KEYNOTE INTERVIEW

Why the mid-market matters

The rapid growth of many larger infrastructure funds can overshadow what is happening in the mid-market. Ancala Partners' Spence Clunie discusses the opportunities in this market

Mega-funds tend to attract investor and media attention. Recent *Infrastructure Investor* fundraising figures for closed-end unlisted vehicles in the first half of 2020 suggest that significant amounts of capital are flowing to the larger end. Of the nearly $57 billion raised by the industry during this period – the highest H1 total since 2008 – a single fund accounted for $20 billion.

Yet there is more to the market than just these large-scale opportunities. Spence Clunie, managing partner of Ancala Partners, notes that there are many mid-market investments with attractive risk-return characteristics that can offer resilience through cycles.

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Q Where are you seeing most activity in the mid-market?

Many investors are looking for covid-proof investments. For many that means areas such as digital infrastructure, including fibre, data centres and mobile towers.

This has become one of the hottest sub-sectors in the market as funds seek to capitalise on remote working and video calling. There is also a lot of activity in renewable energy, particularly if there is protection from merchant power prices, which have fallen materially in the last six months. These were popular sub-sectors before the pandemic and they have become more so now.

Yet for Ancala, hot sectors are not particularly attractive because of the typically high pricing. We do have renewable energy and fibre businesses in our portfolio and we will continue to look at opportunities in these areas, but we will only target the right assets with the right risk and return profiles. We have completed three investments since the start of covid-19, but only one is in these markets.

Q How difficult has it been to complete investments through the pandemic?

With Holmleigh, a business that specialises in care for adults with special needs, the investment was already well advanced when the pandemic struck.

As we had been working on it for 18 months, we knew the management team, we had visited the business pre-covid-19, and we had performed extensive due diligence, so there were no major challenges to completion.

Holmleigh is an attractive operator because it owns all its properties, has a strong operational and reputational track record and, on account of this, has continued to perform well throughout the crisis. It takes people out of full-time local authority care and helps re-integrate them into the community which, we believe, is the best solution for all stakeholders. It was also a bilateral investment that we managed to achieve at a good price.

Another investment was Hector Rail, which is a rail freight business that primarily provides services to industry in Sweden and has been resilient to the covid-related market downturn. It is asset-backed and we managed to secure an attractive price because of the ongoing pandemic.

Unusually, we were able to complete this investment without meeting management in person and viewing the assets. This is because its chairman is also an Ancala industry partner – he knows the business and hired the current management team, so we completed a lot of our due diligence remotely.

This is an example of using bespoke insight into a business to secure an attractive investment despite the disruption caused by covid. That does not mean it was easy to do – we had to make certain assumptions about the future, including uncertainty around the ongoing impact of covid.

Q What changes do you expect in due diligence processes?

I am not expecting wide-scale changes to due diligence because we still need to meet management teams in person. However, the earlier stage identification of opportunities and preliminary meetings prior to commencement of formal due diligence have been accelerated by the increased acceptability of video-conferencing technology. A video conference is a very different form of communication from face-to-face meetings, particularly when it comes to the critical due diligence phase. As we have all seen, it is difficult to get people's full attention in video meetings. People do other things while they are on the call and it is difficult to judge body language.

I am also not expecting significant changes to other aspects of working. I do not think everyone will start working from home full-time. The issue with working from home is that people typically just do a set list of tasks – there is reduced interaction with others. Conversations are needed to uncover risks and opportunities. There are also the conversations that one doesn't set out to have but which unfold organically in a team environment.

We look to immerse ourselves in an investment and that is very hard to do when isolated at home. We need to be thorough, share ideas and judge risks so we can get a proper understanding of how to manage assets through the life of an investment and how they will perform.

Q How is the pandemic affecting the way investors view opportunities?

It has shifted things to a degree, but not as far as one might think. Certainly, it means investors are now running new scenarios before investing – we have never had a total shutdown of economies before, for example. Yet we have always factored recessions into our analysis. For our recent investments, rather than assuming a V-shaped recovery, we have assumed a prolonged U-shaped recovery.

