ASIA INFRASTRUCTURE With 40% of the world's trade and 60% of planet's population, should Asia be attracting more investment? **Georg Inderst** investigates

Missed opportunity?

The Asian infrastructure market has great potential but it currently plays only a marginal role in most investor portfolios. This appears odd given the continent's growing importance: it has share of roughly 30% of global GDP, 40% of world trade, and 60% of the globe's population. Will Asia attract more private finance and institutional capital in future, and if so, how?

The need for higher infrastructure investment is certainly there, given the fast demographic and economic growth. The Asian Development Bank (ADB) estimated that infrastructure investment in developing Asia should rise to US$800-900bn (€705-793bn) per year, or 6.5% of GDP in the near future. South Asia and East Asia Pacific will require 20-25% and 35-50%, respectively, of infrastructure spending in emerging markets, according to World Bank estimates.

Asia is, of course, not a homogenous continent in any sense, nor is the state of its infrastructure. Japan, and more recently China, has made substantial public investments in the past, leading to overcapacity in some areas. However, most other countries suffer from shortcomings, especially in the energy, transport and water sectors.

Given the competition for investable infrastructure assets in developed markets, some institutional investors have started to look at emerging markets. The journey often starts in Mexico, Chile and other Latin American markets. Entry to Asia tends to be slower. It is useful to learn more about the main features of the region, as highlighted in a new ADB working paper .

First, the financing of Asia's infrastructure is dependent on state budgets. Private participation in infrastructure is still only 0.1-0.2% of GDP in most of Asia, much lower than the global emerging markets average of 0.6-0.8%. Many countries still make very little or no use of public-private partnerships (PPPs). Even in India, the most active place in this respect, volumes have fallen back substantially

Secondly, Asia's project finance is very dependent on bank loans, especially from state-owned banks. This implies a large maturity mismatch between short-term bank deposits and long-term project financing. Non-traditional and foreign lenders are often deterred by low credit standards and excessively low cost of funds from those sources.

Thirdly, there is scope for more securitisation in this field, even in countries with more advanced capital markets. For example, listed infrastructure companies only constitute about 2-2.5% of GDP in Asia, which is roughly half the global average. The market for dedicated infrastructure and project bonds, including infrastructure sukuk, is overall tiny, although interest is rising in some places.

Fourthly, there is a shortage of appropriate investment instruments. Not too many dedicated infrastructure funds are on offer, and the annual deal generated by such funds is a comparatively low 0.1-0.2% of GDP.

Concentrated local asset base

Faced with budgetary and banking problems, many Asian governments are trying to find new sources of private infrastructure finance. They are calling for higher engagement especially from (domestic and international) asset owners such as pension funds, insurance companies and sovereign wealth funds (SWFs).

Let us first look at the local investor scene, which shows some distinctive features. The institutional capital is rather concentrated. Asian insurance companies hold assets over $6trn, of which about $3.5trn is in Japan, $2trn in China and $500bn in Korea. Of the $4.4trn Asian pension assets, $3.3trn are in Japan.

Asia's funded pensions are also small compared internationally, especially private schemes. Even in the best funded countries (Singapore, Japan, Korea), assets are well below the OECD average of 84% of GDP, with developing Asia at less than 5%. However, there are several very sizeable public pension reserve and social security plans in the region with total assets of about $2.5trn, led by Japan (about $1.2trn), Korea ($400bn), China ($200bn), Singapore ($190bn), Malaysia ($180bn), and India ($120bn).

Asia also has a significant share of 40% of SWFs, with the largest ones in China, Singapore, Hong Kong, Kazakhstan, Korea, Malaysia, Brunei, Azerbaijan and East Timor-Leste. In addition, there is massive capital with other public institutions, including central banks.

Conservative investment policies and regulation

Most asset owners have traditionally been investors in infrastructure companies – for example, in listed stocks or corporate bonds of privatised utilities. This is also true for Asian markets that have developed their capital markets in recent decades. There are some very different regional Asian indices on the market, covering infrastructure companies with a market capitalisation of up to $500bn.

