Hamilton Lane

Crossroads: The Inframation Podcast

Featuring Brent Burnett, Co-Head of Real Assets

JON BERKE: Welcome to the Crossroads Podcast. I'm Jon Berke, America's Editor for Inframation News. Joining me on today's program is Brent Burnett, Co-Head of Real Assets for Hamilton Lane and Jonathan Carmody, Editor of our Latin America Team. Welcome to the podcast, gentlemen.

BRENT BURNETT: Thanks, Jon. Nice to be here with you today.

JONATHAN CARMODY: Always a pleasure, JB.

JON: Hamilton Lane is a global private markets investment management firm with $667 billion in assets under management and advisement. On the infrastructure side they work with clients on a discretionary basis and also do advisory work with pension funds on real assets allocations. 2020, for obvious reasons, saw a big drop off from third-party fundraises from 2019 and 2018 in terms of infrastructure funds.

Overall though, there was over $200 billion or so raised during that three-year period, which saw two global flagship funds, Brookfield Infrastructure Partners IV, and Global Infrastructure Partners IV, exceed the $20 billion threshold. Third-party managers also sought to whet the appetite of LPs eager to increase allocations to infrastructure in other ways, such as infrastructure credit platforms, geographic-specific vehicles, and energy transition funds. Brent joins us today to reflect on the fund landscape and what the rest of 2021 might look like.

Brent, before we get into specifics, it seems like there's a mandate to get a large infrastructure bill passed by Independence Day. I'd like to get your general view on what the Biden infrastructure plan looks like, and what specific sectors it will impact.

BRENT: Sure, Jon. It's a good question; we're fielding this question frequently from clients as well. As you know, there appears to be bipartisan support for getting something done. I think, you know, ultimately what the bill will look like may be pretty different from what's been proposed, but if you just take the plan as proposed, I think there are some sectors within infrastructure that are likely to benefit from it and there are others that I think it will be either neutral to even slightly negative. So, if you look across the sectors that have specific spending allocations that are allocated to them, you know transportation and water, those have been sub-sectors within infrastructure, at least here in North America, that had been pretty small targets for private infrastructure funds. There have been some PPPs done in that space, but they have been relatively few. And generally where the private capital has benefited has been from projects where there's a lack of federal spending available to fund those projects. If we see the Federal Government coming in scale into some of these sectors like transportation, like water, I think there is some risk to crowding out some of the limited opportunities that have been available to private capital that primarily work through state and local governments on those PPPs.

I think transportation and water, depending on how that spending plan is structured, could be neutral to slightly negative for private capital. On the sectors that I think are potentially positioned to benefit from it, data/telecom, specifically rural broadband, electricity in terms of electric vehicles, transmission, distribution, those are sectors that have sizeable allocations for spending, they've been good sectors for private capital. I think it's unlikely that the Federal Government takes a directly competitive role with private capital in those sectors, and would more likely look to either backstop loans, or provide incentives to consumers to select their provider. And I think that approach will on balance be potentially very positive for private infrastructure capital.

The last sector on the social infrastructure side, this has been a small target for infrastructure investors in the U.S. as well, and a much larger target in Europe. I think it will depend on the form that the Federal Government takes in terms of how it approaches this. If they take a model that's similar to what we've seen in European countries, where consumers have some choice about which care facilities they choose, and the level of service, while the government essentially backstops the bill, while setting service standards. I think if they take that model, that could be positive for private capital. I think we're all watching it intently to see how it comes out, but if you take it as it's laid out today, I think there are going to be some winners and losers that are created from it.

JONATHAN: I think ostensibly, it seems like the Republicans want a scaled down version of the bill, which bypasses what Biden was targeting in terms of clean energy initiatives. Actually settling around transportation has been the core focus of what they'd like to see in the scaled down version. You have two different agendas and they're going to have to meet in the middle somewhere.

