KEYNOTE INTERVIEW

North American mid-market steals the show

Surging consumer demand for data in tertiary markets, as well as unequal access to modern technologies, is driving investor appetite, says DIF Capital Partners' Kanan Joshi

It might be cliché to say that data in the 21st century has become the new oil, but it would not be easy to make a counterclaim. Global data consumption is projected to nearly triple between 2022-27, reaching 9.7 million petabytes, according to PwC.

Everything from private 5G networks and fixed wireless home broadband to the boom in artificial intelligence and cloud computing is set to boost the investment case for digital infrastructure.

The asset class is among the fastest-growing segments across private infrastructure and shows little sign of slowing. Kanan Joshi, global head of digital infrastructure and co-head of North America at DIF Capital Partners, expands on the key trends and challenges shaping the North American mid-market.

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Q How has the digital infrastructure sector in North America evolved in recent years?

As we look at digital infrastructure as an asset class, data centres and fibre industries have evolved tremendously over the past five to six years. As demand for computing has increased, internet access has become a critical aspect of day-to-day life.

Strong demand for hyperscale data centres in the top markets in Silicon Valley, Virginia, New York, Chicago and Dallas has had attention from public and private investors and soaked up a considerable amount of capital. In addition, we are seeing a shift and growth in data centre demand towards population centres in Tier 2 and Tier 3 markets. Companies, both local enterprises and global webscalers now demand nearly 100 percent uptime, cooling, power and connectivity in these markets that a traditional in-house network and data solution cannot provide.

Previously, large telecom companies rolled out fibre to US metropolitan areas. Post-pandemic, there is unabated demand for fibre nationwide, particularly in small towns and rural and underserved communities. That shift of population and employment out of the biggest cities is also driving greater demand for fibre and data centres.

Everyone wants a strong broadband internet connection, and people in rural areas especially do not want to be left behind. As we saw during the pandemic, internet access has become essential, and remote work has only intensified many of these trends.

Q What makes the mid-market so attractive?

One of the main reasons is that there are several value-creation opportunities. There is scope for smaller businesses and investments to turn those into platforms to build a bigger company and create significant value.

Ensuring that the business has the appropriate management skills by adding senior talent in the form of operating advisers on the board or an executive with track record in an area that the company needs help in can add significant value to a mid-sized business. In comparison, larger funds deploying billions of dollars per transaction often have limited scope for this sort of value-add.

One of the key attractions of the mid-market is the ability to avoid auctions when acquiring assets. Our transactions are often bilaterally sourced – such as situations where we know the CEO/founder already, or companies coming to us directly because we have built those relationships over many years.

Likewise, there is a wider variety of exit options in the mid-market.

Q What trends are driving interest in second- and third-tier markets?

We have found some exciting use cases driving broadband demand. For example, farming communities want broadband internet and are willing to pay higher prices to get it in remote areas.

Improving agricultural productivity is an essential driver of data usage in those communities. Today, there are sensors measuring everything from soil composition to water efficiency. High-speed broadband access can make a real financial difference there.

There has also been a noticeable population shift to second and third-tier cities because of the pandemic, remote working opportunities, and overall cost of living. People today are far less fixed and have more flexibility. They might relocate permanently or for parts of the year.

These markets are also underserved and have not reached the level of infrastructure needed despite having growing populations. This can give our portfolio companies first-mover advantage.

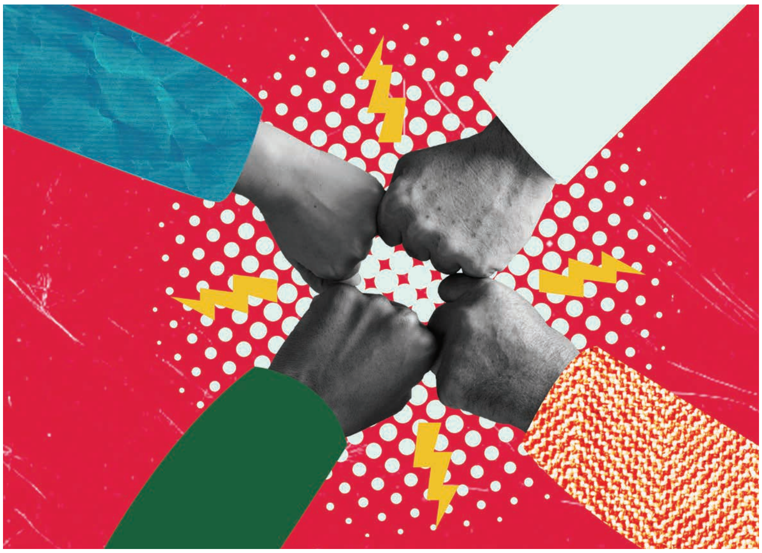
Our digital infrastructure footprint in second- and third-tier markets has expanded significantly in recent years. For data centres, we invested in a platform called Tonaquint, which had initial sites in St George, Utah, and Boise, Idaho. We then completed an add-on in Oklahoma City.

