PAVILION

ENERGY AND INFRASTRUCTURE

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Oil prices have enjoyed a steady recovery from their lows and are at a level where there are attractive investment opportunities in the energy private equity market. Even more promising is the evidence of increasing demand for oil. If the economic recovery continues and further increases demand, energy prices may well experience additional improvement. A challenge in 2018 for energy markets is identifying quality private equity fund managers that can consistently generate attractive returns when the underlying value of their assets is highly dependent on a decidedly volatile commodity. In the infrastructure market, record levels of dry powder have led to increased competition for projects globally. As infrastructure tends to be at the lower end of the private equity return spectrum, significant increases in pricing could be detrimental to project yields. A challenge for infrastructure in 2018 is identifying assets that have the potential to generate attractive returns despite the higher entry prices.

Energy

During 2016, virtually everyone in the energy industry proclaimed that oil and gas prices would be "lower for longer." However, by the end of that year the price of oil had doubled from its February lows -- a 100% increase in 10 months! Clearly, consensus commodity price forecasts are almost always erroneous. Thus the challenge for energy investors in 2018: how can we profitably invest in a sector where asset values are likely to be impacted by volatile commodity prices? The keys to accomplishing this are sourcing, analyzing, and accessing fund managers who can successfully navigate industry cycles.

Sourcing and accessing top fund managers comes largely from many years of experience and deep immersion in private energy investing. Performing thorough due diligence is not dissimilar to analyzing managers in other alternative asset classes: careful review of the team, track record, strategy, competitive advantages, etc. But there are some additional factors that should be given particular attention.

One of those factors is over-confidence. Any fund manager that believes they can forecast oil and gas prices profitably should be regarded with suspicion. History shows it simply cannot be done. Instead, look for fund managers with a strategy to generate attractive returns apart from rising commodity prices.

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Another factor is the use of leverage. The amount of leverage utilized must closely align with the risk profile of the strategy. Leverage must also be accompanied by the proper amount of hedging. Too much leverage and too little hedging are a deadly combination—and can destroy significant value—when commodity prices decline, as we saw in 2016. The best private energy managers do not avoid leverage completely, but they use it wisely and appropriately.

If the world-wide economic recovery continues—and signs are positive for that—energy prices should remain near or above current levels—resulting in the potential for strong returns for private energy investors.

Infrastructure

In the infrastructure market, record levels of fund-raising and dry powder have led to strong competition for projects globally. This competition has resulted in higher asset prices and, therefore, lower expected returns going forward. The challenge for infrastructure investors in

2018 is to identify fund managers that have the potential to generate attractive returns despite the higher entry prices for many assets.

Core assets are widely considered to be fully valued—and, in this case, we believe the conventional wisdom is correct. Everything else being equal, increasing interest rates will also reduce the value of high-yielding core assets. Therefore, investors should consider boosting the value-add portion of their infrastructure portfolio. Fund managers that can acquire assets operating at less than optimal levels and then implement the necessary operational and technical improvements, can add significant value to their assets post-acquisition.

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Investors should also consider increasing their allocation to greenfield projects, which offer the potential for better returns. However, investors must select experienced managers that possess the ability to mitigate the risks associated with building new projects and then successfully transition them into operating assets.

Managers and investors are also stretching for returns by allocating more infrastructure dollars to emerging or frontier markets. We believe that, in most cases, this strategy is unlikely to be successful. The risks in such regions have generally been higher than anticipated, while returns have disappointed. We see no near-term catalyst or secular trend that would materially alter this high risk/low return dynamic going forward.

Energy and infrastructure hold significant opportunity for investors in the coming years. However, these asset classes are not unloved or out-of-favor, and investors cannot simply deploy capital indiscriminately into them and expect to generate attractive returns. Thus, it is important to determine the strategic role these asset classes can play in your institutional portfolio, source quality fund managers, and engage in thorough due diligence of opportunities to ensure that the energy and infrastructure components of the portfolio generate the appropriate returns commensurate with their risk levels.

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