2020 PREQIN GLOBAL **INFRASTRUCTURE** REPORT

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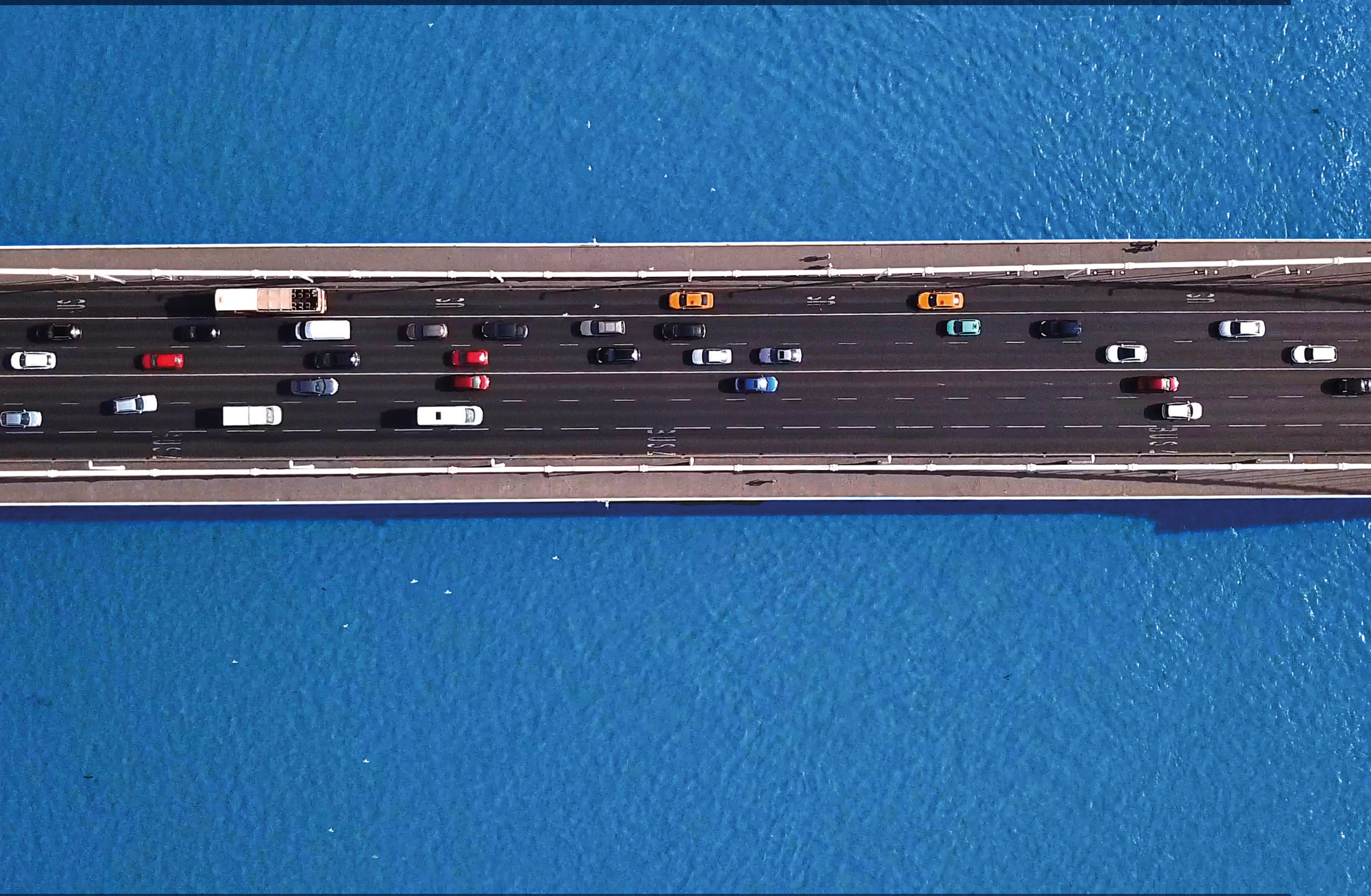

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ISBN: 978-1-912116-25-6

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Executive Summary

2019 was a capstone to a decade in which infrastructure truly entered the mainstream. Success has fueled future challenges, but the infrastructure train keeps rolling

In the private capital space, infrastructure does not have the same exciting reputation as venture capital, the high-flying dominance of private equity, nor the intrigue of new-kid-on-the-block private debt. Investors have typically looked to infrastructure to add ballast to their portfolios: hedging against inflation and adding a revenue stream to counteract the substantial but unpredictable payouts from other alternative asset classes.

