

Available Volume	Actual Volume	Average Cost	Market Price	Amount (Price)	Market Value	Unrealized P/L	%Unrealized
400	400	254.19	290.00	101,675.56	116,000.00	+14,324.44	+14.09
100	1,100	210.57	197.00	231,630.33	216,700.00	-14,930.33	-6.45
400						+5,505.28	+12.95
000						+1,122.32	+17.97

# A defined solution to the infrastructure financing gap – Infrastructure Investment Trusts (IIT)

By Fraser HUGHES & Ben MORTON



**G20/OECD Report on the Collaboration with Institutional Investors and Asset Managers on Infrastructure: Investor Proposals**

*“A purpose-built Infrastructure Investment Trust (IIT) structure could act as a liquid investment vehicle for essential infrastructure, particularly in emerging markets where foreign investment in listed equity is now common amongst many investors.”*

The G20/OECD Report on the Collaboration with Institutional Investors and Asset Managers on Infrastructure: Investor Proposals, released in July 2020 at the G20 Finance Ministers and Central Bank Governors meeting, presents multiple proposals received from the private sector on mobilizing investment in infrastructure. This includes a proposal on a clearly-defined financial vehicle<sup>1</sup> for infrastructure – an infrastructure investment trust (IIT) – for which GLIO provided comments and feedback.

The IIT structure, as proposed by pri-

vate sector investors, could harness the legal and financial blueprint set by real estate investment trusts (REITs).<sup>2</sup> We examine this proposal, its aim, potential hurdles and the administrative process and tools required for it to work.

## What purpose would IIT serve?

The development of an IIT structure, tax-efficient for both governments and investors, aims to create a financing tool for essential but costly generation-to-generation infrastructure. The proposal, coming at a time when the funding of public

<sup>1</sup> IIT has the potential for tax efficiency for both governments and investors  
<sup>2</sup> We first raised this idea in issue 2 of the GLIO Journal. See: <http://tiny.cc/rmodsz>

## *We believe that innovative and case-supported privatisation programs can address the mismatch between capital poised to invest and public assets in dire need of upgrade.*

projects are under extreme pressure, offers a potentially harmonious social outcome:

- Citizens get quality infrastructure assets and services
- Politicians get happier voters, job creation and an economic boost
- A wider range of willing investors get access to infrastructure assets

### Private sector proposals for the G20 and OECD

The G20/OECD Report, which brings together private sector perspectives and proposals gathered over the course of various meetings and interviews, examines a variety of proposals including recent insights from investors on infrastructure in the context of the pandemic. The G20/OECD worked with institutional investors and asset managers to compile the report, which is aimed at improving the investment environment for infrastructure.

Section 3.3 of the report states that given the cost, complexity, and risks of infrastructure investment and the need for specialised staff, not all investors are able to invest directly in infrastructure projects. A number of institutional and retail investors seeking exposure to infrastructure assets prefer instead to invest through publicly listed securities, fund structures, and pooled vehicles.

The report cites a number of countries that have already established REIT legislation, defined by clear rules to qualifying assets, income, taxation, and distribution. Private sector proposals in the report suggest that REIT structures can act as a blueprint for a de novo IIT structure.

### Potential frameworks the world over

A number of corporate and fund structures exist around the world, each tai-

lored to specific regulatory or market circumstances, the report argues, reflecting the views of investors from multiple jurisdictions. By listing shares of infrastructure companies, including partial listings, the general public become shareholders, particularly through pension savings.

Sound governance and transparency structures are essential to help build social acceptance and trust.

In the USA, where REITs were born, there are six vehicles backed by infrastructure assets, which are predominantly telecom towers.<sup>3</sup> Today about 25% to 30% of all commercial real estate is in the hands of private investors through the \$1tn market capitalization REIT market.<sup>4</sup> NAREIT estimates that 80 million Americans own REITs through retirement savings and other investment funds.