The pandemic has brought back into focus the need for downside protection and resilience in portfolio businesses. That has always historically been a focus for infrastructure investors, but it is more important than ever today. We always expect a recession to occur in our 10-year investment cycle and that has not changed, although the price we are willing to pay has become more conservative.

Q Is this changing which sectors investors look at?

It shouldn't, because infrastructure investors should always be investing in resilient businesses. However, it is likely to have provided a timely reminder to ensure that portfolios are not exposed to assets or sub-sectors without strong downside risk protection.

There are often opportunities within sub-sectors that provide downside protection – this is due to different business models that may be found among businesses within the same sub-sector. For example, if one looks at fibre in the 1990s, nearly every business in that sub-sector went into insolvency or restructuring because the cost of building fibre to homes was not covered by what customers were willing to pay for the service. There is a good chance some investments will fall into this category again today.

By contrast, we are invested in a fibre business that targets business parks. It signs up customers on contracts for base fibre rental and only builds out the fibre when enough customers have signed up. Even when businesses have been operating remotely, they have still been paying their fibre rental. That ongoing rental has provided downside protection.

In the home fibre market, operators are typically relying on customers signing up after they have built the networks. They are also relying on customers paying for more than just basic services, with spend on add-ons highly discretionary. We do not really see that as an infrastructure investment. It is clear there will be winners and losers in this market, which emphasises how important it is to get the correct business model.

Q What should investors look for in a mid-market fund?

They need to be looking for downside protection, diversification (which is easier in the mid-market than at the larger end), a strong, relevant track record and a clear understanding of the fund's investment objectives so they are not unknowingly accepting additional risk.

Yet, in a market where many players have moved up in scale or have diversified into other areas, such as credit or super-core funds, investors also need to look carefully at the operational capability of a manager. They cannot just sit on an asset like they might with a bond in order to get yield.

For example, we have operating partners who are ex-CEOs and have the capability to improve operations and make the businesses as efficient and cash-generative as possible.

This is not a financial exercise – one is dealing with real people running a real business. Investors should also be looking for managers that can grow a business in a fragmented market organically or through bolt-on acquisitions at accretive returns, thereby delivering economies of scale and increased diversification.

We are looking to build a clean, larger, well-operating, cash-generative asset that will be attractive to a much wider range of investors when it comes to exit. The mid-market typically offers more opportunities for operational improvement. However, within mid-market infrastructure it is still uncommon to find managers that have demonstrated a track record of value creation through operational improvements.

> *"The pandemic has brought back into focus the need for downside protection and resilience in portfolio businesses"*

Q You have completed carve-outs in the past. What are the main challenges in this type of investment?

These can be very rewarding because they are often unique opportunities and it is very difficult for a corporate to do a carve-out entirely through a competitive process. Carve-outs tend to be more complicated because the business will rely on a number of central functions, including IT, payroll and human resources. So, for the transition, a team is required that understands how to operate the business on a standalone basis and the costs associated with that.

In corporate carve-outs, a buyer's execution ability, capacity to navigate complexity and flexibility as an ongoing partner become just as important as price for vendors. Investors also need to understand what the strategy with the business will be. The business is unlikely to have been a core focus of the previous owner, so one needs the experience to know what can be done to grow and improve the business.

Q How do you see mid-market infrastructure investment developing over time?

Infrastructure remains an attractive asset class for investors at a time of low yields. Yet it is nascent relative to private equity and real estate, so we are still seeing newer investors come on to the scene. Their first forays tend to be in the large, generalist funds, but we will see them move to more specialist mid-market vehicles over time as they diversify their infrastructure portfolios.

Overall, there will be more capital flowing to the market as investors seek yield and downside protection post-covid. European, Canadian and Australian investors have already built diversified portfolios. However, there will be a lot of growth to come from US and Asian investors as they see the potential for strong performance with downside protection in the mid-market and different geographic areas.

Additionally, although many managers have moved up the deal size spectrum, some mid-market managers, such as Ancala, will remain in the part of the market we know well because – covid-19 or not – investors want to see fund managers perform through both good and bad times. ■