STEPSTONE

INFRASTRUCTURE'S MIDDLE MARKET

An emerging opportunity

JANUARY 2024

Introduction

Perhaps one of the biggest developments in private markets' relatively short life span is the emergence of infrastructure as a stand-alone investable asset class. In only 20 years, the capital raised in support of infrastructure private markets has risen dramatically. Its attributes of inflation protection, stable cash yield, defensive growth, and low correlation with other asset classes bring significant benefits to portfolios in all economic environments, especially during periods of high inflation.

When it comes to infrastructure investing, we tend to think of deploying big pools of capital into massive works of civil engineering. And while this can be true, it is not the rule. The fact is, smaller GPs have accounted for most of the funds raised since 2010—more than 8 out of every 10.

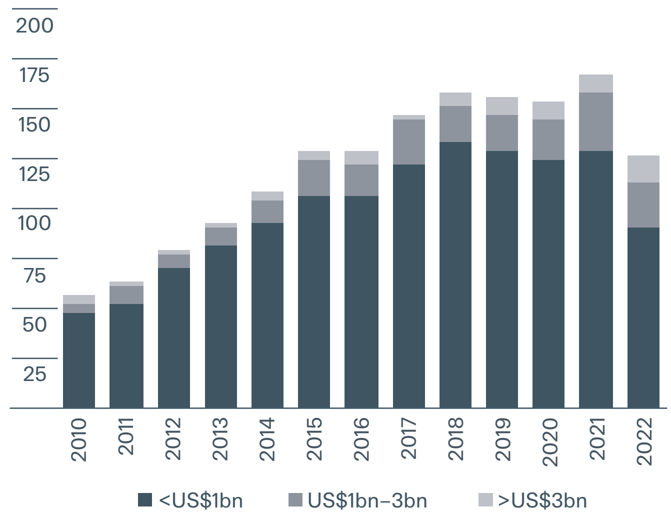
We define these smaller funds as the Middle Market, and while no standard definition exists, some investors have begun to consider infrastructure funds reaching as high as US$8 billion as Middle Market—which would have been unthinkable even two years ago. In private equity, our firm historically defined the upper range of Middle Market as funds up to US$3 billion in size. However, as the average market cap of target companies has increased and the number of publicly listed companies has decreased, fund sizes have grown. As a result our private equity team now considers funds as large as US$7 billion to be Middle Market.

Owing to these same dynamics, infrastructure has seen an increase in the average fund and deal size. This paper focuses on the lower end of that range (according to our older definition). That said, we believe the opportunity set in infrastructure has similarly increased over time.

Historically, as seen in **Figure 1** and **Figure 2**, funds raising US$3 billion and below in infrastructure have seen a significant amount of activity:

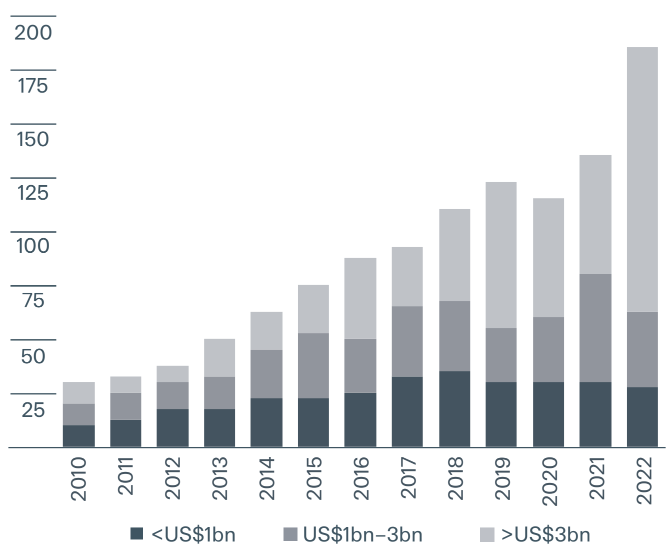
- On average, 85% of funds raised during 2020–2022 had a fund target of less than US$3 billion; and
- On average, 49% of aggregate capital raised during 2020–2022 came from small- and mid-market funds

FIGURE 1: ANNUAL NUMBER OF CLOSED UNLISTED INFRASTRUCTURE FUNDS BY FUND SIZE 2010–2022



Source: Preqin and StepStone analysis, as of June 2023.
Note: Excludes data with undisclosed fund sizes.

