EXPERT COMMENTARY

The crisis is accelerating infrastructure's transition into a 'new normal'. Identifying businesses that can capitalise on this is the key to value-add investing, says Simon Gray, co-managing partner at Arcus

Value-add investing in a post-covid world

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The past six months have served to remind us all why relying on established understandings is not always a great strategy. Pre-January 2020, the concepts of core, core-plus, value-add and opportunistic were applied broadly to segment infrastructure investment strategies. Although there is no doubt that everyone's definition of these buckets was different, it was generally accepted that core investments were of lower risk than core-plus and that core-plus investments were in turn lower risk than those of an opportunistic or value-add nature.

Everywhere you look you see fractures of the status quo. The current pace of change across many of the established sub-sectors – with the possible exception of water – is greater than at any point in the 30 years or so that some of us at Arcus have been operating in the infrastructure space.

The pandemic could well have dramatic consequences for infrastructure investors. Short-term impacts on air travel and transport usage are clear. But, in the longer term, will the embedded concerns on crowds and contamination usher in a new focus on personal transport rather than shared, let alone crowded, transport? Will the quiet, brilliantly clear morning skies and dust-free breathable city air of the past months offer people a taste of what a greener, less polluted world could be like?

The stellar rise in the acceptance of – or even the reliance on – video-conferencing platforms such as Zoom or Teams has made it all too apparent that virtual working is both possible and efficient, so virtual offices are really not a pipe dream any more. Clearly in all that follows from the inevitable recovery from the pandemic, there will be businesses that become winners and there will also be some that will become losers.

Investing in infrastructure is almost by definition a long-term endeavour, so all of us involved in this business should question how best to undertake it in this rapidly changing world. We do not believe that extrapolating from the past should form a cornerstone of the answer to this question.

In its place we would advocate a thoughtful analysis of the trends that are shaping this 'new normal' and investing capital in those businesses that are positioned to benefit from the underlying trends. We would also call for an acute focus on the management and direction of those businesses to adapt and steer them such that they capitalise to the maximum extent possible on opportunities as the exact shape of the new normal becomes apparent.

This is the approach we have adopted at Arcus. We are seeking to identify businesses that are poised to capitalise on the fundamental changes taking place to the economies, social structures and attendant infrastructure throughout Europe. We are then working closely with management teams to build value for our investors, through scaling-up or expansion into adjacencies, and seeking to improve business models and profitability. To us, this is the definition of value-add investment.

Deep understanding

Our investment targeting and selection process is highly reliant on our conviction on the opportunity, and that in turn relies on deep business understanding. This is the reason why we have focused on a small number of specific sectors and why we organise our investment team professionals into sector teams, supported by a network of senior industry advisers. High-quality insight and robust business assessments require deep sector understanding and experience.

The thematic underpinning of our investment strategy is anchored in an exercise carried out three years ago, to examine and identify the key trends that we believed would drive the value of infrastructure investments over the coming years.

Decarbonisation is at the heart of the changes that are taking place in the energy sector in its broadest sense. It is increasingly at the centre of the changes taking place within the transport sector as well.

Demographic shifts throughout Europe will shape future energy demand and particularly transport modalities – although this is one area where covid-19 is likely to have a significant medium-term impact.

Finally, the transformative impact of mass-scale data use is felt across almost every facet of modern life – from the growth in home shopping to the covid-accelerated adoption of video-conferencing and home-learning, the integration, management and pricing of transport and logistics, and the control and management of the distributed energy model. By looking at the specific impacts of these three trends across transport, telecoms and energy, we calibrate a proactive origination approach. This involves seeking out specific businesses that we feel are well placed in the context of these trends and establishing dialogues with the owners and

Three trends shaping investment landscape

Decarbonisation

40%

of the increase in total generation by 2040 will be renewable

Decarbonisation driving transportation and heating energy sources

Source: IEA World Energy Outlook, 2018

Changing demographics

76%

of the population will be non-working dependants by 2050

Demographic shifts impacting consumption, logistics and transport

Source: Eurostat, 2020

Data explosion

175ZB

of data expected in use by 2025

Ubiquitous connectivity driving disruption, efficiency and disintermediation

Source: IDC, 2019

management of these companies with a view to acquiring them.

Putting it into practice

Establishing a dedicated asset management team for each new business is essential to overseeing the management of an investment. This team, typically 1.5 to 2 full-time equivalents at Arcus, is responsible for all aspects of the investment – from performance and reporting to implementing our environmental, social and governance agenda and assisting in the formulation and development of strategy and any significant corporate activity, such as financings or M&A. To effect the most change in a business – that is, to add the most value – you need to be a majority shareholder, so we believe an investor should always look to take controlling positions.

In the time of covid-19, working closely with our management teams as a value-add manager has meant being in the trenches with them. We have been able to make quick decisions and leverage off a network of expert advisors to help alleviate the impacts of the coronavirus, keep employees safe and, in some cases, benefit from small gains. We would typically speak to our management teams each week and have formal board meetings on a monthly basis.

However, during covid this dialogue has increased to weekly taskforce calls, as well as informal catch-ups to ensure key strategic priorities remain on track and that health and safety are at the forefront of everyone's mind.

Among recent investments, both E-Fiber and Swiss4Net – fibre-to-the-home businesses in the Netherlands and Switzerland, respectively – provide last-mile fibre connections to homes and businesses in rural or semi-rural areas. They operate on a B2B basis supplying last mile connectivity to ISPs and other service providers that enter into contracts with business and residential end-users.

The restrictions imposed during the pandemic have made everyone aware of the value of high-speed, reliable connectivity. A 1GB fibre connection to your house makes simultaneous family home working and schooling effortless, when compared with single MB/s ADSL services. And in nearly all cases the costs of the 100-fold improvement in throughput are minimal and sometimes even cheaper.

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Strong relationships with suppliers have meant that, past the initial lockdown phase, construction has continued uninterrupted at both businesses, with a backlog of customers waiting for connection.

A third recent investment, Constellation Cold Storage, is a roll-up play in the specialised European cold storage logistics space. To date under this investment, we have acquired three regional businesses in Norway, Belgium and the Netherlands, with a healthy pipeline of opportunities to follow. The sites are typically located close to key food manufacturers and processors from which they receive products for freezing, storage and onward delivery.

Each of these businesses constitutes an essential element in the 'farm-to-fork' supply chain for food products in their locality. They also provide a critical part of the food supply chain, ensuring availability of seasonal products on a year-round basis and enabling the widespread availability of goods that have historically been difficult to transport and store.

One impact of covid was the high levels of certain food stocks in cold storage facilities across Europe, with limited movement in pallets. As a result, certain revenue streams associated with handling and value-add services were significantly reduced at Constellation's facilities.

With value-add guidance, Constellation's management implemented dynamic labour management, with weekly planning and a view to longer-term right-sizing of the cost base. This has contributed to continued healthy margins and strong EBITDA performance through the pandemic.

A fourth investment is Horizon Energy Infrastructure, a UK smart metering business. The roll-out of smart meters is seen as a key element in the UK's green energy agenda, facilitating a raft of other de-carbonising initiatives. Horizon is also well placed to look at near adjacencies such as electric vehicle charging and electricity-based domestic heating alternatives. Arcus has spent time with Horizon's management team during the covid period strategically exploring these areas, which are at the forefront of furthering the decarbonisation agenda.

As we work towards making the next investments for our fund, the changes that we see and the opportunities that result are exciting. We remain convinced of the merits of a proactive approach to value-add investing and taking portfolio companies to the next level on their growth trajectory. ■