For all that, it is sought after by investors, which have been expanding into the asset class at a gradual pace for some time. There are now around 4,000 institutions making allocations to infrastructure, a substantial pool of capital for fund managers to appeal to. And appeal they have – as investors have become active in the industry, new fund managers have formed to raise vehicles and cater to demand. There are now 707 active infrastructure fund managers. This is a new record for the industry, and demonstrates that infrastructure has become a mainstream part of the alternatives industry.

Fundraising has been substantial in the past few years, and reached new highs in 2019. A total of $98bn was raised from investors – a new record, of which half went to just five funds. Mega private capital funds have been a feature of the industry for some time, but given the limited size of the total infrastructure fundraising market, they wield outsized influence.

Partly fueled by such strong fundraising activity, assets under management (AUM) hit new records in successive years throughout the 2010s. As of June 2019, AUM stands at a record-high $582bn, having crossed the $500bn mark for the first time at the end of 2018. And fund managers have been putting that capital to work: called capital reached a peak of $89bn in 2018, and 2019 looks set to approach or surpass that level. Distributions in H1 2019 have been at a record pace too, even if overall net capital flow remains negative.

The truth is that infrastructure can no longer be classed as a dull counterweight to more exciting sectors. Median net IRRs for infrastructure funds have hovered around 10-11% in recent vintage years, and overall the industry has returned a net annualized 7.7% in the year to June 2019, and 8.7% in the decade to that point. It has coupled strong returns with consistency, with among the lowest variation in rolling one-year returns of any asset class.

A period of strong performance could not come at a better time for investors: rock-bottom interest rates, low bond yields, and sluggish global growth have all hit their portfolios. The difference between gains from bonds or fixed-interest products and the ambitious return targets of many institutions has never been wider. Infrastructure has been particularly sought after as a means of plugging that gap – a predictable income stream, yes, but one sufficient to help make up for volatile returns in other markets. This has been particularly appealing as we head toward what is generally agreed to be an all-but-certain equity market correction – even if no-one can agree on just when to expect it.

But success, as ever, is not all positive. Good returns have drawn more capital into the asset class, which has meant more competition for attractive investment opportunities. This has pushed up asset pricing, and made deal-making more challenging. The infrastructure deals market has slackened in the past two years, with assets in North America and Europe requiring more lengthy due diligence in order to make sure high pricing has left enough potential upside. Ultimately, it has eaten into the returns that fund managers can expect to make in the coming years.

Operators are adapting in two main ways: first, they are reducing the targeted returns of the funds they have in market, recalibrating their ambitions in light of the current environment. Second, they are looking to move into higher-risk strategies and new markets. As such, we have seen a shift toward value-added funds and a renewed focus on emerging markets.

The overall mood in the industry is upbeat, though. Infrastructure has enjoyed a considerable run of success in recent years, and is still in the midst of a fundraising boom. Unlike other asset classes, where a flood of capital has proved challenging for fund managers to absorb, infrastructure has plenty of release valves left to pull. Activity is highly concentrated on developed markets and on certain sectors like renewables. There is a huge amount of scope for managers to explore new sectors and markets that are as yet untapped. And investors certainly have faith in their ability to do so: in the long term more than nine out of 10 intend to invest as much or more capital in the industry compared to today. It will be up to fund managers to innovate ways to keep meeting those expectations.

Data Pack

The data behind all of the charts and tables featured in this report is available in Excel format at no extra cost. This data may be used in marketing materials, presentations, or company reports with appropriate accreditation to Preqin.

Infrastructure Megatrends

Key themes shaping the unlisted infrastructure industry

Capital Concentration

The majority of capital flowing into the industry has been swallowed by a small group of the largest fund managers, creating a two-tiered fundraising and deals market.

ESG

Arguably the hottest topic in the investment world, ESG is a key consideration behind investment decisions for investors and fund managers alike. Is it just a phase, or is ESG here to stay?

LP Sophistication

As much as fund managers are in a constant race for the best opportunities, so too are investors always looking for the next big thing in allocating. We look at how LPs are increasingly evaluating, contacting, and competing with fund managers themselves.

Competition for Deals

With new firms being founded and bringing funds to market, existing managers raising larger-than-ever vehicles, and investors developing a taste for direct investment, there is more competition for prime assets than ever before.

Market Slowdown

If there is one thing almost everyone can agree on, it is that there is a market slowdown coming. But when exactly to expect it, what sectors will be most exposed, and whether investors should be adjusting their approach in anticipation are all hotly contested.

