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Equity Shortage Plagues Partnerships.

High leverage keeps pension funds out of many public-private deals

U.S. public pension funds looking to follow their peers in Canada, the U.K. and Australia into public-private infrastructure partnerships face yet another hurdle to direct investing.

The lack of infrastructure equity available through PPPs, or P3s, which in most cases are vastly debt-heavy, compounds cultural and some political hurdles that remain.

That lack of equity hinders even veteran pension fund players in infrastructure like the C$154.4 billion Ontario Teachers' Pension Plan, Toronto. "It's frustrating," said Andrew Claerhout, senior vice president at Teachers' Infrastructure Group, the C$14 billion ($10.7 billion) infrastructure investment unit of OTPP. Ontario Teachers has participated in public-private partnerships for years, Mr. Claerhout said, "but … it's hard for us to do. These deals are highly leveraged — as much as 95% of a partnership vs. only 5% equity. For $1 billion in the partnership, that's $50 million in equity — that's too small for an investor like us. There's no way for equity to outperform our cost."

In addition to political or legal restraints that still exist in about half of the states, U.S. public plans face other roadblocks, sources said.

"There are two limitations in the U.S. market," said David Altshuler, partner and co-head of infrastructure and real assets at StepStone Group LP, a San Diego-based private markets consultant with $70 billion in assets under advisement. "It's at a nascent stage in the U.S., more because of the traditional mode of financing through municipal bonds, and because of the capital structure of PPPs, transactions tend to be more debt than equity, which limits how much opportunity there is for investment.

"There are relatively few PPPs in the U.S. vs. other markets. Part of the reason is that the U.S. has had a successful bond market to finance public infrastructure. … More than half of states have passed legislation to enable PPPs, so we think interest will increase. But the other aspect is that the equity requirements tend to be on the lower side."

Sources said they were unaware of any U.S. public pension fund doing direct investing in P3s; instead pension plans are investing through infrastructure managers in separate accounts that include the partnerships as part of their portfolios.

"These are new to the U.S.," said Brian Budden, executive vice president of Plenary Group USA, Los Angeles, a brokerage that has been facilitating P3 deals in Canada and Australia. "Canada is 10 years ahead of the U.S. in its P3 approach. The political regime in the U.S. makes it pretty challenging to get investors there. But the market there is almost identical to Canada. We started 10 years ago buying off the underwriter, and now Canadian funds go in directly. That's how I suspect (U.S. plans) will eventually go."

Mr. Budden said Plenary has four large public funds waiting to invest in infrastructure equity via

P3s. He would not identify the plans.

Added Thomas Robinson, senior managing director and portfolio manager, private fixed income, at Sun Life Investment Management, Toronto: “Local infrastructure investing is at an early stage in the U.S. We’re not seeing the same level of sponsorship as we are in Canada.”

For the year ended Oct. 31, 14 public-private partnerships closed in Canada with a total long-term financing value of C$3.7 billion, according to Sun Life.

That’s not to say there aren’t opportunities in the U.S. Mr. Budden pointed to the recent P3 deal in Pennsylvania to repair and reconstruct 558 bridges overseen by the state’s Department of Transportation. However, the partnership, which closed in March, included only $58 million in infrastructure equity as part of the overall $1.1 billion deal; the remaining funds came from tax-exempt private bonds ($793 million) and government payments.

Added issue

Such a dearth of equity in P3s is an added issue to other restraints to U.S. pension plans participating in direct infrastructure investing — not the least of which is the tradition of funding U.S. infrastructure work through the issuance of municipal bonds.

“The reasons it’s at an early stage include the availability of municipal bonds and the political allotment of private capital, and the difficulty faced by local institutional investors such as pension plans other than the largest ones in having the illiquidity budget and/or capability or resources to do this,” said Toby Buscombe, partner and global head of infrastructure, Mercer LLC, London. “Consequently, there’s not a lot of activity. It’s not for a lack of providers, whether infrastructure managers or brokers, but more a lack of political will.”

Canadian specialists in P3s have an advantage in looking for U.S. business because of their experience with such partnerships, sources agreed.

“Canada just happened to be an early adopter of the P3 model, and its institutional investors were early into the private placement game,” said Sid Vittal, senior infrastructure specialist at Mercer in Toronto. “Definitely, Canadian firms have been working with P3 markets for 10-plus years. Naturally, they understand the process and have that competitive advantage.”

U.S. pension funds can also follow the process that’s been successful for Canadian retirement plans, said Sun Life’s Mr. Robinson: Find the opportunities, select the most optimal kind of infrastructure available for investment — social infrastructure like roads, hospitals and courthouses, and operational infrastructure like airports and water-processing systems — and find like-minded investors.

“There’s a huge demand from the institutional market,” Mr. Robinson said. “They need to assess what’s out there. They have a big role to play to let their governments know that there’s capital available.”

Mr. Claerhout at Ontario Teachers said that more opportunities, not just for U.S. pension funds but all institutional investors, could be generated by P3s that broaden their investments beyond social infrastructure. “We’re arguing that P3s should continue but be ambitious with other investments, like toll roads, ports and other infrastructure with operating risk and the ability to generate revenue. Instead of availability payments from sponsors, you own it, and market forces determine what your return on investment is.”

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