

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 The Infrastructure Investment Trust

In recent years, we have seen amplified returns for infrastructure, portfolio diversification benefits with other major asset classes and reduced risk¹. 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. The second is 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 for new ways of financing infrastructure obligations without necessarily owning or managing the underlying assets².

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. 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, while retail investors utilised listed options. This is starting to change as institutional investors assess their risk profiles and the portfolio implications of holding some illiquid investments³. Publicly traded infrastructure assets include airport operators, utilities and toll roads.

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

² This is the rationale behind the public private partnerships and public finance initiatives which were pioneered by the UK in the 1990's.

³ http://www.cohenandsteers.com/downloads/Infrastructure_Top_of_the_List_.pdf



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>

For our purposes 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 projects⁴. The current size of the international listed infrastructure market is approximately £1.2 trillion⁵. Leading infrastructure indexes, including the S&P GII and Macquarie GIIS, 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"⁶. Moreover, such assets offer returns with low correlations to equity and debt finance making them, like the REIT stock, good for portfolio diversification and long-term income and growth. 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

⁴ <http://www.investopedia.com/terms/i/infrastructuretrust.asp>

⁵ http://www.standardandpoors.com/_Infrastructure_Primer_March2009.pdf (as of March 18 2009)

⁶ Standard & Poor's, 2009, *Listed Infrastructure Assets – A Primer*



fails to offer the inherent tax advantages of the REIT vehicle. As will be also discussed, they 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. On some measures the global listed market decreased by almost £700 billion over the 12 months to March 2009⁷. 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 growth⁸. 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 the REIT model.

The listed infrastructure market is 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 capitalised IIT to exploit.

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 slowing⁹. 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”¹⁰. As we have demonstrated in the real estate markets, what is good for the investor can also be beneficial for broader policy goals.

⁷ http://www2.standardandpoors.com/spf/pdf/index/Gbl-Infrastructure_Primer.pdf and http://www.standardandpoors.com/_Infrastructure_Primer_March2009.pdf

⁸ Ernst & Young, 2010, *Global REIT Report; Against All Odds*: 20.

⁹ <http://www.mercer.com/summary.htm?siteLanguage=100&idContent=1326325>

¹⁰ <http://www.moneymanagement.com.au/Article.aspx?ArticleID=220539>



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 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 listed and unlisted infrastructure returns have historically 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 offer individuals and retail investors a relatively efficient and cheap method of access to a broad selection of infrastructure assets. As we shall see, 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 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, such as 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. Securitising 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 (e.g. 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 (e.g. 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), but 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 Government's policy of £16 billion of asset sales to help alleviate the budget deficit¹¹.
- 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

¹¹ <http://www.telegraph.co.uk/finance/economics/6300638/Government-to-sell-off-16-billion-of-assets.html>



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 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;

- 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 investment¹² 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 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 events¹³. 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.

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

¹² See: <http://www.finance-glossary.com/define/split-capital-investment-trust/1348/0/S>

¹³ See: <http://lexicon.ft.com/term.asp?t=cocos>



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.

1.1 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 years¹⁴ whilst Canada is looking at a \$120 billion (£80 billion) deficit each year¹⁵. In Europe, annual infrastructure requirements are forecast to hit almost **£140 billion annually**¹⁶.

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”¹⁷. These sentiments have also been mirrored by senior investment officers in J.P. Morgan¹⁸. 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

¹⁴ American Society of Civil Engineers: <http://www.asce.org/>

¹⁵ <http://moneymorning.com/2009/02/05/infrastructure-stimulus-2/>

¹⁶ *Ibid.*

¹⁷ <http://www.reit.com/tabid/477/News/default.aspx?type=E&ID=54>

¹⁸ <http://www.reuters.com/article/idUSTRE54674D20090507>



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”¹⁹. Essentially this denoted that returns from the infrastructure asset must conform to the existing 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 in the UK 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 shortterm, this would help support the recovery by enhancing aggregate demand and employment and over the longerterm improving the competitiveness and productivity of the UK economy.

¹⁹ <http://www.mondaq.com/unitedstates/article.asp?articleid=79356>



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;
- Similarly 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 would function in the infrastructure markets;
- 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.

1.2 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 asset²⁰. We can outline the key differences below:

²⁰ <http://www.allbusiness.com/trade-development/trade-development-finance/10206156-1.html>



- 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 premiums; 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 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 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 infrastructure²¹. 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

²¹ Reit.com, 2010, *Institutional Investing in 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 allocation²². Nevertheless, academic research from Australia²³ 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.

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.

²² There is also of course also no one type of infrastructure asset; correlations will vary depending on sub-sectors.

²³ Newell, G, Peng, H W, 2008, *The Role of US Infrastructure in Investment Portfolios*, Journal of Real Estate Portfolio Management.



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.

To view the full Infrastructure investment trust paper please [click here](#)



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