Performance Pressure

Infrastructure has performed well in recent years, but maintaining those returns is a challenging prospect. Fierce competition, large dry powder stores, and sluggish global growth have all made it more difficult to return tomorrow what you returned yesterday.

Creating Value in Infrastructure

Martin Lennon, Head of Infracapital, on ESG, rising competition, and the "enormous potential" to create value

What role does private capital have in reducing the funding gap in European infrastructure?
It is estimated that Europe needs to invest about €270bn a year between now and 2030 to build new infrastructure and to maintain the existing network. A significant amount of this investment requirement is expected to be funded by private investment, which will play a vital role in driving economic growth and global competitiveness.

How is competition for deals driving changes in the market, and has it altered your investment approach?
The market has certainly evolved as a result of growing competition, and what you see now is even more variety in investment strategies as a result. There's differentiation by geography, sector, and risk/return appetite, with strategies such as core, core-plus, super core, and value add to address specific segments in the marketplace. That kind of specialization reflects, to a certain extent, the challenge of demand for assets vs. supply.

We have positioned ourselves quite deliberately to participate in the mid-market, which we define as businesses of up to about a billion pounds (or euros) in enterprise value. Here we see the biggest proportion of opportunities to find or create assets and to drive value creation to deliver attractive investor returns.

What value creation opportunities do you see in the infrastructure space?
There's enormous potential, and I'll make three points about that. First, value creation starts with good origination. We operate in two core strategies: greenfield – which is about building and delivering new infrastructure – and brownfield, which is about acquiring operating infrastructure. Across both strategies, we go out into the marketplace and

Martin Lennon
Head of Infracapital

proactively procure opportunities. With our brownfield strategy, about one in three of our deals have been proprietary. On top of that, about another third are what we call 'limited competition.' Instead of full-blown auctions, you can get to a one-on-one, bilateral conversation relatively quickly and look to avoid squeezing the last penny out of the bid price.

On the greenfield strategy, about 60% of our deals are non-competed. That's because we work extensively with developers, construction companies, entrepreneurs, and corporations and position ourselves to understand where the deal flow is coming from and when. We seek to help to get development-stage propositions to the late stage where they're more or less certain to happen, but where we can still influence key elements around construction and financing. Over time, you are able to form strategic alliances or joint ventures and become a trusted financing partner. From a value-creation point of view that's incredibly powerful, because you avoid the cost of competition.

Second, there's creating value through delivery. In a greenfield context that's delivering a construction project, a network buildout, or taking a pre-operating opportunity and making it operational, so if delivered successfully, you should benefit from a reduction in the risk premium when you sell. In a brownfield context this refers to situations where delivery is 'complex,' but where there's the potential to improve the asset, de-risk, and drive value. That could mean carving out a division from a corporation, putting in place a new management team, implementing a new billing system, and creating a standalone company.

The third example is the platform approach, which involves growing a small- to mid-cap company and transforming it into a real leader in its sector. If you can show that the growth that you've delivered is expected to continue you can drive some very exciting returns. We see this a lot in our greenfield strategy – we start with constructing assets, but with a view that these become multi-asset platforms where you can put in place quality management teams and drive synergies and efficiencies.

Let's talk about ESG. How do you see its role in the industry – is it seen as an optional extra, or is it more critical than that?

I think we need to take the ESG opportunity as far as we can, because infrastructure provides us with a relatively unique opportunity to make a positive impact on the environment and society. At Infracapital, we issued our first comprehensive ESG report to our investors last year, and we've identified a set of KPIs that we want to manage and measure transparently across our portfolios and within our team. These KPIs include, for example, climate impact, diversity, employee wellness, data, cybersecurity.

For those measures, we will be looking at equivalent businesses and industries to see where there are differences, so that we can use best practice. It's a huge advantage having a large portfolio of companies; while one might be a broadband business and another might be a waste-to-energy business, some KPIs share common features. And if one business has an effective solution, we can share learnings and help others come up to that standard. What we want to drive is ongoing improvement across those KPIs, so that every asset is proactively looking to deliver best practice across the board.

In Focus: How Big Will Infrastructure Get?

Sustained investor appetite and strong long-term performance have boosted infrastructure assets past $0.5tn, and the industry is on the way to hitting $1tn by 2023

The infrastructure industry has grown phenomenally over the past decade. Although it remains a relatively small part of the private capital industry overall, total AUM has quintupled since 2009. As of June 2019, the industry holds $582bn in assets, up from just $129bn at the end of 2009 (Fig. 2.6). Can infrastructure keep up this rate of growth?

