Fundamentals of infrastructure secondaries

Stepstone

The secondary market has been a hot topic of conversation across private markets throughout the 2020s. Continued growth in deal volumes driven by overall private markets net asset value (NAV) growth and the ongoing evolution of the general partner (GP)-led market, along with increased activity in the secondary GP universe—through new strategy launches and merger and acquisition (M&A) activity—has brought secondaries to the forefront in limited partnership (LP) conversations.

As a less mature private market sector, infrastructure has not always been a major part of the secondaries conversation; however, this is changing as deal volume has grown markedly in the past few years. While the specifics of those conversations vary from one LP to the next, they do share a common interest in understanding the fundamentals, which we explore in depth in this whitepaper.

The opportunity

Like other asset classes, infrastructure's secondary market includes two distinct components: LP interest and GP-led deals.

- In an LP interest deal, LPs sell their stakes in private market funds to another investor. LPs may seek to exit their positions owing to reasons including portfolio rebalancing, liquidity requirements and strategic reallocation.
- In a GP-led deal, the fund manager initiates a sale to offer liquidity for existing LPs. The GP retains control of the asset(s), which are often transferred to a new vehicle. Existing LPs are typically given the option to either liquidate their position or reinvest. GP-led deals can take many forms, for example, single-asset or portfolio continuation vehicles (CVs), tender offers or strip sales.

While each type of deal has different characteristics and drivers, common tailwinds are propelling the market in aggregate.

Secular tailwinds

Despite its prevalence and stable position in investors' portfolios today, infrastructure as an institutional asset class is young relative to private equity, venture capital and real estate. Largely establishing itself in investors' portfolios in the low interest rate environment that came out of the Global Financial Crisis, the infrastructure GP and LP landscape has evolved significantly in recent years as the market has matured.

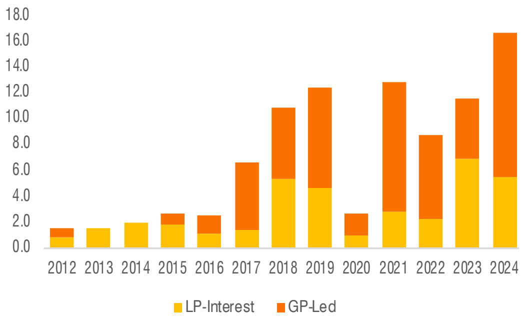
Because infrastructure is a relatively recent addition to most investors' strategic asset allocation, most LPs have been working to ramp up their infrastructure exposure to meet target allocations. Consequently, capital is flowing into the asset class. Assets under management (AUM) has grown rapidly—compounding at a CAGR of 17% from 2014 to 2023.

The number of GPs in the infrastructure market has also grown significantly in response to this demand shift. In the early 2010s, only a handful of infrastructure GPs had a credible, longstanding track record. Today, we track more than 260 distinct infrastructure GP strategies, over 75 of which are in their fourth vintage or greater.

These factors contribute to the large and rapidly growing opportunity in infrastructure secondaries as illustrated by Figure 1. Secondary market brokers report that 2024 volume exceeded US$16 billion—a new record, 30% higher than the prior peak in 2021 when deal volumes were elevated to address pent-up supply that had carried over from a pandemic-affected 2020.

Even with 2024 representing a record-setting year, we believe there is still significant room for the market to grow in both LP interest and GP-led deal volumes.

Figure 1. Infrastructure secondary deal volume (US$ billion)



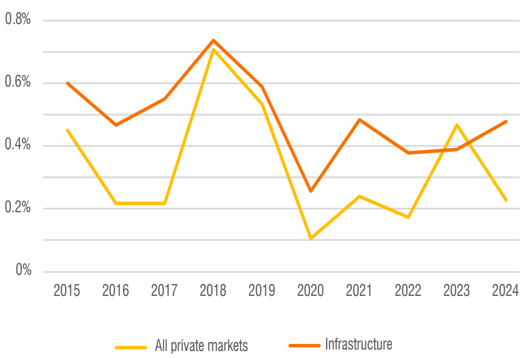
Source: Campbell Lutyens.

