

The Infrastructure Investment Trust

Enhancing the UK infrastructure
investment environment the *REIT* way.
An ACE conversation starter

An ACE publication

In conjunction with **Eyediate Solutions**



ACE suggests

- The Infrastructure Investment Trust (IIT) can provide an effective tool for enhancing investment in the UK's infrastructure network by providing an optimally efficient regulatory regime to attract investors into the infrastructure market;
- The IIT is a corporate vehicle which pools the capital of investors to acquire, manage and develop income yielding infrastructure assets. It would enable a single tax wrapper for the currently disparate infrastructure space;
- The IIT – modelled on the existing Real Estate Investment Trust (REIT) – distributes most or all of its profits to equity holders removing tax distortions. Thus incentivising an increase in capital flows into infrastructure assets;
- This focus on the investor level can help the UK Government achieve simultaneous public policy goals, notably economic development, sustainability and the localism agenda;
- The IIT has the potential to become the new public private partnership of the 21st century by opening up the infrastructure market to retail investors; enabling community participation in infrastructure provision; monetising local infrastructure assets and thus freeing up resources for capital investment and also by being a hybrid public-private vehicle for a national infrastructure bank;
- ACE suggests that the Government explore introducing the IIT in the UK as a cost-effective means of channelling finance into infrastructure assets at a time when the public sector is expected to retrench from capital expenditure;
- This approach can help the UK quantitatively ease its £500 billion infrastructure crunch.



1.0 Introduction

A Real Estate Investment Trust (REIT)¹ is effectively a company which undertakes a high level of property investment activity and whose rental income and capital gains are generally exempt from corporation tax. Since the introduction of REITs in the UK, leading development firms have transformed themselves into REIT structures because of their inherent economic advantages. Today, the global REIT population has a combined market capitalisation of approximately £382 billion².

However, at present REITs predominantly only operate in the residential and commercial sectors. This paper discusses how employing the REIT model for infrastructure assets could significantly increase investment in the UK's infrastructure network at a time when it is estimated that the UK faces a **£500 billion infrastructure crunch**³. Indeed, it goes on to propose developing a new framework for such investment which we call the Infrastructure Investment Trust (IIT). Such a vehicle could open up the asset class to retail finance and local communities as well as unlocking extra value for investors through tax-efficiency and higher distributions. There could also be potential for infrastructure provider firms to transform themselves into IITs. Understood in these ways, the IIT could become the Turnpike Trust of the 21st Century.

With the increasing global focus on the infrastructure asset class and the challenges governments face in funding infrastructure commitments the IIT could be pivotal in providing part of the solution especially as risk appetite returns and the markets look for stable, long-term returns. Furthermore, adopting such a regulatory mechanism in the UK would also signal that the Government is serious about attracting the finance necessary to build the integrated infrastructure systems that the UK needs to compete in the global economy.

¹ Pronounced 'Reet'.

² Ernst & Young, 2010, *Global REIT Report; Against All Odds (as of December 31 2009)*.

³ Helm, D, Wardlaw, J & Caldecott B, Policy Exchange, 2009, *Delivering a 21st Century infrastructure for Britain*.



1.1 The economics of infrastructure

The correlation between infrastructure investment and economic development is well documented⁴ and is therefore not the primary focus of this paper. Nonetheless, it is worth reiterating briefly, so we can understand how incentivising extra finance in the infrastructure space creates considerable economic gains at the micro and macro-levels. Essentially, a high quality infrastructure base enhances a country's national output, competitive advantage and labour market flexibility in addition to improvements to productivity and skills capacity⁵. Moreover, infrastructure spending generates a large multiplier effect across the full economy by creating additional demand for goods and services. Some studies⁶ suggest that the economic yield of targeted infrastructure investment can be up to a factor of 10. Therefore, £1 billion spent could add around £10 billion of economic activity.

This paper seeks to go beyond purely economic considerations and add another dimension into the public policy mix; that of the investor and how optimising capital investment using the IIT – structured around the existing REIT wrapper – could increase the attractiveness of infrastructure assets to private finance. This could help to close the gap on the UK's extensive deficit in transport, energy, utilities and communication spending.

2.0 The Real Estate Investment Trust

In this section, we outline the principal aspects of the REIT. This is important, as we consider the central components of the REIT to be directly conveyable for infrastructure assets.

A REIT is a corporate vehicle which pools the capital of investors to acquire, manage and develop income yielding property assets (known as equity REITs) or

⁴ See ACE, 2009, *Avoiding an Infrastructure Crunch*.

⁵ Increasing the productive capacity of a countries economic base can constrain inflationary pressures. With the Bank of England's recent £200 billion quantitative easing program such an approach could be required over the medium term.

⁶ Eddington, R, 2006, *The Eddington Transport Study, The case for action*.



mortgage loans (mortgage REITs) or a combination of the two (hybrid REITs). Simply put, an equity REIT takes an ownership position in its real estate investments whilst mortgage REITs invest in loans secured by real estate property, the REIT either underwriting the original mortgage or purchasing secondary mortgage debt for higher interest returns. Most REITs focus on the 'hard asset' business of property operations.

Although we refer to REITs as trusts, they are actually similar to other private investment companies with the exception that they remove tax distortions. They are an effective way for small, medium and large capitalised firms and individuals to invest in income producing, professionally managed assets, without having to invest in property directly. As an investment REITs historically provide portfolio diversification, reliable dividends and long-term risk adjusted returns. Publicly traded vehicles also offer the liquidity and transparency of the capital markets⁷. REITs can generate cash flow for investors through accumulating rental income as well as the potential to appreciate in capital value as the underlying assets grow.

The wrapper was designed to provide an optimal structure for investment in residential and commercial property as mutual funds offer for investment in equities. As REIT shares are listed on public exchanges this means that unlike the underlying real estate assets they represent they are very much liquid equity. This innovation opens up the residential and commercial market to retail investors and individuals who would be able to invest in derived stocks of a property portfolio instead of the greater individual financial commitment of buying real estate directly. Such an investment model creates a whole extra level of sector investors and helps drive direct investment in the asset class. As we shall see this paper proposes utilising such a mechanism for democratising participation in infrastructure investment – there is no real minimum investment in REITS – and eventually creating the opportunity for local communities to fund and perhaps even manage their own infrastructure needs.

In the UK, REITs are constituted as closed-ended investment trusts⁸ that invest solely in real estate assets. An investment trust is a type of collective investment

⁷ NAREIT, 2009, *Frequently Asked Questions About REITS*.

⁸ Closed-end funds have a fixed amount of shares.



whereby investor's capital is combined from the sale of a fixed number of shares the trust issues when it launches. The price of a share depends on the market value of the underlying securities and the supply and demand for these shares. Hence, the trust (and REITs) is referred to as trading at a premium or discount to its Net Asset Value (NAV)⁹. They then trade at market value, and the spread between the discount and the premium can enhance investor gains unlike open-ended funds which always trade at NAV. Moreover, closed-ended funds have the added investor advantage of not having the cost of creating and redeeming shares. The US Congress constructed the REIT regulatory framework in 1960 as a means to enable the investing public to benefit from investments in large scale commercial and residential development. Since then, the model has been replicated in countries across the world.

