Use Private Equity to Fix Infrastructure

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American infrastructure needs significant improvements, and President-elect Trump plans to encourage the private sector to ramp up investments. The American Society of Civil Engineers has given U.S. infrastructure a D+ rating, estimating that between 2016 and 2025 the US will need approximately $3 trillion in infrastructure spending, two-thirds of which are needed for transportation. The society further expects that there will be nearly a $1.5 trillion funding gap. Private equity can step in.

The problem with infrastructure is not necessarily a lack of funding but more importantly a lack of using funds efficiently. Private equity can succeed where public funding has failed. Private equity firms (fund managers and institutional investors) invest either by making an investment in a company itself or by simply providing the equity financing for a specific project. In each case, when a firm invests it must put its own fund and reputation at stake, which creates an incentive to allocate money efficiently.

Most private contracts involve construction, operation, and maintenance, all costs which need to be minimized. Private investment is also able to minimize financial risk in a way public funding cannot. When a private equity firm invests in an infrastructure company it will typically establish a special purpose vehicle (SPV) which becomes a legally distinct entity from the parent company. As such, the funds used to invest in infrastructure become independent from the success or failure of the parent company.

Past PE deals in the United States can serve to illustrate these advantages. In 2006, the Indiana Toll Road was leased to the ITR Concession Company, which filed for bankruptcy in 2014 and was then sold to IFM investors for $5 billion dollars. Since the toll road's privatization, the road has expanded from two to three lanes, converted to electronic toll collection, and begun the Bridge Capital Plan which aims to repair every major structure of the ITR. This is an example of how private contracts that require construction and maintenance of roads incentivizes companies to efficiently use its resources and in the case of ITR turn around a failing asset.

Beyond the immediate advantages of a better road, decreased traffic and faster travel times have been shown to increase the productivity of workers and thus the economy as a whole. The improvements in the ITR are just one step towards making up for the 200 billion dollars that we currently lose in productivity due to poor infrastructure according to Trump. Additionally, the success of the ITR has become attractive enough that IFM recently sold a share of its lease to the California based pension fund CalPERS. Therefore, success of the road will be felt by public employees and retirees.

Critics of private equity infrastructure deals claim that private equity only makes the rich richer (not necessarily), gives too much political capital to wall street, straddles companies with unsustainable debt, and in some cases increases costs for consumers but decreases quality of service. However, much of these criticisms are anecdotal and underestimate the size of the private equity industry as a whole. In 2015 for instance, PE firms had nearly two and a half trillion dollars in assets under management and on net lead can lead to greater job growth in the years following an acquisition. As for placing companies under too much debt, it is likely more often than not that if a company cannot be saved by a PE firm it would fail anyway. Indeed, just as it was the case with ITR, a fundamental thesis of PE firms is looking for distressed companies that have large operational profits but an unsustainable cost structure which would otherwise fail without a private investment.

A criticism that is not popularly expressed however is that in the PE space there is a gap between where capital is most needed and where capital is invested. As Kathryn Wilmes of Pantheon Partners puts it, "Most infrastructure investors are risk averse, which means they have a strong bias to invest in existing, operating assets as opposed to funding new development, which is a higher-risk opportunity. According to Wilmes, the solution “is public-private partnerships, whereby governments combine with private funds to finance long-term projects.” This reduces some of the associated risks, creating incentive for firms to fund new development.

What has stood in the way of increased private infrastructure investment is excessive federal regulation and taxation. In the past 30 years there has been a global trend towards privatizing infrastructure yet the United States has lagged behind. As Chris Edwards of the Cato Institute writes, “About one fifth of public infrastructure spending in Britain is now through the [public-private] process, and in Canada [public-private deals] account for between 10 to 20 percent of public infrastructure spending. According to Public Works Financing, only 1 of the top 38 firms doing transportation [public-private] around the world are American.” Moreover, the largest PE infrastructure deals in the past ten years have been done primarily in Europe and the UAE and three of the largest PE infrastructure funds are located in China. On neither list does the United States fall. So when Trump writes “[w]hen I travel internationally, I see magnificent places you wouldn’t believe. I see properly maintained bridges, tunnels, and airports. I see great highways and unbelievably efficient power systems. Then I come home and I get caught in traffic, and when the car moves, it bangs over potholes. It never seems to get better.” it is precisely this trend that he is touching on.

A Repeal of Dodd-Frank would likely reduce the compliance burden for many firms and repealing the Volcker rule would allow banks to invest in private equity funds. Taken together, there would be lower costs for PE firms and a larger pool of capital in private equity. However, a total repeal of either law certainly comes with risks and might still be unlikely.

In the case of transportation there is strong evidence to suggest that private equity can succeed. A big question for the Trump administration will be how to find the right balance between public and private investment. Cutting red tape will allow America to see the same growth in infrastructure observed by our global competitors.