How financial products can attract infrastructure capital from institutional investors

By mitigating key risks of investing in major infrastructure projects in emerging markets, banks, governments, and international financial institutions can close the funding gap in developing Asia.

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Developing Asia is facing a serious infrastructure shortfall. Currently, the region invests about $881 billion in infrastructure annually. But to keep pace with growing populations and developed economies around the globe, the region will need to increase that investment to $1.7 trillion per year.[1] Currently, developing economies get 70 percent of infrastructure funding from government budgets, 20 percent from private players, and 10 percent from multilateral development banks (MDBs). This mix differs significantly from that of developed economies, where just 40 percent of infrastructure is funded by governments, with the private sector and MDBs contributing 55 and 5 percent, respectively.[2] Mobilizing private capital, then, represents an untapped opportunity to bridge the funding gap in developing Asia.

The Asian Infrastructure Investment Bank (AIIB), an international financial institution (IFI) comprising 86 member countries, was set up three years ago to help address this challenge. Mobilizing private capital is one of the AIIB's thematic areas of focus, in addition to building sustainable infrastructure and enhancing cross-border connectivity. To date, AIIB has provided more than $4.5 billion of financing for projects across Asia and beyond.

Looking to the future of major infrastructure projects in Asia, we see institutional investors as an important and largely untapped source of vast amounts of private sector funds. The Organisation for Economic Co-operation and Development (OECD) estimates that as of 2013, the funds managed by institutional investors in OECD countries amounted to nearly $100 trillion.[3] However, institutional investors' current allocation to emerging-market infrastructure assets is insignificant compared with the potential. Despite historically low interest rates and an unprecedented low yield in developed markets—a result of the post–global financial crisis environment—these investors still tend to see investments in developing markets as too risky. Such investors are accustomed to the low but certain return of investments such as government bonds. But in fact, infrastructure assets—even those in developing markets—should be appealing to these investors for a number of reasons. And a handful of financial products can help appeal to these critical investors and work toward solving the Asian investment gap.

The lure of infrastructure assets for institutional investors

Infrastructure assets have several characteristics that make them well-suited to institutional investors' needs.

First, infrastructure projects by nature are long-term investments: once an infrastructure project is completed, it lasts decades, providing a steady revenue stream. In this way, they match the long-dated exposure of pension payouts and insurance policies that have traditionally appealed to institutional investors.

Second, infrastructure investments tend to be less volatile because project revenues are defined by a long-term contract provided by the government, which sees infrastructure as critical to economic growth. Governments prioritize these revenue payments, which can provide institutional investors peace of mind.

Finally, in many cases, these contracts from governments offer returns that exceed inflation. As such, these contracts can be attractive to institutional investors who, for example, may need to count on a certain level of return to meet pension payments.

Barriers to investment

So why don't more institutional investors finance major infrastructure projects in emerging markets? Several factors currently limit institutional investors' and other private sector actors' investments in infrastructure across the globe.

These factors are compounded in emerging markets, which have a higher baseline level of risk than other economies.

The j-curve of infrastructure assets

The profit profile of infrastructure assets exhibits a "j-curve." This means that investors must endure several years of absorbing investment funds before operations begin and cash flows are generated. In emerging markets, because of project delays and other common complications, the j-curve is even deeper—meaning it takes more years of spending before investors start to see returns. This profile is not attractive for those needing to demonstrate a more immediate, if modest, return from the start of an investment.

Transactional costs

Large, complex infrastructure projects in emerging markets often require unique financing structures and processes to make the projects bankable. For instance, project leaders often have to bring in specialists from outside the country because of skills shortages, or they might need to jump through excess bureaucratic hurdles. These factors increase the costs of completing deals and can drive away investors with limited resources, time, and expertise, who may find it difficult to assess projects when standards are fragmented and markets undeveloped.

Lack of tradability

Investments in infrastructure assets are usually not easily tradable. Investment structures and revenue contracts are often bespoke and have a degree of opaqueness that could deter would-be investors. The lack of a ready secondary market to sell and refinance infrastructure investments can make it difficult for investors to shift their portfolios.

Monetization

By their very nature, infrastructure benefits can be harder to monetize or turn into cash flows for investors, as social returns are often greater than the benefits to individual paying users. For instance, a rural road network connecting villages may have greater economic benefits for the region than the sum of benefits to individual road users.

Financial products to mobilize private capital

Our research and discussions with investors and those seeking investment revealed the kinds of financial products that could correct for these barriers and the overall risk profile of emerging-market infrastructure projects, ultimately helping to direct more private capital to these investments across developing Asia.

Long-term loans and financing

Infrastructure assets need long, large loans—and providing the entirety of that amount can be daunting to any single investor. To mitigate this risk, IFIs can offer long-term loans for part of the project and allow private sector actors to make short-term investments for the remainder. These arrangements help investors overcome the j-curve because revenue streams from the infrastructure assets can be allocated to investors when they need returns while the IFIs wait out the investment.

Bundling assets

One way to decrease the overall risk of an infrastructure investment in this environment and therefore appeal to institutional investors is to securitize operational infrastructure assets through bundling. For example, infrastructure assets with different risk profiles could be bundled together so that the resulting financial asset carries less risk. Then institutional investors can invest in the bundle, which has an overall lower risk profile than some of its individual components.

Refinancing

As mentioned above, the lack of a secondary market or tradability for infrastructure assets can dissuade institutional investors from investing in the asset in the first place. IFIs can reduce the risk of investors' capital being tied up in infrastructure

by buying those assets off of investors—in other words, refinancing the infrastructure assets. Such refinancing frees up funds for investment in new brown or greenfield projects.

Public-private partnerships and guarantees

Public-private partnerships (PPPs) usually involve a nongovernment entity agreeing to finance, build, and operate an infrastructure asset, such as a power plant, in return for the government promising a stream of payments for a set amount of time. Offering guarantees or viability gap financing is another way to make investing in infrastructure assets more palatable. In this case, if the infrastructure provider—for instance, a rail operating company—was unable to make its loan repayments to lenders, the guarantor would pay out instead, thus ensuring the investors receive their returns.

Of course, these products alone won't solve Asia's financing challenges. However, these solutions are a requirement to overcoming obstacles to private capital investment in Asian infrastructure and are steps on the path to support the standardization that would allow infrastructure in Asia to emerge as an asset class.

Closing the infrastructure financing gap will require all players, including IFIs, national governments, and private sector specialists, to work together. It is only through acknowledging the need for collaboration and supporting the free flow of knowledge that we can hope to make a difference in meeting Asia's infrastructure requirements, thereby creating a better tomorrow for billions of people. ■

[1] *Meeting Asia's infrastructure needs*, Asian Development Bank, February 2017, adb.org.

[2] *Closing the financing gap: Infrastructure project bankability in Asia*, Marsh & McLennan Companies, 2017, marsh.com.

[3] "Institutional investors: The unfulfilled $100 trillion promise," The World Bank, June 18, 2015, worldbank.org.

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