ACE feel such a concept would be mutually beneficial and provide sustainable solutions to infrastructure provision by involving the very people who use such networks in their funding. In economics parlance, it affords a resolution to the agent-principal problem of the owners of a system being removed from its operation. Since the establishment of the REIT, leading UK commercial development groups have elected for REIT status, including FTSE listed firms such as Land Securities, Hammerson and British Land.

In return for such a favourable tax designation, the REIT has two unique features; its primary business is in managing property investments – a minimum percentage must be allocated in yield generating assets – and it must also distribute a high proportion of its profits as dividends. These are then taxed on the investor as property income rather than as dividends¹⁰. The structure is then deemed 'tax transparent' in that holders of REIT stock are taxed as if they were direct owners of the underlying assets. This also removes the double taxation (corporation and dividend tax) of regular property funds, and although there is a slight tax cost of entry into the regime the economics are extensively weighted on the upside.

⁹ In terms of REIT valuation, more insightful metrics include; adjusted Funds from Operations (*AFFO*) and Cash Available For Distribution (*CAD*). However, such financial measures are not the key consideration of this contribution.

¹⁰ The purpose being to stop the REIT being used as an income tax shelter.



2.1 Implications for the IIT

Generally, real estate assets provide a secure investment during cyclical slumps as equity indexes face downward pressure. However, the sub-prime crisis and the consequent dislocation of credit hit the property sector hard. Nonetheless, if the recent recession functioned as a stress test of the global REIT market, then the model has proved surprisingly robust. One would expect the IIT to be an even more value adding and resilient security. This factor and other emerging market trends suggest a potential optimal fit between the capital markets and UK policy makers of developing the IIT vehicle:

- In the UK, REITs are primarily publicly traded property development firms that converted to REIT status. This means that they are more exposed to real estate development risk than their international competitors. Diversifying their portfolios with long term infrastructure assets would help dampen such risk and provide share price stability in bear markets;
- As REITs enhance their capital positions in the marketplace, after tapping the equity markets, an increase in M&A activity is expected as REITs are increasingly driven by opportunity and not just survival. At the same time, as risk appetite returns, there is a perceived limited availability of prime investment property. On both counts infrastructure assets provide a logical next investment step and the IIT could help drive this forward;
- The credit crunch highlighted the vulnerability of illiquid assets. It is likely that the IIT, like the REIT, would represent a highly liquid instrument whilst also ensuring the initial investment necessary for the development of infrastructure assets;
- With the UK likely to emerge slowly from its deep recession and with underutilisation in office and commercial rental and subsequent high vacancy rates, demand for real estate investment will remain constrained over the short term. Opening up the infrastructure market through the IIT would provide an alternative tax-efficient wrapper for fixed investment;
- Pension funds and institutional investors seek long term, stable returns which can be provided by infrastructure assets. The IIT would further attract such investors into the sector. In addition, as infrastructure demand increases at the



UK and international levels there could be considerable potential for enhanced gains. Furthermore, the IIT could be a key investment vehicle of an eventual national infrastructure bank of which ACE has been a leading proponent. The IIT could then be the actual mechanism from which to leverage public funds with private capital¹¹;

- After recent volatility in the residential markets, the IIT would offer a more risk averse and stable investment option for individuals and retail investors especially as demand for such assets is only likely to increase moving forward. At the community level in the UK, the IIT aligns with the political parties proposals for enhanced localism and regional funding;
- Broader macro-trends such as urbanization, sustainability and industrial development in emerging economies are driving forward trillions of pounds of infrastructure investment over the next decade. Infrastructure investment is becoming an increasingly crucial public need as well as a key component of investment portfolios. As an innovative financial instrument the IIT would attract capital from global institutional investors because of its inherent economic and regulatory advantages. Moreover, the IIT would be a positive step in the right direction and a message of intent that the UK is focused on incentivising the private capital needed to construct a world class infrastructure network.

To summarise; ACE believe that the IIT can provide an effective means of encouraging increased infrastructure investment in the UK by potentially delivering attractive dividends with more stability than common stock and high yield bonds¹². If as some analysts suggest¹³, investors are increasingly targeting domestic investment opportunities then the IIT would offer a tax-efficient shelter for the £3000 billion UK asset management industry¹⁴ whilst also adding diversification strength.

Integral to diversification is incorporating equities from multiple markets and sectors of the economy. Indeed, research from Ibbotson Associations found that

¹¹ A national infrastructure bank could also provide an alternative source of finance for IITs in a mutually reinforcing relationship. In this it would be similar to a Hybrid REIT. See page 26 for more details.

¹² Such an outcome would also depend on well-managed IITs with strong balance sheets and judicious leverage.

¹³ Ernst & Young, 2010, *Global REIT Report; Against All Odds*.

¹⁴ According to the UK Investment Management Association:
<http://www.investmentuk.org/>



historically, adding REIT shares to an already diversified portfolio has “improved total portfolio returns or lowered overall portfolio risk”¹⁵. In fact their analysis of asset allocation data highlights that adding REIT stock to such a portfolio adds upward pressure on the efficient frontier of the portfolio. If REITs add diversification value to portfolios then developing a broader infrastructure vehicle like the IIT for asset allocation could further enhance diversification gains. This position is extended by academic research that points to a lower Beta-risk (β) – systemic or non-diversifiable risk – profile in REITs that invest in broader sectors than primarily retail-orientated REITs¹⁶. The same logic could hold true for an IIT investing in the full spectrum of economic and social infrastructure.

The significant amounts of new capital raised by REITs internationally would suggest robust support for REITs as an investment model as investors ‘de-risk’ their portfolios and get back to basics. Looking forward, IITs should be able to sustain this inclination and offer acceptable returns with a primary focus on long-term stable cash flows. If the Government introduced the IIT regime in the UK then the country could become a pioneering location for global infrastructure investors. All this would indicate that economic and political trends support the transferal of infrastructure assets into a REIT-like structure.

The IIT can proffer latent investor benefits, including a bricks-and-mortar style asset base and the creation of long term liquid value from usually, fundamentally illiquid assets like infrastructure (a new road or a renewable energy source for instance) and enable public access to infrastructure systems that otherwise may have not been built. We can now examine the rationale of the Government in introducing the REIT model in the UK to assess if such logic can be mirrored for the introduction of a similar approach to infrastructure investment. If so, then it makes the legislative process for the introduction of the IIT more fathomable because of the implicit precedent of the REIT.

In 2005, the UK Government published a consultation paper alongside the Budget

¹⁵ <http://www.reit.com/Portals/0/PDF/2009Kekst.pdf>

¹⁶ Gyourko, J, Nelling, E, 1994, *Systemic Risk and Diversification in the Equity REIT Market*, Rodney L. White Centre for Financial Research.



of that year which proposed reform to the taxation of the property investment market. The eventual result was the REIT. The following were the key motivations¹⁷:

- Improving the quantity of finance for investment in commercial and residential property;
- Supporting structural change in property markets to reduce costs [of investment];
- There [was perceived to be] limited secondary trading and liquidity in the property sector and thus insufficient information to ensure efficient market pricing and capital allocation;
- Improving stability in the property investment market – and wider economic and financial security – by rebalancing some debt with equity among property companies;
- Allowing smaller scale investors the opportunity to access commercial property returns, currently unavailable without significant capital outlays;
- Providing the opportunity for companies [and agencies] to release property assets from corporate balance sheets into professionally managed companies; and
- Alongside wider reforms to the planning system, providing a route into which newly developed [property assets] can be sold, thereby increasing the willingness of house builders to increase supply.

