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