

Bond Case Briefs

Municipal Finance Law Since 1971

Many Scratching Their Heads Over White House Infrastructure Plan.

An ambitious White House infrastructure plan released Feb. 12 that depends on private investors and state and local governments to finance as much as \$1.3 trillion in projects is leaving out a lot of details, including whether the money and attractive projects are there, potential partners and industry experts say.

A core tenet of the plan is transferring decision-making authority to state and local governments, along with streamlining the permitting process and reducing regulatory barriers. The federal government would put in \$200 billion to stimulate that \$1.3 trillion, with \$100 billion of that going to a new incentives grant program for state and local government projects that attract additional investment, including credit for some past projects if they generate revenue.

Another \$20 billion would go toward expanding infrastructure financing programs, with \$14 billion for existing credit programs, and \$6 billion to expand tax-exempt private activity bonds. Another \$50 billion would go to block grants to governors for rural projects, which experts say are now overlooked. Another \$20 billion would be for what the White House calls “transformative” projects highlighting next generation approaches as opposed to rebuilding current systems. The remaining \$10 billion would be for a “capital financing fund.”

According to the American Society of Civil Engineers, the United States needs to invest \$4.6 trillion in infrastructure through 2025 - but only \$2.5 trillion in funding identified is available. The ASCE puts the infrastructure investment deficit at \$2 trillion over 10 years.

Still, infrastructure investing is growing in the U.S., with \$418 billion in private capital assets under management for infrastructure funds, including \$65 billion raised for infrastructure funds that closed in 2017, according to data from Preqin.

Ball in states' court

The major shift away from Washington had board members of the \$356.6 billion California Public Employees' Retirement System, Sacramento, meeting right after the announcement, wondering if states would have the money to match the federal dollars. “When you look at the state and local jurisdictions fiscally, there’s a lot of question marks about whether they can afford to participate in this without raising a whole bunch of charges,” CalPERS portfolio manager and head economist John Rothfield told the board. “There’s been such a build-up in federal debt that the situation here seems to be to pass some of this on to state and local municipal-level debt funding or raising revenue.”

Andrew Marino, Washington, managing director and co-head of Carlyle Group LP’s \$750 million global infrastructure fund, is much more optimistic. Providing incentives for state and local governments “is absolutely the best thing for this market,” he said. “What makes our country different than other countries is that the U.S. infrastructure market is fundamentally a local market. And each of these jurisdictions have their own stakeholders to manage and their own process to follow. Those dynamics are incredibly important ... to balance the needs of the investors and the

stakeholders.

“That means that more deals are going to get done. It means our market is going to get more efficient. It’s going to force investors in infrastructure to be local,” he said, adding, “we are not daunted by local politics.” Carlyle has a long history managing union pension funds, and “we also see creating jobs and protecting taxpayers as integral components of any project,” he said.

Carlyle, which has a large presence in local and state infrastructure markets, is “happy footing the bill (for the project) ourselves,” said Mr. Marino, who foresees state and local governments adopting more of an Australian model that lets local officials step in if agreements are violated. “Out of financial necessity, state and local governments are becoming more innovative and very entrepreneurial,” including airport terminal projects and broadband systems.

Increased demand

“The Trump proposal will increase the demand side. I’d say the investor side is already there,” said Michael Likosky, principal and head of infrastructure at 32 Advisors in New York, whose firm advises on the origination, structure and close of funds. He has seen U.S. investors traditionally in real estate becoming increasingly interested in infrastructure over the last 15 years in terms of the risk/return profile.

“It’s a perfect asset class for institutional investors, who have been doing it for 20 years internationally. What they’re doing is stuff that has worked in other places. It’s a basic formula. It’s just a matter of people seeing that opportunity,” particularly in small markets and particularly overlooked rural areas, said Mr. Likosky. The learning curve for institutional investors, he said, will be monitoring their third-party fund managers. Private-sector pension funds “aren’t allocating as much as they could” because they have been waiting for third-party managers to find the deals in a “Balkanized” market with countless states and counties for investors to figure out.

For the states, a key to making Mr. Trump’s infrastructure plan work is expanding the use of tax-exempt debt, said Vermont Treasurer Beth Pearce, who is also president of the National Association of State Treasurers. She notes that state and local governments finance more than 75% of all U.S. infrastructure projects, and while state and local governments appreciate the emphasis on partnering with them, it’s up to Congress to support tax-exempt financing, including maximizing the use of tax-exempt municipal bonds and private activity bonds, and reinstating access to tax-exempt advance refunding bonds, which were eliminated in the 2017 tax law.

Even coming up with that \$200 billion in federal funds will be a challenge, following an expensive tax reform plan that adds \$1 trillion or more to the federal deficit over the next decade. The \$200 billion for infrastructure would have to be offset by cuts to other programs such as mass transit, which would face stiff resistance in Congress. The fight over infrastructure financing has not even begun and the administration’s proposal is far from the bipartisan solution that affected parties say is necessary.

Add in the midterm elections this fall, and the clock may run out on the proposal, said William Galston, Brookings Institution senior fellow, Washington. “Getting private capital involved makes a lot of sense in principle, (but) the idea that states and local governments are going to be able to come up with that much money strikes me and a lot of other people as a stretch.”

Who pays for it?

Another question is whether Americans will pay to use public assets, a necessary part of making the

deals attractive to investors who would need to earn a return on their investments and eligible for the proposed federal incentives. “The problem for U.S infrastructure has never been a shortage of private capital, but rather how it is paid for,” wrote analysts at S&P Global Inc. in New York, in a research note published Feb. 14.

Even if the White House plan, including the role for private capital, is rejected, they see “an inevitable need for Americans to accept paying more to use the nation’s infrastructure. At its very essence, the plan forces into the political debate a conversation about who will support new infrastructure because massive federal funding is no longer on the table. And if the gap cannot be bridged by local and state governments alone or through additional direct federal spending or programs, the private sector will inevitably have to be involved in the solution.”

Mr. Marino of Carlyle believes that federally funded infrastructure projects may follow, but will be more complicated. He sees “the first big wave of transactions” inspired by a shift away from Washington that will pave the way, helping bankers and other intermediaries get more knowledgeable and comfortable, which in turn can lower the costs of infrastructure capital, he said.

“We think that the market right now supports a different type of deal because it requires more expertise to make things happen,” he said. For both the potential financial and societal benefits, “it is really exciting.”

PENSIONS & INVESTMENTS

BY HAZEL BRADFORD · FEBRUARY 19, 2018