BRENT: I think that's true. I think at least some of the early moves that the Biden administration has made on the renewable sector have been a positive, in terms of looking to speed permitting for offshore wind, federally backstopping some of those loans on offshore wind. Potentially providing some more permanent subsidies to wind and solar. Or tax credits. So, I do think that there are some grounds for compromise in there. But as you know, the one sector that I think has benefited most from some federal intervention here has been on the renewable side, and it'll be interesting to see how that gets impacted.

JON: Excellent. Thanks for that. What I alluded to earlier, again, about these different vehicles that I and others have been writing about over the past couple of years... LPs have a lot of choices today, in terms of increasing their real assets or infrastructure allocation, and this obviously goes beyond infrastructure into other forms like real estate, for instance. Just from your experience, what type of funds do you see are making an impact and why are they making an impact?

BRENT: I think there are a couple of things happening. As you know, this is an asset class that has grown almost exponentially over the last 10 years. Our data suggests that 10 years ago it was roughly 1% of a $500 billion private markets asset class. Today it's roughly 8% of a $6.5 trillion private markets asset class, so the growth in infrastructure allocations has really been significant over the last 10 years. That said I think there's sort of a natural evolution of this asset class in that we're seeing a lot more choices offered to LPs in terms of how they approach their infrastructure portfolio construction.

So, as you noted, the mega-funds have moved up in size, obviously over the last few years. They had very strong fundraises in 2019 that I think is partially why you saw lower activity in 2020; because a lot of those mega-funds had come to market in 2018 and 2019 and weren't really in the market in 2020. But at the same time, I think where we're seeing some growth and new opportunities has been in sector-specific funds that are around the data/telecoms space that are attracting a lot of its traditional capital. We're also seeing growth in the number of offerings in the small to mid-market infrastructure space.

This is actually from Inframation's data, if you look at where the number of transactions that occurred in 2020, about 75% of the number of transactions were below $500 million of enterprise value. You think about fundraising as being strongest in that larger end of the market, but the liquidity of the infrastructure or assets is actually much greater on that smaller end of the market. We've seen more small to mid-sized focus funds targeting anywhere from $500 million to $1.5 billion of capital being launched this year, and in response to what is a dearth of capital availability for those small to mid-size deals.

JON: Great, Interesting points there. Moving on to ESG, it remains a very important buzzword in investing in general, but let's talk about it at a base level from the view of the pension funds. What are you seeing today in terms of how ESG is affecting investment strategy as it pertains to real assets?

BRENT: I think, as you know, this is a critical piece to institutional investment to date. It's not just enough to have a policy. Groups that are coming to market to raise capital, they need to have a very robust ESG policy, but they have to be able to look through that to show institutions how they're measuring and monitoring specific ESG criteria within their portfolios. I think we're moving beyond the implementing ESG at a screening phase and moving toward being able to monitor each specific ESG criteria within portfolios, and that's what institutions are starting to expect now.

BRENT: I think that the easiest one to focus on is the environmental piece because it's a little bit more quantifiable, but I think institutions are really trying to take a comprehensive view of the environmental, the social and the governance aspects of those policies, such that even an upstream energy strategy, for example, that may rank negatively on the environmental side, they still need to be able to show that they are mitigating the environmental effects to the extent that they can, and they have a robust policy with respect to social and governance issues, if they want to have any chance of raising capital in today's markets. And that's very true for infrastructure funds as well. They've historically been heavy on the midstream infrastructure side. It's critical to fundraising today, and it's no longer a nice-to-have, it's a must-have, for the institutional market.

JON: I think early on, when we were covering this from the perspective of the investor or the LP, there's always a question about what was governing their ESG? Was there a metric? Metrics like GRESB. I'm wondering what the evolution's been there. Has there been a more common metric adopted? Have more people opted into GRESB as a metric?

