REITs: the case for infrastructure

Building a better working world

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That the world has a desperate need for infrastructure investment is an often-discussed and widely accepted premise. Reports suggest the cumulative investment needs are anywhere between US$53t and US$71t.[1] Developed markets need to expand and renew existing assets while emerging markets need to build critical new infrastructure to accommodate population growth, rapid urbanization and rising incomes. Governments continue to face major challenges in financing and delivering large infrastructure projects, with low productivity, uncertainty and funding highlighted as primary concerns.

Private sector capital is often highlighted as a critical component of solving what is a global problem with a significant economic impact.[2] Private capital is needed in two areas:

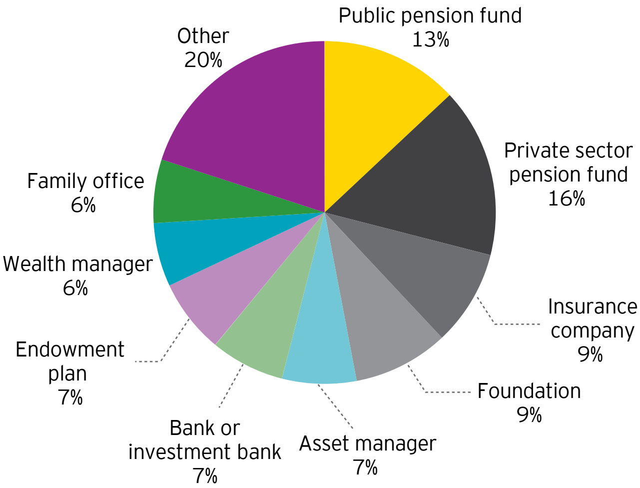
1. Funding development: restrained public budgets reinforce the need for innovative financing instruments, such as public private partnerships (PPPs), to engage with the private sector and develop alternative funding models.
2. Funding acquisitions of government or PPP assets in order to transfer stabilized, income-producing infrastructure assets out of public ownership and into private hands. This enables governments to recycle existing capital back into new projects.

It is the second area that institutional investors making allocations to infrastructure as part of a multi-asset portfolio are targeting and the part of the market to which we believe a real estate investment trust (REIT)-like structure could contribute.

Private capital targeting infrastructure

Private capital dedicated to infrastructure has grown from US$99b in 2007 to US$418b in 2017.[3] Much of this capital emanates from pension, insurance, foundation or endowment funds, and banks via private equity vehicles, targeting stabilized assets with robust and often regulated cash flows allowing a degree of growth. The cash-flow profile of many liability-driven institutions aligns well to infrastructure, which is evidenced by public and private sector pension funds and insurance companies comprising the top three institutional investors contributing a combined 38% of all capital.[4]

Figure 1: Institutional investors in infrastructure



Source: Preqin.

1. "Bridging Global Infrastructure Gaps," McKinsey & Company, June 2016.
2. Ibid.
3. "2018 Preqin Global Infrastructure Report," Preqin, 2018.
4. Ibid.

Characteristics of private capital targeting infrastructure

Private capital is not typically targeting higher-risk opportunistic type investments, which may include development. Analysis from Preqin shows just US$50m was raised in 2017 for opportunistic infrastructure strategies compared with US$32.6b for core or core plus and US$21.1b for value-add strategies. As figure 2 highlights, deal flow is a top investor concern and capital looking to access the sector has increased markedly since 2007. This suggests part of the problem is not the availability of capital in the private sector but the flow of assets out of public ownership into private vehicles.

