UBS Asset Management

Why middle-market infrastructure has a place in every investor's portfolio

Recently, **Chase McWhorter,** Institutional Real Estate, Inc.'s managing director, *Institutional Investing in Infrastructure,* spoke with **Alex Leung,** director, Research & Strategy, Infrastructure, for UBS Asset Management (Americas) Inc. Following is an excerpt of that conversation.

Can you define what middle market means within private infrastructure?

First of all, the phrase "middle market" is a bit opaque in our industry. In my mind, it involves equity investments up to several hundred million dollars, and an enterprise value up to around USD1 billion. However, other people in the industry may give you different numbers and, most likely, something much higher. Even within the middle market, we break it down further into smaller segments. For example, at UBS we define "lower-middle market" as equity check sizes of around USD50 million to USD150 million. Overall, as the sizes of infrastructure funds have increased significantly the last few years, the definition of middle market has also increased.

Mega-funds have been getting a lot of attention the past few years. Can you describe the positioning of middle-market funds in this changing landscape?

Mega-funds have definitely taken a lot of the spotlight, but when you get to that size, there are some challenges. For example, mega-funds have to target very large deals in order to deploy their capital, but there is a shortage of these types of opportunities. This means mega-funds tend to go after the same deals, making it harder to differentiate one strategy from another.

On the other hand, there is much more variability across different middle-market strategies. For example, there are diversified global strategies, but also strategies that target specific sectors or geographies. The deal pipeline in the middle markets is also more robust, with deals smaller than USD250 million accounting for around 60 percent of the number of completed transactions in the last two years,[1] even though middle-market funds only account for a minority of infrastructure dollars raised. This allows middle-market funds to deploy capital quickly.

What kinds of investments are middle-market funds making compared with mega-funds?

By their very definition, middle-market funds focus on smaller investments, but a more nuanced answer is that these funds tend to focus on assets that are more niche and are often overlooked by the bigger funds. And this could include assets in smaller markets, non-core assets sold by larger companies, unregulated utilities, emerging technologies and so on. A lot of clean energy and renewables opportunities sit within the middle markets, which is an advantage for investors who want to deploy more capital into ESG-friendly investments. Middle-market funds can also pursue an aggregation strategy by acquiring a number of smaller assets to create a larger platform, which can then be sold to larger funds or other investors once the platform has been de-risked.

Mega-funds, on the other hand, tend to go after larger trophy assets, since it would be difficult to deploy that much capital otherwise. This includes multi-billion dollar investments like LNG terminals, oil and gas pipelines, airports in major cities, or big utility networks.

Another new frontier for mega-funds is that some of them have been acquiring large companies outright. This includes the buyout of publicly-traded companies in order to take advantage of market dislocations and dips in public valuations. Finally, some mega-funds also look at emerging markets, which fewer middle-market funds focus on.

How different is the execution of the middle-market deals compared with larger deals?

Generally speaking, one advantage with middle-market opportunities is that there is more potential for bilateral negotiations or limited auctions, rather than having to go through a broad auction process. You are usually talking to smaller management teams or even company founders and entrepreneurs, so opportunities become more relationship based. However, the level of information transparency also tends to vary much more in the middle markets, so you have to be more proactive in your due diligence process. Fund managers must have the right expertise and track record to execute these kind of transactions.

On the other hand, larger deals tends to have more transparent information and disclosures, given there will likely be more structured auctions involving investment bankers and many other advisers. On top of that, some of the well-known assets have been transacted multiple times over the years, so the industry is already familiar with them. Obviously, if the target is a publicly-traded company, the amount of readily available disclosures is also very robust.

However, just like middle-market fund managers must have certain expertise to execute smaller transactions, mega-funds also need a specialized skill set. For example, they may need to implement more complex structures for certain large investments, or have experience in emerging markets to navigate certain unique risks, or have a deep understanding of the public markets to justify a privatization strategy. Overall, different investment strategies require different skill sets, which investors should be aware of when vetting fund managers.

How about the asset management side of middle-market investments?

Generally speaking, smaller assets tend to be easier to manage as you work more closely with on-the-ground employees, and so you can implement changes and other value creation

activities faster on an operating level. Larger investments are a bit more complicated, as you are dealing with more layers of bureaucracy within a legacy corporate structure, so implementing change could take longer. Of course, when we start talking about aggregation strategies within the middle markets, asset management can also be a quite complicated, so it really depends on the specific investment.

Another important part of asset management is having a good exit strategy. Smaller assets tend to be more liquid, which is an advantage for middle-market funds especially if there is market volatility around the time of exit. On the other hand, there are generally fewer buyers for very large assets, which may be an advantage during the bidding process, but becomes a disadvantage when trying to make a sale. This means large funds may have to be a little more creative during the exit — for example, restructuring or breaking apart larger investments before a sale, or even selling to the public markets. Once again, it goes back to a fund's own capability and whether they have people with the right skills in place.

Do middle-market strategies have other advantages that are less obvious?

One benefit that middle markets have is that, because the investments are smaller, they also tend to attract less scrutiny from the public and from regulators. This is particularly important in a world where populism is rising and public outrage spreads quickly through social media. You can just think about all the negative attention over the last few years around big trophy assets like oil pipelines, major airports, large utilities and so on, and you will be reminded why being under the radar can be a good thing.

Another underrated advantage is that middle-market funds can react rapidly to the various kinds of disruptions that are happening in the infrastructure sector, whether it is digitalization, electrification, the rise of energy storage, or other emerging technologies. Often investment opportunities for these disruptive technologies start out being quite small, so middle-market funds tend to see them first, before they attract the attention of broader markets. This helps the smaller funds remain nimble and stay ahead of the technological curve.

Would you say there are certain investors that are more attracted to the middle-market strategy versus the mega-fund?

It is difficult to generalize why investors are allocating their capital to specific strategies, and so I will only attempt to do so at a high level. For investors who have already invested in mega-funds, middle markets present a way to diversify their infrastructure portfolio, while still being able to increase their allocation into the asset class. As I mentioned, the type of assets that middle-market funds target can be vastly different from both a sector and a geographical point of view, and so the strategy is quite complementary to that of a mega-fund. For investors who are actually relatively new to infrastructure, middle-market funds provide them with an opportunity to work more closely with a smaller team of professionals, which some investors may value. For example, they may have more co-investment opportunities with a middle-market fund that they may not have with a mega-fund, since the latter will likely have many more Limited Partners and also a longer priority queue for these transactions.

Any final thoughts?

I think the key takeaway is that not all middle-market strategies are created equal, and there's definitely a right one for every investor, whether you already have infrastructure exposure or not. Middle-market funds offer different value propositions versus mega-funds, with different risks and opportunities, different deal origination and asset management strategies, and overall, require different skills and expertise. But it is exactly because of these differences, that make middle-market strategies a compelling way to diversify an investor's portfolio.

[1] Based on data from Inframation Group

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CORPORATE OVERVIEW

UBS Asset Management

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