LP-interest market

Stepstone believes two factors will drive market growth in LP interest deal volume:

- Continued AUM growth: The total addressable market (TAM) for LP interest deals is effectively the market AUM, since every position could be traded theoretically. As noted above, we expect TAM to continue growing at a high-double-digit CAGR given sustained strong demand.
- Increasing market maturity increases secondary market usage: As the infrastructure market matures, the percentage of AUM that trades should also grow to be more in line with other private market asset classes. As shown in Figure 2, the percentage of infrastructure AUM that has traded via LP interest secondary has been lower than the private market average in all but one year.

Figure 2. LP interests as % of AUM



Source: Campbell Lutyens, Preqin and StepStone analysis.

With these two factors acting in concert, the growth potential in the infrastructure secondary market is vast.

Even if we were to assume—conservatively—that TAM will grow at a 10% CAGR going forward (versus ~17% over the past 10 years), total infrastructure AUM would reach ~US$2.9 trillion by 2030. If the infrastructure secondary market continues to develop and mature as we expect, and total LP interest trades as a percentage of AUM match the 10-year median for all private markets, infrastructure secondary LP interest volumes could reach US$14 billion by 2030, more than double the volume traded in any year until now.

GP-led market

It is harder to predict how much the GP-led market could grow, since deal flow is typically quite lumpy; fewer but larger deals characterise the market. It is also harder to infer potential growth from other asset classes since the GP-led market is developing concurrently across the private markets.

Nonetheless, several drivers point to continued growth in GP-led deal volume in infrastructure:

- *High capital intensity of high-growth sectors*: Infrastructure assets tend to be capital-intensive. This rings particularly true for energy transition and digital infrastructure assets, where vast capital investment is required to meet global needs for decarbonisation and connectivity. The combination of capital intensity and long timelines can make platforms in these sectors strong candidates for GP-led investments when attractive growth opportunities persist beyond the hold period or capital availability of a closed-ended fund.
- *Mixed liquidity needs of LPs*: While some LPs are still clamouring for liquidity, others may prefer to see GPs continue compounding returns within high-quality assets to avoid reinvestment risk in a slower deal-making environment. GP-led deals afford the opportunity to provide a liquidity option to LPs that would not otherwise be available through more traditional exit routes.
- *Desire to hold the highest-quality assets*: Though not unique to infrastructure, GP-led secondaries have allowed GPs to keep their most prized assets. In a world where direct investors or open-ended funds with perpetual investment horizons can take high-quality assets out of the investable universe, the opportunity for a GP—and its LPs—to retain ownership of a top-quality asset for an extended period of time can be appealing.

While total annual volume fluctuates significantly, it is clear that the above trends have supported significant growth in the infrastructure GP-led market. From next to nothing in the early 2010s, GP-led secondaries have represented two-thirds of the total infrastructure secondary deal volume since 2020 as depicted in Figure 3 on the following page.

