PRIVATE EQUITY AND THE BUILT ENVIRONMENT: 2024 INVESTMENT OPPORTUNITIES

BY JAYSON POST

Despite changing fundamentals and increased investor scrutiny weighing on private equity (PE) deployments, we continue to see opportunities in the built environment attracting new PE investment. PE buyout activity in the built environment climbed approximately 40% to $60 billion in 2023, from $43 billion in 2021, according to data from Pitchbook.

That increase comes despite an overall drop in private equity investment during the same period, with capital deployed dropping 41% to approximately $700 billion in 2023, from over $1 trillion in 2021. The first quarter of 2024 is off to a slower start for private equity activity in the built environment. However, indicators suggest a potential catch-up in the second quarter, similar to 2023 when most year-to-date investment occurred in March and April.

Traditionally, private equity has been reluctant to deploy funds in certain subsectors within the built environment, due to perceptions of cyclicality, project-based work, and other factors that make investing with a defined investment horizon seem like a riskier proposition. But as more investors gain a better understanding of the underlying fundamentals and business drivers of companies in the space, many are discovering niche subsectors with increasingly promising risk/return profiles.

"The built environment is such a vital part of the nation's GDP, and investment in the space is continual and far more resilient than most think on the surface," says Paul Giovannoni, FMI partner and head of the private equity consulting team. "Few segments are truly cyclical, and unfortunately those [cyclical segments] stereotype the broader industry."

As the market for capital becomes more commoditized and manager track records more heavily scrutinized, investors will need insights from industry experts so that they can differentiate themselves and facilitate superior outcomes for limited partners (LPs) and portfolio company management teams. Following are some of the areas ("themes") in which our investment banking teams see potential for outsized returns in today's environment.

PE BUYOUT ACTIVITY IN THE BUILT ENVIRONMENT CLIMBED APPROXIMATELY

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THEME 1: ENERGY TRANSITION

Many companies, consumers and governments are exploring ways that they can reduce carbon emissions and meet net-zero mandates and commitments. Additionally, investors are increasingly demanding that more of their portfolios be comprised of environmentally minded companies — and operators across the energy transition landscape are reaping the benefits, promoting an uptick in interest in the space.

Allocating dollars to this space could yield gains for investors as well as the environment. Buildings produce almost 40% of global carbon-related energy emissions. One quarter of buildings' carbon footprints come from carbon-intensive structural materials, and three quarters of buildings' carbon dioxide is produced through operations. This heavy weighting toward operations points to one area where investment can help bridge the gap toward a decentralized, digitized and decarbonized built environment.

"The built environment has always offered attractive investment opportunities. In the past decade, around 70% of our energy transition transactions have involved private equity. With significant funding (IIJA, IRA, etc.) and major trends like renewables, AI and re-shoring, most sectors in the broader industry have become too important and attractive to ignore."

— RUSSELL CLARKE, MANAGING DIRECTOR, FMI CAPITAL ADVISORS

THE THREE D'S OF ENERGY TRANSITION

An investment of $3 trillion to $9 trillion per year is needed to fend off the worst of climate change, meaning a carbon-neutral future will require a top-to-bottom industry transition.

To help investors organize the range of opportunities in this space, FMI's Energy Transition Group uses a well-known 3D rubric when talking with clients:

DECARBONIZATION encompasses software, technology, products and services needed to reduce the carbon intensity of the built environment both through using less energy via energy efficiency and creating less carbon-intensive energy via renewable sources. Because renewable sources produce electricity, this category includes electric-powered manufacturing, fleets and green roofing.

DECENTRALIZATION accounts for technologies and business services that support the decentralized grid. Examples include combined heat and power (CHP) and electric vehicle-charging stations.

DIGITIZATION includes the controls and analytics needed to optimize energy use at home, school, work and in transit. Examples include data- or tech-enabled energy efficiency and demand-side management, energy management technology and smart/intelligent buildings with building control engineering.

Many consider the transition to greener energy supplies and grids to be one of the largest untapped investment markets. Some ways to enter this space include:

- **Energy service companies (ESCOs)**
  ESCOs design, develop and build projects for building owners that save energy, reduce costs, and decrease operations and maintenance budgets. ESCOs make money based on a percentage of their clients' cost savings. Often, they work with municipalities, universities, schools and hospitals (MUSH), serving institutions that are likely long-term clients.

  ESCOs are a favorable energy subsector for PE investment because they can scale quickly without adding corresponding employees, which keeps overhead lower and makes improving operations a simpler proposition for many turnarounds. They also have long-standing client relationships, allowing for easy additional sales as technology changes or services broaden. All told, their scalability, strong margins, low capital intensity, repeat work and multi-year contracts bode well for investment.

