EXPERT COMMENTARY

Infrastructure investors will continue having to adapt to changing market conditions in 2025, write InfraRed's head of capital formation, Michael Straka, and head of research, Gianluca Minella

Embracing new realities

Infrastructure investors face a new market reality in 2025, as a result of several recent structural shifts to the investment environment, including a higher-for-longer interest rate environment and a new US administration.

US equity markets continue to appear bullish, and long-term bond yields have not been as attractive over the past 15 years as they are today. With infrastructure valuations having largely stabilised, and entry returns having widened, core infrastructure is becoming increasingly attractive on a relative basis, with upside potential should interest rates decrease.

Moreover, looming large on the horizon is an anticipated multi-decade infrastructure investment super-cycle underpinned by the investment opportunities in decarbonisation and digitalisation, which offers potential for enhancing infrastructure returns through value-add strategies.

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The fundamental strengths of the asset class are not expected to change, including its performance resilience to economic cycles and inflation protection. The focus for investors is how to allocate to infrastructure effectively in today's market environment, balancing income and growth opportunities.

Private markets have changed

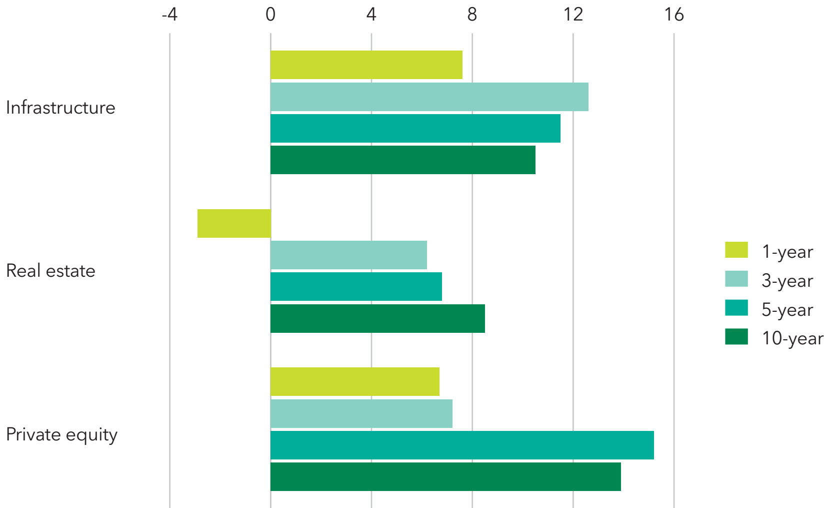
Over the past decade, private markets were breaking fundraising and deal records every year, amid historically low interest rates and weak inflation. The denominator effect in 2022, and the subsequent increase in interest rates, led to a deceleration in market activity.

Following a weaker 2023, private markets moved back to growth in 2024, with fundraising and deal volume expected to accelerate further in 2025. Nevertheless, despite the very high number of funds in the market, investors will be more likely to allocate to managers that have a proven track record, and that are demonstrating their performance through distributions and successful exits to third-party buyers – DPI is the new IRR.

On top of other economic changes, higher interest rates have had two main consequences on private markets. First, they have contributed to reducing valuations from the peaks reached in 2022. Amid widening bid-ask spreads, primary deal volume has decelerated, particularly in the large-cap infrastructure space and for heavily leveraged private equity deals. This has exposed assets where valuations were supported by more unorthodox assumptions, and with continuation vehicles being increasingly tapped into for liquidity at exit.

Secondly, despite the recent reduction in central bank interest rates, long-term government bond yields have continued to remain high, amid expectations of sticky inflation and limited fiscal policy flexibility. The effects of a higher-for-longer interest rate environment on private markets are yet to be fully comprehended, but the risk is that performance and valuations may continue to be negatively impacted for assets where debt will be refinanced at higher rates.