FIGURE 2: ANNUAL UNLISTED INFRASTRUCTURE CAPITAL RAISE BY FUND SIZE 2010–2022 (US$ BILLIONS)



Source: Preqin and StepStone analysis, as of June 2023.

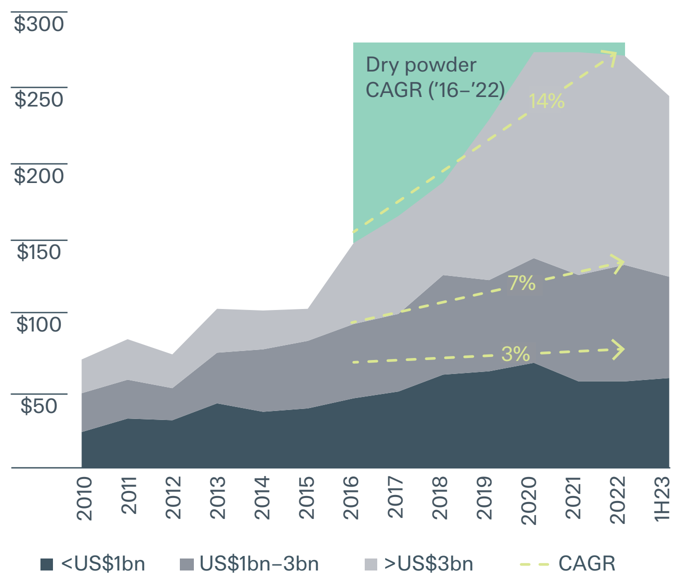
The rise of infrastructure's Middle Market is a function of the growth of investment opportunity at this fund size. As the asset class has matured, a handful of dominant and growing large-cap GPs have accounted for a large proportion of total fundraising. These same managers were raising fund sizes considered Middle Market a decade ago, when there weren't any larger private capital pools, so the universe of deals they could access was different from today's mid-market opportunity. Their move to larger transactions has left a void, which newer managers have filled.

Whereas large-cap managers tend to deploy billions into marquee assets and take-private transactions, mid-market GPs tend to be more specialized in standing up new platforms or "buying and building," adding potential exit multiple expansion for a scale premium as modest-size platforms grow. On exit, a smaller fund can sell to a larger fund or a strategic buyer, whereas large asset positions in larger funds may have more limited liquidity options.

Other advantages include:

- **Enhanced partnership**—Mid-market GPs allow the possibility of greater investor influence, including fund documents, management fee discounts, GP stakes or the ability to affect fund strategy to meet an investor's program objectives.
- **Differentiated strategies**—Mid-market deals provide access to parts of the market that are inaccessible to larger peers, such as platform build-outs, roll-up or aggregation strategies that cannot be done at a scale large enough for the large infrastructure funds.
- **Specialists**—There are more specialist GPs, which offer the ability to rely on superior industry-specific expertise and sourcing networks. In infrastructure, there are many telecom, greenfield and energy-transition specialists to consider.
- **Co-invest opportunities**—Mid-market GPs offer their LPs greater access to co-invest as they typically avoid programmatic co-invest terms. Many GPs offer co-investment opportunities associated with their fundraise, allowing for reduced blind-pool risk with new fund commitments.

FIGURE 3: INFRASTRUCTURE DRY POWDER BY FUND SIZE 2010–2022 (US$ BILLIONS)



Source: Preqin and StepStone analysis, as of June 2023.
Note: Excludes data with undisclosed fund sizes.

