KKR

Market Review

Infrastructure
June 2024

Picking Up the Pace

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Written by:

Raj Agrawal
Partner and Global Head of Infrastructure

EXECUTIVE SUMMARY

In our last Market Review, published in December 2023, we predicted that transaction activity would gather pace in 2024 and that the opportunity set would make this a special vintage year. Indeed, we are now seeing a full deal pipeline and some valuation relief in sectors that previously had been too expensive to meet our risk-return expectations.

Given the modest-growth, high-inflation environment, however, we temper our optimism with a healthy dose of caution. We have always sought to structure our investments so that they do not depend on either economic growth or the potential receipt of tax credits and subsidies, and we believe that this approach may serve us well in the coming years. In addition, with uncertainty still the default setting of the global economy, our focus on value creation remains critical to driving growth and optimizing efficiency at our businesses.

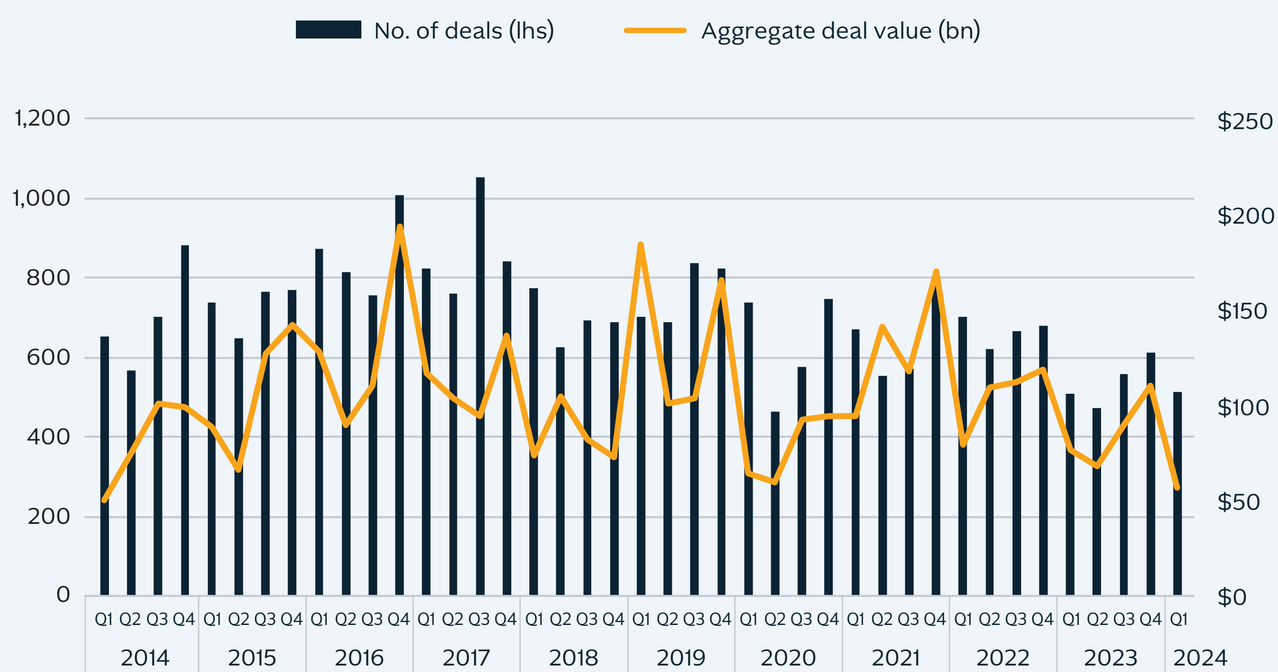
Looking through a longer lens, we have been encouraged to see that the investor community's interest in infrastructure continues to grow, especially given the strong performance of the asset class in volatile and high-inflation environments. Amid this heightened interest, we have seen industry consolidation among infrastructure investment firms and expect to see more asset managers look to enter the infrastructure space. Through these changes, we have maintained an even keel, focusing on delivering attractive risk-adjusted returns with a stable team and maintaining our emphasis on capital preservation.

