RPM Ep. 50 | Now is the time for infrastructure secondaries with Tim Rees

Micheal Venne: Hi and welcome to RPM. Today we're going to be discussing infrastructure secondaries. Now, as an asset class infra is relatively new making infra secondaries newer still. Tim, I'm sure you're getting a lot of questions from clients. So, hopefully we'll address some of the more burning ones today. Before we get started, tell us a little bit about yourself and how long you've been with Stepstone etc.

Tim Rees: Yeah. Hi, I'm Tim Rees. I'm a partner on the Infrastructure and Real Assets team based in London, although I've also spent time working out of Stepstone New York office. I've been with the firm for about 11.5 years at this point. So being part of of the exciting journey that has been StepStone and now lead our activities on the infrastructure secondary side of the business.

MV: That's wonderful. I mean, so let's go to some level setting. You've been infrastructure investor for over a decade now. Fundraising last year hit something like $84 billion, according to some estimates. Now, that wasn't always the case. Can you just talk about how much infrastructure has grown since you've been an investor.

TR: Yeah, I mean, you touched on it in the intro. Infrastructure as an asset class is relatively new in comparison to some of the other private markets asset classes that are managed by Stepstone, notably private equity venture real estate. Um, a little bit like private credit. This is really a post GFC sort of emergence in most LPs portfolios. It's really become a sort of material part of the thinking in asset allocation exercises in that time. And so there has been a humongous growth in the market as LPs have increased their allocations.

Um, in the past, you know, 15 years or so, while also there being a substantial number of LPs that have added infrastructure to their portfolios for the first time. And that continues to be a lot of LPs out there that are still thinking about infrastructure as a potentially new component of the asset class. So you talked about fundraising, you know, last year. Where does that take us? Well, overall, AUM in the infrastructure market is somewhere around $1.5 trillion today. So it's now a significant part of the private markets ecosystem. But it's been a rapid growth. So looking back over the past ten years, it's been a dagger of sort of 15% annually in terms of overall growth. Um, a little bit above that. So it's now a significant part of the ecosystem. As I mentioned, when you think about where we started in infrastructure, a handful of GPS, uh, raising sort of first vintages in that immediate, um, you know, wake of the GFC, probably only, you know, a very small handful that had any sort of proven credentials prior to that. We're now tracking more than 250 distinct infrastructure GP strategies. Um, in our dashboard, uh, we have a group of over 75 of those strategies that are in their fourth vintage or beyond. So the market growth has been significant. You also have a huge increase in the maturity of the asset class in comparison to only a few years ago.

MV: I mean, and part of the maturity of any asset class is the emergence of a secondary market. How big is the infrastructure secondary market and how large do you think it will become?

TR: Yeah, it's a great question. So depending on which source you use, the infrastructure deal volume in 2024 was somewhere between 15 and $20 billion. And that's a substantial growth over the previous peak. So the number that we cited in our our white paper was 16 billion. And that was 30, 33 0% above the previous maximum annual deal volume. So now a pretty material component of the overall secondary market, give or take 10% of total secondary deal volume, you know, which is again a huge growth in comparison to where it was historically, which was really a secondary thought. Um, forgive the pun. Uh, in in really the secondary consideration, there was the odd trade. In infrastructure secondary specifically, you might see some positions thrown into a more diversified portfolio. But today, um, you know, it really is an established part of, of the market in aggregate.

If you think about where it can go, you know, it really, uh, it's really got a lot of room to run once you start talking about the nav growth that we, we just discussed. Um, the increased and continued maturity of the market based on some conservative assumptions that we'd used. Um, on those numbers, we think it could get to 30 billion or more by 2030. And if you use the sort of current trends and growth history in the market, that number could exceed 40 billion. So again, a huge growth opportunity in terms of total deal volume. Uh, in the in for a secondary market.

MV: From your perspective, what are the main driver of this growth is it? Lp is looking for liquidity. Is it wanting to hold on to marquee assets? Is it all of the above?

TR: It's a little bit of all of the above. I think you can bifurcate the market a little bit in some of the drivers. So I'll split it into the LP interest trade. So um, what often people think about as the traditional part of the secondary market where an existing LP and a primary fund decides to sell their stake, and then the other part of the market that is now a very significant component is the GP led market, so typically characterized as as continuation fund, single asset or multi-asset. That could also include tender sales, strip sales, spin outs of GP's, etc.. On the LP interest side, I think there's really two significant drivers. One is the overall AUM growth in the market. If you think about the theoretical size of the secondary market on the LP interest side, it's every infrastructure LP position that is owned. Anyone could wake up tomorrow and decide they want to sell that position. So when your market is growing at a mid-teens level in terms of overall AUM, you expect that to flow through to growth in secondary volumes at some point in the future. That's assuming a consistent and steady rate of sales. The other part of things that I think will drive a growth on the infrastructure secondary side specifically, is the ongoing maturity of the market.