Investors Ensure a Thriving Pipeline

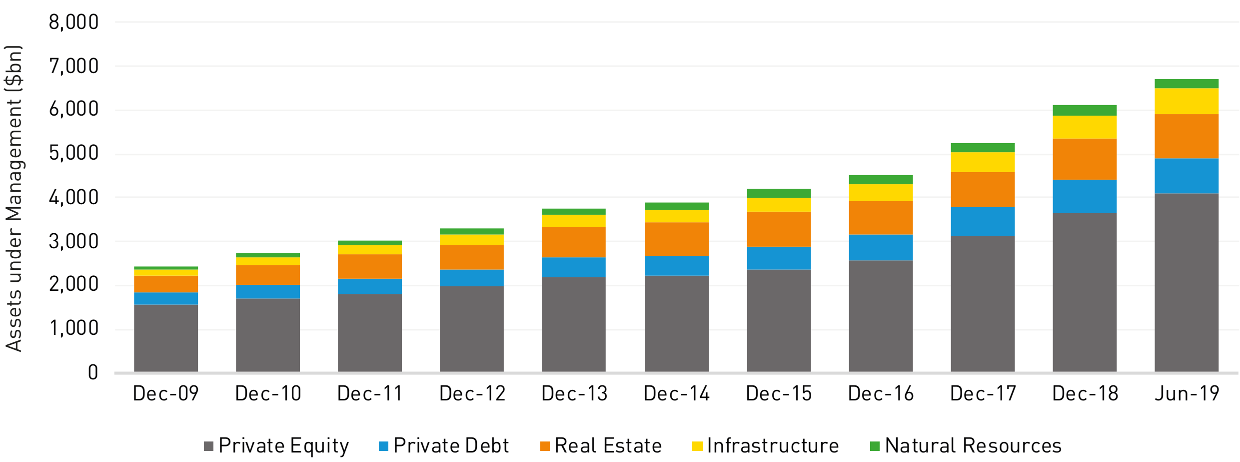
Sustained interest from investors is a key driver of the industry's expansion. Fundraising has exceeded $50bn annually since 2015 and set five consecutive annual records. Totals in 2018 and 2019 both approached $100bn – a substantial increase compared with full-year fundraising of $17bn back in 2009. This flood of capital shows no sign of slowing, either, as 84% of surveyed investors intend to commit as much or more capital over the next 12 months compared with the previous year.

A booming community of fund managers has sprung up to service this demand. Over 250 infrastructure funds are collectively seeking more than $200bn from investors at the start of 2020, which is more than double the total capital targeted at the start of 2015. Given that investor interest looks set to continue, it seems likely that fund managers will keep bringing new funds to market to capitalize on that demand.

...Encouraged by Robust, Consistent Returns

Abiding investor appetite reflects the success that infrastructure has enjoyed. Performance has been strong, and in recent years has rivaled or exceeded that of asset classes like real estate or listed equities. As a traditionally low-risk/return asset class, infrastructure has no business outstripping high-growth sectors like these. Moreover, returns have been remarkably consistent: funds of all recent vintage years have posted median net IRRs of 9-12%, and rolling one-year

Fig. 2.6: Private Capital Assets under Management by Asset Class, 2009 - 2019



Source: Preqin Pro

horizon returns have hovered around 10% annually since 2016.

It is no surprise, then, that investors are so happy with their infrastructure investments. Eighty-seven percent report that their infrastructure portfolios have met or exceeded expectations over the past 12 months, and 86% are generally positive about the asset class.

...And a Market-Resilient Record

This consistency is thrown into even sharper contrast by two macro factors: recent market volatility, and the seemingly certain prospect of a market slowdown in the near future. Sixty percent of infrastructure investors now say we are at a peak in the equity market cycle, and 28% are increasing allocations to private capital accordingly. Infrastructure's main advantages are that it offers a reliable income stream and has low correlation to other asset classes – vital factors for investors looking to mitigate possible swings in other parts of their portfolios.

History bears this out: while infrastructure has not been completely immune to previous market movements, it has proved resilient to recent swings in equity markets, which have played havoc with investments in listed equities and hedge funds. Where one-year returns for listed equities fell from 22.8% as of December 2017 to -9.6% a year later, and hedge fund returns sank from 12.20% to -3.05% in the same period, infrastructure returns swung from 11.4% to 9.6% respectively.