Although there are many benefits to investing in infrastructure's Middle Market, doing so has its challenges. For starters, the opportunity set is significantly larger, with many more GPs to consider than the large-cap universe. Many LPs lack the time and resources needed to research and review the myriad of generalists and specialists, or the time needed to conduct diligence on the growing universe of emerging managers. Active participation in the less trafficked Middle Market, however, brings the potential for outsize returns from top-tier managers, along with a portfolio "edge" created by sector and strategy diversification and potential for greater alignment and access to smaller GPs.

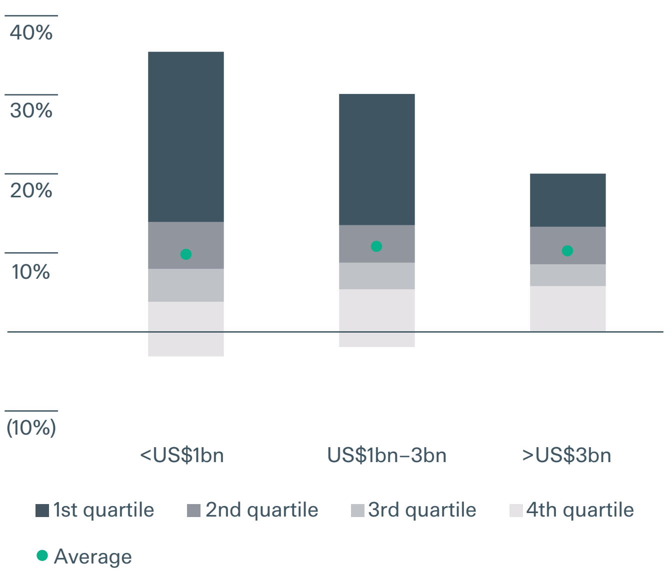
By working with a global partner that possesses a large and active sourcing engine and a team dedicated to the infrastructure market, LPs can receive assistance in assessing opportunities and can mitigate some of these challenges.

Fund performance

With an appropriate focus on manager selection and disciplined execution, the Middle Market can potentially generate outsize returns from top-tier managers. To estimate this return potential, we evaluated the performance of 1,384 mid-market and 170 large-cap infrastructure funds raised between 1992 and 2022.[1]

Figure 4 compares the net IRR performance quartile ranges across fund sizes. While average returns across the data set were not meaningfully different, first-quartile performance for funds smaller than US$3 billion shows significantly higher upside potential.

FIGURE 4: FUND NET IRR PERFORMANCE BY FUND SIZE



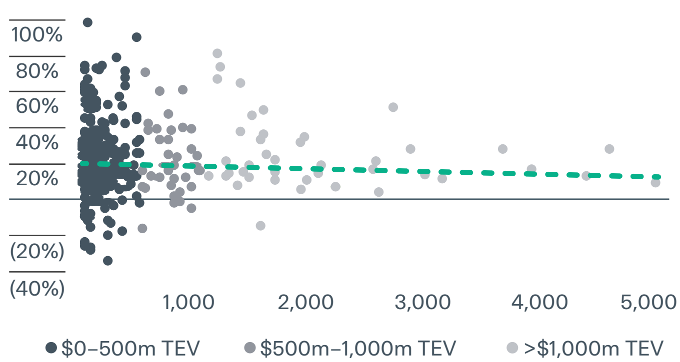
Source: SPI Research, as of June 2023.
Note: GP track records as of latest available reporting date.

Because average returns are not meaningfully different, with lower variation in larger fund sizes, portfolio managers could decide to anchor their portfolio with large-cap managers to provide the stability expected of an infrastructure portfolio. We believe that portfolio construction should, however, also include allocations to the Middle Market to benefit from the additional diversification as well as the potential performance "edge" it provides.

Deal-level performance

Taking a closer look on a deal-level basis, we assessed the relationship between asset-level returns and transaction size at entry. Our analysis found a negative correlation between TEV and realized gross performance based on our observations of available private market data for realized deals, as illustrated in **Figure 5**. This indicates there may be a potential performance upside from obtaining exposure to infrastructure transactions with more modest capital outlays. That said, investors do need to be cautious and highly selective, as we observe a greater number of losses for deals with a smaller TEV.

