

Stimulating Infrastructure Investment in the United States

(Part II)

This is the second part of a three-part “Food for Thought” report that explores a conceptual model — detailed on page 8 — that uses federally credit-enhanced taxable revenue bonds for institutional investors to finance U.S. infrastructure projects. In part one, it was established that a preference for a more income-oriented, stable-value (core-like) infrastructure investment option has kept many institutional investors on the sidelines. The objective of this “Food for Thought” series is to promote thinking and discussion about how to compel these investors to take a more active role in financing infrastructure developments in the United States. The conversation will continue at the Institutional Investing in Infrastructure (I3) conference Nov. 30–Dec. 2 in Washington, D.C., where this report will be presented and discussed. The results will be published in part three of the report in the January issue of Institutional Investing in Infrastructure.

For part two, input from the investment management and plan sponsor community was solicited and used to further explore the conceptual debt model and to examine the role of public policy in stimulating infrastructure investment.

Concerned over the deteriorating state of American infrastructure and how to attract private investment to finance the needed improvements, members of Congress have explored new vehicles to attract private sector investment, particularly pension fund investment. There remains, however, a measure of skepticism regarding public-private partnerships and pri-

ivate sector equity investment. Rep. James Oberstar, the powerful chair of the House Transportation and Infrastructure Committee, while acknowledging that the private sector could play a role, has expressed concern that equity investment or privatization, even in the form of long-term leases to private investors, does not sufficiently protect the public interest or the need for a nationally integrated transportation system.

Large pension funds have been negotiating more favorable terms and better alignment of risk, and some funds have instituted longer hold periods and clearer exit strategies.

Sensitive to the concerns expressed by Rep. Oberstar and others regarding the need to ensure that their investments are in the best interest of the public, and concerned about the perceived shortcomings of the existing private equity models, some of the largest plan sponsors have been exploring alternative ways to invest. The traditional private equity closed-end funds continue to be viable investment vehicles, and state and local governments continue

to seek innovative ways to use them or to combine private and public investment — for example, the work of the New York State Commission on Asset Maximization. But large pension funds have been negotiating more favorable terms and better alignment of risk, and some funds have instituted longer hold periods and clearer exit strategies.

Also on the equity side, Pension Consulting Alliance (PCA), acting on behalf of some large public funds, issued a request for information (RFI) in August 2009. The goal of the RFI is to identify investment managers capable of constructing an infrastructure portfolio for a group of public pension funds interested in pooling their resources and jointly investing directly in infrastructure projects.

A recent development is pension funds' growing interest in infrastructure debt instruments. Generally, in the United States, unlike Europe, infrastructure has been financed by federal, state and local governments through direct subsidies from general revenues or user fees as well as from the sale of tax-exempt bonds issued as general obligations of the government entity or backed by revenues derived from dedicated taxes, such as water taxes or the gasoline tax, or by user fees. The tax-exempt nature of these bonds meant that the yield was lower than that for similarly rated corporate bonds and this precluded investment by tax-exempt fund sponsors who did not benefit from tax exemption.

BUILD AMERICA BONDS

As a result of the crisis in the financial markets, which decimated the tax-exempt municipal bond mar-

ket, and to give municipal issuers access to the much larger *taxable* bond market, Congress included a provision to encourage the issuance of *taxable* municipal bonds in the American Recovery and Reinvestment Act of 2009 — stimulus act. These are the new Build America Bonds (BABs). For qualifying infrastructure projects, the federal government provides a direct subsidy, making the returns of government-issued taxable bonds comparable to the higher interest rates paid by taxable corporate bonds, while lowering the cost of issuing taxable bonds for state and local governments and public authorities. There is no federal guarantee or insurance for these bonds, and the credit rating is tied to

the California Public Employees' Retirement System, California Teachers' Retirement System and New York State Teachers' Retirement System.

Yet BABs alone are not likely to be the instrument of choice to finance the vast amount of infrastructure development that is required to help the United States remain competitive in the global marketplace. If matched with private capital in a material way, regulatory rules governing BABs would deem this "private activity," and the 35 percent federal interest subsidy is lost.

An opportunity exists to create a similar but new bond structure that explicitly encourages institutional investors (private capital) to help finance greenfield development proj-

assets outright, bringing in the private capital on the debt side; and a *Private Capital Model*, which would use a consortium of private debt and equity to fund construction and stabilization of an infrastructure asset, and then be bought out of their share of the project at prearranged parameters (the "take-out") from proceeds from a bond issuance.

As envisioned in the example, private capital investors would receive their return on, and return of, principal at "take-out." To the extent the greenfield project is delivered at pro forma, the private investors would earn pro forma target IRRs. An additional incentive bonus to reward timely and cost efficient performance would likely also be included. There would be far less government subsidy in the private capital model but there could be some. For example, the California High Speed Rail Financial Plan has a level of government protection to private investors for regulatory and entitlement risk.

Note that both examples are conceptual and over-simplified, and are intended to promote an inclusive discussion at the I3 conference — much work would be needed to advance either model.

An opportunity exists to create a similar but new bond structure that explicitly encourages institutional investors (private capital) to help finance greenfield development projects — an infrastructure development bond (IDB), for example.

the rating of the issuer, not the federal government.