Performance analysis (Total returns, equity, 10-year to June 2024, %)



Source: Preqin, December 2024. Past performance is not indicative of future returns. There is no guarantee that the forecast highlighted may materialise

Performance resilience

In the context of higher interest rates and inflation, infrastructure has generally proven to be a comparatively resilient asset class. The recent valuation adjustment has been feeding through, with one-year performance down to 8 percent as at June 2024. Nevertheless, infrastructure has outperformed other alternative asset classes despite challenging macroeconomic conditions. Real estate has faced pressure due to rising interest rates, while private equity has experienced return compression, largely due to limited exits and elevated financing costs.

Over the last few years, various sectors in the economy were exposed to unprecedented stresses. Amid the shockwaves of covid-19, some sectors in the alternatives space, such as offices in real estate, rapidly fell out of investors' favour, while others, such as core infrastructure, have demonstrated their operational resilience and ability to reap the benefits of positive inflation correlation.

Infrastructure assets with inflation-linked revenue streams, particularly in core strategies, continued to deliver cashflow growth. The long-term nature of underlying debt contributed to protecting many assets from higher refinancing costs. Secular trends, such as decarbonisation and digitalisation, provided a boost to performance and returns, particularly for core-plus and value-add strategies, with the asset class outperforming private equity over the last three years.

New strategic role

With interest rates expected to stay elevated and US listed equities projected to underperform their past decade's exceptional returns according to most investors' long-term policy portfolio return assumptions, investors are rebalancing their portfolios.

As a result, more investors are increasingly allocating to infrastructure no longer solely for diversification and income. The asset class is ideally positioned to leverage the advent of global mega-trends, such as energy transition and digitalisation, for return enhancement investment strategies, with a growing number of investors focusing on leveraging the asset class for generating a long-term return premium over listed equities.

An attractive vintage for core

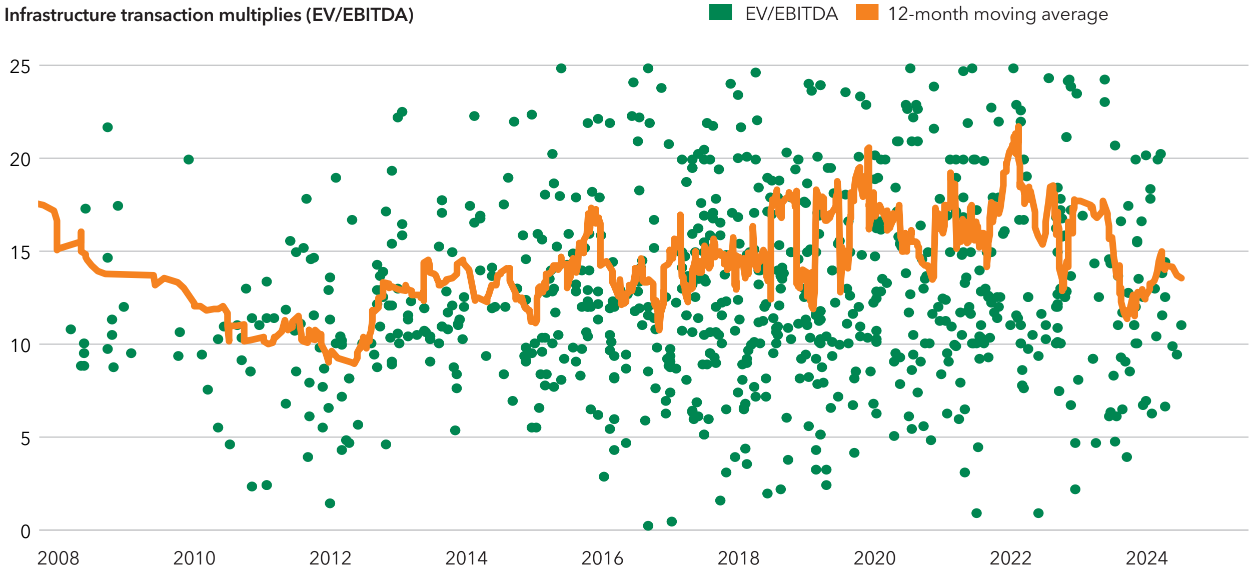
The repricing of core infrastructure equity has created compelling entry points today, with assets offering a solid premium in terms of total return potential. Sticky inflation may present tailwinds to future cashflow upside for core assets whose revenue growth comes also from positive correlation to inflation. We forecast 2025 average entry returns for core infrastructure to be at circa 10 percent.