As we can see these objectives are directly relevant and applicable to the infrastructure market in the UK. It then makes sense to suggest that the IIT could be a solution to enhancing infrastructure investment as the REIT was for the same reason in the property sector, especially in terms of augmenting the tax efficiency of such investments and improving the access to and the supply of infrastructure assets. The issue of addressing infrastructure debt is also important as the IIT can create the equity capital to reduce debt and develop new investment. It can be the case that incentivising investment into the UK's transport, utilities and electricity networks can have a similar effect that liberalising the communication markets –

¹⁷ *UK Real Estate Investment Trusts: A Discussion Paper*: <http://www.hm-treasury.gov.uk/d/Bud05Reits.pdf>



i.e. mobile phones and broadband – had on productivity, technological advancement, infrastructure development and wealth creation over the last 30 years.

At the macro-level, pioneering the IIT, or at a least broadened infrastructure REIT security, would attract increased foreign direct investment in UK infrastructure. It would allow the UK to participate in the globalisation of the infrastructure markets with a more competitive financial base in relation to other economies without an IIT regime (this would also stimulate the UK capital markets coming out of a recession).

For these reasons it appears that investors are starting to take note of the international infrastructure arena; analysts point to the potential future interplay of dynamic supply and demand pressures. As we have shown a whole new level of investors could be drawn to infrastructure markets – as they have been to real estate – but this demand would need to be met with a supply of innovative financing structures to attract and lock in such interest. The IIT can then help satisfy this demand.

3.0 The Infrastructure Investment Trust

In recent years, we have seen amplified returns for infrastructure, portfolio diversification benefits with other major asset classes and reduced risk¹⁸. Two major trends have driven forward this investor interest in the sector; the first has been discourse articulated on ‘real estate-related’ assets and their investment and diversification benefits, which this paper has also contributed to and; the increasing recognition by global decision-makers of the importance of integrated infrastructure systems to economic growth, living standards and the functioning of the commercial real estate markets. Juxtaposed against this backdrop, we are facing an environment of governments de-leveraging capital spending and looking

¹⁸ <http://www.allbusiness.com/trade-development/trade-development-finance/10206156-1.html>



for new ways of financing infrastructure obligations with out necessarily owing or managing the underlying assets¹⁹.

As made reference to *supra*, this demand and an enhanced interest in infrastructure as a separate asset class has in part been met by a range of infrastructure funds, structured products and bonds whose coupons are linked to infrastructure cashflows. However, listed and non-listed funds are the most widespread types of investment; the key differential being, whether this equity can or cannot be purchased on a public exchange, and although both vehicles can be securitized and offer diversity only the listed variety can be deemed highly-liquid. Unlisted assets though typically offer lower volatility. Traditionally, institutional capital has targeted unlisted infrastructure to obtain exposure in a range of products including local (and hence unlisted) infrastructure whilst retail investors utilised listed options but this is starting to change as institutional investors assess their risk profiles and the portfolio implications of holding some illiquid investments²⁰. Publicly traded infrastructure assets include airport operators, utilities and toll roads.

Here we look briefly at the strengths and weaknesses of different infrastructure exposures:

	Main Advantages	Main Disadvantages
Unlisted funds	Indirect control of assets through legal vehicle; Able management that can add value.	Management fees; Acquisition risk; Manager risk; Portfolio focus.
Listed funds	Liquidity; Smaller outlays needed; Transparency;	Agency risk; Acquisition risk; Fee structure;
Listed companies	Liquidity; Large universe of options; Can assemble diverse portfolios.	High volatility; Prices exposed to investor sentiment; No social assets.

Mercer Group <http://www.mercer.com/summary.htm?siteLanguage=100&idContent=1326325>

¹⁹ This is the rationale behind the public private partnerships and public finance initiatives which were pioneered by the UK in the 1990's.

²⁰ http://www.cohenandsteers.com/downloads/Infrastructure_Top_of_the_List_.pdf



For our purposes then the listed infrastructure market – collective funds and publicly traded firms – provides the majority of the asset base for the IIT. Similar to the REIT, an infrastructure trust is a type of distribution fund that can finance, construct, own and manage infrastructure projects²¹. The current size of the international listed infrastructure market is approximately £1.2 trillion²². Leading infrastructure indexes, including the S&P GII and Macquarie GII, trade billions of pounds of stocks each year. According to Standard & Poor's, "listed infrastructure stocks offer stable yields that are higher than the broad stock market and have lower volatility"²³. Moreover, such assets offer returns with low correlations to equity and debt finance making them, like REIT stock, good for portfolio diversification and long-term income and growth. Again similar to the REIT they also represent significant advantages over direct investment in fixed assets. These include: liquidity; the transparency and governance of public markets; daily market pricing and smaller capital commitment for participation.

Essentially, listed infrastructure is similar to the REIT wrapper in that they both provide a more efficient approach to property investment. Where they differ – and this is perhaps the crucial point of this contribution – is that listed infrastructure fails to offer the inherent tax advantages of the REIT vehicle. As will be also discussed, they also do not provide access to unlisted assets. Without these attributes then they will fall short in attracting the huge amount of capital that is needed for infrastructure projects in the UK. Indeed on some measures the global listed market decreased by almost £700 billion over the 12 months to March 2009²⁴. As a comparison over the same period, REIT stocks recorded a rebound from their March 2008 lows. Indeed, analysis from Ernst & Young reveals that all markets were in positive territory for one year returns, with only Japan failing to achieve double digit growth²⁵. Such data perhaps underlines the strength of the REIT in attracting sector-specific investment and how existing infrastructure vehicles are not mature or refined enough on their own to recreate the success of

²¹ <http://www.investopedia.com/terms/i/infrastructuretrust.asp>

²² http://www.standardandpoors.com/_Infrastructure_Primer_March2009.pdf (as of March 18 2009)

²³ Standard & Poor's, 2009, *Listed Infrastructure Assets – A Primer*

²⁴ http://www2.standardandpoors.com/spf/pdf/index/Gbl-Infrastructure_Primer.pdf and http://www.standardandpoors.com/_Infrastructure_Primer_March2009.pdf

²⁵ Ernst & Young, 2010, *Global REIT Report; Against All Odds: 20*.



the REIT model.

The listed infrastructure market is then still in its development stage and is far from the historically proven product needed to stimulate infrastructure investment. The existing infrastructure fund is simply a collective investment rather than an optimally designed vehicle to achieve broader macro-economic objectives in the space. However, the downward pressure placed on infrastructure assets over the past 24 months, due to economic conditions via debt concerns, has provided attractive investment opportunities for a well capitalized IIT to exploit.

This is where the IIT model comes into the policy mix. We have shown how the REIT model ‘works’ in that it can unlock value for investors and, as intended, increase investment in the property markets. The same result is expected in the infrastructure arena. It was also highlighted how the potential of the undeveloped – but functioning – listed infrastructure markets can provide the essential structure that can be transferred into a potential IIT regime. We then annotated the similarities of infrastructure assets to real estate to show the feasibility of such an approach. In short, it appears that there is a strategic fit between creating a novel financial wrapper incorporating the REIT tax structure and existing infrastructure trusts.