FIGURE 5: GROSS IRR AND ENTRY ENTERPRISE VALUE FOR REALIZED DEALS[2]



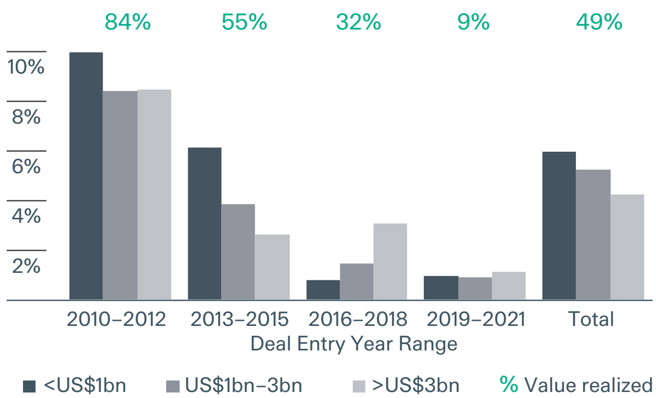
Source: SPI Research, as of June 2023.
Note: Based on 349 realized infrastructure deals.

[1] The data was sourced from SPI Research, our proprietary private markets library, which as of October 2023 garnered performance data on more than 2,600 infrastructure funds and 1,000 managers.

[2] The returns are gross of underlying GP fees and gross of StepStone fees. Gross IRR will ultimately be reduced by management fees, carried interest, taxes, and other fees and expenses. For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.

We explored the risk of potential losses for deals done by mid-market managers by analyzing the loss ratios generated by over 3,000 infrastructure transactions since 2010. As illustrated by **Figure 6**, mid-market deals have experienced modestly higher loss ratios relative to larger assets, driven mainly by earlier vintages (2010–2015).

FIGURE 6: LOSS RATIO BY FUND SIZE



Source: SPI Research, as of June 2023.

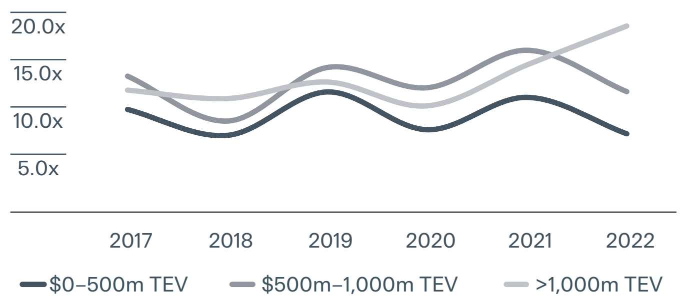
Note: Based on 3,272 deals. GP track records as of latest available reporting date.

Losses were largely concentrated in midstream and conventional power generation sectors. Neither of these sectors features prominently in today's infrastructure portfolios because the opportunity set is shifting toward renewable energy and energy transition–related infrastructure.

Since 2016, however, mid-market assets have performed in line with or slightly ahead of larger peers in loss ratios. Although the track record for deals struck after 2016 is largely unrealized, it does suggest that the Middle Market is becoming less risky.

As illustrated by **Figure 7**, assets and portfolio companies with a TEV up to US$500 million have historically been acquired at lower median valuation multiples. Smaller deals, especially in infrastructure, may result in GPs paying less for "platform value" and consequently for growth as a result of the business plan requiring a greater amount of professionalization and "built to scale."

FIGURE 7: ENTRY EV / EBITDA MULTIPLES FOR INFRASTRUCTURE DEALS BY FUND SIZE (MEDIAN EV / EBITDA)



Source: SPI Research, as of June 2023.

Note: Based on 300 infrastructure deals. GP track records as of latest reporting date.