Key Themes

01 Deal Activity: Getting Warmer

In the first half of the year, we saw transaction activity begin to thaw. While the overall number of private infrastructure deals closed in the first quarter of 2024 was similar to average quarterly activity in 2023 (Exhibit 1), we are seeing a heightened activity level, which we think should lead to an increasing number of deals closing in the second half of this year. Elevated interest rates in the United States and Europe have continued to drive asset prices down, narrowing the gap between what buyers are willing to pay and sellers willing to accept. In fact, it was notable that the *value* of private infrastructure transactions was down significantly in the first quarter, both in aggregate and in average deal size. We think this could reflect a preference for smaller transactions in a tight financing market, a drop in asset valuations, or both.

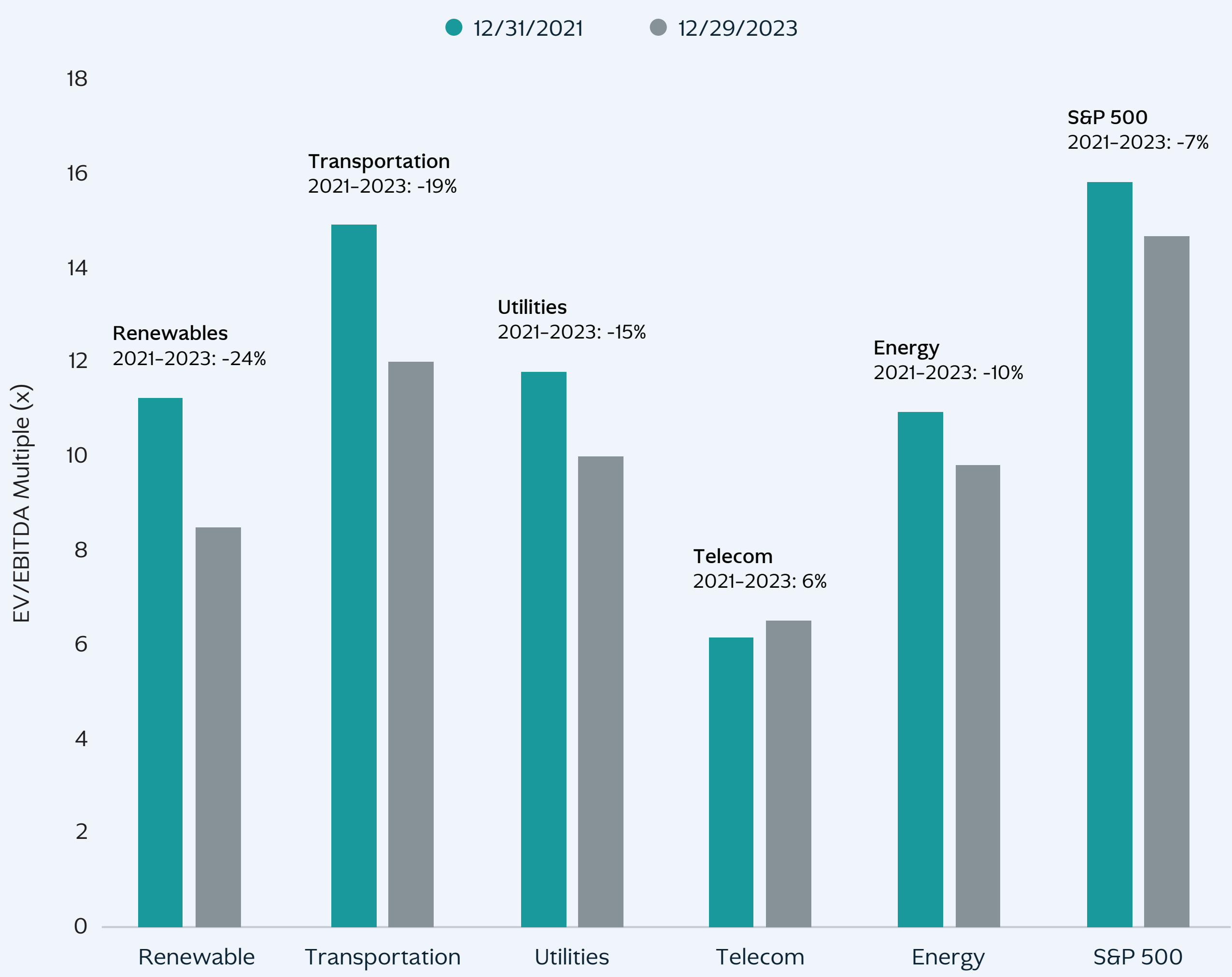
EXHIBIT 1: Private Infrastructure Transaction Activity