On the Way to One Trillion

Given all of this, there is no reason to suspect that the growth in infrastructure AUM will slow any time soon. There are concerns about competition and pricing in core developed markets, but thus far these concerns have not been reflected in a fall in returns. Infrastructure funds also have more room to expand into new sectors and regions. Asia in particular enjoys huge demand for infrastructure, but very few specialists currently focus on the region. And even so-called 'played-out' markets like European utilities can still offer significant value to fund managers if they can secure attractive opportunities.

Preqin predicted back in 2018[1] that the infrastructure market would hold $1tn in AUM by the end of 2023, doubling its size from December 2017. The industry grew by 17% over 2018, and expanded by a further 11% in the first half of 2019. If this rate of expansion continues, then infrastructure assets will breach $1tn by the end of 2022 – a full year sooner than we predicted.

[1] *Preqin: The Future of Alternatives, 2018, go.preqin.com/future*

Investors Go Slow and Steady

The make-up of the investor universe has not changed significantly in recent years, but the overall pool is expanding as investors look to infrastructure for stable returns

The infrastructure investor pool consists of almost 4,000 institutions as of the start of 2020. This represents 35% of the total alternatives investor universe, and is an increase of around 50% compared to the end of 2015, as institutions have been increasingly drawn to infrastructure in recent years. Strong and consistent returns, as well as regular cash flows and a hedge against inflation, have proved to be durable attractions. While the overall universe has expanded, the constituent investor types have stayed proportionately equal, and average allocations to the asset class have remained the same over the past five years.

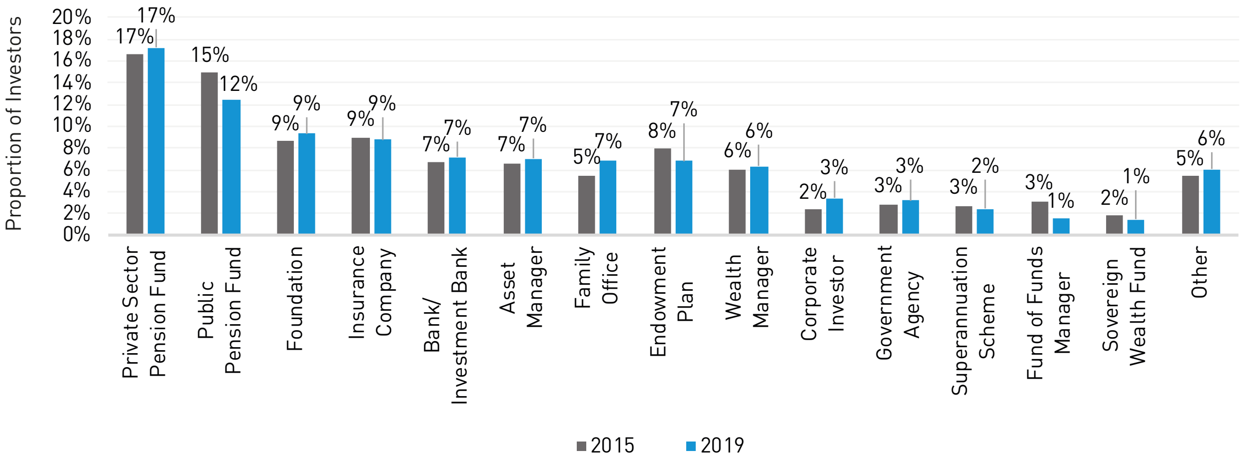
Little Change in Investor Make-up

The largest proportion of infrastructure investors are pension funds, with foundations, insurance companies, and banks making up significant proportions (Fig. 5.1). These institutions are most likely to have long investment horizons and need regular, stable cash flows, making infrastructure an appealing investment. It is notable that, unlike in private equity where we have seen a development in the balance of investor types, the make-up of infrastructure investors has remained stable.

Allocations Are Slow and Steady

The allocations that investors make to infrastructure have not changed significantly in the past five years. Investors are habitually underweight to the asset class (as with most alternative asset classes), and commit a median of 2.2-2.4% of their AUM, while targeting around 5%. While investors have identified infrastructure as a relative safe haven in the event of a

Fig. 5.1: Investors in Infrastructure by Type, 2015 vs. 2019



Source: Preqin Pro

market downturn, we have not seen a wholesale shift toward larger allocations. For investors, infrastructure is still a risk-mitigator and downside-protector rather than an alpha-generator.