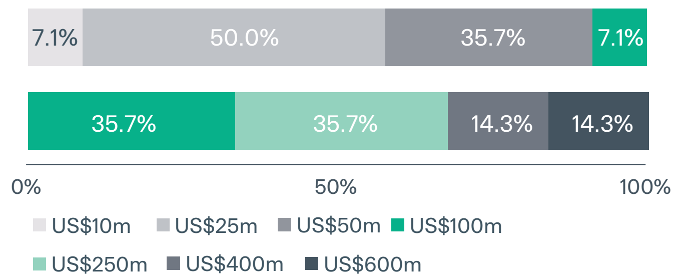
Although the data utilized for the deal-level return above may be influenced by survivorship and vintage biases,[2] it does provide some evidence of a trend that our private equity team has observed in buyout markets: There is a potential premium associated with focusing on the smaller end of the market.

[2] Here, survivorship bias means that successful GPs feature more prominently in the data. Vintage bias means that earlier vintages featured a greater proportion of smaller transactions.

What do the GPs think?

We surveyed 14 leading mid-market infrastructure GPs. The majority seek to invest between US$100 million and US$250 million in companies earning between US$25 million and US$50 million. The Middle Market's greatest benefits concentrated around proprietary sourcing and platform scale-up opportunities; greater professionalization of management and cost of due diligence were identified as challenges.

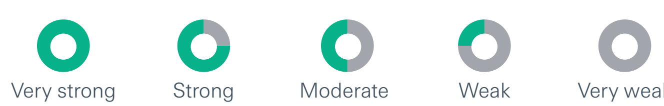
FIGURE 8: ANNUAL EBITDA (TOP) AND TARGET EQUITY CHECK SIZE (BOTTOM) OF MID-MARKET COMPANIES (% OF RESPONDENTS)



Source: GP responses, StepStone analysis, as of April 2023.

FIGURE 9: KEY BENEFITS & CHALLENGES ASSOCIATED WITH INVESTING IN THE MIDDLE MARKET

	Strength
Benefits	
Greater opportunities for proprietary sourcing	
Easier to scale platforms	
Flexible approach to control	
Greater ability for value-add improvements	
Greater ability to access niche or emerging sectors	
Challenges	
Need to improve financial controls and governance	
Need to professionalize and improve management teams	
Higher cost of effective due diligence	
Difficulty in accessing cost-effective debt	



Source: GP responses, StepStone analysis, as of April 2023.
Note: Strength based on percentage of mid-market managers that agreed.

NEW AND EMERGING MANAGER OPPORTUNITIES

As seen in **Figure 10**, investors have several avenues to access infrastructure's Middle Market, including as an influential anchor in funds, investing in later-stage seeded primaries, and co-investments. These benefits can be efficiently combined across GPs by investing through separately managed accounts (SMAs). While the Middle Market can offer the potential for stronger governance and influence along with greater access to co-investments, in general, it is harder to evaluate owing to the sheer number of GPs raising each year, smaller fund sizes, and smaller commitment sizes resulting in higher due diligence costs.

In many cases, to entice LPs, mid-market GPs may offer a co-investment in an existing portfolio company that is stapled to a fund commitment, reducing blind-pool risk for LPs who are able to vet a fund and co-investment simultaneously.

