

KEYNOTE INTERVIEW

Ample opportunities and diverse exits



A greater range of deal opportunities coupled with multiple routes to exit are the main themes driving LPs to the mid-market, believes Morgan Stanley Infrastructure Partners' [Alberto Donzelli](#)

LP appetite for infrastructure is greater than ever – yet it is the mid-market space that particularly stands out for its attractive risk-return profile. With lower entry multiples, less market competition, greater operational agility and more flexible exit options, momentum is truly starting to build for mid-market infrastructure.

The asset class already had a strong reputation for resiliency, stable cash-flows and low correlation with inflation. Yet in today's economy, the increase in mid-market dealflow is catching the attention of investors keen to diversify and develop a more balanced portfolio.

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Alberto Donzelli, co-head of Europe at Morgan Stanley Infrastructure Partners, explains how mid-market managers are looking to secure assets at attractive entry multiples, deliver value creation and benefit from a wide range of options at exit.

Q How do you define mid-market infrastructure?

By current standards, I would define mid-market infrastructure as funds in

the \$3 billion-\$7 billion range, as well as investing in assets with enterprise values below \$1.5 billion. This equates to equity cheque sizes of approximately \$300 million-\$800 million.

When we launched Morgan Stanley Infrastructure Partners in 2006, there was little segmentation in the infrastructure market. Many funds were of a similar size and targeting similar deals. However, as many managers have tripled or quadrupled the size of their funds, they are now in front of entirely different counterparties and subject to very different market dynamics. That's the case for both buying and exiting assets.

“As infrastructure continues to develop as an asset class in LP portfolios, diversification as well as finding alpha are becoming increasingly topical”

Indeed, many LPs ask if the infrastructure industry has become more competitive since we started two decades ago. They point to overall industry growth. While it's true that infrastructure has grown from \$1.5 trillion in assets to \$18 trillion plus today, it's important to note that the lion's share of infrastructure AUM growth has actually been in the mega-fund space. This tends to target transactions with enterprise values upwards of \$10 billion. That translates into a greater opportunity set for deals at \$1.5 billion enterprise value or below, and we strongly believe that our longevity gives us a true edge.

Q How does the risk-return equation compare with the large-cap space?

Most of our deals in the mid-market are bilateral. This means that we don't necessarily need to compete to have the lightest markup in the sale and purchase agreement, or have the most bullish business plan. When we partner with a family or a strategic, we believe that the business plan must create alignment with the partner. And often the partner has a tangible vested interest in ensuring that the company is able to deliver on the agreed business plan.

Ultimately, we believe transactions executed in this manner are characterised by lower levels of risk. And thus, even assuming similar returns to competitive situations, tend to have a much more interesting risk/return profile.

Anecdotally, we've heard from our LPs that they've found sub-\$3 billion enterprise value deals outperforming \$5 billion-plus deals by around 200-300 basis points on average, irrespective of vintage or sector.



Q What does it take to operate successfully with a mid-market focus?

Time and patience are key. Our DNA as a mid-market manager is to execute the vast majority of deals through bilateral discussions outside of an auction process. It takes a tremendous amount of time to cultivate relationships with potential sellers before discussions ultimately lead to transactions.

Participating in an auction and winning is easy – you just need to pay the highest price. The relationships that lead to proprietary deals take years to develop, but generally lead to better results. That's why we believe being

a veteran in this space – where we've been building deep, localised relationships for decades – provides a true advantage.

Q How can managers originate bilateral discussions that lead to deals?

When you've developed relationships with strategics and founding families, you find that there are a lot of opportunities to do deals in the form of partnerships or carve-outs. Our bread and butter is to identify assets where the underlying assets and cashflows have very clear infrastructure features, but they need to be packaged and

commercialised. We consider this to be a “primary deal”, as we’re uncovering the asset through our own origination. We also believe LPs prefer this form of deal sourcing relative to buying assets from other GPs (ie, secondary origination).

This type of deal sourcing takes time to examine which assets are held by different owners and evaluate why they might have a rationale for parting ways with those assets. In the case of family owners, this requires developing a trusted relationship and helping them understand how we can add value to their business. We have many references that we can provide in the form of current or former family partners.

There needs to be something in it for them as well. They care about the financial side, of course. But in many cases the economics are not the primary consideration. If the family owners remain as shareholders, they also want to ensure that we have a common and agreed understanding of the future direction of their business. For example, if you can show to them that you have a track record of helping businesses expand, then you have a greater advantage in securing those kinds of deals.

Take-privates are another avenue as well. A lot of companies below a certain size feel they’re between a rock and a hard place. Their trading volumes might be thin, they may not be in an index and/or they’re unable to receive research coverage. They might also have growth opportunities that they need to fund but cannot raise the equity. Going private under the ownership of a fund opens up far more possibilities.

Q What are the main exit options for mid-market managers?

We’ve historically sold mainly to pension funds, insurance companies and strategics (ie, those with more permanent capital structures), but the exit

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universe has expanded since our inception. Over the past few years, we’ve also been selling to other infrastructure GPs.

Since day one, we’ve acquired assets often inaccessible to the market. This is because, for instance, they’re treated as cost centres within conglomerates, or held as long-term family businesses. As previously mentioned, we take these “primary assets” then add value and grow them until they’re ready for exit.

LPs have commented to us that this primary-to-secondary process is quite unique to us within the infrastructure space. It’s also very beneficial from a returns perspective. It’s something that our LPs are very pleased with, especially when we buy from strategics or family-owned businesses and then sell to other GPs.

Q Which factors will influence LP appetite in the years ahead?

As infrastructure continues to develop as an asset class in LP portfolios, diversification and finding alpha are becoming increasingly topical. For example, at what point does your mega-fund exposure become “beta” rather than alpha?

Given the asset class as a whole has performed reasonably well in recent years, certain LPs may be perfectly fine with that. However, for investors seeking returns uncorrelated with the broader market, the mid market offers more compelling opportunities.

Finally, I can’t think of any recent meetings with LPs where they haven’t brought up distributions to paid-in capital. There’s a great degree of focus among investors about making sure that they get their money back. Plenty of LPs are concerned that they’ve put a lot of capital into alternatives, but haven’t received their cash back to allocate into additional commitments. We believe that the mid-market has a competitive advantage when it comes to DPI. ■

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