TR: So in any given year, historically, looking back over the past ten, the percentage of total AUM that has traded via the secondary market, the LP interest secondary market in infrastructure has been below what you've seen in the overall private market in aggregate. The reason for that is the asset class is less mature.

So there hasn't been the same rationale for people to be selling infrastructure LP stakes as there might be in in private equity or real estate where people have got more mature portfolios. They're looking to rationalize the number of GP relationships that they have. They might have decided not to re up to a manager and sell out. They might hit their overall Nav target for infrastructure as part or for an asset class as part of their broader portfolio within infra, because it's a newer part of most portfolios, people have been chasing a Nav target, adding to their allocation. And so selling has been a less significant focus for them. So as we continue to see the maturity of LP portfolios, I think you're going to see a greater percentage of those positions. Outstanding trade. So you've got those two parts acting in concert, an overall bigger market to trade, and what we expect to be a bigger percentage of the market trade in aggregate.

TR: So those are really two of the sort of, you know, macro trends, if you will, that are driving deal flow on the LP interest side on the GP led side. This is a more recent sort of development in the secondary market broadly, and so infrastructure is really moving along at the same pace as what you've seen in other subsectors. So GP led secondary is becoming or have become a significant component of the private equity secondary landscape, the private credit landscape, you know, recapitalization or GP led secondaries have been a material component of the real estate market that our colleagues on the real estate side have pursued for a long time. So we're really continuing to develop at the same rate as others. And I think to your point, part of that is GP's wanting to continue to own high quality assets and LPs wanting to retain control of high-quality assets that they, you know, have within their portfolios. So there are times when that, you know, GP led continuation makes sense for multiple parties. So I think that is some of the significant drivers that we're seeing to growth in the two components of the market.

MV: That was great, Tim. Thanks. I want to talk a little bit about maybe synergies. You know, we talk a lot internally and with our clients about the importance of having a multi strategy view to the private markets, you know, leveraging primary secondaries and investments to bring to bear the full potential of the private markets. Can you talk a little bit about why, you know, having a primary and a co-investment platform is critical to finding success in secondaries.

TR: Yeah for sure. Um, so if you think about what a secondary is, um, at its heart, it's there's really two significant components to it as we see it. Obviously, you are underwriting assets. At the end of the day, you are looking through the portfolio companies that are included in the deal that you're doing. You're assessing the current valuation that the GP is carrying that asset at, and then you're making an assessment of what the return potential is for that asset on a go forward basis. Fundamentally, that looks a lot like the work that you are doing on a co-investment. You're assessing value for an asset in a in a deal today, and you're trying to predict what the return potential is for that asset on a go forward basis. It's just spread across multiple assets. The second component, and I think what you need to be able to do to assess whether you want to do a secondary deal with a given GP, is assessing how good that manager is at driving value for their assets. Are they the right person to be owning this asset on a go forward basis? Do they have a proven capability of driving operational value creation in that given subsector? That part of the underwrite is really informed for us, at least by a lot of the work that we do on the primary side.

TR: So the due diligence processes that we go through on funds, on GPS informs our thinking on secondaries. It allows us to aggregate data on those given managers. It allows us to build relationships with those managers that can help us with sourcing, can help us with execution. So at the end of the day, secondaries for us is kind of viewed as, you know, able to benefit from the advantages that we've created with our market leading co-investment and primary investment franchises. That's really, I'd say, our key competitive advantage. It's not the only way to do secondary deals. You know, there are plenty of people out there that take a slightly different approach. Our secondary specialized as an only business line within what they do. But for us, you know, that information advantage created by that co-investment activity by that primary activity is really integral. I would say to our secondary strategy.

MV: And how much of our maybe historical secondary deal flow has originated from a co-investment?

TR: Yeah. I mean, I would say rather than originating deals from co-investment. What we're able to leverage is the insights that we have gathered from co-investment. So looking back on all the secondary deals that we have done within the infrastructure space, a little above 25% of the portfolio companies within those deals, we have reviewed a co-investment in those assets, about half of that. So, you know, give or take 12 or 13% of the total portfolio companies that we've purchased via secondary. We have an active co-investment exposure to that portfolio company.

MV: A level of insight that you couldn't get through a typical like a broker. Completely secondary. Yeah.

