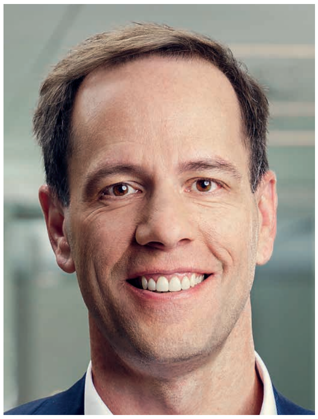
KEYNOTE INTERVIEW

Putting people at the heart of infrastructure



Infrastructure investors have the opportunity and responsibility to create long-term value by engaging with, and meeting the needs of, communities, according to Instar Asset Management's Gregory Smith

SPONSOR
INSTAR ASSET MANAGEMENT

Infrastructure investment is going through a period of change as hikes in interest rates make waves through the economy and institutional portfolios. Meanwhile, the definition of what's considered to be essential continues to evolve. Investors and fund managers will need to adapt by sharpening their focus on value creation if they are to capture the opportunities presented by these long-term macro trends.

We spoke to Gregory Smith, president and chief executive officer of Instar Asset Management, to explore how investors can build and grow resilient essential businesses in North America's mid-market, and why purpose and people lie at the heart of infrastructure.

Q Why do you think value investing is important in today's mid-market?

We believe the mid-market presents a unique and substantial value creation opportunity. In our experience, small and medium-sized companies typically deliver stronger returns for investors on a same-sector, same-geography basis than in the larger-scale segment of the marketplace. Smaller businesses are nimble and tend to have a disproportionately positive impact on the economy in terms of competitiveness, employment growth and resilience. They are the lifeblood of our communities and economy. That's what infrastructure is fundamentally about: improving quality of life in our communities and creating economic opportunity. There is a growing demand to build new, long-lasting infrastructure as technological advancements and an ageing population continue to shape the future of this sector.

Current macro trends are creating new essential needs and shaping new

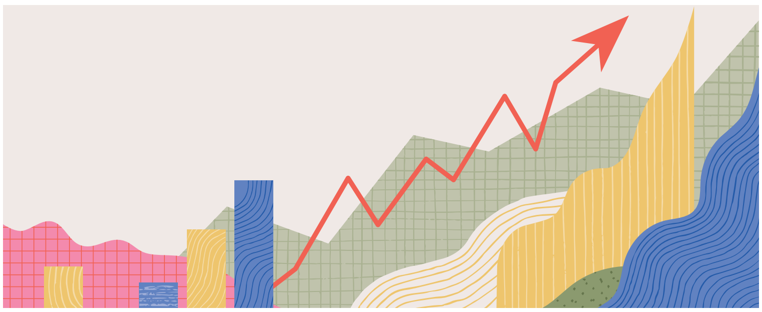
Q How would you describe the infrastructure investment environment today?

There has been a fundamental pivot in the marketplace over the past 12 to 18 months that requires a different approach. Value investing is coming to the fore. Over the past four decades, we have seen a high level of monetary stimulus and enhanced liquidity go into the economy. Back in 1980, long-term government bond rates were around 15 percent; they went to 1 percent.

This shift shaped institutional portfolios as investors sought out better returns, with private markets allocations increasing from between 1 to 2 percent of portfolios in 1990 to as much as 30 to 40 percent today. This liquidity fuelled an era of momentum investing where many investors benefitted from - and relied on - rising multiples.

Today's environment is completely different. Higher interest rates and reduced liquidity in portfolios are profoundly affecting private markets. Our population is ageing, so many portfolios are experiencing net withdrawals. We can no longer count on monetary stimulus or an increase in allocations for growth.

In the next few decades, the focus will shift to value investing and active management. Now, when looking at manager selection, investors will notice a stark increase in the standard deviation in returns between the good and the average manager.



those tailwinds. We seek businesses that are dominant in their sector or subsector and leverage macro tailwinds around technology, climate change and changing demographics.

Our experience is that there is more scope for operational enhancement and that mid-market companies are typically more flexible and better able to adapt quickly, embrace innovation and capitalise on growth opportunities. This is especially relevant as infrastructure has shifted from being government-backed or about project finance to becoming business-to-business and about growing platforms.

The speciality of mid-market investing also lies in how we develop companies' advantages, especially in the areas of culture, talent and technology to eliminate barriers to innovation and growth. Mid-market companies tend to engage with communities more closely than larger operators.

For us, it is about relationships and partnering with management teams to make great businesses even better. We do this through sharing value-add expertise across functional areas of the business and investing in the right people in the right place and at the right time to promote organisational development, support growth and "future proof" each company.

investable sectors and subsectors that are different than five or 10 years ago and will be different again in the future.