But the IIT can offer more value than just incorporating listed infrastructure funds into a REIT-like model. As the range of investment demands in the market have evolved so must the products. This is particularly important with the cost of debt rising, smaller deals being priced out and aggregate volumes of infrastructure transactions slowing²⁶. According to the head of portfolio management at AMP Capital Investors, a “new breed of infrastructure investment products” that combines existing instruments in an innovative structured product can “reduce the risk and increase the returns of a theoretically balanced portfolio”²⁷. As we have demonstrated in the real estate markets, what is good for the investor can also be beneficial for broader policy goals.

Thus, in the IIT we have a vehicle that can harness and potentially integrate the best features of listed and unlisted infrastructure, while diluting their less

²⁶ <http://www.mercer.com/summary.htm?siteLanguage=100&idContent=1326325>

²⁷ <http://www.moneymanagement.com.au/Article.aspx?ArticleID=220539>



redeeming qualities. The high barriers of entry have previously made it hard for small and medium sized investors to combine both assets in their portfolios. The key to doing so now is to package them effectively. To do so would:

...enable investors to reap the benefits of unlisted assets' stable uncorrelated returns, whilst using listed assets to offset their more negative attributes... Essentially the asset classes have a number of distinctive characteristics that make them an important addition to investor's portfolios. If these investment products [are incorporated] they can deliver on either a regional or global basis.

<http://www.moneymanagement.com.au/Article.aspx?ArticleID=220539>

As historically, listed and unlisted infrastructure returns have exhibited low correlation, such a strategy could offer key diversification benefits. This logic has worked effectively in the REIT market where the robustness and diversity of unlisted securities and the liquidity of the listed type have proved attractive. Together they help dampen the illiquidity of private infrastructure and the volatility and market beta in public instruments. This mix would work in an IIT because the vehicle would purchase equity in listed and non listed assets; and although the IIT would own a basket of unlisted shares the underlying assets themselves would still be in effect unlisted.

This process would also combine the best strengths of our two key listed components – funds and companies – whilst reducing the higher beta risk in public companies and improving the low access that typify funds. Not only is this endeavor likely to reduce costs but it also brings exposure to wider and deeper markets and projects by integrating both asset classes. An integrated listed and unlisted infrastructure model could also choose direct investment as part of its asset allocation.

The IIT could then consist of:

- Publicly traded infrastructure funds
- Publicly traded infrastructure firms
- Privately traded infrastructure assets
- Direct investment in listed and unlisted infrastructure assets



The IIT would then offer individuals and retail investors a relatively efficient and cheap method of access to a broad selection of infrastructure assets. As we shall, in this mechanism also lies the opportunity for a local community or region to set up an IIT to develop new transport, communication and energy services that are actually popularly owned. In this conception they would also be able to receive income from these assets as well as using them directly. They could be funded at the local level from either existing council tax payments or new forms of funding such as tax incremental financing or a local infrastructure levy with overall taxation levels reduced to compensate.

It is likely that investors will choose exposure in a Pareto-optimal implementation vehicle which should experience strong capital inflows just as they have utilised REITs for residential and commercial exposure. As the IIT can provide solid fundamentals, attractive valuations and generate excess value over a benchmark for investors – again as the REIT has done – it is in a pioneering position to generate long term value through defensive yield enhancing strategy (YES) structures and relatively high income.

Let us now expand on possible ways in which the IIT model can be employed:

- The IIT can be a simple and effective way for individuals and retail funds to get exposure to previously unavailable investments in a wide range of infrastructure assets, companies and listed/unlisted funds. It could also be a vehicle to invest tax free ISA allowances. We envisage IIT shares to be as liquidly traded as common equity stock on the major exchanges;
- At the same time, the IIT can also continue to be an enhanced investment option for larger institutional investors like pension and insurance funds and sovereign wealth capital than the existing suite of options. With greater economic efficiency at the margins this should channel significant new funds into asset development. Securitizing all the previous disparate asset classes into one wrapper can help augment diversification and risk-adjusted gains;
- A perhaps more interesting and novel approach would be to see infrastructure provider firms, key clients (i.e. BAA, Balfour Beatty, etc) and large contractors transforming themselves or their part of their operations (for say individual projects/assets) into IITs. This would be similar to the leading UK property



developers entering into the REIT regime soon after it was introduced. A more exciting take on this ideation could see publicly listed ACE firms who help operate infrastructure for local authorities or capital agencies transform these operations into an IIT entity (i.e. Amey). In addition, we could also see listed infrastructure assets such as Drax power station convert to IIT status. In such a case, the IIT would not need to retain large amounts of capital for growth (the initial purchase would usually be the most capital intensive), merely to fund operations. Growth could be funded through debt instruments.

- It is likely that we would see a wave of new capital in the sector into these new IIT firms. In this way, the IIT would not only benefit investors but also the infrastructure providers as it has with their counterparts in the real estate arena. In this conception, the income element of the asset would come from government concessions or from the user directly (if the asset in question is say, a new high speed rail line). There would of course need to be consultation over such a development but although building a large infrastructure asset is somewhat dissimilar to a new apartment block, the mechanics of the asset life cycle remain comparable;
- The IIT could help monetise local infrastructure assets, thus freeing up resources that a public authority can direct towards new capital expenditure. This would see the priority of government shifting towards delivering new infrastructure assets and allowing IITs to effectively manage and maintain existing capital stock. Indeed such a policy would align with the Governments' policy of £16 billion of asset sales to help alleviate the budget deficit²⁸.
- The IIT model could also enable more wide ranging trends towards direct individual and community level engagement in their own infrastructure provision. Communities could raise funds to build a new bridge or recycling plant through not only the wholesale markets but through the citizens themselves. This could lead to an environment whereby an individual could own part of the road on which they are driving. The income for the IIT would come from either a tolling system or a long term contract from the local authority or agency. Empowering individuals to decide upon and even own their own infrastructure could take the existing public-private partnership models to the next level through an

²⁸ <http://www.telegraph.co.uk/finance/economics/6300638/Government-to-sell-off-16-billion-of-assets.html>



innovative form of popular infrastructure democracy. These infrastructure assets would technically be privately owned, but by a publicly traded entity which allows individual fractional ownership. Simultaneously, the Government (or development agency) could have an equity share in such a project as well as instituting a framework for public oversight in strategic assets. This ideation leads us to our next point;

- The IIT could also borrow some of the functions that we would identify with an infrastructure bank. It could use its capital – accrued from the money markets, organs of government or local communities – to fund viable infrastructure projects. Understood in this way, it would be similar to a Mortgage REIT, which invests in loans secured by the underlying real estate assets, or Hybrid REIT which combines such ‘mortgage’ income (interest) with returns from an equity stake. With equity shares in infrastructure projects potentially also being owned by public bodies then this would be a true public finance initiative. The public or community stake could take a similar form to a ‘split’ investment²⁹ with different classes of equity capital. This would prioritise the collective equity in the public good (a power station or new road for instance) in a similar way that contingent convertible capital (“Co-Co’s”) securities can be converted into equity when certain triggers are met. Such instruments hold down the cost of capital (through public guarantees) as well as providing a buffer against stochastic events³⁰. This interpretation of the IIT could lead to the development of not only one infrastructure bank, but multiple. Commentators, including Vince Cable *et. al*, have stated that a national infrastructure bank would leverage public funds to draw in private capital. The IIT would be perfectly placed to have such a capacity.