TR: That's right. And so what do we gather. It's you know, it's underwriting thinking how is the GP thinking about the return potential, the risk profile of that underlying asset. Um, its key metrics on, you know, future forecast growth of that given asset. So not only do we have the detail from the time of underwrite that we can leverage as part of our thinking. We also have real life insights into the ongoing performance of those deals where we have co invested, so you can track on a quarter-to-quarter basis based on that, um, you know, co-investment, how it's performed against its business plan, how it's tracking what you think budget might look like in the in the years to come. That's a level of detail that, to your exact point, isn't available to the average LP in a fund. It's certainly not available to someone that is not an existing investor. Um, with that GP. And so those insights factored directly into the the secondary underwrite that we're looking at, we'll use it to model out, um, you know, EBITDA growth will use it to inform our assumptions on multiples or discount rates that would be used on exit. You know, those are key data points to our underwriting and something that we wouldn't have without the synergies created from our co-investment business.

MV: You know, I think on a related topic, um, we talk a lot about data in the paper and the importance of having it and the value that it creates and underwriting secondaries. Everyone claims they have data and that they use data. But how does our data and our approach to it differentiate us in the infer secondary space?

TR: Yeah. So look, I think Stepstone as a whole is a data led firm. So it's it's a key part of, of the way that we think about things. And I think both the primary work and the co-investment work builds the funnel to aggregate that data. So in terms of co-investment, to put it into perspective, we're typically reviewing 2 to 300 deals in a in a given year. Multiple hundred funds are being reviewed will produce 80 give or take fund summaries or one-page overviews of primary funds in a given year. If you think about those co-investment reviews, those primary fund reviews, all of that provides information, insights, data that we can utilize through our investment process, as I highlighted. So whether it's using our internal sort of database systems by, by Stepstone, whether it's the reporting information we receive from the underlying funds, all of those data points are valuable and can be used. There's a couple of specific sort of data tools that I think flow through very well to our secondary underwriting on the infrastructure side. One is the Stepstone Infrastructure Risk Index. It's a proprietary model that we have built to assess effectively a risk return balance for any given infrastructure deal. So it takes a range of qualitative and quantitative factors for each portfolio company and assesses a risk score and will tell you what an appropriate return is for that given asset.

TR: Now, to run the index, you need a full deal model, which is typically not available in LP interest secondaries, so it can be used real time in GP led deals when you're provided with a full asset model. But the other way we can utilize it is looking back on the risk index assessment that we have built on co-investment that we've looked at in the past, that are now portfolio companies in the secondary deals that we're reviewing so commonly. You know, a deal will come up and we'll look through it and say, look, we've seen co-investment in, you know, 3 or 4 of these portfolio companies. We'll go back and review the infrastructure risk index scoring that we had put together. What were the key risks identified? Is there, you know, much more Capex being assumed than a comparable business in a comparable sector in a comparable region. If so, why is that? How much were you paying in debt? Why did the banks assume that the cost of debt would be higher? So all of these individual metrics you can run through and compare, it's not going to give you the perfect answer in the way that you underwrite a secondary, but it's giving you more information to consider as you go through that underwriting process.

So I think that one is key. The other tool that we've been using a lot is an assessment of realization premiums upon exit.

TR: So looking through the historical exits that have been achieved by a GP and seeing what sort of premium they've been able to deliver above and beyond their carrying value, obviously, in a secondary context, if you can buy a portfolio company and sort of expect that it can be, um, or underwrite that, it can be, you know, realized that a premium to the GP's Nav in a forward basis, that's super helpful for your process. And so looking across the history, you can start inferring to some extent how conservative or aggressive you think a GP's typical approach to valuation is. Again, it doesn't give you the perfect answer and particularly in a um, call it a more challenging exit environment than probably what we have seen in the infrastructure world for the past 5 or 6 years. You have to be careful about not assuming that historical premiums will continue, but it's a useful insight to think about as you're going through that secondary valuation. That model, at the end of the day, relies on insights from history. And so the more data points you have, the more thoughtful you can be in the in the way that that you assess the data. So those are two of the key tools I think we've been thinking about and using on the infrastructure secondary underwrite side, leveraging the data that we're pulling from our primary and co-investment work.

MV: What advice would you give to an LP that is either new to infrastructure as a whole, or maybe has an existing allocation to infrastructure, but hasn't participated in secondaries yet? What advice would you give to somebody just starting to maybe kick the tires?