Source: Preqin as of April 30, 2024.

Our own deal pipeline is growing, with some opportunities at more attractive valuations than we have seen over the past three years. The broader reset is evident in looking at valuations of publicly traded companies in sectors that are thematically important to infrastructure (Exhibit 2). By year-end 2023, the decline was most notable in the renewables segment, and our activity since reflects that opportunity. Indeed, we have signed or completed five transactions in the last six months. The dramatic decline in valuations of renewables development projects in particular enabled acquisitions much closer to book value than in the past.

EXHIBIT 2: Public Infrastructure Sector Valuation Comparison

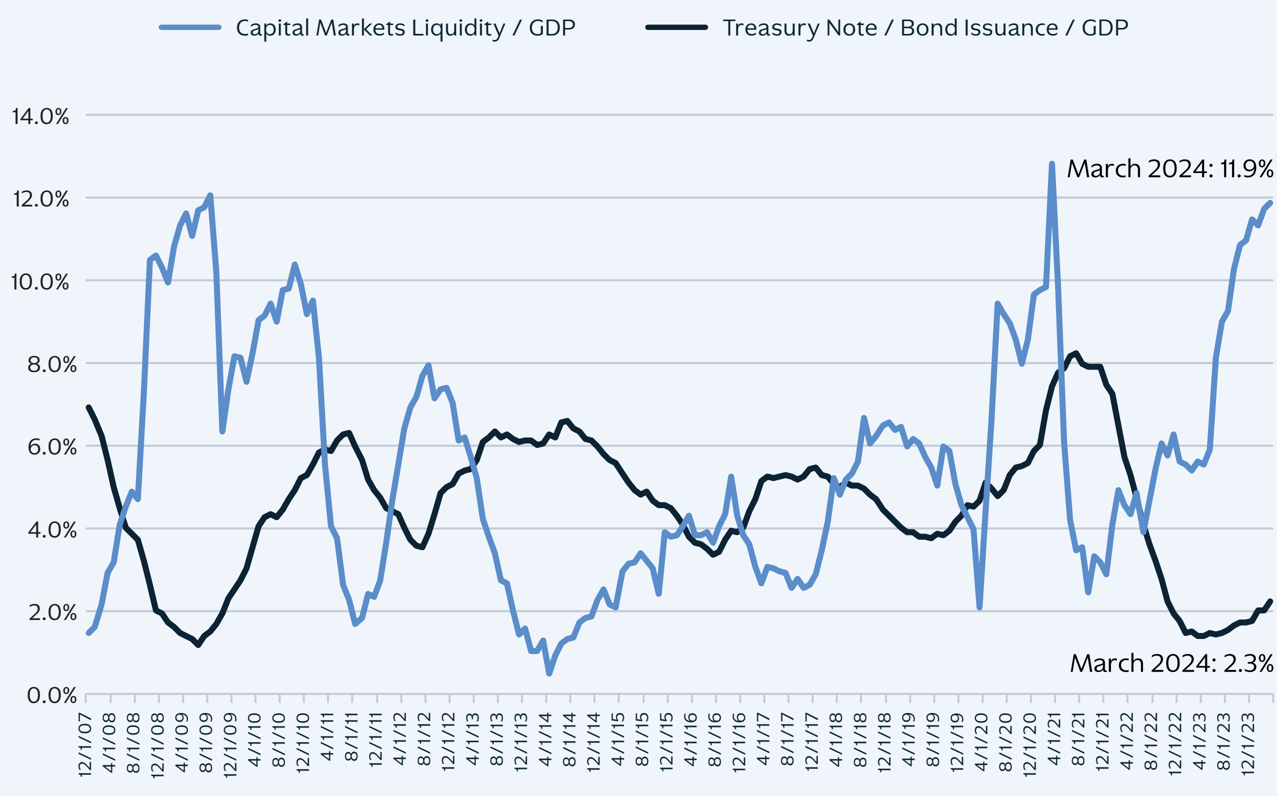


Note: Analysis conducted on MSCI Sector Indices. Source: Bloomberg, MSCI, KKR Global Macro, Balance Sheet and Risk analysis as of May 31, 2024.

The adjustment in valuations is also changing the types of transactions that are taking place in private markets. Public-to-private transactions were prominent in private equity markets in 2023. (We use available private equity data as a proxy for