FIGURE 10: METHODS OF ACCESSING MID-MARKET MANAGERS

	Anchor primaries	Seeded primaries	Co-investments	Single-fund SMAs	Diversified SMAs
Summary	Large commitments to commingled funds during the early stages of fundraising	Commitments to funds with existing investments in the later stages of fundraising, or single-asset funds	Investment alongside GPs in select assets & companies	Tailored sector or individual-asset exposure	Tailored solution through co-investment, secondaries and primaries into a diversified set of GPs
Governance	Moderate	Weak	Moderate	Strong	Very strong
Liquidity	Weak	Weak	Moderate	Strong	Strong
Economics (fee efficiency)	Strong	Moderate	Very strong	Strong	Very strong
Ease of due diligence	Moderate	Moderate	Moderate	Strong	Strong
Co-investment potential	Strong	Moderate	n/a	n/a	n/a
Overall risk	Moderate	Moderate	Strong	Strong	Very strong
Benefits	• LPs may be offered a GP stake when anchoring primaries • Preferential fund terms may be offered to LPs, e.g., preferential access to co-investments or reduced fees/carry	• Access seeded portfolios that help mitigate blind-pool risk and the J curve • More preferential terms may be offered to LPs relative to large-cap funds	• Investment-level selection supports returns & portfolio optimization • Negligible J curve • Typically attracts lower fees & carry	• Bespoke investment solution; requires higher minimum allocation • Investment-level governance • Enables single-asset or strategy focus for small or specialized teams	• Bespoke investment solution with access to a large set of GPs • Leverage the asset management and governance capabilities of SMAs • Enables single-asset or strategy focus for small or specialized teams

For illustrative purposes only.

Very strong · Strong · Moderate · Weak · Very weak

Finally, many emerging GPs may consider SMAs prior to a formal fundraise, where a fund can be raised around a single asset or sector strategy with either a single LP or a small club. Because this situation may bring an additional risk for investors, this approach should be compared with the diversification benefits of an SMA seeking exposure across multiple funds.

The Middle Market also gives LPs an opportunity to invest with new or emerging managers. To help LPs overcome the potential for additional risk associated with new managers versus their more established counterparts, some of the newer GPs have developed attractive solutions including:

- **Favorable economics and terms**—LPs that anchor new or emerging managers may be offered a discount on fees and favorable fund and co-investment terms.
- **Seeded primaries**—Because it often takes a new manager longer to hold a final close on its initial fund, an initial set of deals are often executed in the fund prior to the fundraise being closed, with support from initial or anchor LPs. This gives LPs some validation about the GP's abilities, helps reduce blind-pool risk and mitigates the J-curve effect.

Risks & Areas of Diligence

The sheer size of infrastructure's Middle Market can be a challenge for LPs given the varying fund options and more complex investment due diligence. But this fundraising competition can accrue to the benefit of LPs—namely, better fund terms and economics. However, there are risks involved with small and first-time fundraisers that require additional scrutiny. Here are some of the biggest risks for LPs to consider, based on our experience:

- **Team stability**—For first-time funds, fundraising outcomes are far from guaranteed, and any LP making early commitments needs to assess the suitability of a GP's budget and management fees to cover the costs required to achieve critical mass and invest in and manage assets effectively.
- **Key-person risk**—Smaller GPs necessarily rely on fewer key individuals to drive investment outcomes, requiring greater focus on the LPA terms and motivations and alignment of the senior team.
- **Track record**—In many cases, first-time funds will have a shorter track record or may not have a fully portable track record from prior experience.
- **Operational and back-office capabilities**—Less established organizations tend to have less back-office support initially. To meet the needs of their LPs, new and emerging GPs often outsource their back office. LPs interested in diversifying their portfolios into the Middle Market should recognize this constraint and consider evaluating the capabilities of a GP's back-office suppliers.

Conclusion

For many LPs new to or not yet active in the space, infrastructure's Middle Market offers the opportunity to enhance portfolio diversification by accessing differentiated deal flow and strategies. A focus on smaller or emerging managers can also offer the potential for improved economics, enhanced access to co-investments, stronger governance and an opportunity to build relationships that grow over time. In our estimation these benefits may offset the challenges associated with track record, team size and GP stability.

While a large part of the total growth in private infrastructure fundraising has been due to the increasing fund size of large-cap managers, the Middle Market has been keeping pace through a proliferation of new managers and specialist strategies. We believe the growing opportunity in infrastructure's Middle Market could enhance portfolios, making it too important for investors to overlook.

All data is as of October 2023 unless otherwise noted.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. ACTUAL PERFORMANCE MAY VARY.

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For more information regarding StepStone's research, please contact us at research@stepstonegroup.com.

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