Another US example is the Master Limited Partnership (MLP) model, which has succeeded in stimulating broad ownership of energy pipeline infrastructure. Following the example of US REITs, MLPs successfully attracted much-needed capital into US energy transportation infrastructure from 2000 onwards. The market capitalization of MLPs grew from \$15bn in 2000 to a peak in 2014 of just under \$500bn.<sup>5</sup> The period was known as the 'North American Energy Renaissance'.

In April, China announced an extension to its REIT structure to include infrastructure. "A REITs market helps unlock value trapped in existing real estate assets and will channel private money into China's strategic infrastructure and offer investors a liquid investment product that generates stable income," CITIC Capital commented in a Reuters article. Belgium extended its REIT structure to include public-private partnerships and infrastructure in 2017, and India introduced

InvITs in 2016 to encourage infrastructure investment.

In an opinion piece in June, Australia's Financial Services Council (FSC) called for the government to create "Australian Superannuation and Infrastructure Investment Vehicles" (ASIIVs).<sup>6</sup> Currently, most infrastructure investment by super funds comes from larger institutional funds, but the FSC urged that the ASIIV open this investment to a broader range of super funds, including self-managed super funds. This democratization of infrastructure investment would substantially widen the asset classes available to super funds, while allowing infrastructure to tap a much wider range of investors collectively with over A\$1tn to invest.

These are positive developments towards addressing the infrastructure investment gap. An IIT joins these initiatives around the world using the principles and similar legislation, while accurately describing the assets held and which ensures clarity to investors from country to country.

We believe the private sector proposal found in the G20/OECD Report for a clearly defined IIT is the next step forward in this evolutionary process.

### Getting IIT done – hurdles and possible solutions

A Cohen & Steers paper earlier this year examined the weight of investment dry powder awaiting suitable infrastructure assets, titled "*Let Private Capital Heal What Ails Public Infrastructure*."<sup>7</sup> It concluded that while governments struggle for capital to maintain or develop essential infrastructure, \$220bn<sup>8</sup> in potential investment is seeking a home. Clearly the shortage is not of capital, but governments' willingness to work with the private sector and create suitable asset vehicles. >

3 REIT.com

4 Source: UBS Global Real Estate Analyzer, 2017

5 DWS Opinion Paper, 1Q.2020 – MLPs-what now?

6 www.fsc.org.au/news/asiiivs

7 www.cohenandsteers.com/insights/read/let-private-capital-heal-what-ails-public-infrastructure

8 Preqin. See 'Mind the Gap' article in this issue of the GLIO Journal.



North America, for example, has rather limited track record so far in transportation infrastructure.<sup>9</sup> Toronto’s Highway 407 is a positive precedent that has supported \$16bn in economic benefits for the area since it was sold 20 years ago, but the privatization of transportation assets remains rare. Passenger railroads and airports tell a similar story of underinvestment and limited private investment involvement.

Decades of under-investment have detrimental effects on the state of national infrastructure. The American Society of Civil Engineers (ASCE) scores US infrastructure D+, defined as ‘poor, at risk’. Moreover, the ASCE estimates that the ‘funding gap’ is \$2.1tn to 2025. The story is similar through the developed world.

We believe that innovative and case-supported privatization programs can provide the mechanism to address the mismatch between capital poised to invest and public assets in dire need of upgrade.

The biggest hurdle, however, is politics. Getting state and local lawmakers to release ownership and control of critical assets to private companies remains a challenge. And voters, the users of the assets, may need convincing that the aim of the privatization is to fund the building and management of costly, yet essential, transport and communications infrastructure, rather than profiteering.<sup>10</sup>

Another issue lies in the provision of assets in less densely populated areas. The need for infrastructure maintenance may be acute, but expected user fees may not present a feasible investment case.