BRENT: We're seeing more institutions adopt GRESB, more so in Europe, Jon, than what we've seen in North America. It's really become, in many ways, a standard, and in fact, when we're looking at new opportunities or even pursuing new business in certain European markets, it's a requirement to have either GRESB or some other recording capability on the ESG function. So, I think GRESB has emerged as the standard in Europe. I think we're starting to see it a little bit more in North America, but it's not to date a requirement like we see in other markets.

There are some other providers out there as well that are trying to solve this issue, and fundamentally what these service providers are about is being able to quantify and monitor the ESG compliance, the ESG impact of the underlying assets in a portfolio, so this is what I mean when I say we're trying to move from incorporating ESG into a diligence approach, and taking a step further, in integrating ESG into monitoring and services like GRESB, help with your data.

JON: Are there any newer metrics that U.S. LPs are looking at right now, or is it more the sense of them getting used to GRESB?

BRENT: I think GRESB is one provider. I think institutions in North America are starting to look for what the specific metrics should be in their ESG policies that they can measure and monitor. I think first they're trying to define what those metrics are and what the standards are that they will hold their underlying GPs to, and then they would look to identify what provider it is that they will require to monitor those. I think GRESB is out in front, given its footprint in Europe, but I can't say that that's been the only service or the only way that groups in North America have looked at it.

JON: Moving to just some of these energy-centric funds that are out there and have raised a ton of capital over the last decade, have you seen ESG impacting LPs' relationships with these fund managers and how has it changed? How has it forced them to change their approach? What have you seen from the GPs in these relationships that have focused on energy for so long and now are being forced to adopt ESG standards or LPs' different approaches to this?

BRENT: I think it's an interesting and natural evolution to where their strategies have been in the past, and I think the groups that have the poise to really benefit from this, and I say benefit, but what I should say is those groups that can more easily pivot to these energy transition strategies have been the more diversified energy-focused funds. If you were a pure upstream production-oriented fund, it's very difficult to, I think, transition into an energy transition-type strategy, but some of the more diversified energy managers, I think have been successful at transitioning their approach, to focus more on the energy transition theme. I think this is driven by a couple of things. It's not just ESG, although that is a big driver here, but one of the very practical drivers is that institutions have been very underwhelmed by the returns that they have experienced in their historical upstream strategies. They've seen a lot of volatility there, they've seen limited distributions coming back now for nearly 10 years from those strategies, and in addition to that, you have a new ESG policy, which is really driven by the desire to fully quantify all the risks that are inherent in a strategy, so I think you take combination of the poor returns, the lower distribution, plus an additional risk overlay through an ESG policy, and it's natural that institutions are migrating away from a more volatile upstream type approach. This has created a market for these energy transition funds that are really looking to provide bridge capital to these types of companies that are helping with this electrification trend in North America and globally. We think it's a pretty interesting space because many of these companies in the energy transition space, they're not quite ready for infrastructure capital in the sense that they may have some technology risk, they may have some business model risk, they may need to scale their manufacturing capability, they may need to diversify their customer mix. But once they get through that growth phase and really start to function as an infrastructure provider, there's a lot of ready capital that will be available to come in and take out those positions. We think it's a pretty interesting place to play, and we think that those groups that are the best positioned to play there are the ones that have historically had more diversified energy strategies.

JONATHAN: Well, along those lines of alternatives, we've seen some other fund starts to rise, such as aquaculture for one, and then obviously as alluded to earlier, seeing specializations start to take place in certain efforts, what KPR is doing in Asia, but can you just from your view tell us a little bit more about what asset classes are starting to gain popularity?

BRENT: I think a lot of it, Jon, reflects my earlier comments in terms of being a natural evolution of being in a structured market, and by extension the capital raising markets and real assets. And that is that capital has increased, and it's targeted toward more traditional infrastructure, and there's been an expansion of the definition of what infrastructure is, and 10 years ago when there were not many players in the space, I think it was easier to find plain vanilla infrastructure that could meet the returns that groups were targeting. Today that's more difficult because it's become more competitive, especially on the larger end of the market.

