

The role of public-private partnerships in infrastructure

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Deferred maintenance and the need for infrastructure spending

The need for infrastructure spending in the United States has been well documented and observable for some time. In its most recent assessment of the country's infrastructure, the American Society of Civil Engineers graded the country's infrastructure with a C-, which was actually an increase from its prior score of D+ and the highest rating in 20 years.¹ Infrastructure needs across America span the spectrum of real asset types and ambitions – ranging from schools to energy and from safety-driven deferred maintenance to carbon-reducing innovations – and together they constitute a comprehensive call to action. In response, the federal government has passed legislation to approve multiple spending packages including the Infrastructure Investment and Jobs Act ("IIJA") of 2021 and the Inflation Reduction Act ("IRA") of 2022. Portions of the funds made available from the government are expected to be used towards renovating real assets that serve municipality, university, school, and hospital ("MUSH") users across the country. Specifically, buildings across US higher education institutions are estimated to require as much as \$133 per square foot in deferred maintenance and targeted spending.²

The appeal of public-private partnerships

In seeking to address these deficits, universities and government agencies have been increasingly turning to public-private partnerships ("P3s") as vehicles to align the interest of public entities and private capital. When structured correctly, P3s can leverage the speed and specialisation of the private sector with the credit profile of mission-critical, public facing real assets to form mutually beneficial relationships that address unmet demand. While the sector is highly fragmented, Harrison Street is typically drawn to opportunities due to their long-term nature, inflation protection mechanisms and reduced correlation to other asset classes.³

Meanwhile, P3s can be beneficial to public entities through the following:

- **Operational risk management and core competency concentration:** Universities and health systems can be unique in that their campuses typically demand numerous large-scale specialised real asset services (e.g., housing, water and utilities, transport, power generation) that fall outside their academic or healthcare related specialties. By entering into P3s, these entities can outsource services to experts and focus spending on true core competencies. Further, even in cases where granting agents were already outsourcing services, P3s can be protective by offsetting the liabilities of operations and maintenance to their private counterparty.
- **Access to structuring experts and financial risk transfer:** P3s present the opportunity for public entities to leverage the creativity and scale of private market experts in seeking the best deal available. This expertise is expected to be increasingly relevant in devising bespoke structures to unlock incentives from the aforementioned IIJA and IRA. Finally, capitalising agreements with private equity allows the granting entity to transfer financial risk to the private side and reduce the risk of public disputes with bondholders when left-tail outcomes occur and leave projects unable to cover bond obligations.
- **Balance Sheet Relief:** Simply put, hard assets financed by the private market reduce the spending burden previously borne by the granting entity. This alleviation can be the difference between whether or not a marginal project is approved and may also allow the granting agent to realign its budget to allocate dollars to other key needs.

Navigating inherent challenges

The increasing prevalence of P3s has not occurred without failures, which can turn into contentious disputes at their worst. These challenges are often well documented and typically trace back to flaws in the original transaction framework and key party motivations. Common examples are summarised below:

- **Competitive bidding processes:** The largest RFPs from the highest-credit grantors are the most likely to attract a high number of qualified



Worcester Polytechnic University, USA, 40-year partnership with Harrison Street on the campus utility system

bidders and result in a desirable outcome for the granting entity. However, aggressive bidding from the winning private entity can percolate through the ongoing discourse of an agreement and become contentious as private partners seek to recapture returns through various nickel and dime mechanisms. Harrison Street believes this risk can be mitigated by (i) focusing on infrastructure assets whose deal sizes are smaller on average than traditional infrastructure P3s and less likely to attract the largest bidders, and (ii) utilising industry relationships and successful in-place P3s to generate off-market or follow-on transactions.

- **Transaction-specific nuances:** No two public entities are the same, and differences are demonstrated across their mission, geography, regulators, balance sheet, real asset needs, and more. What works for one P3 may not work for the next, and transaction documents must be reflective of specific details that can cause problems in future years if left unaddressed. As such, it is key that private sector counterparties are able to draw from their extensive track records to predict unidentified future pressure points and draft protective measures into an agreement's initial concept.
- **Long time horizons:** Many P3s are structured with durations ranging from 30-99 years, which are often longer than the hold period of private investors. This can stir anxiety from the public side as they are forced to work with a new, often unknown counterparty. Open-end, perpetual-life private capital structures can mitigate this risk by allowing the equity provider to underwrite the agreement's entire hold period.

Selecting the right partner

P3s are expected to continue their increase in prominence as an efficient method to address the ever present infrastructure needs across the United States. Harrison Street has invested in more than 50 projects of varying types – ranging from district energy to on-campus residence halls – structured as P3s with more than 30 universities, health systems, municipalities and other MUSH users that comprise nearly \$5 billion in gross value.⁴ Through this experience, Harrison Street believes P3s represent an optimal vehicle to access opportunities in infrastructure that display attractive risk adjusted return characteristics and also may qualify for support from recent federal spending packages. In doing so, partner selection is paramount in structuring healthy, mutually beneficial relationships that are able to pass the test of time to satisfy the real asset needs of stakeholders and simultaneously deliver strong, consistent returns to investors. Managers with relationships and capabilities across the asset spectrum that are able to serve as a one-stop capital provider may be well-postured to structure P3s with the requisite degree of customisation and long-term orientation.

FOOTNOTES:

- 1 American Society of Engineers, A Comprehensive Report Card for America's Infrastructure 2021
- 2 Gordian, State of Facilities in Higher Education A call for Adaptability and Transformative Action 2023
- 3 Inderst Advisory, Social Infrastructure Finance and Institutional Investors A global perspective 2020
- 4 Indicates Harrison Street's aggregate P3 experience through March 31, 2023