- **Energy efficiency and renewables products and technologies**
  Investors will need to research and carefully weigh options in this subsector due to the wide array of new building efficiency products and technologies that are coming to market. These include digital products such as smart building and lighting controls, and energy management systems and technologies that sit on top of these systems. Other analog options with less technology risk — but that also promote energy efficiency — include equipment such as backup generators, heat pumps and solar panels, as well as building products like environmentally friendly insulation, energy efficient windows, and specialty roofing and solar racking solutions.

- **The decentralized and decarbonized power grid**
  Another key aspect of the fight against climate change stems from new ways energy will be generated, transmitted and stored. As renewable energy systems and storage come online — and fossil fuels no longer dominate the centralized grid — end users will become increasingly active participants on the grid. The utility and consumer sides of the meter will continue to blur with distributed generation and the software, products and services that span this previously rigid border.

THEME 2: ENVIRONMENTAL SERVICES

Environmental services is a broad umbrella term for the consulting, permitting, legal, testing, engineering and remediation services involved in mitigating the impact of human infrastructure and construction on the environment. Relatedly, this segment includes disaster preparedness and recovery services, and the management of human-made environments, such as parks and lakes.

"Any company that's positioned to take advantage of the mega-environmental trends of today is worth digging into," says FMI Managing Director Brooke Navarro.

This sector boasts multiple verticals with recurring revenue profiles, low capital expenditures and nondiscretionary services, all favorable for investment. However, given the variety of services in this sector, investors need to understand the differences in service models depending on end customers, industries and geographies.

Several areas to consider in this sector include:

- **Environmental testing and compliance firms**
  Environmental compliance companies help firms comply with a continuously evolving patchwork of federal, state and local laws that can be complex and difficult to navigate. Some of these firms work on large projects to anticipate and prevent obstacles to completing projects on time while testing services perform special analyses on water, waste soils and solids.

  These companies range from low- and middle-market operators with regional or local footprints to several large multi-regional or national companies. Some are more analog than digital. Investors are advised to look for companies that leverage technology in innovative ways or provide a technology-based solution to an ongoing environmental service such as inspections or monitoring.

- **Disaster response and remediation**
  From deadly wildfires to storm surges, disasters are occurring more frequently and with greater intensity. Over the past five years, the U.S. has experienced an average of 20.4 climate disasters per year that have exceeded $1 billion in damage, and with climate change, we can expect these life-threatening and property-destroying events to continue.

  The Guardian Weekly reports that, since 2020, private equity firms have invested in more than 72 disaster recovery and clean-up firms. The report illustrates the complexity of working in this area, both in partnering with the government on projects and in terms of ethical considerations in restoring communities impacted by disasters.

- **Niche environmental services**
  Environmental management and remediation take many forms. Examples include firms that manage and develop golf courses, parks, lakes and coastlines, as well as stormwater management companies that serve construction projects and develop management plans. There are also environmental services to provide the infrastructure space with, such as erosion control services for new highway construction.

SINCE 2020, PRIVATE EQUITY FIRMS HAVE INVESTED IN MORE THAN

72

DISASTER RECOVERY AND CLEAN-UP FIRMS.

THEME 3: INFRASTRUCTURE AND MAINTENANCE SERVICES

Both the Bipartisan Infrastructure Law (2021) and the Inflation Reduction Act (2022) made billions of dollars available for infrastructure updates. Add in new housing developments, which require laying roads, water pipes and other needed utilities, and infrastructure services are booming.

In addition to increased funding, this sector's stable long-term demand, mission-critical work and earnings visibility make it attractive to PE investors. The best businesses boast recurring revenue through multi-year contracts and strong relationships. Additionally, a strong safety record is a must, and maintaining a base of business in multiple states provides revenue stability.

Buying firms that construct, repair and maintain the nation's road, power, water and transportation systems is one investment direction. Or PE investors could seek out companies that provide ancillary services, which are also benefiting from the increase in project activities.

Consider exploring:

- **Utility service providers**
  Because much utility work is underground, companies provide excavation, trenching and drilling to install pipelines. This work spans water, sewer, data line, oil and gas, and electrical transmission.

- **Water and wastewater pipeline construction**
  Historically, PE firms have avoided water and wastewater construction because the work was awarded through complex bid structures. Now, with improved contract structures and the tremendous opportunity in the sector, PE is taking a second look.

  FMI estimates construction spending in the water supply sector will increase 8% in 2024 and then level off to about $31 billion per year through 2028. Not only is funding coming from climate change adaptation measures, but the EPA's revised Lead and Copper Rule will require counties to replace all lead water service lines in the next 10 years, at an estimated annual cost of $3 billion.

