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New horizons for infrastructure investing

Investors are having trouble finding attractive deals. They might be looking in the wrong places.

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The world needs new infrastructure—$57 trillion worth over the next 15 years, according to the McKinsey Global Institute. That's an enormous sum, but as investors well know, there is no shortage of capital. Institutional investors are jumping in with both feet; indeed, infrastructure is now seen as an asset class in its own right. Limited partners and giant sovereign-wealth funds are putting money into play. Multilateral and development-finance institutions also are stepping up their efforts. Across all investor groups, we estimate that more than $5 trillion a year is available to build airports, roads, ports, and so on.

If capital is not the problem, then what is? Investors are having trouble finding attractive projects. At a recent Global Infrastructure Initiative Roundtable held in New York, a senior member of a leading global infrastructure investor pointed out that his challenge is to clarify risk and policy uncertainties associated with potential deals, rather than find the capital to pursue them.

It seems that, in some ways, investors have not yet turned over all the necessary rocks. New winning deals can be found if investors shift gears and try new approaches. Here are three principles that can guide the search.

Consider emerging markets and greenfield assets

Investors need to deal with each emerging market individually and harness local knowledge on the way. That may sound obvious, but it needs to be said. The fact is, many investors (or their limited partners) restrict themselves to Organisation for Economic Co-operation and Development (OECD) members or other investment-grade countries. Others will not take on “greenfield assets”—new-build infrastructure projects where investors must take on the risk of development and construction. Instead, they prefer to focus on already-built brownfield assets. As another infrastructure investor recently told us, one reason is that emerging markets’ greenfield assets present more severe information asymmetries to foreign investors.

As more money flows into brownfield OECD markets (industry-data provider Preqin has estimated that the number of institutional investors in the sector more than doubled between 2011 and 2014), heightened competition is placing pressure on returns. Although measuring precise changes in such investments is difficult, many institutional investors with long track records are looking beyond brownfield OECD infrastructure assets in response to rising prices.

Investors who want to consider these types of opportunities should be aware that doing so could mean taking calculated risks in emerging markets; adopting a country-by-country approach to risk assessment is important. But identifying appropriate returns for each market is not easy, in part because of the scarcity of reliable information regarding typical returns from infrastructure projects by asset class, region, and stage of investment. The rewards of emerging-market deals can be significant (for instance, power-plant deals can often generate project-level returns 5 to 10 percent higher than for a comparable OECD project, although they typically entail greater currency, political, or counterparty risk).

In addition, investors might want to ensure that limited-partner agreements allow them the flexibility to invest in what may be considered riskier countries, as long as these markets meet certain criteria. For instance, if investors consider a country like Croatia, they would find that though the three major rating agencies rate the country as sub-investment-grade, Croatia has an attractive regime of public–private partnerships (PPPs). The Economist Intelligence Unit rates it well ahead of its peers in southern Europe in many ways, and it has a more favorable legal and regulatory profile than a number of countries that do better at attracting capital. Infrastructure projects in countries like Croatia that fall just outside investment grade (rated BB+ through BB– by Standard & Poor’s) account for $4 trillion of infrastructure needs over the next five years.

Smart investors will deploy a variety of tactics—not least assessing the sometimes considerable risk profiles of potential investments and partnering with local sponsors and development-finance institutions—in order to pursue high-growth projects where fewer players are at the bidding table.

Bid for overlooked public assets

Many governments, particularly in developing markets, are sitting on a stock of cash-generating assets. The world’s infrastructure stock is valued at an estimated $48 trillion. Some of these assets are already profitable, while others could turn a profit if operations improved. There are examples at hand. Greece’s government recently agreed to sell a network of 14 regional airports to a consortium, and in 2013, the Brazilian government sold for nearly $800 million a 30-year concession to operate Confins Airport in the state of Minas Gerais.

Reforming or privatizing state-owned infrastructure presents challenges, of course. An asset may operate at a loss, have a difficult labor situation, or need to be untangled from other businesses unsuitable for privatization. Despite these complexities, purchasing these assets can yield greater returns from selling assets or turning money-losing assets into profitable ones. For example, Jordan’s Queen Alia Airport once required a government subsidy to operate; a private-sector operator not only has invested in its expansion but also makes enough money that it can now pay fees to the government and remain profitable.

Deepen partnerships with infrastructure providers

The infrastructure-finance market is plagued by a lack of information. Governments and businesses aren't in the habit of sharing best practices or benchmarks with one another, much less the details of what went wrong (or even right). Governments, investors, developers, and operators alike would benefit from sharing more information, in more structured ways. Many governments recognize that developers can be a valuable source of ideas—for example, about which projects would have the best economic returns or how to attract private investment. Early evaluation of project plans can help prospective bidders warn governments if the project looks unviable.

One way to contribute ideas and expertise is to submit unsolicited proposals for infrastructure projects to governments that allow such proposals. Brazil and Colombia, two of the busiest and most promising infrastructure markets in South America, accept them. Other entities are seeking to open new channels of communication. For example, the Port Authority of New York and New Jersey has invited private investors and developers to share their perspectives on how to develop the region's infrastructure. Tanzania's government uses "delivery labs" of public-, private-, and social-sector experts to set infrastructure-investment plans. And Chile has developed a way of evaluating PPP projects that rewards developers for proposing low-cost solutions to national-infrastructure problems. These are just a few of the governments showing a growing interest in investors' views.

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It's common today to hear that too much capital is chasing too few infrastructure assets. But the problem is not a lack of worthy projects; it's a lack of expertise and, perhaps, daring. Finding attractively priced assets with solid economics is not easy—it requires a change to traditional ways of working. But the deals investors uncover can repay the effort. ■

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