You see groups transitioning into other sectors that are infrastructure-like but may not meet a traditional definition of infrastructure. Aquaculture could be considered one of those, in the sense that depending on the company, you can have high barriers to entry and have high CAPEX requirements, you can have long-term off-take contracts. So, groups are starting to look for companies that are infrastructure-like, but that may not meet a traditional definition of infrastructure. So, I think that's spurred some of the interest.

The other, I think, is there's been a growth in, as I mentioned, the sector-specific funds. I think some of the thematic-based investing approach that groups have taken have allowed them to make sector bets in data and telecom, renewable infrastructure. Traditional midstream energy infrastructure was your single sub-sector dedication in the past, but the number of new entrants that's come into this space for specializations and data/telecom, and renewable energy has really grown. And I think the other place that we're seeing more, as I mentioned, on the small to mid-cap sides, we are seeing groups come in with a strategy targeted towards smaller assets with either a platform build-out strategy, a small asset aggregation strategy. They're looking to take advantage of the strength the capital raising on the larger end, by assembling positions that could easily be sold into that market.

Lastly, as you know, we're seeing more on the emerging market side. And I think, again, this is a natural evolution of the return compression that we've seen in the larger end of the infrastructure space in more developed markets like North America and Western Europe. Groups are migrating toward more prolific economies in order to try and target the returns that they want to target for those strategies. So those are the areas that we see are newer that are starting to attract capital. And again, I think a lot of this is driven by the natural evolution in the global infrastructure market.

JON: Before we get to the emerging markets side we should note that in a deal that was announced only about 10 hours ago, KKR did announce that they had made an offer to acquire John Laing in concert with Equitix, which is another trend we've been following over the last two years that you can mark an investment with Greenfield development as well, which we see constantly through deals like CDBQ acquiring Plenary, and today's deal with KKR and John Laing. So, it's going to be interesting to see the growth of those businesses now under deeper, well-pocketed owners.

BRENT: I think that is interesting, Jon, and just one comment on that, that this is another area where we think infrastructure investors are finding some arbitrage opportunities in terms of what stabilized assets sell for, versus what they can develop, or build new assets for. If you think about stabilized renewables in North America, for example, that's a very competitive space. Once they are contracted under long-term PPAs with utilities, the cost of capital that comes into those is very long. But there's still an opportunity to develop and construct renewable assets in North America in a yield that represents a pretty significant spread to where those stabilized assets trade. Similar to the deals you've mentioned, we've seen more interested companies that have some stabilized operating portfolio, but also have a big backlog of the construction-ready development opportunities, because that's how groups can drive incremental returns in competitive sectors.

JON: Switching gears over to emerging markets, Jonathan Carmody has had extensive experience over the last couple years covering the fund formation in Mexico, Colombia, to name a few.

JONATHAN: Thanks, JB. Hi, Brent. We've been curious about the kinds of investors that have started to look more and more at Latin America. Macquarie, for example, had a Mexican fund for a long time, it was their first Latin American vehicle raised inside of Mexico for local pension funds. We have seen other investors like Aberdeen, raising Andean specific funds, regional specific funds. How do you see the appetite for emerging market risk, not just in Latin America, but in places like Africa and Asia as well?

BRENT: I think that the appetite is there, I think it's growing from a relatively small base, and that's really driven by the return and compression I think that we've seen in developed markets. At the same time, as you know, there's a balance between trying to achieve incrementally higher return and trying to quantify the risk that you take in those developing markets. Latin America is a good example of that. There have been groups that have historically been active in Latin America, some of those that you mentioned, Brookfield's done a number of things in Latin America, GIP as well. There are certain constructs of the power markets there that are actually, from a regulatory perspective, in some ways better than what you find in developed markets.