As infrastructure investors, we are always thinking about how to solve the challenges presented by the macro environment to make communities more livable and resilient. The 'buy and build' opportunity for growth in the mid-market is what's most exciting for us, to be able to scale a smaller company into a platform by building value through organic growth, greenfield developments and growth through acquisitions with lower entry multiples.

Q In what other ways do the dynamics of the mid-market differ from those of larger deals?

The mid-market opportunity set is more robust today than it was a few decades ago. Most firms that start in the mid-market move up market as they raise larger funds. We've chosen to stay in the mid-market and become a specialist in this space because small and medium-sized enterprises make up the vast majority of the economy and typically have greater capacity for growth and value creation.

Mid-market investing is not simply about investing in smaller companies; it is a speciality that lies in identifying new macro trends early on and finding great companies that will benefit from

Q You stress the importance of communities. Why do you view social impact as such an integral part of infrastructure investing?

We have found that people-led strategies are much more successful than those based solely on products. Gone are the days when infrastructure was merely a physical asset. It is integral to take a customer-centric, solutions-based approach and engage with communities to meet their evolving needs. Since emerging around two decades ago, the industry has rapidly evolved and was only adopted by large-scale institutions about 15 years ago. It has moved from being comprised of regulated assets – such as power transmission – to renewables and digital infrastructure, and now today to incorporate considerations such as water, wastewater, and food safety and security. What's considered to be essential continues to evolve as communities' needs change.

Today, you need a social licence to operate at the very least. A project can meet all its financial and technical specifications, but it is really only successful if it is perceived to be successful in the eyes of the community. It is important to engage with people to understand what they need and develop products and solutions around that need. We believe ESG is truly about the 'S' because, with good governance, the decisions around the 'E' become easy as they are integrated with societal needs.

Q What does that engagement look like and how can it create value?

We've always said we take great companies and make them even better. With an organisational purpose of enriching people's lives, we see four main pillars for creating value in the businesses we partner with: purpose, people, process and technology. Communities are at the heart of each. Every one of our portfolio companies has a purpose embedded in their DNA, and that purpose defines what they do for others.

People want to work for organisations with a strong purpose, so this focus helps attract and retain the best talent. People are fundamental to the success of every business, so we believe it is vital to elevate human resources to help embed purpose and ESG within the culture – that is what brings an organisation to life.

Process is the third pillar and that is about making improvements to our processes and systems to ensure successes are repeatable and to establish a strong foundation for growth. Lastly, we must embrace technology – every company today is a technology company. Leveraging technological advancements and innovation, we can improve efficiency and effectiveness to stay ahead of market disruptions. We believe in investing early across all four pillars to enable growth.

> *"You need to take a customer-centric approach and engage with communities because infrastructure is no longer just a physical asset"*

Q Do you have any examples of these value creation initiatives in action?

There are a couple of interesting stories around a strong purpose statement, working with communities and engaging people that spring to mind, demonstrating how value investing in infrastructure is multi-dimensional and does well for people, communities and investors simultaneously.

One example is Steel Reef, a business that captures, processes and transports associated natural gas that would otherwise be flared or vented into the atmosphere and provides vital environmental solutions to the Canadian energy sector. We invested seven years ago, when the company was run by three great founders. By enabling the four pillars early in our investment cycle, we have helped the company to grow EBITDA by more than five times.

It's also leveraging its core competency to expand into power production through power purchase agreements to help the province of Saskatchewan move away from coal. The company has strengthened the environmental profile for its industry and offers benefits to communities.

Creative Energy is another example. Operating for 50 years prior to our investment, this company owns and operates one of Canada's largest district energy systems located in downtown Vancouver. By working alongside management to enhance the four pillars, the business has grown from about $100 million to more than $400 million in capital projects across Vancouver, Seattle and Toronto since 2018. Creative Energy is integrating innovative technologies including heat recovery and building geo-exchange to improve the carbon footprint of the cities in which it operates.

Q How do you see the mid-market infrastructure landscape evolving over the next few years?

The landscape is shifting as the era of momentum investing comes to an end. We had 40 years of declining interest rates and a flood of liquidity into the private capital marketplace, which resulted in increasingly larger funds and, for some, the ability to simply count on rising multiples to drive returns.

I do not think people have fully realised the extent of this fundamental pivot towards value investing. As we discuss risks and economic disruption, people are now starting to take a different view on what I'd call remote possibility, high impact events, with climate change, geopolitical events, wars, populism, pandemics and interest rate rises taking place more frequently over the last few years. These events do not fit neatly on a spreadsheet, so investors need to think more fundamentally about their impact on our communities, economy and environment.

In infrastructure, that means looking to the future. When we rebuild, we cannot simply rebuild what we already have or rely on long-term contracts with government. We need to look at how technology and communities are evolving and future-proof our infrastructure by building a resilient business model that will adapt to the needs of people and communities over time. ■