NAVIGATING INFRASTRUCTURE INVESTMENTS IN A SHIFTING ECONOMY

The impact of federal rate hikes on funding, joint ventures, and securitizations

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Since the beginning of 2022, the Fed has hiked interest rates 11 times seeking to tackle elevated inflation with tighter monetary policy, resulting in an increase in the cost of capital. Over this same period, the 10 Year Treasury Rate has nearly tripled from under two percent to over four percent. Furthermore, the 30-day Secured Overnight Financing Rate has increased from near zero to over five percent, and the S&P 500 has declined over five percent through the end of November.

The higher cost of capital and the reversal of the post-pandemic supply / demand imbalance in infrastructure allocations has impacted fundraising and investment in our sector. Infrastructure fundraising peaked in 2021 at 162 billion USD as investors found themselves underweight in the category while the pandemic highlighted the importance of connectivity. In 2023, amidst a backdrop of increasing cost of capital, infrastructure fundraising has reached only eight billion USD as of writing this article. Additionally, the initial surge in infrastructure deal-making has slowed significantly, decreasing from a 2021 peak of 522 billion USD to 248 billion USD in 2023 year-to-date. This large slowdown in infrastructure investing activity has led to a build-up of dry powder, which has resulted in ample capital to pursue attractive opportunities. As of the halfway point of 2023, infrastructure dry powder stood at 132 billion USD.

Downside Protection in Focus

The rising cost of capital has negatively impacted asset valuations, tightening the supply side of the market as investors seek to avoid realizing losses and taking markdowns on existing investments. Greater market uncertainty has enhanced investors' focus on downside protection, thereby increasing the utilization of structured securities in order to balance attractive growth opportunities with risk mitigation. For example, in connection with our transaction involving Shentel's recent acquisition of Horizon, Energy Capital Partners made an 81 million USD preferred stock investment into Shentel to fund the company's fiber network expansion. Similarly, in our transaction

with GoNetSpeed, we recently raised a 125 million USD preferred equity investment from Ares and Macquarie Capital to accelerate the company's fiber build.

High Quality Assets Still Commanding Premium Multiples

Despite the more uncertain macro environment, high quality growth assets are still commanding premium multiples. For example, rapidly expanding hyperscale data centers continue to see demand for the establishment of joint ventures at six to seven percent cap rates as investors underwrite the economic impact of artificial intelligence (AI) and other secular growth tailwinds. Valuations in M&A transactions have remained resilient for hyperscale and interconnection-oriented data centers with long duration customer agreements. KDDI's one billion USD acquisition of Allied Properties' data center business and Brookfield's 5.6 billion USD acquisition of Compass are both recent transactions that were valued in excess of 25x EBITDA. Investors are increasingly prioritizing attractive growth opportunities; however, we are also seeing the early signs of value investors engaging with more challenged situations.

We are at an inflection point for data center capacity requirements, fueled by strong demand for generative AI adoption. Over the last 90 days, more than 2GW of data center leases were signed in the US, which compares to the entire third-party US data center market at ~10GW. This unprecedented demand for data center capacity is creating attractive expansion and investment opportunities.

Joint Ventures

Post-pandemic, off balance sheet joint venture structures have risen in popularity due to partnerships between strategics and financial sponsors. The commitment of anchor tenant customers, as seen in AT&T's Gigapower joint venture with BlackRock, has brought renewed attention to the open access fiber-to-the-home model, which had previously struggled for many years to gain significant traction domestically. Today, the increased potential for symbiotic partnerships with high-quality leading consumer brands is supporting investors' ability to underwrite the early days for open access networks in the US.

Infratil's and HKT's strategic partnership with Console Connect, a leader in software-defined interconnection, represents another unique joint venture structure. In this two-step transaction, Infratil will own 60 percent of Console Connect at initial close and fund new subsea cable development projects in exchange for full ownership of the assets while HKT can leverage technology investments beyond the infrastructure layer. The combination of Infratil's strategic partnership with HKT's global backhaul is expected to accelerate Console Connect's growth profile.

Securitizations

Despite the higher cost of capital and greater uncertainty in the credit markets, we have seen the resurgence of more creative financing structures, including borrowing base facilities and securitizations. These structures offer a step-function improvement in the average cost and quantum of capital available to digital infrastructure companies across a broad spectrum of sizes and stages of financial maturity.

Hyperscale data centers are particularly suited to securitization financing due to their fundamental business characteristics—multi-year contracts, high customer retention rates, investment-grade rated tenants, and real estate ownership—that support attractive fixed cost structures even amidst a more volatile macro backdrop. For example, this year, Stack Infrastructure priced three securitizations with coupons of 5.9 percent, and Cyrus One priced a securitization with a weighted average coupon of 4.5 percent. In addition to providing a low blended cost of borrowing and greater portability, securitization enables investors to capitalize on higher leverage while benefiting from leveraged equity upside.

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