The situation is different for unlisted infrastructure investments. Pension schemes globally hold an average 1-2% of their assets in unlisted infrastructure funds or direct investments. Australia and Canada are the exceptions, allocating 5-6%. Insurance companies have only recently become more active in infrastructure debt, especially in Europe.

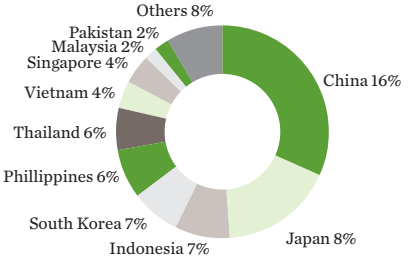
Turning back to Asia, Preqin tracked 295 infrastructure investors based in the region (13% of Preqin's worldwide universe). Banks and insurance companies are the largest groups, while pension funds, foundations and endowments are less prominent than they are in other continents. The asset allocation to infrastructure of the largest 100 Asian investors is about $65bn – only 0.3% of their total assets.

Given the relatively strong concentration of assets in a number of large public funds in Asia, much depends on their specific behaviour. SWFs have very different (financial and strategic) objectives; some (but not all) are keen on infrastructure at home or abroad. Social security schemes traditionally run very conservative investment policies with a high allocation to domestic government bonds and deposits.

Investor regulation is often a major hindrance for pension funds and insurers. There are all sorts of (qualitative and quantitative) investment restrictions in place that affect direct and indirect investing in infrastructure. National regulators should review overly restrictive and out-of-date regulation.

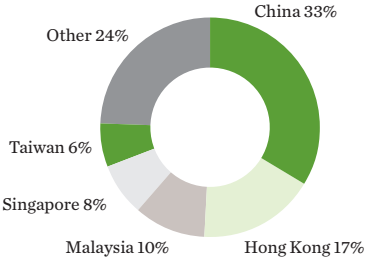
Some change seems to be underway. For example, the world's largest pension scheme, Japan's Government Pension Investment Fund (GPIF), revamped its strategy in ►

1. Infrastructure deals in Asia by country, 2010-2015



Source: Preqin

2. MSCI AC Asian infrastructure equity index, ex Japan



Source: MSCI

◄ 2014 to allow alternative assets, moving into infrastructure last year.

It must be added, though, a commitment to infrastructure by Asian investors does not necessarily mean more finance for Asian infrastructure. Much of the capital goes to western markets. Singaporean and Chinese SWFs have been very active in European real estate and infrastructure markets in recent years, as has the Korean National Pensions Service.

What about international investors: Will they become more involved in Asian infrastructure? Its attractiveness has so far been sub-par, except for listed stocks. It is reported that this region is targeted by less than 20% of infrastructure investors, the main focus being on Europe and North America.

The first thing to note is that there are pronounced differences in terms of market openness across countries. According to IOSCO, the value of foreign direct investment (FDI) to stock market capitalisation is around 30% in economies like Korea, Taiwan and Malaysia but only 1% in China. There are widespread restrictions for FDI in infrastructure sectors also in most ASEAN and south Asian countries.

There are also other factors that make life difficult for potential foreign investors, such as cryptic regulations and bureaucracy, land laws and judicial processes. In addition, there are the 'classic' macro-risk factors, such as policy inconsistency and currency volatility. Some countries are trying to build a pipeline of projects – for example, airports in Japan. Others, like Indonesia, are trying to reform PPP institutions and accelerate programmes. However, much more needs to be done by all national governments to enhance private investors' trust.

As of today, investing in Asia is mostly through infrastructure funds, especially global ones that might have a small Asian exposure. Occasionally, investors seek exposure via single-country, private-equity funds, especially in India. There is certainly room for the creation of more regional vehicles such as the recent $3bn Macquarie Asia Infrastructure Fund.

Very few large pension plans have been venturing into direct investments in the region, or are planning to do so. The Dutch pension group APG opened an office in Hong Kong, and provides mezzanine debt for Indian projects. Canada Pension Plan Investment Board is planning to move into India and China and it takes time to find good local partners.

Co-investment with other funds is an increasingly popular route. The California Public Employees' Retirement System formed a partnership with Australian fund manager QIC to invest in infrastructure projects in Asia. In 2012, APG became part of the Philippine Investment Alliance for Infrastructure, together with the Philippine Social Security Fund, ADB and Macquarie, to form a closed-ended fund for brownfield and greenfield projects in the country.