private markets activity in this instance.) The rapid rise in interest rates took an immediate toll on corporate earnings and share prices, encouraging companies to go private or divest non-core businesses. However, take-private activity in private equity markets fell 50% over the previous quarter in Q1 of 2024, as equity markets rebounded.[1]

Meanwhile, we have been seeing more opportunities to invest in privately owned companies, and the industry-wide mix has shifted accordingly. We think the strength in public equity markets this year, combined with a continued narrowing of the private market valuation gap, will shift more of the industry transaction mix toward acquisitions from private holders. The scarce liquidity conditions in the capital markets, which are reminiscent of the Global Financial Crisis (Exhibit 3), present an opportunity for private capital to provide an alternative source of funding.

EXHIBIT 3: Capital Markets Liquidity (Trailing Twelve Months)



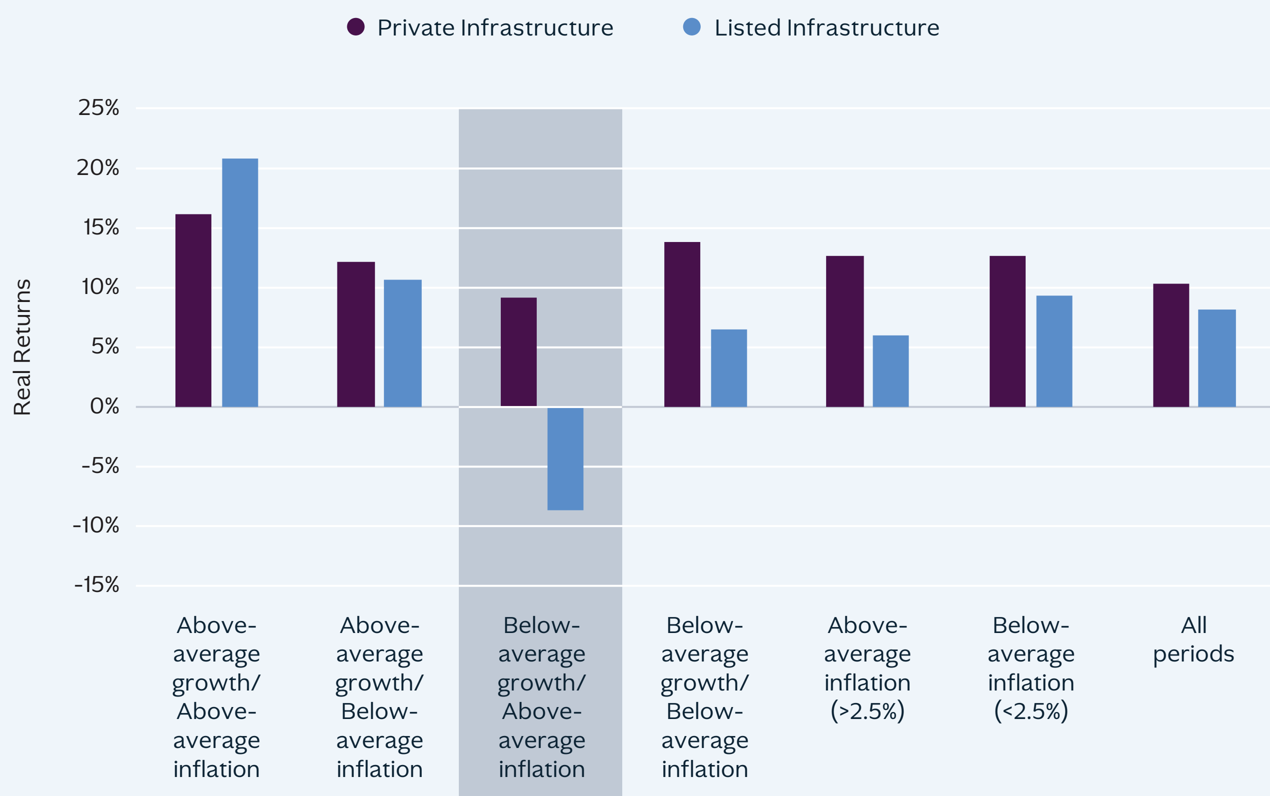
Source: KKR GMAA, Bloomberg, S&P as of March 31, 2024. Liquidity is measured by IPO activity, high yield bond issuance, and leveraged loan issuance.