Indeed, all of these approaches identified above, would lead to enhanced capital flows into infrastructure. In addition the investment environment would be improved through increased competition of asset development which would help bring down costs and augment efficiency. Such endeavors would help fill the gap in the forecast reduction in government spending and go some way to filling the larger infrastructure gap in the UK.

²⁹ See: <http://www.finance-glossary.com/define/split-capital-investment-trust/1348/0/S>

³⁰ See: <http://lexicon.ft.com/term.asp?t=cocos>



3.1 Infrastructure finance: in focus

It has been established that the UK faces a £500 billion funding hole in its infrastructure network. But in the Western world this challenge is far from unique. In the United States alone, their infrastructure ‘crisis’ requires \$2.2 trillion (£1.5 trillion) of investment over the next five years³¹ whilst Canada is looking at a \$120 billion (£80 billion) deficit each year³². In Europe, annual infrastructure requirements are forecast to hit almost **£140 billion annually**³³.

Thus, investigating innovative ways to finance these capital spending needs are gaining traction in the global public policy space. It then makes sense to affirm that an infrastructure REIT – our IIT – could be part of the answer as unlike existing listed infrastructure funds it would not be liable for corporate taxation as the dividends it pays are tax deductible. As highlighted, there is just one level of tax. This investment logic has slowly led to some industry experts across the Atlantic starting to take note. For instance, on talking about how to finance infrastructure solutions, Deloitte’s US leader of the real estate tax group stated that he hoped the “REIT would emerge as an infrastructure investment vehicle”³⁴. These sentiments have also been mirrored by senior investment officers in J.P. Morgan³⁵. However, this logic has not yet made an impact on decision makers. What’s more current discourse has tended to concentrate on definition whilst this paper has attempted to outline the broad themes of how this would work in practice. In this respect the IIT is our contention.

Nonetheless, the issue of definition is important and it is worth briefly examining the issue. This spotlight on capital finance recalls a complex private letter ruling issued by the US Inland Revenue Service in 2007 (*PLR 200725015*) that added to the permitted investments by a REIT to comprise certain infrastructure systems as long as the “REITs activities in relation to the system will not cause income received...to be treated as other than...qualifying REIT income”³⁶. Essentially this denoted that returns from the infrastructure asset must conform to the existing

³¹ American Society of Civil Engineers: <http://www.asce.org/>

³² <http://moneymorning.com/2009/02/05/infrastructure-stimulus-2/>

³³ *Ibid.*

³⁴ <http://www.reit.com/tabid/477/News/default.aspx?type=E&ID=54>

³⁵ <http://www.reuters.com/article/idUSTRE54674D20090507>

³⁶ <http://www.mondaq.com/unitedstates/article.asp?articleid=79356>



REIT regime. At the time, it was widely expected that this ruling, although only applicable in that individual case rather than systemically, would boost REIT interest in including infrastructure assets as part of their portfolios. However, this has not really occurred and discussion continues over whether infrastructure constitutes 'real estate' or 'real property' – with investors seeing the latter as being 'good' REIT-able assets. The debate continues. Looking ahead, it is possible that a more optimal approach would see this debate inverted; broadening out the definition and composition of infrastructure rather than that of real estate.

Nevertheless, what is needed at the UK level is the Government to look into employing the IIT model as an effective and, as it mostly relies on private capital, economical means of increasing investment in transport, electricity, utility networks. Over the short-term, this would help support the recovery by enhancing aggregate demand and employment and over the longer-term improving the competitiveness and productivity of the UK economy.

To kick-start this process the Government should:

- Consult with the investment and construction industries and the public over the introduction of either an expanded REIT regime or the new IIT vehicle and what assets can be included;
- Explore ways of optimising the REIT wrapper to attract significant new capital inflows into infrastructure and how its own capital spending programmes can help leverage private capital through the IIT;
- And similar to how it introduced the REIT in 2007, establish how the proposed IIT regulations would fit in with existing legal restrictions on UK companies;
- Consider additional regulations necessary to ensure the appropriate and intended use of the potential UK IIT legislation;
- Ensure regulatory transparency over how the different IIT conceptions – outlined *supra* – would function in the infrastructure markets;
- And review its partnerships with private investors and local communities over how best the Government can contribute to investment in infrastructure using the IIT model (i.e. through a national infrastructure bank or a hybrid IIT structure); and



- Perhaps most importantly, ensure that the UK is at the global forefront of developing innovative means to attract more capital into our infrastructure network.

3.2 The IIT going forward: investor issues

Infrastructure assets share some characteristics with real estate; namely predictable cash-flows, long-term investment, high yields and valuation based performances. Moreover, when securitised in collective investments they benefit from high liquidity and low entry costs. Nonetheless, they also have some key differences in structural variations, investment packaging, the scale of capital required and the *ownership* of real estate as opposed to the *right to operate* the infrastructure asset³⁷. We can outline the key differences below:

- Overall, real estate assets resemble commodity securities whilst infrastructure assets are more specialised and have monopoly-like characteristics which enhance their relative pricing power;
- Real estate is more sensitive to economic cycles and thus cash flow volatility whereas infrastructure assets – in a somewhat monopolistic position – generally generate more stable cash flow and lower risk premia; and
- Individual properties typically meet a ‘ready’ market and scope exists to refurbish or redevelop such properties to maintain viability as demand and competition varies. Infrastructure assets on the other hand, are usually highly specialised and if revenues are challenged by a new technology or facility, the reactive capacity may be low.

It is these differentials that channel our thinking, especially in regard to the regulation and monopolistic nature of infrastructure assets, which suggest that as it stands neither the current REIT wrapper nor standard listed infrastructure do not, on their own, provide the best vehicles to enhance infrastructure funding through collective investment in a broad array of vital capital assets. Thus, at the same that

³⁷ <http://www.allbusiness.com/trade-development/trade-development-finance/10206156-1.html>



infrastructure should be considered a separate asset class, it should also be categorised as a separate asset class that can include key sectors currently represented in REITs.

We then envisage not a REIT holding certain infrastructure assets but a potential IIT holding certain real estate assets – particularly distribution systems and industrial parks – and degrees of listed and non-listed infrastructure in a diversified portfolio. This could make more sense as investing in such real estate assets can be “analogous” to infrastructure³⁸. Furthermore, although some infrastructure assets can be REIT-compliant, the process is not optimally transparent and a lot of other infrastructure assets such as bridges and ports can not be included. In addition, the critical importance of infrastructure may somewhat necessitate a unique and explicit tax designation for these assets. A designation which provides augmented advantages for the *right* type of capital flows into the sector to all vital listed and non-listed infrastructure assets. Neither the current REIT model or infrastructure trusts have this capacity. There is of course, some work to be done on creating a properly structured IIT model, but bearing in mind the size of the UK’s infrastructure gap, it would be a very much worthwhile and eminently sensible endeavour. A specific IIT designation would also ensure that the vehicle could be improved from the REIT and optimised for infrastructure.