Q How important are management teams for portfolio building?

If you think about digital infrastructure, these are long-term assets once they have been developed, but you need strong teams and platforms to build them. Typically, we strengthen talent based on where we see gaps.

There have been instances where we partner with the same management team across different portfolio companies, and there are times when we partner with an existing team and then bring in a CFO or chief revenue officer to scale the business. We aim to set in place incentive structures where interests are fully aligned.

Building the right management team for an investment is one of the most important factors in achieving growth, value creation, cashflow generation, and, ultimately, exit valuation, which we and our LPs are looking for.



For fibre, we expanded our footprint with Joink, based in Indiana. Again, we realised an add-on with a smaller internet service provider in Illinois. Further north, we have Valley Fibre and RFNOW, which operate in the Canadian provinces of Manitoba and Saskatchewan.

Q How is the ESG agenda shaping digital infrastructure?

That is something that our LPs are monitoring closely. ESG is very important to us and a key part of the value-creation process for our portfolio companies.

As you know, data centres consume a lot of power. Our approach has always been to acquire assets and exit with a much-reduced carbon footprint. We also look to find ways of adding renewable power and improving efficiencies.

For fibre, we focus on making a social difference. Typically, that might be providing broadband access to underserved communities.

For example, one of our portfolio companies in Canada serves one of the First Nations communities. We also work with underserved communities in the Midwest. We try to make a positive difference by working directly in partnership with local governments and agencies to introduce high-speed fibre to those that would benefit the most.

Q What are some of the key challenges that the sector faces?

Three main ones are affecting the industry universally: interest rates, supply chain and power pricing.

When we think about interest rates, we typically maintain conservative levels of leverage for our portfolio companies. When we find an attractive structure, we try to lock in rates for the long term.

During times like now, when interest rates are elevated, and we have to access debt markets, we try to preserve a very flexible structure so that at the appropriate time, we can refinance with more attractive rates.

"There is a wider variety of exit options in the mid-market"

"AI servers require large amounts of power, and sourcing that power will be key"

Supply chains have been an issue primarily due to a high demand for raw materials and equipment. For the fibre sector, some of that was caused by companies hoarding a lot of inventory, but that has now abated. We have been working with our portfolio companies to make volume purchases and orders as a group rather than as individual companies.

On the data centre side, the industry is facing issues procuring generators and batteries. We have tapped into our senior adviser network as well as our relationships across different sectors within portfolio companies to access the components we need.

Having a solid management team and planning in advance has also been helpful. We are trying to take advantage of our extensive portfolio by cross-pollinating companies across subsectors, including renewables and data centres.

Q How do you see opportunities developing over the long term?

AI is going to drive a lot of growth in data centres. AI servers require large amounts of power, and sourcing that power will be key as demand surges and the market expects greater capacity.

Demand for lower latency will also become a factor. People expect an immediate response from AI, but it does not work like a search engine. Crunching the data at speed will require data centres to be located closer to end users. This, in turn, will increase investor focus on Tier 2 and Tier 3 markets with easier access to power and rising consumer demand.

The digital divide is another factor. More than 20 million homes in the US do not have internet access. Many homes still do not have access to broadband speeds, so that, combined with bipartisan government support for digital infrastructure, will continue to drive opportunities to build out the fibre infrastructure.

FibreCo consolidation is another theme to monitor closely. Smaller platforms will be combined into larger platforms or even super-regional platforms. AI might take a lot of focus, but other subsectors, including the Internet of Things, have infrastructure characteristics and will require more significant investment. We also expect that our partnership with CVC will further expand the opportunity set across the globe. ■