1 Source: PitchBook "Q1 2024 US Private Equity Breakdown" as of March 31, 2024.

All things considered, our view that 2024 will be a strong vintage for infrastructure has not changed. Our Global Macro & Asset Allocation team expects interest rates to remain higher for longer, with no rate cuts until 2025. This high cost of capital should continue to put downward pressure on valuations, which in turn should lead to continued investment opportunities.

However, we also take a cautious approach to the market. Our macro team's long-term view is that growth is slowing, while inflation is likely to remain elevated. History shows that private infrastructure has outperformed in similar environments in the past (Exhibit 4), but we think our preference for investing in businesses with cushions against economic downturns and with inflation protections is particularly salient in the current environment. As we will discuss later, we are also paying careful attention to policy risk, particularly when it comes to investments related to the energy transition.

EXHIBIT 4: Real Returns Across Different Economic Regimes



Returns modeled using annual total returns from 2002 to 2022. Real returns are calculated using nominal returns after subtracting CPI inflation rates. Below-average inflation defined as CPI < 2.5%. Above-average inflation defined as CPI > 2.5%. Below-average growth defined as real GDP < 2%. Above-average growth defined as real GDP >2%. No representation is made that the trends depicted or described above will continue. Source: Edhec, Haver, KKR GBR analysis.

02 A Renewal in Renewables

The adjustment in private market valuations has been particularly significant in renewable energy investments. Valuations on renewable assets and transaction activity soared in 2021, encouraged by a growing recognition that a vast amount of capital formation will be required to meet the net zero targets set by corporations and governments.

Our allocations bucked the trend. Since inception through 2019, we deployed roughly a quarter of our capital into renewables and energy transition assets. That number dropped to 10% in 2020 and 2021, when we saw increased interest and activity in the sector. This conservative stance served us well when interest rates began to rise, investors discounted long-term growth more heavily, and valuations and deal activity took a sharp downward turn. The higher cost of capital lowered valuations on operating assets and had a dramatic effect on the economics of renewables development.

As my colleague, Tara Davies, Co-Head of European Infrastructure, recently wrote, our Infrastructure team specializes in derisking complex investments and managing them to rerate. With more favorable conditions for renewables investing, we have been able to acquire developers with fundamentals that we find very attractive. We recently announced the acquisition of Avantus, a company that develops utility-scale solar and solar-plus-battery-storage projects in the western United States. The company already has a deep pipeline of development projects, some 30 GW of solar capacity and 94 GW of battery capacity in some of the country's strongest solar markets (Texas, California, Nevada, etc.), which typically have high barriers to entry.

We're also seeing opportunities to help address some of the challenges renewables developers are feeling. In May, we announced that we will seek to form a strategic partnership with Hannon Armstrong Sustainable Infrastructure Capital (HASI), a publicly traded sustainable infrastructure firm, to form a new entity that would invest a combined $2 billion in renewables and asset-backed energy transition investments in the United States.