Figure 2: Infrastructure dry powder, transaction volumes and challenges

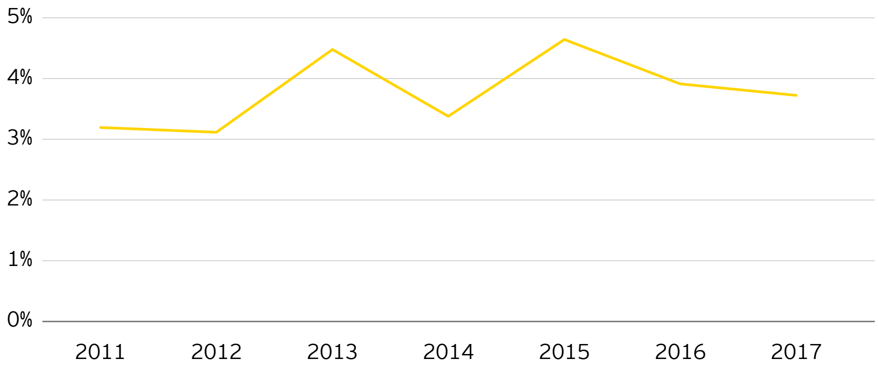
Infrastructure dry powder	Top three investor concerns	2017 transaction volumes	
		Infrastructure	Real estate
2007 >> US$65b	1. Valuation	**US$337b**	**US$845b**
2017 >>>> US$150b	2. Regulation 3. Deal flow		

Source: Preqin, RCA.

A REIT-like infrastructure vehicle is unlikely to make a meaningful contribution to development of new assets

Solving the need for development capital is not likely to be the role of an infrastructure investment trust (InvIT) modeled along the lines of a REIT. Investors expect REITs to distribute current yield and properties that are under development do not generate cash flow. However, in the US, it is possible from a tax perspective for a REIT to develop and then use property. A REIT that develops and sells a property within two years would be subject to the 100% prohibited transactions tax, but that tax does not apply if the property is developed and held for the production of rental income on a long-term basis. As figure 3 shows, in the US development activity typically accounts for less than 5% of REIT market cap. At the extreme, Japan's J-REITs are prohibited entirely from undertaking development.

Figure 3: US REIT development pipeline as a percentage of market cap



Source: SNL Financial.

What role would a REIT-like product play?

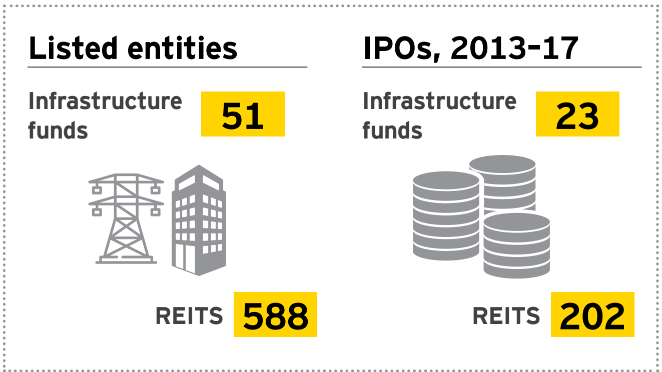
1. Create a deeper pool of capital to purchase developed infrastructure assets

Perpetual life vehicles such as publicly listed REITs enable long-term ownership of assets. They can therefore play a critical role to provide an exit strategy for developers of infrastructure. The result is infrastructure developers – whether government, private sector or a combination of both – can recycle capital more rapidly and ultimately build more projects to help address the huge investment needs.

2. Accelerate growth in the listed infrastructure fund market

Listed infrastructure funds already exist, but as figure 4 shows they are few in number. In contrast, there are 588 listed REITs operating in 31 markets globally.[5] Expansion of the REIT concept to new markets as well as IPO activity has driven growth. Worldwide, 14 new markets have introduced REIT legislation since 2008[6] and market cap has grown from US$430b in 2008 to US$1.7t today.