The advantages to those with greater infrastructure awareness are nevertheless clear:

- Citizens get to use higher quality better-funded assets and services than they otherwise would. This is particularly pertinent post-COVID, in a world where global government finances are already stretched by the attempt to reboot the economy.
- Politicians are enabled to provide the solutions voters want to go about their lives more efficiently and safely, with the added benefit of creating jobs and boosting the economy.
- A broader range of investors access the infrastructure assets they crave in a coherent, transparent and regulated vehicle. Put simply, the population can own a stake in the essential assets they use on a day-to-day basis.



*“A vehicle encouraging capital formation and deployment for infrastructure assets is becoming increasingly critical. An IIT would increase the tax base, improve infrastructure quality and performance, plus enhance user experience. For example, on highways and in airports, and, of particular importance in this fiscal environment, an IIT would allow governments to direct public capital to places that most need it and cannot support a privatization model. Moreover, the vehicle enables investors to participate in building out 21st century infrastructure targeting the biggest impact on the most citizens.”*

**Ted Brooks, Chief Investment Strategist & Portfolio Manager, CenterSquare Investment Management**

*Creating an IIT structure, coupled with the pent-up global demand for targeted infrastructure investment, could open the floodgates to private capital.*

<sup>9</sup> Much of the US utility, telecom infrastructure and energy transportation sectors are listed and boast broad ownership.  
<sup>10</sup> In 2008, the Pennsylvania Turnpike lease to Abertis was to get a proposed 27% toll increase. The bid was withdrawn due to widespread legislative opposition.



*"IITs represent a unique opportunity for African asset owners, governments and the continent's capital markets, to support much-needed infrastructure investment to bridge Africa's \$100bn per annum infrastructure deficit, achieve competitive risk-adjusted returns and build resilience in line with the sustainable development goals and the African Union's Agenda 2063."*

**Hubert Danso, CEO,  
African Investor**

## An IIT that includes the ability to pass through tax losses to offset an investor's ordinary income would create a powerful investment incentive from a broad base of long-term global investors.

- Factoring ESG considerations into the development and maintenance of assets is critical to receive funding from private markets. To successfully raise capital, investors must be convinced the management of assets is doing the right thing.

For those who doubt the imperative, the cost of doing nothing could be huge. The risk of continued inaction is alarmingly clear and the time to act is now.

In practical terms, less financially attractive assets (in rural areas) can be bundled with those that offer higher returns (in populated areas), and the combination of public and private capital may offer a route to make these deals more acceptable to investors.

Another approach may be asset recycling, a circular funding program in which public fixed assets are sold or leased to private owners and the proceeds used to upgrade or build other infrastructure assets. For example, a local government sells a 49% stake in an airport and uses the process to build a hospital.

Once these assets are 'stabilized' and profitable they can be sold to retail investors, pension funds and insurance companies in a tax-efficient IIT structure. Then the cycle can be repeated.

Creating an IIT structure against a backdrop of pent-up global demand for targeted infrastructure investment could open

the floodgates to private capital. Conditions would then be in place to attract investment to mission-critical transportation and utility infrastructure assets, much of which is in dire need of investment.

For investors, the steady cash flow characteristics of infrastructure projects would also mean that the IIT could be used as part of a stable, lower-volatility, high yield-oriented investment allocation. This type of asset class is in high demand by investors.

### Boosting the tax base with IITs

The introduction of an IIT should, ideally in our view, act to increase the tax base. Currently, publicly owned infrastructure competes with private business, but

is not part of the tax pool (i.e. private airlines vs. government-owned rail). If owned privately, these assets could then contribute to the tax base – for example in the case of an airport, states and municipalities benefit from an increase in property taxes, dividend payments and capital gains could also be taxable.

For those infrastructure assets that are already privately owned, there would be very little change in the effective rate paid by most corporate structures, plus any dividends paid to investors would remain part of the income tax base.