Looking forward, we continue to feel positive about the renewables sector. A widely cited Wells Fargo analysis predicted that electricity demand in the United States could rise some 20% by 2030, partly due to advances in artificial intelligence. (The infrastructure of digitalization, incidentally, is another key theme we are pursuing today.) As we build our renewables portfolio, we see more opportunities to share best practices and realize the benefits of scale in our supply chains. For example, the leaders of some of our companies came together this year at a forum to discuss decarbonization and net-zero strategies, a best-ideas approach we took last year with our fiber optic cable companies.

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Is Clean Power on the Ballot?

Our upbeat outlook on the renewables sector is generally independent of questions about the future of green energy related to the potential impact of the upcoming U.S. elections. That election comes against the backdrop of a larger political moment: Half of the world's population will have the opportunity to vote in a major election in 2024. However, one advantage of the types of infrastructure assets that KKR looks for is that they tend to be "nonpartisan," addressing critical needs that eschew party politics. In a post-COVID world, we believe key themes such as supply chain resiliency, technology and artificial intelligence tend to create jobs, make economies more efficient, and spur investment, regardless of the political party in power. We saw this up close with the two Telecom Italia-related transactions, announced respectively in 2020 (FiberCop) and 2023 (NetCo), which have both been negotiated with consistent government support through three changes of government. Likewise, both major parties in the United States have come together in recent years to pass major infrastructure legislation, including the Bipartisan Infrastructure Law and the CHIPs Act.

Renewables and clean energy are an area where we see a structural and long-term global need for infrastructure investment. The conflict in Ukraine demonstrated and reinforced the need for energy security, which is inherently tied to the transition to renewable energy. However, in the United States, clean energy investments are more politically complex than other types of infrastructure investments, with increasingly partisan views on climate change interacting with industrial policy, job creation, and national security considerations.

Many of our clients are asking whether we think there is an electoral outcome that will result in the repeal of the Inflation Reduction Act (IRA), which is providing hundreds of billions of dollars in funding and tax incentives for clean energy innovation, research and development, and deployment. Informed by the views of our colleagues Ken Mehlman, Global Head of Public Affairs, and Neil Brown, Managing Director of the KKR Global Institute and a member of our Infrastructure team, we think it is unlikely that the IRA will be fully repealed. Many districts on both sides of the aisle are benefitting from projects enabled by the legislation. However, certain programs within the IRA, along with specific regulations, could be vulnerable. Discretionary spending programs depend on who occupies the White House, and Congress could consider targeted IRA tax code revisions; thus, we feel confident in continuing our time-tested view of discounting reliance on future public funding. We think that companies that have locked in funding are less risky investments than companies that are counting on funds being approved or allocated in the future.

We have long known that global policies will fluctuate, and so will the subsidies and funding that come with them. However, investment in renewables is a structural trend that is not going away. Renewable energy capacity has grown for the last 22 years in a row, and the International Energy Agency expects that global capacity will increase more in the next five years than in the century since the first renewable energy power plant was built.[2] Beyond renewables, we see a wider-range of clean energy companies coming to scale with proven business models, including in areas such as fleet electrification, smart meters, and behind-the-meter solutions. While global policy trajectories are strongly positive for clean energy, how that plays out in specific policies and funding streams will always be uncertain. However, we think that demand for clean energy will continue and create substantial investment opportunity for disciplined investors.

2 International Energy Agency. "Renewables 2023: Analysis and Forecast to 2028." January 11, 2024. https://iea.blob.core.windows.net/assets/96d66a8b-d502-476b-ba94-54ffda84cf72/Renewables_2023.pdf

03 Changes in the Infrastructure Landscape

At a time of macroeconomic uncertainty, high inflation, and elevated interest rates, investors are becoming more interested in allocating to infrastructure. In a November 2023 survey, 89% of investors said they were interested in either allocating more capital to infrastructure or maintaining their current allocation in the coming year, and nearly all of them said the same when they were asked about longer term plans (Exhibit 5).