And that's one of the sectors on our side that we've seen groups commit capital to in Latin America. That said, there has been a lot of geopolitical risk and changes in some of those Latin American countries. Most recently, in Mexico, you've seen a re-trade on some of the power contracts there trying to make some of the renewable generation there, its costs. The inefficiencies that it creates for the grid operators, that has funneled down to traditional generation as well in the Mexican market. You have to go into these markets understanding that that regulatory construct can change at any time. Chile has historically been a very, I think, comfortable market for institutional investors to transact in. I wouldn't call it developing by any means, it's an OECD country. But even a country as stable as Chile we're watching now, and maybe see how this new contribution may come out, and how that may impact private asset owners in what has historically been the most stable jurisdiction for foreign investment in Latin America.

I think it is on the radar, for instance, but I think they know and in developing countries, especially the needs for infrastructure spend and the need for infrastructure assets is much greater, the competition is lower, there's the prospect of better returns in those markets without taking incrementally higher credit risk. But there is some geopolitical risk that investors have to be aware of. And so, although I think it's growing in interest, I think they're going to remain, call it end of ~15% target investors relative to North America and Western Europe, which are going to be 60% and 40%, respectively, where they're targeting infrastructure allocation.

JON: That's an interesting point. When it comes to the political risk, which obviously is relatively inherent in places like Latin America, how do you at Hamilton Lane assess that risk? What kind of techniques and what kind of resources do you have for gauging that beyond just the price or ratings agencies?

BRENT: We have local market expertise in those markets at Hamilton Lane as a global firm. We have presence, obviously, in North America, Europe, Latin America, Asia. So, it's very helpful to have local market resources that can help us to assess those risks. And I think, to your point on some of these groups that have been active down there, having a track record and local market presence in those Latin American economies, or Asian economies, or African economies is really important. I think it would be very difficult for us and for most institutional investors to invest with a group that is just looking to parachute into those markets and figure them out.

When we invest selectively in those developing markets, we do it with the benefit of having a local presence ourselves or investing through a partner that has a team on the ground in those markets that has a long history of operating. I think the other way you mitigate that risk is your contract counterparties really matter; your ability to secure contracts that are U.S.-dollar-denominated and mitigate some of your currency risk that the pass-through of those contract structures, the holding companies that have A-rated credit or above, is a way to mitigate some of that geopolitical risk. So, I think there's ways to mitigate that for both local partnerships, but also the way you structure the agreements for assets in those markets in trying to mitigate some of the currency risk, but also the counter-party risk.

JON: That's a very interesting point, especially regarding the real assets themselves. When you discuss fund-to-fund strategies, is there much appetite among those investors to actually invest in Latin American-based vehicles, or vehicles based out of Asia or Africa who might be GPs operating from the region directly? How do you view those investors, those local investors compared to say, BlackRock or a Brookfield?

BRENT: I think those locally based investors have an advantage in a lot of ways over some of the groups that may be more global but not as experienced in the emerging economies. We have seen institutional appetite for country-specific strategies or region-specific strategies in Latin America, in Asia, to a lesser extent in Africa, but there is some interest there. But again, when I say there's some interest, I would say your typical institutional portfolio may have up to a 10% allocation for that type of market exposure. It's not zero, but they're mitigating that for portfolio construction as well. But the local funds in those markets, they've typically been much smaller obviously than the globally diversified funds, but they have on the whole been successful at hitting their fundraising targets. But they're typically raising $500 million funds, not multiple billion-dollar funds, when they're specific to those markets.

JON: Okay, fantastic. Brent, let's focus on these mega-fund managers for a minute. So, as you talked about earlier, when you raise a lot of money, the number of opportunities you look at in terms of dollar sizes, it gets rarer. There are fewer opportunities that co-measure with the size of the equity check that you need to write at that level versus the type of returns you're trying to achieve, and not only that, achieve that consistent with historic returns, which is what got you to these super-sized funds in the first place. What's your view on capital deployment today through these larger funds? And are there enough opportunities out there for them to achieve these returns consistent with earlier generations of fund?