- **Road and highway construction firms**
  As infrastructure and housing developments are built, roads and highways required to reach them must be constructed in addition to a growing deferred maintenance backlog. The American Road & Transportation Builders Association expects transportation investments to grow by double digits for the second year in a row, which make paving and highway construction companies an attractive asset to own.

- **Site development firms**
  Municipal and private projects require site analysis, development and improvements before construction can begin. Site development companies perform layout and planning, including stormwater management or, for renewable projects, assessing the solar resources.

THEME 4: RESIDENTIAL BUILDING PRODUCTS

Residential building products — from roofing to flooring to glass doors — continue to be successful PE investments.

Opportunities exist in part because many building product segments are fragmented, with unsophisticated, locally focused businesses that have not adapted to consumer trends or implemented technologies that will streamline their businesses.

Despite relatively high interest rates and home prices, building products are still in demand in part due to:

- **A national housing shortage**
  Developers have not built enough houses in the past 15 years to keep up with household formation. Experts estimate 2 to 7 million units would need to be built for supply to match demand. (However, conditions vary significantly in local markets.)

- **Aging national housing stock**
  The housing stock available is ripe for improvements. More than 75% of current homes are 20-plus years old, according to the National Association of Home Builders, which will drive demand for residential building products focused on remodeling.

- **A trend toward trade-up**
  Relatively higher interest rates and few options on the market give homeowners every reason to invest in their current domiciles.

These factors encourage PE investors to enter the residential building products market. Here are some subsectors for investors to explore:

- **Innovative products taking market share**
  Luxury vinyl flooring, terracotta, composite decking and manufactured stone are among the materials that have become highly popular in recent years. Products like these that are easier to install, cost less and are more environmentally sustainable are becoming attractive to home builders and homeowners. Innovative products will continue to attract a higher share of the market at the expense of legacy products.

- **High-end market products**
  The high end of the residential market — generally defined as homes valued at $1 million or more — is more immune to changing economic cycles than the middle- and low-end markets. Products such as luxury kitchen and bath appliances and fixtures, high-end windows and premium flooring provide stable growth and superior margins.

- **Multifamily building products**
  Some one million multifamily housing units are under construction this year, the highest number since 1973. While new multifamily housing starts have been dropping as interest rates climb, a tremendous amount of inventory is nearly or newly completed. On average, multifamily units turn over once every two years, creating a frequent need for repair and remodeling for categories such as flooring, cabinets and countertops.

DEVELOPERS HAVE NOT BUILT ENOUGH HOUSES IN THE PAST

15

YEARS TO KEEP UP WITH HOUSEHOLD FORMATION.

MORE THAN

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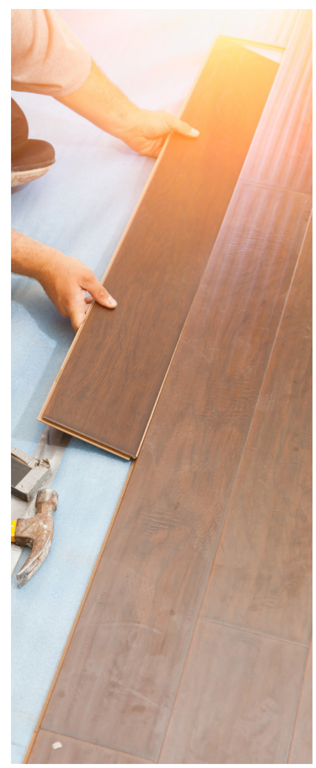

HOW TO INVEST IN THE BUILT ENVIRONMENT

As more capital pours into the built environment, PE companies will need to have access to deep market insights, understand the nuance of various subsectors and develop clear investment theses to find areas that will generate outsized returns for underlying investors.

Private equity firms should have clear, sector-specific plans and understand the full life cycle of projects — whether that's building a road or helping those responsible for facilities achieve their carbon emission reduction goals. It's important to work with partners that have extensive, industry-specific expertise and an understanding of the unique investment drivers and considerations within these sectors.

Amid an increasingly crowded landscape, each individual stage of the investment life cycle is becoming critical to the overall success of general partners (GPs). Choosing an advisor who thinks and acts like a strategic partner, with deep industry expertise that adds value at every stage, can give you a distinct advantage over the competition.

AUTHOR

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Jayson brings extensive experience in private market investing and mergers and acquisitions (M&A), having invested more than $2.5 billion in private equity buyouts during his previous role at Partners Group, a private market asset manager with more than $200 billion in assets under management. Before joining Partners Group, Jayson was an investment banker at RBC Capital Markets, where he provided M&A and capital markets advisory to telecom and communications companies.

Outside of his full-time role, Jayson leads the board of directors at Reaching HOPE, a Colorado mental health services nonprofit, and enjoys outdoor activities, writing and spending quality time with his partner, Avery.

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