At the same time, there has been a flurry of consolidation in the industry. The increased demand for real assets and diversified sources of return in an inflationary environment has encouraged several large financial services firms to launch or seek to grow infrastructure investing businesses. On the other side of the ledger, we have seen several independent infrastructure firms seek to crystallize the value they've created to date in starting and building their investment businesses.

The changes in the competitive landscape have not impacted our approach to the market. We believe we are well positioned to benefit from our stable platform, consistent leadership, deep bench, and a proven approach to the market that has helped our infrastructure investment platform grow to some $65 billion since 2008.[3]

We see the trends in the marketplace as a validation of infrastructure as an asset class and the increasingly important role real assets are likely to play in investor portfolios going forward. We continue to think that 2024 will be a rewarding vintage year for investors, while also believing that we are in the early stages of the infrastructure investment story. The opportunities that lie ahead are not just in the second half of this year, but also in the years to come.

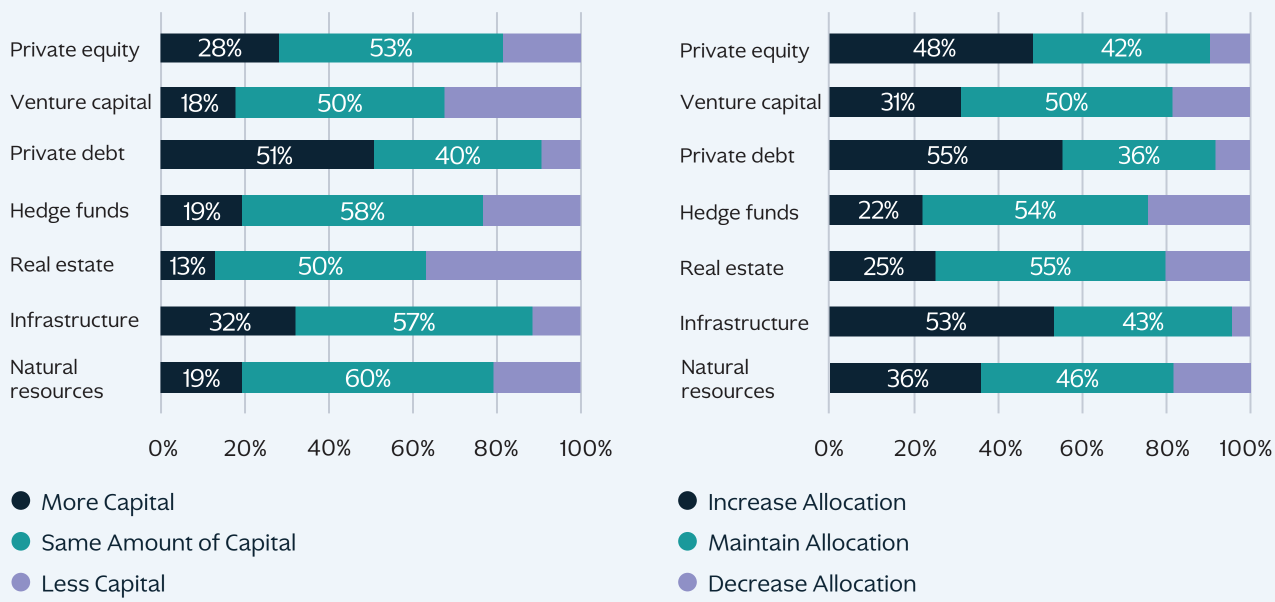
EXHIBIT 5: Investors' Attitudes toward Infrastructure Allocations

Investor Investment Intentions

Investors were asked: In the next 12 months how will you invest in the following asset classes, compared to the last 12 months?

Investor Allocations Intentions

Investors' intentions for their alternative assets allocations over the longer term.



Source: Preqin Research Insights' Investor Survey as of November 2023.

3 As of March 31, 2024.

DISCLOSURES:

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
212-750-8300

www.kkr.com