TR: Yeah, I think probably what you've taken away from some of the comments so far is that we're super excited about the opportunity in infrastructure secondaries. I think the growth is going to come. That Nav is coming. The maturity of the market is coming and so the opportunity is vast. I think the flip side of that, that makes us even more excited is that the market is actually relatively undercapitalized. So the amount of dedicated dry powder available, um, within infrastructure, secondary focused funds or infrastructure, secondary focused pools of capital is not very large.

The estimate is it's give or take 14 or $15 billion. So it's only about a year's worth of deal flow, if not slightly less. In the infrastructure secondary world. So that supply demand dynamic is very much in the favor of, of buyers, um, which creates a really good pricing opportunity for those people that can underwrite deals in this space. The logical sort of question is, well, if there's that great opportunity, why aren't more people entering the space? And I think they will. You know, people are seeing the opportunity and established secondary players are thinking about how they can grow into the infrastructure world.

TR: But the challenge for them is it is a specialized asset class. You don't underwrite infrastructure, assets or companies in the same way that you do private equity. There are different risks. Um, there's different opportunities to create value. There's different GP's that you need to build relationships with to source. So it's it's not going to be easy for that supply demand balance to shift. So my advice to people that are thinking about a commitment in the space is, is do it. Um, you know, honestly, whether it's with us or with someone else, I, I feel like the next, um, you know, 2 or 3 vintages in the infrastructure secondary world are going to be strong. Um, given that supply demand imbalance, given the opportunity that we see coming. So find a way of getting exposure to the market, we think there's potential to, um, you know, generate pretty good outperformance in comparison to primary fund commitments based on those discounts, based on your timing of entry and with lower risk, because you don't have the same blind pool sort of risk being taken on. So that is my advice. Make commitments to infrastructure secondaries.

MV: Um, maybe one more practical consideration that I wanted to ask you about. And it is related to diversification. GP Leds have accounted for most of the secondary volume. And simultaneously, fundraising is kind of increasingly concentrated in mega funds. How should LPs think about these forces from a portfolio construction standpoint?

TR: Yeah, I think both great questions. Secondaries in its nature should be a diverse pool of of investments. You're making investments into ten, sometimes hundreds of funds within a given portfolio. Therefore hundreds and hundreds of portfolio companies, the single asset continuation funds obviously bring a different investment proposition.

Those are, to your point and by nature, more concentrated, so you have to size them appropriately in a portfolio. I think is is point number one. And point number two is you have to be pretty confident in the underwriting that you're doing on those, those companies to justify a position within a secondary portfolio. So it comes back to, to underwriting, um, you know, quality and, and capability. If you are going to invest in a secondary fund, you want to make sure that if they are going to be doing single asset continuation vehicles, they can underwrite infrastructure assets very well. So I would say specialization is an important component of that. The other point that you mentioned in concentration in in large cap or mega-cap within infrastructure is, I'd say, an increasingly popular topic of conversation, um, with infrastructure LPs. We wrote a white paper a couple of years back. I think it was covered in a podcast about the opportunity in the infrastructure mid-market, which we continue to believe in. It hasn't quite developed in the same way as the private equity market, partly because of the immaturity of the asset class.

TR: But we're seeing some really great opportunities in the mid-market broadly, whether it's primaries, whether it's co-investment, whether it's secondaries on the secondary side. I think, you know, the relationships that we have built with GP's that are operating in this space from primary commitments, from co-investment that we've done, give us a strong point of differentiation. So we do feel like that's something that, you know, that our secondary strategy offers that, you know, maybe others don't have the same angle on. You know, we can do deals with people that we know in the mid-market that may not be as strong a relationship for some of our competitors that don't have that primary capital, that existing relationship with smaller managers that don't trade on the secondary market as often, that adds to diversification, whether it's building diversification within, you know, add products. So adding mid-market alongside exposures in some of the larger, um, you know, cap managers. It also allows. Lp’s that are considering a commitment to our fund to think about that being a diversifier within their broader portfolio. So, you know, they would know that committing to a vehicle managed by Stepstone is likely to provide them with mid-market exposure. That could be a nice complement to, uh, commitments that they have elsewhere if they are concentrated in some of the larger cap names in the market.

MV: Tim, this has been excellent. Thanks a lot for your time, and hopefully I'll see you in New York in a few months.

TR: Yep. Looking forward to it. Um, I'm sure I'll be there extolling the virtues of infrastructure secondaries again. So look forward to seeing you and anyone else that wants to chat through the market further. Take care. Thank you.

MV: Thanks for tuning in to this episode of PM. To download a copy of our white paper on Infrastructure secondaries. Head to Stepstone Group. Com. You can watch this episode on our YouTube channel or listen on your favorite podcast application.