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Infrastructure investment by Japanese institutional investors poised to grow

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Executive Summary

Infrastructure investment is growing globally as an alternative investment. It is now coming to Japan also. Japanese airports are already preparing to solicit bids to privatize their operations. Infrastructure investment opportunities are about to become available to Japanese institutional investors as a new asset class.

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Japan's infrastructure investment market has been left behind

Infrastructure investment has emerged as a growing alternative-investment asset class in recent years. It is distinguished by stable long-term investment returns from projects in regulated sectors such as energy, utilities, and transportation. In light of such attributes, infrastructure investments are generally regarded as inflation hedges positioned in the middle of the risk-return spectrum. Individual infrastructure investment projects range in size from billions of yen (e.g., provincial airports, small-scale waterworks) to hundreds of billions of yen (e.g., metropolitan airport, large-scale power generation/transmission projects). Infrastructure investment deals are often structured as limited partnerships[1)] like private equity funds[2)]. Globally, such infrastructure funds' assets under management are growing every year. The global infrastructure investment market is currently valued at US$200-300 billion.

While the infrastructure investment market continues to grow globally, Japan has no investable infrastructure assets and few domestic institutional investors with infrastructure investment experience. The reason is that Japanese law has until recently required that the types of infrastructure in which infrastructure funds invest overseas (e.g., energy, water utilities, roads, airports) be operated by the national government, a municipal government, or a quasi-government corporation. Projects in which private investors are permitted to participate have been extremely limited.

Additionally, in the energy sector, a major sector of the global infrastructure investment market, power plants, transmission grids, and other such infrastructure in Japan are financed almost exclusively by electric power companies themselves. In Europe and elsewhere, by contrast, such infrastructure is financed on a project-by-project basis through asset finance. In the transportation sector, another major infrastructure

NOTE

1) Partnerships in which partners' liability is limited to their equity in the partnership.

2) Private equity funds are mainly medium/long-term investment funds that raise capital from multiple investors and aim to earn high internal rates of return by buying shares of private companies, increasing their value with injections of longer-term growth capital, and then reselling them.

investment sector, expressways and airports (Narita Airport, Chubu Centrair International Airport, Kansai International Airport) are operated by corporations, but investment opportunities are generally limited to corporate bonds.

In sum, with infrastructure projects financed by issuance of JGBs, municipal bonds or quasi-government corporations' bonds, Japan has effectively had no investable infrastructure assets.

This situation could change dramatically as a result of a 2011 amendment to Japan's PFI Law (Act on Promotion of Private Finance Initiatives).

Creation of a new infrastructure investment market through concessions

The 2011 PFI Law most notably permits private corporations to acquire concessions[3)] to operate infrastructure projects that previously could be legally operated only by the national government, a municipal government or a quasi-government corporation. Adoption of this public infrastructure concession framework has enabled private investment in infrastructure projects such as airports and water utilities even in Japan.

The sector in which discussions of specific investment projects are currently most advanced is the airport sector. In April 2014, Sendai Airport, which is managed by the national government, unveiled a plan to privatize its management. It plans to start soliciting proposals from would-be operators as early as June. An even bigger concession to operate the Kansai International Airport and Osaka International Airport is slated to be sold at the same time. According to media reports, the company that wins the Kansai and Osaka airport concession will have to pay a concession fee of ¥40 billion annually for 45 years[4)]. In other words, the concessionaire will pay a total of ¥1.8 trillion over the concession's life.

Investment returns will vary from project to project, but a major airport like the Kansai International Airport should generate stable returns for decades to come in the wake of growth in the civil aviation market. The Kansai and Osaka airport concession is consequently likely to be seen as a highly attractive investment opportunity even by overseas institutional investors. In fact, last year when I interviewed overseas infrastructure fund managers with airport investment experience, I learned that several institutions were performing due diligence on the possibility of investing in the Kansai and Osaka airport concession. There is apparently substantial interest in the deal even overseas. Additionally, this deal is expected to offer institutional investors opportunities

3) A concession confers the right to operate a public facility for profit. The public facility's original manager (e.g., national or municipal government) outsources operation of the facility to a concessionaire. The concessionaire independently makes management decisions regarding matters such as setting usage fees charged to the facility's users, maintenance and management of the facility, and replacement of equipment. In other words, a concession is an arrangement whereby the concessionaire can increase the value of a public facility through its management and collect revenues as compensation for doing so.

4) Asahi Shimbun, April 22, 2014.

to participate as not only equity investors but also mezzanine or securitized loan investors. The scale of such opportunities will presumably be in the hundreds of billions of yen.

In addition to Sendai and Kansai airports, the media has reported that the government is considering selling concessions for nearly 10 other airports throughout Japan, including in Fukuoka, Takamatsu, Hiroshima and Shizuoka. Investment opportunities in airport operation concessions are likely to become available on an ongoing basis going forward.

With opportunities for both financial and strategic investors to invest in infrastructure projects thus steadily taking shape, infrastructure is on the verge of emerging as an alternative investment asset class even in Japan.

Japanese investors likely to become more active in infrastructure investments

Meanwhile, very few institutional investors in Japan have experience investing in infrastructure projects. In addition to a few institutional investors that have previously invested through overseas infrastructure funds, some Japanese nonfinancial companies, mainly trading companies, have invested directly in infrastructure projects. However, such investors are still a rarity in Japan. Alternative investment experience, including even real estate investment experience, is currently limited in Japan.

However, according to a Cabinet Office survey[5], many Japanese investors are willing to invest in infrastructure projects. If such investment opportunities actually manifest in Japan, Japanese infrastructure investors will surely grow in number.

5) Survey of Private-Sector Interest in Investing in Post-Earthquake Reconstruction Projects (March 2012).

Additionally, the Private Finance Initiative Promotion Corporation of Japan (PFIPCJ), established in 2013, is expected to enable Japanese institutional investors to invest in infrastructure projects with confidence, although it has yet to publicly disclose exactly how it will do so. The PFIPCJ is an infrastructure fund organized as a joint stock company with equity funding from financial institutions and the Japanese government. Set up with a limited life of 15 years, the PFIPCJ is expected to function as a sort of primary fund and offer infrastructure investment opportunities to secondary investors. The PFIPCJ can provide investment opportunities to investors that want to avoid early-stage business risk by investing in the newly established public infrastructure concessions in Japan and selling its interests in these concessions to institutional investors once the concessions are reliably generating stable cash flows. The leadership of such a national infrastructure fund could prove instrumental in inducing the currently limited number of Japanese institutional investors with infrastructure investment experience to participate in the domestic infrastructure investment opportunities expected to increasingly arise going forward.

We expect Japanese infrastructure to become an asset class that bears close watching as an alternative investment option for Japanese institutional investors.

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