BRENT: I think return compression is a natural occurrence when you get more capital coming into a sector. That said, historically, those funds have returned private equity-like returns. I think going forward, what we should expect from those funds are more infrastructure-like returns which on a net-to-LP basis for a core plus the value-add road, we think is more in the 10 to 12 percent range, right? That return compression, it doesn't mean that they can't achieve what they're advertising to us, it means that they may not achieve what they have historically. But historically, if you look at some of those mega-funds and their earlier vintages, they've really returned private equity-like returns, so we think that moderates to a more infrastructure-like return.

The funny thing is too, for those mega-funds, and we have a relationship with all of them, we rarely see them run into each other on transactions. I won't say it never happens, it does on occasion, but they have been for the most part successful with pursuing opportunities independent of each other. We haven't seen a lot of overlap in their portfolios. For some of the widely marketed larger deals, we have seen them, multiple players in that space, be a part of the same option. But I would say, that's been the exception. And so, for the most part, we have seen them successful in continuing to execute their strategies. They've done that without bumping into each other a lot. I think they've focused more on some of the large asset corporate carve-outs that are really not accessible to some of the smaller groups. And I think they've also been successful at, as I mentioned, expanding the definition of what infrastructure is, away from the plain vanilla assets and looking more toward other sub-sectors that behave in an infrastructure-like manner, but may not meet your traditional definition of infrastructure.

JON: Great, let's talk about secondary vehicles. Again, getting back to our point about alternative asset classes becoming very popular as of late, what have you observed about what kind of assets are finding a home in these funds and why? I'd like to get your perspective on how the returns stack up in secondary funds as opposed to primary funds. And again, this is, to be very specific, about infrastructure. We know that there have been secondary funds that are years old on the private equity side. So, just wanted to get your take on things.

BRENT: I think that, on a total return basis for a performing primary and a performing secondary, the expectation should be that the secondary fund shouldn't perform better. And the reason for that is because the value proposition of the secondary fund is to get you closer to where the monetization events happen. If you have a similar asset performance, but you're coming into it from a secondary perspective, closer to when that asset's going to be monetized, you should have a higher IRR. Even if you're not transacting at a discount, just by virtue of being closer to the cash flow return, you should expect to have a higher IRR in a secondary vehicle. That said, within infrastructure, the traditional LP secondary market in infrastructure is still reasonably thin especially relative to private equity. Even though it's grown exponentially in institutional portfolios and a number of players has increased on a number of positions, and scale of the capital opportunity, the infrastructure secondary is relative to private equity, it's still a much, much smaller growth.

JON: I have a feeling you're going to tell me next, it's far more popular in Europe right now. Am I correct in saying that?

BRENT: No, no. I would say it's more popular in a sense that many of the... I shouldn't say many because there aren't that many, but most of the larger infrastructure secondary players have been European-based, and predominantly, have European LPs. So, you could say that that market is a little bit deeper in Europe versus North America, but they're still chasing the same secondary LP interest that some of the North America funds are chasing as well.

The one area, Jon, that we've seen growing a lot on the infrastructure secondary side been in the single asset recapitalizations, the GP roll-over vehicles, the continuation vehicles... And this makes sense when you have an asset that the GPs maybe owned it for four or five years, there's been some value creation over that time period, there's been some stabilization and de-risking of the asset base, but there's still runway left on the business plan for value creation. There has been a good liquid market for roll-over transactions or GP-like syndications of those single assets as they progress through their life cycle. But that's probably been the fastest growing area in the infrastructure secondary market.

JON: Great. On that note, Brent, Jonathan, thanks for joining me on today's program. I really appreciate it.

BRENT: Great, thanks Jon.

JONATHAN: Thanks everybody.

JON: Thanks to the listeners and we hope you'll tune in next time.