The quote

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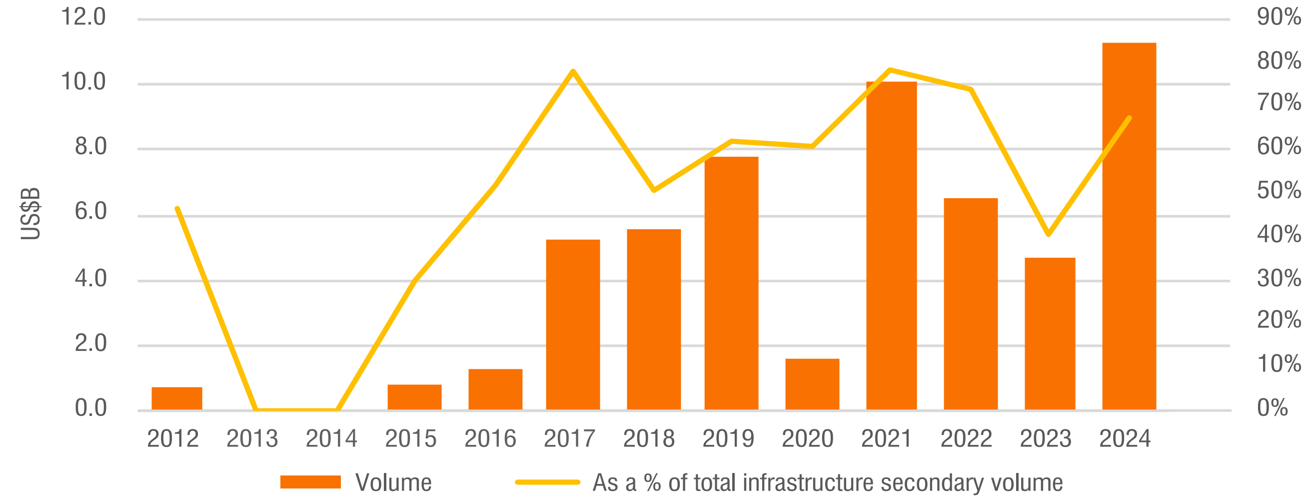
Figure 3. Infrastructure GP-led volume



Source: Campbell Lutyens, Preqin and StepStone analysis.

Conservatively assuming that GP-led deals represent half of the total infrastructure secondary market going forward, GP-led volume would match our assumed volume for LP interest trades (~US$14 billion) by 2030, in line with total 2024 infrastructure secondary deal volume. But if GP-led volume represents two thirds of total infrastructure secondary deal volume, as it has in three of the last four years, this would imply more than US$28 billion of GP-led deal volume by 2030.

What is DPI?

The distributions to paid capital ratio (DPI) represents the cumulative distributions paid by a private equity fund to its limited partners, relative to the amount the partners have invested. DPI is also known as the realisation multiple.

Future market sizing

Adding these two components together, the secular trends supporting the infrastructure secondary market suggest that even under what we believe are conservative assumptions, annual infrastructure secondary deal volume could reach almost US$30 billion by 2030—just under double current levels. If current trends continue, it is plausible that the market could even exceed US$40 billion.

Market dynamics

Driven by these secular trends, infrastructure secondaries may represent a multi-vintage opportunity for LPs. While we expect these trends to persist over the long run, certain factors also make infrastructure secondaries particularly compelling in the near term.

Denominator effect

Although denominator-driven sales peaked in 2023, we are still engaging with sellers who want to rebalance their private market allocations now that pricing has improved.

Slower DPI

A slowdown in distributions due to reduced M&A activity is leading some LPs to use secondaries as an alternative means of generating liquidity. Strong, vocal demand for DPI is partly responsible for the rise in GP-led deals as fund managers look to strengthen rapport with their most important LPs and demonstrate strong exit activity in older funds, which can support capital raising for future vintages.

Relatively attractive pricing

Infrastructure valuations have held up well through recent market volatility compared with other asset classes. In aggregate, pricing discounts to NAV are typically tighter in infrastructure because of the stable cash flow profiles of the underlying assets. These factors combined can make pricing of an infrastructure divestment appear more compelling to vendors.

Attractive vintages nearing sweet spot for LP interests

Secondary investors typically prefer to purchase funds that are substantially allocated (i.e., have limited blind pool risk), are in the value creation phase, and on the upslope of the J-curve.