Figure 4: Listed markets, infrastructure vs. REITs

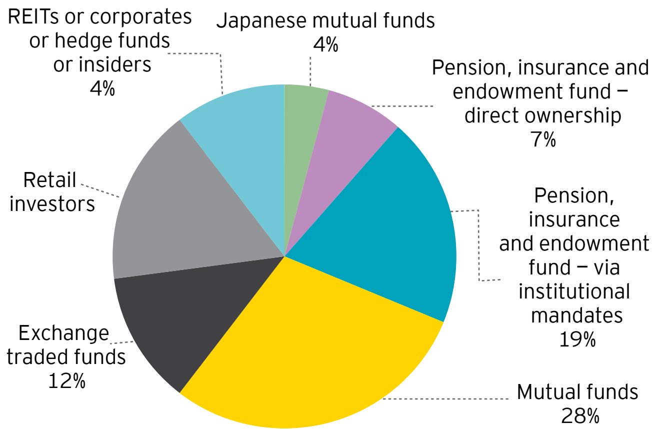


Source: Preqin, SNL Financial.

3. Bring new capital sources to the infrastructure sector

At present, private infrastructure funds are largely the preserve of institutional investors. Pension funds are the largest single investors followed by insurance companies and foundations. REIT ownership varies significantly between jurisdictions but as figure 5 shows, in the US – which remains both the most mature and largest market globally – ownership is very diverse. A deep and diverse ownership base is important in order to see capital flow to a wide variety of strategies.

Figure 5: US REIT ownership



Source: Citi.

4. Enable governments to design an appropriate regulatory framework for the private ownership of infrastructure assets

The REIT concept may be a globally recognized brand but REITs are fundamentally creatures of individual jurisdiction's tax codes. Qualifying assets for REIT status in the US and Japan differ significantly with a facts and circumstances test used in the US vs. a specified list of allowable assets – including renewable energy generating plants – in Japan. Many subtle differences exist which have been designed to maximize the effectiveness of REITs in any one particular country and do so in a way that is acceptable to regulators and tax authorities as well as shareholders and management teams. The result is a tax-efficient (which from a government perspective usually means tax-neutral position), onshore and regulated industry.

5. SNL Financial, SNL XL Database, accessed, June 2018.
6. Not all of these markets have active participants but countries such as Mexico, Spain, Ireland and South Africa have been major adopters.

5. Help improve transparency in the infrastructure market

Transparency is important and public markets are a proven catalyst. Infrastructure is, by its nature, an immobile, illiquid and capital-intensive investment. That makes the political environment, ownership rights and the ability to enforce them through legal means critical investment considerations. Jones Lang Lasalle (JLL) has observed there is a strong link between transparency and investment activity. In the real estate market, the 10 countries classified by JLL as highly transparent account for a staggering 75% of all global real estate investment.[7]

6. Deliver core plus type returns over the long term

Analysis from Cambridge Associates[8] has shown among private infrastructure funds, that opportunistic strategies have underperformed both core and value-add strategies. The result is that 50%–60% of capital raised typically targets core or core-plus type investments, i.e., standing investments, stabilized cash flows with some scope for growth. This aligns well to the REIT product in the real estate space where a degree of "non-core" activity such as development compliments standing portfolios. Long-term returns in the mature US REIT market have averaged 9.8%[9] (listed infrastructure 10 year return: 8.9%[10]) which is generally considered a core-plus to value-add type return.

7. Bring tax and regulation of listed infrastructure funds onshore

REITs are designed as a cost-efficient, onshore vehicle that moves responsibility for the payment of tax from the REIT to its shareholders. As compared with a regular C-corp, this removes double taxation and allows shareholders to be taxed according to their own tax status. This gives shareholders a similar tax outcome to owning property directly. Furthermore, they contribute to tax revenues through a variety of additional taxes. Using the UK as an example, these may include stamp duty land tax, property taxes, building levies, environmental taxes, employer payroll taxes and potentially insurance premium tax and irrecoverable VAT.