- The midstream energy space already avoids double taxation through the MLP structure; >

**Figure 1: GLIO's proposed IIT – basic elements**

IIT – Basic Structure	
Purpose	Allow broad access to income-producing infrastructure and development
Legislative formation	De novo structure via an infrastructure bill
Distribution	No distribution requirements to allow incentivized investment
Qualifying Assets	Transportation, utilities, energy distribution, communications infrastructure assets <sup>14</sup>
Qualifying Income (existing)	-NA-
Qualifying Income (proposed)	90% of gross income derived from qualifying income from transportation, utilities, energy distribution and communications infrastructure
Ownership	Widely-held base among domestic and international, institutional and retail shareholders
Taxation	Dividend paid deduction means up to 100% of earnings not taxed at corporate level, distributions include pass-through of depreciation; up-front infrastructure development can be offset against ordinary income

Source: GLIO

<sup>14</sup> Transportation/distribution of energy, power, data, vehicles (air, sea, road), including the ownership of: 1) electric, gas and water utilities; 2) Communications infrastructure; 3) Freight and passenger railways, airports, seaports, bridges and toll roads.

## The creation of an infrastructure investment vehicle could be a net addition to the existing tax base.

- The utility industry in the USA, through a combination of accelerated/bonus depreciation, renewable tax credits and net operating losses from existing business lines, is already a negligible cash taxpayer relative to statutory rates;
- Cell towers are largely concentrated among businesses already structured as REITs;
- Airports, seaports, bridges, and toll roads are almost entirely held by state and municipal entities, placing them outside of tax base for most calculations.

A purpose-built IIT could leverage much of the success offered by other tax-efficient structures and provide a clearly defined path for inward bound infrastructure investment. The tool could be specifically tailored to the characteristics of infrastructure assets, including how assets and income qualify for inclusion.

Figure 1. (previous page) outlines the basic elements of a purpose-built IIT. This definition would cover the ownership of electric, gas, and water utilities, energy transportation and storage, telecommunications/data physical architecture, freight and passenger railways, airports, seaports, bridges, and toll roads.<sup>11</sup>



Much of global infrastructure investment requires new construction projects - both in developed and emerging economies. This involves a period of no income and, in fact, losses from up-front investment. An IIT would need to capture the tax loss pass-through benefits of a private partnership structure, unlike the

current REIT rules,<sup>12</sup> providing a powerful investment incentive from a broad base of long-term global investors. The 1980s construction boom in commercial real estate had just such a stimulating measure behind it.<sup>13</sup>

### Conclusion – IITs a tonic for the economy

Updated infrastructure significantly boosts an economy's long-run potential growth rate and competitiveness.

State-of-the-art, well-maintained infrastructure is essential for countries to keep their competitive edge. Telecommunications infrastructure is ever more important to business and in our private lives, and this sector will form the spine of the transition from 4G to 5G. While the USA, for example, leads the world in innovation, business sophistication, financial markets and higher education, it lags behind in the basic economic structural pillars, of which transportation infrastructure is one – and this needs to be addressed.

The challenges of funding and operating infrastructure in today's economy require an enlightened approach to attracting private capital through the widest possible global investor base. A listed infrastructure vehicle, through a *de novo* clearly defined Infrastructure Investment Trust, can provide global investors with a familiar, easily understandable and liquid exposure to infrastructure that can inject economies with fresh, essential capital.

Governments need to proactively encourage the development of new infrastructure projects that offer long-term

economic benefits, constructed under the eye of an environmentally aware global investment community. We believe that the estimated \$220bn of 'dry powder' currently seeking infrastructure exposure is only at the beginning of a long-term trend to increase target allocations to the infrastructure asset class.

The climate is right for governments around the world to listen to the private sector proposals found in the G20/OECD Report. 



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<sup>11</sup> These types of assets are covered by the methodology governing the GLIO Index.

<sup>12</sup> Up-front tax losses cannot be captured in current REIT regulations.

<sup>13</sup> The 1981 Economic Recovery Tax Act, which dispensed additional incentives. Individuals who invested in real estate could quickly write off expenses and losses against income earned from other sources, while a lower capital-gains tax rate meant that subsequent profits would be taxed at a lower rate, helping fuel the creation of much of today's real estate.