The mechanics of how the IIT would operate and its correlation with other asset classes is beyond the scope of this paper and would any way depend on the investor’s risk profile and their existing asset allocation³⁹. Nevertheless, academic research from Australia⁴⁰ points to infrastructure (specifically unlisted) and real estate assets having investment characteristics which do not possess a high correlation. The research also found that listed and non-listed infrastructure investments do not have a significant relationship (an R^2 of **0.36**). This could indicate the suitability of some real estate and infrastructure to be included in a single vehicle – for instance the IIT – in a mixed-asset portfolio, especially with infrastructure securities historically having shown a low correlation to other asset classes.

³⁸ Reit.com, 2010, *Institutional Investing in Infrastructure*.

³⁹ There is also of course also no one type of infrastructure asset; correlations will vary depending on sub-sectors.

⁴⁰ Newell, G, Peng, H W, 2008, *The Role of US Infrastructure in Investment Portfolios*, Journal of Real Estate Portfolio Management.



What we are then essentially proposing in the IIT, is broadening out existing infrastructure investment options, perhaps with the inclusion of types of social and economic infrastructure already contained in REITs, and integrating them into an optimized REIT like wrapper to enhance infrastructure investment through making the asset class more attractive to investors. The IIT would then take the infrastructure fund and the REIT to a logical next level.

Overall, the IIT is at its basic level a simple concept; a means of making it easier to get capital to flow into UK infrastructure through tax and regulatory efficiency. The IIT is certainly one way of doing this and opening up the market to retail investors, local communities and global finance. Furthermore, just as the investment community is getting back to basics after the financial crisis, the IIT would provide an attractive investment vehicle (with relatively inelastic demand) that rewards investment in critical assets.

Looking ahead, extensive growth is expected in the global infrastructure space, driven by historical underinvestment, increasing demand for infrastructure assets by growing and developing populations and mounting investor interest and participation in the asset class. The IIT can then cater to this extensive demand and provide an international benchmark for attractive infrastructure investment.

4.0 Conclusion

The objective of this paper is to trigger the debate about the potential introduction of the IIT, its impact on infrastructure investment in the UK, and to position the concept in the public policy arena. Analysis in this paper is directed at highlighting how enhancing the attractiveness of the infrastructure asset class can help increase the quantity of finance in the sector. The idea being that this capital could then be used to develop a new generation of transport, power, utilities and



communication assets in the UK.

Our contention focused on how utilising the existing tax-advantaged REIT wrapper and optimising for infrastructure assets could provide an efficient model for augmenting direct and collective investment in the national infrastructure network. We have shown how using such a vehicle could harness the private markets for extensive public benefits including; improving access to retail investors, enabling broad based ownership of infrastructure by local communities and monetising local infrastructure assets to free up resources to direct towards capital spending. Looking forward the IIT could also be a key component of a UK infrastructure bank (or banks) and new public finance initiatives. Looking at the micro-level of investor-gains and potential functions of the IIT in this way can help us understand how to achieve macro-level goals in economic development, productivity and competitiveness. Understood in these ways, the IIT can help quantitatively ease the UK's infrastructure crunch.

For the IIT to be feasible then the model on which it is based must also be feasible. Evidence suggests that the REIT not only increases investment in its sector but also that the model is robust enough to withstand acute economic headwinds. We have shown that on both accounts the REIT model passes the test. Our take is that the IIT vehicle would be well placed to do the same in the infrastructure markets.

Globally, there is an increasing public policy spotlight on infrastructure due to significant demographic, industrial and environmental trends. The challenge is how to finance these infrastructural networks. At the same time, investors are looking at how to gain diversified exposure – with both listed and unlisted securities – in the emerging asset class. The IIT can then be a solution to this dual demand. Moreover it can, depending on the seriousness of the Government in seeking capital flows into infrastructure, offer augmented benefits to large and small investors. Decisions now have to be made at the legislative level about how best to drive the IIT conception forward.

There are no easy ways in building a world-class infrastructure network. It takes a



considerable and long-term commitment by public authorities. Nevertheless, by introducing the IIT the Government would position the UK as the principal destination to attract foreign direct investment into infrastructure systems. Our analysis leads us to believe that the REIT/IIT model can add value on multiple levels. It would then be a crucial step in the right direction.

Frequently Asked Questions

1. Why is infrastructure investment so important?

Strategic investment in the UK's infrastructure systems will lead to increased economic activity as well as providing the infrastructure that UK plc needs to get from A to B, live in a sustainable way and raise revenue for government. Furthermore, it has been argued that a large part of private sector productivity growth is connected to the size of a country's infrastructure base and annual investment in it⁴¹.

This UK's current infrastructure requirement has been estimated at a third of annual UK GDP, around £500 billion⁴². The consequences of not investing will be the gradual erosion of the UK's competitive advantage and living standards – which will be especially pronounced as the economic centre of gravity shifts east and emerging nations invest trillions in new infrastructure systems.

The OECD believes that investment in infrastructure should be one of the UK's top three priorities over the medium term⁴³. It seems that public infrastructure spending provides the biggest 'payoff' in terms of economic growth, way in front of education, health and welfare provision. Essentially then we need to invest in our future to safeguard it and avoid an economically and socially damaging infrastructure crunch. This is why even in a tough fiscal climate the UK Government needs to prioritise capital rather than current spending.

⁴¹ Rodriguez, F, 2006, *Have collapses in infrastructure spending led to cross country divergence in per capita GDP?* Wesleyan University

⁴² Helm, D, Wardlaw, J & Caldecott B, Policy Exchange, 2009, *Delivering a 21st Century infrastructure for Britain*

⁴³ OECD, 2009, *Economic Outlook No. 85*



2. What is a REIT?

A REIT is a company that mainly develops, owns, and operates income producing real estate such as residential property, commercial centres like offices and hotels and some industrial assets such as warehouses and waste facilities. Some REITs also engage in financing real estate projects. REITs can be private or publicly available companies. The two key criteria of a REIT entity are that it must distribute at least 90% of its income to shareholders and in return it can deduct dividends to its shareholders from corporation tax. They were introduced in the UK in 2007.

3. What are the advantages of the REIT?

The REIT provides significant benefits for investors. These include:

- Delivering income and long term growth;
- Having a low correlation with other asset classes like equity and bonds;
- Providing high dividend yield;
- A liquid investment
- A predictable revenue stream; and
- Share price appreciation.

In addition the REIT also offers broader, macro-benefits:

- Increasing the quantity of finance for commercial and real estate investment. In the US alone REIT market capitalisation has grown from £60 billion to approximately £135 billion over the last decade⁴⁴;
- Opening up the asset class to retail investors;
- Research has shown that adding REITs to a wide selection of portfolios boosted compound annual total returns by up to 0.8% compared to non-REIT portfolios⁴⁵.

⁴⁴ <http://www.reit.com/AllAboutREITs/tabid/54/Default.aspx>



4. Who invests in REITs?

A wide array of investors are attracted to REITs because of their high levels of current income and the opportunity for long term growth. Such investors include retail and individual investors; insurance companies; exchange traded funds; wealth managers and pension funds. We envisage a similar broad range of investors for the IIT.

5. How is the IIT different? What similar products are there already?

The IIT would essentially borrow significant components from the REIT and be a comparable tax-efficient model. Similar to the REIT, an IIT is a type of distribution fund that can finance, construct, own and manage infrastructure projects. However, the IIT would optimize the REIT wrapper in terms of the regulatory advantages and in line with the structural differences between the asset classes. The aim would be to replicate the success of the REIT in opening up the infrastructure market to individuals and retail investors as well as rewarding existing institutional finance with greater economic efficiency.