Traditional assets like utilities, airports and toll roads remain central to investors' strategies, but will inevitably undergo changes, presenting opportunities and risks. Amid higher interest rates, value creation, in our view, will mainly come from managers that excel at optimising operations, and that can leverage secular trends, such as decarbonisation and digitalisation, as tailwinds to create further value in core assets.

A broader investment universe

As the global economy continues to modernise, secular trends are contributing to creating new investment themes for infrastructure, such as green energy and green mobility. Changes in market conditions also blur the boundaries between alternative asset classes, necessitating new portfolio strategies: think about the recent increase in real

Infrastructure transaction multiples (EV/EBITDA)



Source: InfraRed Capital Partners, December 2024. Past performance is not indicative of future returns.
There is no guarantee that the forecast highlighted may materialise.

estate investors allocating to data centres, or private equity managers acquiring infrastructure managers to expand into infrastructure investment.

The data underscores a clear trend. New opportunities are constantly emerging in the mid-market, with sectors aligned with decarbonisation, energy transition, and digital transformation attracting the most significant investment momentum.

We recently saw a deceleration in the speed of the energy transition compared to previous estimates, amid rising trade barriers, energy security and affordability concerns. US LNG infrastructure benefited from the curtailment of Russian gas to Europe. Nevertheless, solar PV continues to dominate as the largest sector, battery storage increasingly plays a critical role in enabling renewable energy integration and the transition to a more flexible energy system, with EV charging and heating/cooling electrification continuing to grow.

Artificial intelligence adoption and cloud computing continue to accelerate investment into data centres. This also reinforces the trend of increased energy demand and supports the case for more renewables and for natural gas as a pivotal transition fuel. While data centres present significant opportunities, investors may want to take a more prudent approach to the sector's growth assumptions and valuations.

The role of value-add

A broader opportunity set in growth infrastructure sectors and higher return targets are contributing to a growing interest in value-add infrastructure strategies. These strategies are aligned with investors' higher return targets and the opportunity set, with entry IRR estimates at around 14.7 percent for 2025. Value-add strategies invest to develop or expand assets with strong infrastructure characteristics that benefit from growing demand underpinned by secular trends and are therefore ideally positioned in the current market context.

Long-term historical performance highlights the benefit that an allocation to value-add infrastructure can offer within a broader private infrastructure portfolio, including potential for return enhancement, and the ability to partially reduce the overall volatility profile of the portfolio.

The value-add infrastructure sector is the missing link for investors to deploy capital rapidly and to target higher returns, drawing on the deep pipeline of opportunities. Most investors are focused on managers with a proven track record of growing assets in the mid-market, given the depth of opportunities in this space.

Continuity and innovation in 2025

Despite the macroeconomic and market changes on the horizon, we expect infrastructure to be well positioned to continue providing a resilient source of long-term returns ahead.

The challenge that most investors face to beat their benchmarks in the long term will be to adopt a more nuanced portfolio construction approach, to balance the security and income of traditional core assets, with the growth potential of new infrastructure themes and sectors. As ever, allocating effectively is crucial. ■

InfraRed Capital Partners is an international infrastructure asset manager with more than 160 professionals operating worldwide. InfraRed manages c.$13 billion of equity capital for investors around the globe in listed and private funds across both core and value-add strategies and has been focused on the mid-market since inception. Find out more at www.ircp.com