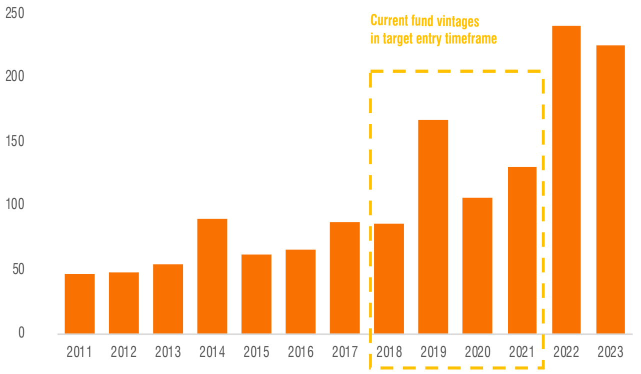
Ideally, they are looking for a portfolio that is old enough to provide a sense of when they might expect some liquidity but young enough that the underlying assets still have room to appreciate.

When this sweet spot materialises varies from fund to fund, but it usually happens four to seven years into a fund's life. As shown in Figure 4 on the following page, this corresponds to periods of strong infrastructure fundraising. In the coming years, more recent vintages that represent even stronger infrastructure fundraising will move into this window, further underscoring why we regard this as a multi-vintage opportunity.

Small pool of specialised infrastructure secondary buyers:

Despite significant growth in infrastructure's secondary market, the number of new managers seeking to raise funds has been relatively limited, likely owing to the specialised skillset needed to succeed in what is a highly specialised asset class. This shortage

Figure 4. Capital raised by fund vintage (US$billion)



Source: SPI by StepStone.
Note: Includes capital raised and funds that are still raising, at their target size.

suggests an inefficiency from which investors could benefit.

A 2024 survey of infrastructure secondary buyers estimates there is US$14 billion of infrastructure secondary-focused dry powder available, representing only 7% of total secondary dry powder available. This results in a ratio of dry powder to annual deal volume of less than 1.0x. With market estimates for dry powder—including forecast fundraising—to annual deal volume should equal 2.5–3.0x to create a market equilibrium between buyers and sellers, this suggests we are currently in a buyers' market for infrastructure secondaries.

Benefits of secondaries

The same advantages that secondaries have long provided to investors in other asset classes are also available to infrastructure investors.

- Quicker deployment: Owing to the size of the market, coupled with the opportunity to buy into well-seeded and well-diversified portfolios, secondaries can help investors build their exposure to infrastructure faster than primary investing alone.
- Diversification: Secondaries can provide diversification across funds, GPs, strategies, vintages and key asset valuation drivers—all of which reduce concentration risk for LPs. The average direct infrastructure fund provides exposure to 12.9 portfolio companies. An infrastructure secondary portfolio, by contrast, typically provides exposure to dozens of different funds and GPs, and hundreds of portfolio companies. Indeed, we recently completed a single LP-interest deal that acquired a diversified portfolio of fund commitments, providing exposure to 12 funds managed by seven different GPs and more than 120 portfolio companies.
- J-curve mitigation: Secondary buyers typically purchase stakes in mature funds that are in their value creation or realisation phase. This, combined with the discounts that are typical of secondaries, means investors are purchasing assets when valuations and distributions back to investors should be trending upward, thereby mitigating the J-curve effect. Secondaries can therefore be a very useful portfolio construction tool for investors early in their infrastructure journey, with positive early performance of secondaries used to support early portfolio performance while primary funds are deploying capital and, in the J-curve.

Seizing the opportunity

Although discounts and leverage can drive higher returns from secondaries, in our experience, quality is the name of the game.

There is not a right or wrong way to zero in on quality. Each investor brings different methods and specialties to sourcing and underwriting. Despite the nuances, there are several immutable characteristics that, in our experience, can help investors succeed: GP relationships, the ability to leverage insights from your co-investment program and specialised data.