The infrastructure market is still developing, but there currently several ways to invest in these assets, these include; direct infrastructure and listed and non-listed securities. The listed variety – funds and companies – does provide certain ways of collective investing and would form the majority of the asset base for the IIT. The two critical differentials being that the IIT would offer a uniquely optimised tax-advantaged wrapper that can attract the right type of capital as well as making it possible for the first time to include the different types of infrastructure asset in such a beneficial vehicle.

6. Would it be easier to broaden out the existing REIT wrapper?

Possibly. Certain infrastructure assets – such as warehouses and distribution systems – are already REIT-able and there is debate in the United States about broadening the assets they can incorporate. However, although some

⁴⁵ http://findarticles.com/p/articles/mi_m3495/is_2_48/ai_97873161/



infrastructure can be held in a REIT the process is not optimally transparent and a lot of other infrastructure assets such as bridges and ports can not be included. There are also issues over the monopolistic nature inherent in some infrastructure assets which prevent the REIT being an effective vehicle. Moreover, the critical importance of infrastructure, its investment characteristics as a distinct asset class and the sheer breadth of assets in the infrastructure sector somewhat necessitate a unique infrastructure wrapper. ACE then envisage not a REIT holding certain infrastructure assets but a potential IIT holding certain real estate assets and degrees of listed and non-listed infrastructure in a diversified portfolio. Thus, whilst an extended REIT could increase capital flows into the sector, and such a result would be welcomed, we feel that a dedicated IIT is the best route to take. In short, broadening out the REIT may be easier but it may not be more effective.

7. What investment benefits do you envisage the IIT having?

As discussed, the IIT would utilise the majority of the advantageous REIT characteristics, notably the tax gains of removing the double taxation element, in addition to the strengths of the listed infrastructure market, such as:

- It's publicly traded nature;
- Relatively stable cash flows and capital gains;
- A high degree of regulatory control and barriers to entry;
- Low volatility; and
- A degree of inflation protection as revenue is linked to the CPI in some assets.

8. What would be the key functions of the IIT?

- Open up infrastructure investment to individuals and retail investors;
- Provide a tax free ISA-able investment
- Enhance interest in the asset class from institutional investors;



- Enable infrastructure development and provider companies to transfer into the IIT regime;
- Provide an opportunity for public and local community participation in delivering their own infrastructure services;
- In this conception, IIT infrastructure ownership would allow local communities to monetise their existing assets to invest in new projects; and
- Become a structuralised vehicle for potential infrastructure bank funding.

9. How would IITs raise capital? What would be the investment process?

IITs would raise capital in the same way as conventional companies; on the capital markets through an initial public offering (IPO). The only difference is that instead of buying the shares of one company, the investor would own a fractional amount of a pooled array of infrastructure securities. These securities could consist of direct, listed and unlisted infrastructure assets. Returns for equity holders are generated through the income of the asset. In terms of infrastructure this would generally be from individual charges (such as a toll road) or from long term concession from a public authority in return for the initial cost of asset development. In the IIT regime the majority of this income would be distributed among shareholders as a percentage of paid out taxable income.

10. How much support would the IIT need from government?

The Government would need to introduce the legislation that would establish the IIT regime in the UK. A consultation process involving the investment and construction industries is likely to be needed first. Nonetheless, as the IIT is modelled on the existing REIT regulations, its introduction should not be that challenging as long as the IIT can be structured and allocated properly. Moreover, as the IIT is essentially 'free' infrastructure investment – as the Government would mostly just incentivise capital – at a time of substantial budget pressure it could provide a relatively quick and effective solution to the UK's infrastructure deficit. Introducing the IIT would then need support from the Government as part of its



capital investment strategy. Furthermore, because of the long-term commitment inherent in infrastructure investment, the IIT would require long-term concessions similar to those in existing public private partnership deals. In this way the IIT can provide a resolution to the time-inconsistency problem associated with regulatory frameworks and control periods.



Appendix A – UK REIT review

The REIT regime in the UK commenced on 1 January 2007 and any company within the legislative regime will generally be exempt from UK tax on both rental income and gains arising from the sale of rental properties. Other profits are subject to corporation tax in the same way. Thus, whilst a regular company pays taxes on its Earnings Before Interest and Tax (EBIT) and decides how to allocate after tax profits between dividends and reinvestment, a REIT simply distributes most or all of its profits and gets to omit the taxation. One of the primary reasons the UK Government introduced REITs was to encourage the smaller investor to allocate capital into the commercial property sector through real estate vehicles similar to an individual investing in the market directly (i.e. buy-to-let property). It then sought to remove taxation as a factor influencing the choice between direct and indirect investment. It was hoped this would result in investment in an array of property assets whilst offering lower financial risk. Moreover, according to the national REIT association the Government also aspired to “support, and promote retail investors by permitting REITs to be held in tax sheltered personal finance products like ISAs and SIPPs”⁴⁶. This government rationale could easily be transferred over into the infrastructure arena as a means of encouraging popular participation in peoples own infrastructure networks, including through individuals tax free allowances, which would also enhance capital investment in the roads, rail and electricity generation.

The REIT jurisdiction has other qualifying conditions⁴⁷ but for our purposes, the principal ones are that the REITs key operations – its income producing assets – can be ring-fenced and at least 75% of such profits must be derived from this business. What’s more, at least 75% of the REITs assets at the beginning of each accounting period should be involved in its tax-exempt business. There are also rules over share issue, namely that a firm can only issue one type of ordinary equity, although preference shares can be issued. As will be discussed *infra* this aspect could have positive implications for a new approach to public-private financial partnerships. Several commentators have noted the relative ease and simplicity of setting up and investing in a REIT vehicle⁴⁸. We envisage a similar model for the IIT.

⁴⁶ http://www.emeraldinvestmentproperty.com/real_estate_investment_trust.asp

⁴⁷ http://www.reita.org/live/resources/downloads/REITs_and_property_UK/UK_REITs.pdf

⁴⁸ <http://www.associatedcontent.com/article/173452>



A model which would permit the IIT – again like the REIT – to be able to invest, develop and manage any infrastructure type, tax efficiently, at both the UK and international levels (although tax benefits to foreign investors may vary based upon the classification of the scheme in their national tax regime. The tax implications as set out in the UK can be found on the HMRC website⁴⁹). This would also mean the vehicle would have an advantage of purchasing power in the marketplace compared to other investment entities because a tax-efficient entity can afford to purchase assets at higher prices than competitors.

Overview of REIT advantages

REITs offer investors a powerful tool for portfolio balancing and diversification whilst also providing ongoing dividend income and the potential for long term competitive total returns.

Here we outline the primary benefits of the REIT regime for investors as we hold that not only that the regime can be directly applicable to broader infrastructure assets but also that an enhanced regulatory environment can help to achieve macro and micro-economic public policy objectives.