BABs have done well in the market. A number of pension funds already have made substantial investments in these bonds and, along with university endowments and insurers, they have been the primary purchasers. The demand for BABs issued by the New Jersey Turnpike Authority was so large that although the initial plan was to offer \$250 million, the agency actually sold \$1.4 billion. One of the principal buyers was the New Jersey pension system. New Jersey also has bought BABs from other issuers: \$150 million in September 2009 and \$100 million in October. Also facilitating pension fund investment in infrastructure, if done properly, BABs can be purchased as part of a fund's domestic fixed-income allocation rather than as an alternative investment. New Jersey has structured the purchase of BABs so that they are part of the fixed-income allocation. Other large purchasers have been

ects — an Infrastructure Development Bond (IDB), for example.

FEDERALLY RISK-MITIGATED TAXABLE REVENUE BONDS — A CONCEPTUAL MODEL

The examples on page 8 show how the investment management industry could help "stimulate the stimulus" by partnering private capital (debt and/or equity) with federal and state governments to launch greenfield development projects of regional and national significance. Federal agencies that could administer this sort of infrastructure banking include the DOT TIFIA group, but a more comprehensive federal agency such as that proposed in HR 2521 (DeLauro) — The National Infrastructure Development Bank Act — or similar proposed entities, would also be well suited to fulfill the function of federal risk mitigator/credit enhancer.

The two very simplified examples on page 8 are a *public capital model*, whereby a state-controlled entity would continue to own the

QUESTIONS TO BE DISCUSSED AT THE I3 CONFERENCE

At the Institutional Investing in Infrastructure conference, Nov. 30–Dec. 2 in Washington, D.C., we will focus on the private capital model example shown on page 8 and discuss the following questions:

1. What features would you include in the model?
2. What features would you exclude?
3. What needs to happen for the model to be implemented?
4. What could the federal government do to make large greenfield investments via a debt facility compelling to your fund (client)? What could be the minimum preferred return, maximum loss provisions, etc.?

Robert Johnson Jr. is an **Institutional Real Estate, Inc.** consultant. He was previously a private equity fund manager and is a veteran real estate industry professional. **Joyce Miller** is president and CEO of **Tier One Public Strategies.**

Public Capital Example:	
Direct Investment: 20 percent–40 percent	<ul style="list-style-type: none"> • Federal government (FG) grants, stimulus funding, etc. • State funds — proceeds from general obligation bond issuance, other
Risk Mitigation:	<ul style="list-style-type: none"> • In lieu of more direct federal investment, employ credit assistance similar to that used by the DOT TIFIA, the RRIF program sponsored by the Federal Railroad Administration, etc. The FG would book amount based on probability analysis of maximum exposure (score system); it is presumed that amount put up by the FG to mitigate risk should be far less than a full grant • Reduce construction and usage risk during greenfield period; upon stabilization, retain a minimum level of credit support for the brownfield bondholders; possibly repay the FG for amount booked from recapitalization (such as from a final bond series issue); and possibly set aside funds to subsidize operations • Options include guaranteed minimum preferred return to bond investors; maximum loss provisions
Bond Debt: 60 percent–80 percent to cost, funded by institutional investors	<ul style="list-style-type: none"> • Issuer: state controlled entity or authority • Type: taxable revenue bonds • Coupon Target: 6 percent to 8 percent nominal based on a spread to Treasuries; overlay an inflation indexing feature with goal of inflation benchmark +300–500 basis points; <ul style="list-style-type: none"> ◆ Accrue interest at, say 8 percent to 10 percent, over greenfield period • Private Placement: Domestic institutional investors, with state and local given right of first refusal (helps funds meet geographic targets); consider tranches for various investor classes • Inflation Protection: tie principal to benchmark of asset fare increases • Maturity & Amortization: <ul style="list-style-type: none"> ◆ I/O and accrue interest during greenfield and stabilization period ◆ 25- to 35-year full amortization at brownfield stage
Operations, etc.:	<ul style="list-style-type: none"> • P3 DBOM: Design-build-operate-maintain structure anticipated • Compensation: provide significant economic incentives to DBOM consortium to deliver project on time/budget; provide ongoing incentive to operator via long-term concession contract (without ownership) with possible bonus distributions for hitting revenue benchmarks, etc.

Private Capital Example:	
Direct Investment: 20 percent–40 percent	<ul style="list-style-type: none"> • Federal government grants, stimulus funding, etc. • State funds — proceeds from general obligation bond issuance, other
Risk Mitigation:	<ul style="list-style-type: none"> • Much less — possible federal and state mitigation of entitlement, environmental and regulatory risk. Private capital consortium to assume much or all of the construction, technological and operational risk up to point of stabilization.
Private Capital Consortium: 60 percent–80 percent to cost, funded by combination of private debt and equity	<ul style="list-style-type: none"> • P3 DBFOM: Design-build-finance-operate-maintain structure anticipated • Hold Period: Private equity term to coincide with construction-stabilization period, say 5 to 8 years • Exit Strategy: Take-out from proceeds of taxable revenue bond issuance <ul style="list-style-type: none"> ◆ Bond underwriter to line up institutional investors via subscription agreement prior to commencement ◆ At risk — Set take-out so that private investors are penalized for cost overruns, etc. ◆ May need some maximum loss provision, depending on infrastructure asset contemplated, and the associated risk inherent in entitlement, construction, operations, etc. • Fees/Returns: anticipate something like a “2 and 20,” except that the private investors would be fully bought out at time of bond issuance <ul style="list-style-type: none"> ◆ Possibly a 1 percent to 2 percent on deployed capital against a target holding period IRR ◆ Provide bonus payout based on successful delivery of asset compared to budget; revenues from operations compared to pro forma; or some combination ◆ IRRs of 14 percent–20 percent, depending on timing and total capitalized cost at stabilization versus pro forma.