Quantitative benefits in focus

- *J-curve*: Our data suggests the J-curve of an average infrastructure fund with a core+ or value-add risk profile can last more than five quarters. In other words, the time value of money (TVM) of a primary infrastructure fund commitment remains below 1.0x for more than a year. A combination of valuation policies—that often hold new investments at cost for some time, expenses borne by the fund and management fees contribute to this drag. Conversely, because secondaries are typically acquired at a discount to NAV, they often close at a positive TVM. Moreover, secondaries often see valuation uplift early in the investment's life.
- *Quicker DPI*: A corollary to mitigating the J-curve, secondaries provide the potential for accelerated DPI through quicker portfolio company realisations and immediate yield potential. By leveraging GP or market insights, well-informed secondary buyers may have greater visibility into portfolio company exits, providing a high degree of certainty over near-term DPI to help de-risk investments. Half of the LP interests the Stepstone infrastructure team has underwritten had a known or high probability exit between the record date and 12 months of closing. DPI can begin immediately across secondaries, providing an accelerated cash flow back to LPs early in the investment life.
- *Alpha potential*: The discounts, attractive entry points in the valuation cycle and shorter hold periods all contribute to secondaries' potential to outperform other strategies with similar risk profiles. Although some LPs raise concerns about the dual layer of fees (fees to underlying GPs as well as the secondary manager), there is evidence that transactional alpha can be achieved on a net-net basis. Data from several infrastructure secondaries recently underwritten suggest that, on average, these deals have offered a 500 bps internal rate of return (IRR) premium over the implied since-inception primary fund return of the acquired positions, more than compensating for secondary manager fees.

GP relationships

Each meeting with a GP, provides a chance to gather insights into how its funds are performing, its return and exit expectations or whether it is planning any acquisitions—all of which can inform your underwriting. You also get a better sense of their quality as an asset manager. Investing in these relationships is particularly beneficial where secondaries are concerned.

Knowing the quality of the sponsor with whom you intend to invest is a crucial aspect of the underwriting process. Pursuing a deal when you have not worked with the GP previously, in particular in a secondary transaction where timing is often truncated, can lead to information gaps that could materially impact underwriting performance. There is no better source of asset-level information and market insights than the GP operating the assets being evaluated.

GPs can also be a strong source of deal flow. They may prefer secondaries to be traded to an LP that may one day be a primary or co-investor.

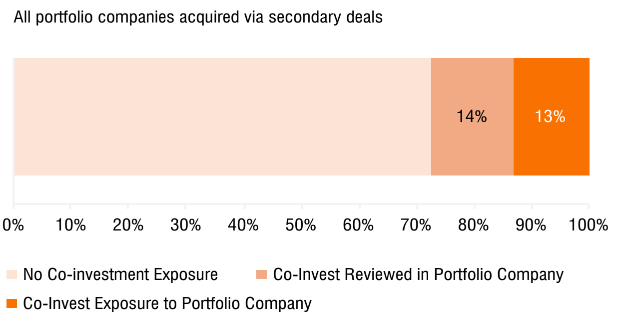
Insights from primary diligence

We conduct a full diligence process on ~30 funds per year. When reviewing secondary opportunities where we have already conducted primary due diligence, we do so knowing our specialised teams thoroughly vetted the legal documentation and operational processes of a fund and GP. In addition, our primary diligence process includes a comprehensive commercial analysis, a review of valuation policies, an evaluation of the key strengths of GPs (e.g., sector expertise, asset management capabilities, etc.), track record review, and, critically, an assessment of the valuation trajectory for existing assets. We also leverage the regular LP reporting received from the funds in which we have invested to further support our underwriting.

Insights from co-investments

Co-investments provide LPs with more insights into a GP's quality and a level of familiarity with the asset that cannot be attained through primary investing alone or outside diligence conducted at the time of a secondary transaction. Moreover, it is common to come across a secondary opportunity that includes assets you have reviewed previously as a co-investor. As a case in point, we have reviewed co-investments in roughly one-quarter of the portfolio companies acquired via infrastructure secondaries in our portfolio as shown in Figure 5. This pre-existing knowledge not only helped us underwrite these secondary opportunities but helped us do so quickly. When liquidity is still hard to come by, speed of execution in secondaries remains at a premium.