Investors often prefer an involvement of national or international development institutions, not only for their expertise but also in the hope to reduce political risk. Publicly sponsored funds include the Asian Infrastructure Fund, the ASEAN Infrastructure Fund, InfraCo Asia and the IDFC Indian Infrastructure Fund. Activities of the new China-led Asian Infrastructure Investment Bank will also be closely watched by international investors.

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ASIA CHINESE REAL ESTATE China is drawing up new laws to tackle rising levels of distressed debt. **Florence Chong** assesses what this means for the real estate sector

China changes gear

The Chinese government is taking a multi-prong approach to deal with the rising level of distressed debt. As real estate companies contribute to a significant level of China's corporate indebtedness, the government is focusing on a series of new laws, including sanctioning leasing and converting debt to equity, to tackle the problem.

Lou Jianbo, associate professor of law and co-director of the Centre for Real Estate Law at Peking University, says these new initiatives could create fresh opportunities for foreign institutional investors.

Lou is helping the government draft new real estate laws. He says the government is planning new regulations to foster property leasing, with the twin purpose of absorbing large unsold housing inventory and providing housing for newcomers to key cities.

These regulations will set out rules for both companies and individuals to own rental properties. "We are still deciding on legislation to cover tax treatment on companies which are interested in owning residential rental assets," Lou says.

For more than two decades, says Lou, the Chinese government's policy was to encourage families to buy their own homes in new developments. While residents in most major cities now own their homes, new migrants from rural or small cities cannot afford the cost of housing in big cities.

To solve their housing problem, the government wants to create a leasing market in China. "That means real estate companies must learn to hold, manage and lease property to make money rather than build to sell," he said. This, he believes, offers "a huge opportunity for foreign investors" to own property in China.

Edmund Ho, chief economist with Standard Chartered Bank, predicts that the current wave of volatility in China will create more opportunities for mergers and acquisitions.

"We are seeking sovereign funds and insurance companies looking for core assets in China," he told a seminar on distressed debt in Hong Kong, hosted by law firm Latham & Watkins.

These institutional investors have replaced private equity groups like Blackstone and Carlyle in the market, he added. "Two years ago, foreign investors were picking up small assets in tier-two or tier-three cities," he said. "Today, you are seeing more good assets being sold in tier-one cities."

Ho expects, as an example, assets in the high-profile Xintiandi precinct of Shanghai to become available.

Recently, China's Shiu On Land sold hotel assets in the Xintiandi entertainment complex to Hong Kong-based Great Eagle Holdings. And Shimao Property, one of China's largest property groups, sold its equity in a Beijing commercial property to Leshi Holdings.

Observers and credit-rating agencies believe Shimao's sale may herald the beginning of a trend that sees over-geared Chinese property groups dispose of assets to lower their debt burdens. Shimao said it would use the RMB3bn (€411m) proceeds of its sale for general working capital and development of other projects.

Ho said foreign investors are now able to look for core, rather than core-plus, assets. But he warned that there would be competition from domestic buyers.

In the past 18 months, Chinese investors have gone from simply expecting a 6% return from investments to adopting a more sophisticated means of assessing return expectations – the internal rate of return (IRR) metric. "They have become more sophisticated and are prepared to look at IRR types of return," he said.

In the late 1990s and early 2000s, China dealt with distressed debt problems by setting up special asset management companies to take on problem loans. This time around, however, Chinese banks are being encouraged to convert debt to equity.

Lou expects developers to try moving their debt to banks in debt-to-equity swaps. "I was in Jiangsu recently and was told that three property companies were in the bankruptcy procedures. And this is in just one province," Lou says.

When asked about the extent of bad debt in the real estate sector, Lou says it is difficult to get an accurate handle on the situation because of the many layers of debt. "We have statistics on loans made to developers by banks. So we know banks' debt exposure to the industry. The government is trying to control the level of debt exposure and each bank has a quota of how many development loans it can make."

But developers have been taking loans from the shadow banking system, which does not have the same level of government oversight. "We believe exposure to real estate in the shadow banking sector is much bigger than that