At first glance, the opportunity looks compelling: REITs are a globally recognized brand with legislation in 38 markets and active companies in 31 countries. The concept of eliminating double taxation on shareholders in order to open up otherwise unattainable ownership of high-value property assets has proven very successful. Global REIT market cap stands at US$1.7t, up 295% in the last 10 years and more markets are poised to introduce REIT legislation.[11] Infrastructure is a near neighbor to real estate and a critical facilitator of not only the real estate market but ultimately of economic growth, as proper infrastructure is vital to the success of our communities. Furthermore, infrastructure shares many similar investment traits with real estate and has a burgeoning private market that already successfully invests in a range of transportation, energy, communication, sustainable resources and utility infrastructure. Extending REIT rules to include more sub-sets of the infrastructure market, or developing a similar product (an infrastructure investment trust) would be a natural progression of the concept.

7. "Global Real Estate Transparency Index 2018," Jones Lang LaSalle, 2018; Real Capital Analytics, rca.com, accessed July 2018.
8. "Digging In: Assessing the Private Infrastructure Opportunity Today," Cambridge Associates, April 2017.
9. "FTSE Nareit U.S. Real Estate Index Series Daily Returns," NAREIT, 1 July 2018.
10. Dow Jones Brookfield Global Infrastructure Index to July 2018.
11. Poland and China continue to develop REIT regimes, Sweden, Portugal, Luxembourg and Malta are considering introducing REITs.

Legislation

Tax authorities have a fine line to tread in maintaining the integrity of the REIT concept by ensuring a widening of REIT rules does not open the REIT concept to non-real estate businesses.

In India, legislators have facilitated the ownership of more traditional infrastructure through infrastructure investment trusts (InvITs). While the REIT concept in India awaits its first active company, two InvITs have listed to date with a further five registered with Securities & Exchange Board of India (SEBI) pending for listing.

In the US, the classification of "real property" by the IRS is a critical and carefully considered assessment to ensure assets meet the definition of real property.[12] In August 2016, the IRS issued final regulations which clarified the definition of real property to include land and improvements to land, which are deemed to include inherently permanent structures and their structural components. The final regulations further clarify that providing a conduit (e.g., pipeline or electrical wire) or route (e.g., road or railroad track) is a permitted passive function of another inherently permanent structure. Therefore, real property now includes: microwave transmission, cell, broadcast, and electrical transmission towers; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; storage structures, silos, and oil and gas storage tanks; stationary wharves and docks; and outdoor advertising displays.

As these represent permitted real estate assets, organizing around a REIT structure would not be unlike a hotel or health care REIT where the entity owns the asset and leases it to an unrelated operator. For a bridge, toll road or port, the same structure can potentially be adopted today with a REIT owning the asset and leasing the property to an operator. That lease can be based on a percentage of gross revenue but the ownership and operation of the asset must be separate. To date however, the inability of the REIT to operate the asset has discouraged large-scale adoption of REIT structures for more traditional infrastructure assets such as toll roads, car parks, energy infrastructure or ports.

For an infrastructure investment trust concept to gain traction, tax authorities likely need to revisit the rules around directly operated assets. This is likely best achieved by:

1. Defining certain types of revenue generated by certain infrastructure assets (these constitute a payment for the use of real property properly characterized as rents)
2. Delineating the REIT and InvIT concept to create a new type of infrastructure vehicle, which closely resembles a REIT yet has its own specific regulatory guidelines

The need for infrastructure investment worldwide is critical. Infrastructure is the bedrock on which economies and communities are built with widespread economic and social benefits. Finding new and innovative ways to fund investment is critical and private sector capital will likely continue to grow in importance. Expanding the use of REIT-like vehicles could be a valuable addition to enhance and grow the listed infrastructure market. It also creates another medium through which to enable the long-term ownership of infrastructure assets and help recycle development capital more rapidly in order to begin to address the huge investment needs.

12. *"Definition of Real Estate Investment Trust Real Property"*, 2016, www.gpo.gov/fdsys/pkg/FR-2016-08-31/pdf/2016-20987.pdf.

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