The average allocation to infrastructure is therefore quite small as a proportion of total assets, even where the absolute dollar allocation may be large. Investors such as pension funds and insurance companies typically commit around 2-3% of their total assets to infrastructure (Fig. 5.3). Most of these investors have relatively high liquidity needs, and the illiquidity of infrastructure investments means they cannot commit too much to the asset class.

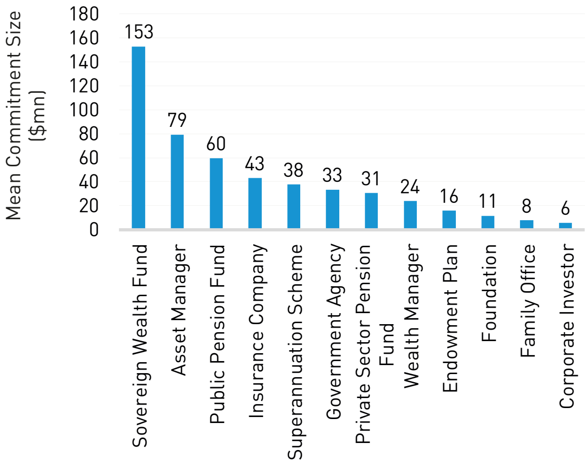
Larger Investors Reduce Allocations

Sovereign wealth funds (which generally do not have high liquidity needs) and superannuation schemes are among the largest allocators to the asset class, with median allocations of 4.9% and 6.0% of AUM respectively. Interestingly, though, in both cases this figure is lower than it was in 2015. Both investor types traditionally emphasize investments in real assets. Over the past five years, however, they have become more active in asset classes like public and private equities, and so have reduced allocations to 'slow and steady' asset classes like infrastructure in favor of these.

Most investor types will make larger individual commitments to infrastructure funds than to other alternative assets. This is partly because infrastructure is a smaller fund universe: there are currently only around 250 infrastructure funds seeking capital, compared with around 4,000 private equity vehicles. It is also likely a reflection of the relative prevalence of large investors in the asset class – asset managers will make larger commitments than family offices in order to disburse their allocations across a similar number of vehicles (Fig. 5.2).

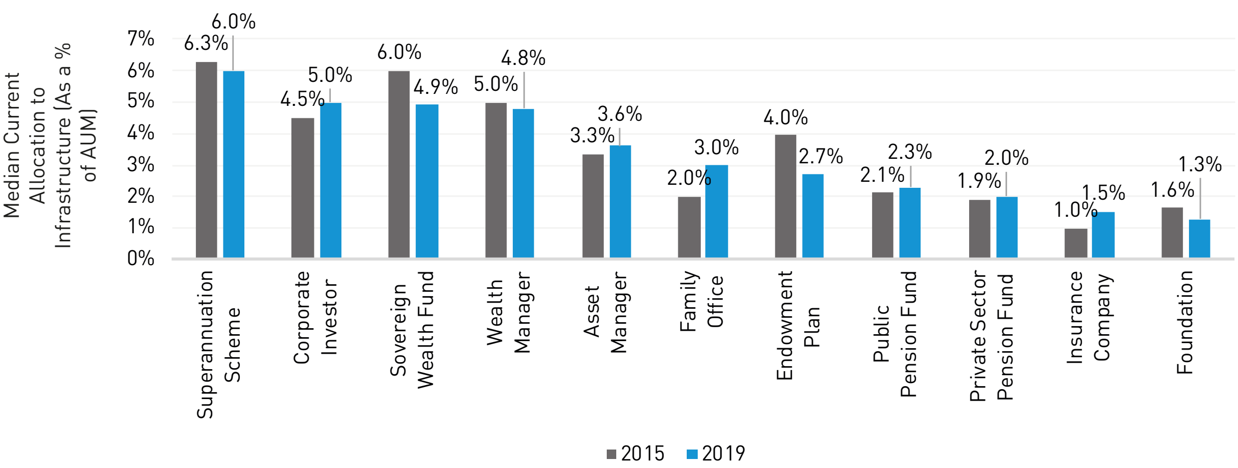
With fewer funds seeking capital for infrastructure compared to other asset classes, and investors looking to make larger commitments than in other asset classes, it is no wonder that some fund managers have been able to raise ever-larger funds in recent years to service demand.

Fig. 5.2: Infrastructure Investors' Mean Commitment Size by Investor Type



Source: Preqin Pro

Fig. 5.3: Investors' Median Current Allocations to Infrastructure by Investor Type, 2015 vs. 2019



Source: Preqin Pro

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