Figure 5. Portfolio company insights



Source: StepStone analysis.

Specialised data

All the data collected from routine GP engagement, primary and co-investment due diligence and portfolio monitoring can be used to evaluate the risks and rewards associated with a given secondary opportunity. Stepstone's infrastructure team has taken this a step further, building a proprietary infrastructure risk index—as shown in Figure 6—that helps determine whether an asset within a secondary's return potential justifies the risk.

The risk index aggregates the quantitative and qualitative measures we collect from across our investment and portfolio monitoring teams. We then take this risk measure and compare it against the universe of infrastructure assets as well as other assets with similar characteristics.

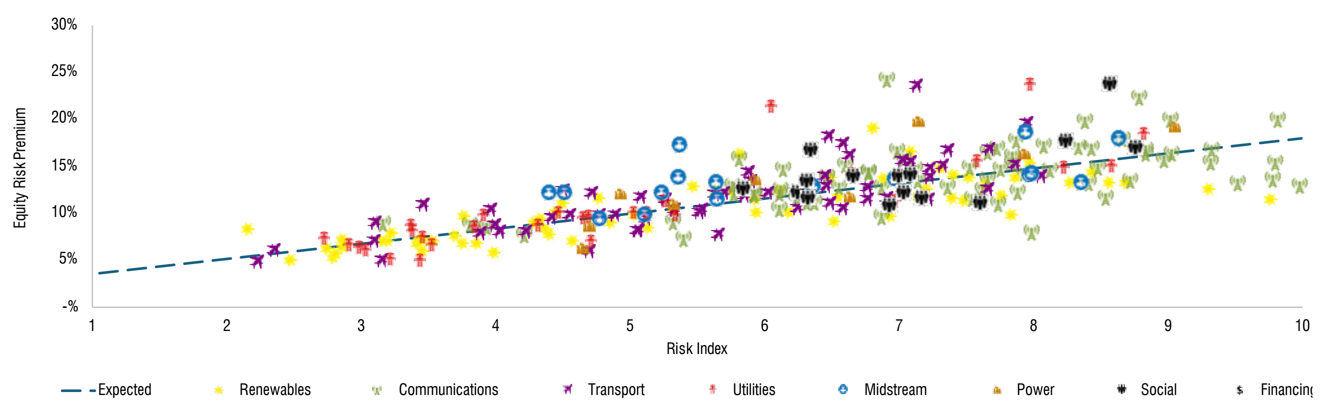
By using this tool, we can assess from where the greatest risk contribution in an investment comes, highlighting areas that may require further diligence or consideration. Ultimately, our risk index seeks to quantify whether a deal is expected to generate enough return for the risk that is assessed in the deal.

Conclusion

Even under conservative assumptions, Stepstone estimates the infrastructure secondary market will grow significantly in the near- to medium-term. Buoyed by a maturing primary market, a growing desire for GPs—and their LPs—to hold on to marquee assets and growing acceptance of secondaries' role in portfolio construction, the infrastructure secondary space may one day grow to be as large as real estate or private equity. Whether new to the asset class and want to quickly build a diversified portfolio or a seasoned infrastructure investor in search of quicker DPI, secondaries have something to offer.

The infrastructure secondary market is nuanced, with investors likely to use this strategy in different ways depending on their portfolio objectives. Even so, there are some rules of thumb to abide—all of which point to identifying quality. As this market grows, the premium on quality grows with it. Whether through investing in data capabilities or leveraging insights from primary and co-investment practices, LPs have several ways to gain an edge. While some can achieve this independently, others may need to look for a partner with the scope and scale to deliver this advantage. **FS**

Figure 6. StepStone infrastructure risk index output



Source: StepStone analysis. For illustrative purposes only.