- The REIT is currently exempt from UK corporation tax if it distributes 90% or more of its net income to common shareholders. There is then increased tax transparency as tax is only payable on income dividends. Because of this requirement, investors have looked to the REIT for stable income;
- Furthermore, there is potential for a proportion of the dividend to be a non-taxable return of capital (if the REIT distributes more than 100% of net income). Simply put, this allows the investor to defer taxes on that part of the dividend until in some cases it is sold. This results in an improved after-tax yield;
- This ‘pass through taxation’ can also result in a potentially higher market valuation of the company through the increase in dividend allocation to equity holders;

⁴⁹ HMRC, UK REIT regime <http://www.hmrc.gov.uk/drafts/uk-reits.htm>



- REITs typically offer a greater inflation hedge than fixed rate bonds as through their rental income REITs adjust themselves in line with rises in the general price level;
- There is a low correlation between REITs and equity and bonds which means that REITs complement these investments and can be a key element of asset allocation in a diversified portfolio by dampening its risk profile, without necessarily reducing returns. Publicly traded REIT instruments are highly liquid as they can be bought and sold similar to stocks in any other listed company (each day, with real time share prices). REIT shares are traded on all the major exchanges;
- And similar to other publicly traded entities REITs traditionally use sensible amounts of debt – and thus low leverage – in their capital structures. Indeed, recent analysis indicates that the average debt to gross assets in the UK is less than 50%⁵⁰;
- REITs, generally offer lower transaction and management costs compared with other investment vehicles and buying property directly;
- They create augmented access for retail investors and individuals to professionally managed residential, commercial and industrial property through collective instruments without personal liability or actual exposure to real estate assets; and
- The REIT structure is also ISA-compatible, so up to £10,200 of annual investments in the vehicle can be free of tax on dividends and gains on share appreciation.

However, as in any investment there are of course some risks associated with the REIT model. For the purpose of balance these will be discussed briefly:

- Whilst conversion into a REIT structure is a relatively straightforward process, retaining it does require increased monitoring and compliance – for the executive – especially in regard to separating the tax except and non-tax except businesses;

⁵⁰ Ernst & Young, 2010, *Global REIT Report; Against All Odds*.



- There is also a fixed entry charge into the regime; a 2% levy on the company's qualifying investment;
- The REIT is also unable to pass losses through to its shareholders;
- Investing only in REIT assets can increase volatility; and
- The requirement of the REIT to distribute 90% of income to shareholders could hamper the company's ability to grow from internal resources.

Moreover, like any stock, REITs can also be exposed to market risk which can not be diversified away. Such risks include:

- The potential for the dividend can be cut, and as a significant component of aggregate return is based on dividend income, this should be taken into account;
- As should interest rate risk; like most economic activity if interest rates rise then growth can slow.

Nonetheless, certain solutions can be articulated to such concerns. To start with it is worth annotating that regulatory burden and systemic risk are issues faced by the majority of corporate entities. Yet, good governance and due diligence can go some way in reducing these factors impact on business activities. We can address the diversification issue somewhat more easily; by its very nature the IIT is likely to invest in a more diverse range of assets (transport, utilities and energy etc.), subsequently enhancing its contribution to a diversified portfolio compared to the standard REIT⁵¹.

What's more, the integral point being that the potential IIT does not have to be fully identical to the existing REIT wrapper. It can essentially borrow the best aspects of the REIT and fit accordingly to the infrastructure asset class⁵². If we consider that

⁵¹ However, both investment vehicles most optimally function in an already diversified portfolio.

⁵² Indeed, the IIT could also potentially borrow some aspects from the Real Estate Operating Company (REOC) which can reinvest income back into the business and be more flexible about which investments it can make. Although on the whole, their less



the current REIT model – although mainly concentrated in residential and commercial property – can also, and does, invest in industrial parks, health facilities and some natural resources⁵³ then it should not take too much regulatory tweaking to be able to incorporate a wider array of fixed assets whilst at the same time improving the current regime to amplify investment demand. Perhaps then, as will be examined, utilising the REIT for infrastructure could be merely a question of definition.

The regime can be further optimised to overcome such challenges. As the IIT would help fund critical infrastructure assets then we can assume that the regulatory environment would be more favourable to the investor and the IIT entity. This leads us onto our next point, that the majority of disadvantages flagged up are met by the executive of the REIT as opposed to the investor. This is important as the essential objective of the IIT is to attract more investors and hence capital, into infrastructure development in the UK. Therefore, if there is demand at the investor level then the management of the IIT would cater to this demand. If this is already happening in the REIT market – which it is – then logically it should also occur, if not more so, with an enhanced tax-efficient IIT vehicle. Any potential IIT legislative framework should then be primarily focused on creating an optimal balance between the goals of the investment community (retail and institutional), government, infrastructure providers and engineering firms and perhaps most importantly the end user; the individual.

The current REIT market

According to Ernst & Young's 2010 global REIT report, between 2008-2009 the REIT model suffered from marked increases in the cost of funding; exposure to significant debt maturities in an illiquid market; and investors selling down their positions. When the US housing bubble burst into a global financial crisis and residential and commercial yield curves inverted, many analysts raised doubts over the sustainability of REIT vehicles. Indeed, across the world, the total market

tax efficient structure and capital gains orientation make the REOC unsuitable to fully model the IIT on.

⁵³ Mostly forestry real estate.



capitalisation of REIT populations was crunched from £422 billion in June 2007 to £290 billion in June 2009⁵⁴. The UK REIT market was especially hit hard during the downturn with market capitalisation falling from £28 billion in the summer of 2008 to £18 billion over 12 months⁵⁵. By some measures the UK had one of the worst performing international REIT markets as it tended to shift away from the traditionally passive and specialist model. As an auxiliary point, infrastructure assets are regarded as principally passive and specialist securities.

However, after several uniquely tough years, there has been an acute upward swing in global REIT stock. REITs have raised billions in capital and shored up balance sheets. Investor sentiment has improved and commentators are more bullish on medium term prospects. The global NAREIT index rose 3.02% in February this year⁵⁶. In the UK, total REIT market value was over £25 billion by the end of 2009. According to REITA, the national REIT association in the UK, positive investor sentiment is growing with £4.5 billion raised in new equity which has reduced the “risk of loan-to-value covenant breaches” and provided the opportunities to exploit business opportunities⁵⁷. Moreover, secondary yields are also anticipated to stabilise over the next 12 months.

Overall, the market for publicly traded REITs is expected to expand during 2010 after a partial recovery in 2009 as investors once again seek exposure in tangible assets and with global interest rates expected to remain low over the medium term. Indeed, according to Ernst & Young, the global performance of REITs are leading the property markets out of the downturn⁵⁸.

The huge growth in the global REIT markets, which in the US alone has seen their equity market capitalization soar from £60 billion to approximately £135 billion over the past 10 years⁵⁹, has then set the scene for the evolution of the REIT model to securitized investment in a broader range of fixed assets.

⁵⁴ Ernst & Young, 2010, *Global REIT Report; Against All Odds (as of December 31 2009)*.

⁵⁵ *Ibid.*

⁵⁶ <http://www.reit.com/tabid/477/News/default.aspx?type=E&ID=98>

⁵⁷ http://www.reita.org/live/Features/PIP_Jun09.html

⁵⁸ <http://www.ey.com/UK/en/Newsroom/News-releases/RE---10-03-10---Global-REIT-performance>

⁵⁹ <http://www.reit.com/AllAboutREITs/tabid/54/Default.aspx>



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