

[Kibe-log]

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The secondary market of infrastructure will bring more investment

This is Kazunari Kibe, the President and CEO of INFRONEER Holdings Inc.

Thank you very much for your continuing to visit Kibe-log.

INFRONEER has been focusing on “de-contracting” and sits in a unique position in our primary business domain, the construction industry. Recently, I have felt that we have been increasingly able to reach out to investors and many other people to promote and share our thoughts and business strategies with them more than before. Your continued support would be highly appreciated as I would like to push our company and our current business strategies in this direction without any hesitation.

The difficulty maintaining and renewing infrastructure without utilizing a PPP (Public Private Partnership) scheme.

First and foremost, I would like to talk about the importance of the secondary market in the industry, especially so when we aim to expand the infrastructure business in Japan.

As I mentioned in the first Kibe-log

(https://www.infroneer.com/en/topics/blog_assets/entries/40/PDF_FILE/kibelog_en.pdf) titled “The future of the general construction industry proposed by INFRONEER Holdings Inc.”, we have been expanding our business domain from our conventional contracting business. We have been developing our concession business by obtaining operating rights for social infrastructure projects. These projects such as airports, water and sewage systems, toll roads, etc. involve the initial construction as well as the continued operation, maintenance, and management of such projects.

In the past, we had won the operating rights of domestic concession projects such as the Sendai Airport and the Aichi Prefectural Toll Road. This past year, the consortium led by Maeda Corporation along with other companies have acquired the priority negotiation rights in both the improvement and operation of the Aichi Prefectural Gym Project under the system of BT + C (Build Transfer Concession) as well as the operation and maintenance of the Osaka City Industrial Water Supply

Specified Operation Project. We utilized the PPP (Public Private Partnership) scheme for both cases.

Winning one or two projects annually is not a bad pace for us given the current market situation. The market supply of projects is never great in number. However, I feel that the speed of PPP penetration in Japan is still too slow in comparison with the markets in Europe and the United States.

It is indispensable for a depopulated Japanese society to introduce and utilize private funds in order to accelerate the speed of improvement and the renewal of decrepit social infrastructure. In other words, the aging social infrastructure cannot be maintained without aggressive utilization of PPP.

If we compare the current situation with ten years ago when we started infrastructure business, PPP has gained more market acceptance and recognition. However, the national government and the local governments still have negative opinions about any aggressive utilization of PPP for management of social infrastructure.

As we showed in the concession of the Aichi Toll Road project, there are more opportunities to enhance efficiency in operation and offer improvement of services by introducing the expertise of private companies in the operation, maintenance and management of public infrastructure.

I think that the national and the local governments should consider introducing PPP more seriously into their infrastructure improvement projects.

There is another reason why PPP projects don't see the same adoption in Japan compared to over sea markets. Alongside the hesitancy from government bodies to utilize PPP for public works exists, there is also the issue of a lack of secondary markets where one can trade infrastructure projects whose operating rights are sold to private companies.

Why can the concession operators take more risk on development projects?

As you know, REITs are the listed funds which own income-producing properties. Thanks to the introduction of REITs, the development of real estate has become more active in last 20 years.

The listed REITS are so-called the final form of REIT. There are many unlisted private funds in the real estate industry. These private funds generally grow their size by adding self-developed properties or by acquisitions of income-producing properties developed by the real estate companies.

Sometimes the funds accumulate a track record and achieve an IPO (Initial Public Offering) or in some other cases, the funds

can sell their properties in the portfolio to REITs and realize the profits as capital gain.

In either case, the properties developed by the real estate companies or private funds will be ultimately acquired by the REITs through sales transactions.

What makes this large flow of the properties to the REITs possible is the difference of each investors' preference of risk vs return.

There are various risks in the development of real estate such as fund procurement, purchasing of land, construction, leasing-up of the property after completion, etc. Considering all possible risks associated with the development of properties, it is not too unreasonable for developers to seek for a return on the project to be around 10% or even 20%.

On the other hand, what is the expected return for an REIT investor? Of course, the higher the better but I assume that under circumstances of super low interest rates they are quite satisfied with current level of moderate return as long as the properties keep generating stable profit.

At the moment, the average yield of REITs is around 3%.

Under the current situation of excessive liquidity, there are no better investments available in the market and the REIT investors are happy with the current yield. If REITs are welcomed to pay only 3% yield to the shareholders, REIT could buy more properties with higher acquisition prices based on the profit return method like DCF.

Considering the above, real estate companies and private funds can take higher risks in developments because REITs, final purchasers of properties, are willing to purchase those properties even with a lower return on investment.

I believe we need to watch the market trend carefully because an overly aggressive movement toward this direction might cause an over-heated market just like what happened before the financial crisis. Also, what I am talking about now is based on theory and generalizations, remembering that each property has its own individual qualities.

But I hope you understand the importance of the role REITs play in the real estate market. The real estate companies can supply "products" also known as income-producing properties into the real estate market with a sense of security thanks to the listed REITs and their liquidity in the stock market.

Pension funds should invest in infrastructure.

The same products flow can be seen in the infrastructure funds that invest in renewable energy related facilities. Seven

infrastructure funds had been listed in the market since February 2016, which was when the first infrastructure fund which had solar power plants was listed. Among these infrastructure funds, there are some facilities which were built by the starter of the fund and some facilities which were developed by a third party. There are many investors who want to invest in renewable energy power plants in order to contribute to our carbon-neutral society but cannot take large risks in the development and the construction of said power plants. The developers of infrastructure projects who take such risks for investors can contribute to renewable energy through their investment in publicly listed infrastructure funds. Thanks to the IPO and the secondary market, the investors who cannot take the risks of development can invest in renewable energy.

INFRONEER plans to divest two renewable energy facilities in the 2021 and 2022 fiscal years. Some people have asked why we want to sell these facilities now, especially when there is great focus into the investments of carbon-neutral projects. As I mentioned before, we ourselves are investors who want to develop the renewable energy facilities from greenfield. We can realize a carbon-neutral society by constructing solar power plants and supplying renewable energy to the community. I believe this is the way we can contribute to society.

Let me talk about PPP for infrastructure. Currently the SPCs (Special Purpose Company) that operate, maintain and manage the projects are owned by a company in the consortium when we proceed with a PPP infrastructure project.

In the case of the Aichi Toll Road, the majority of shares of the Aichi Road Concession Company, SPC for operation, is held by Maeda Corporation. However, in overseas markets, pension funds are the primary investors in the infrastructure, which generates long-term stable cashflow and has less co-relation with conventional assets such as stocks.

In Canada for example, large pension funds have been aggressively invested in infrastructure. Infrastructure investments account for an average 10% of their portfolio. Investments in the infrastructure of OMERS (Ontario Municipal Employee's Retirement System) accounts comes close to 20% of their portfolio.

Thanks to the strong appetite from these pension funds, the unlisted infrastructure funds successfully raised 98 billion dollars in total, a record-high in 2019.

[Reference]

- Survey research on the infrastructure investment

<https://www.nensoken.or.jp/wp-content/uploads/R1-3.pdf>

The GPIF (Government Pension Investment Fund) in Japan had stated that they invest 5% of its total assets in alternative assets (such as infrastructure, private equity and real estate). At the moment however, there are not enough infrastructure projects in the market. As I mentioned there was a record-high fund raising by the unlisted infrastructure funds. The well-balanced development and divestment are necessary for the global infrastructure market to expand going forward.

Development of a high-quality “infrastructure product” is a prerequisite for further growth but it is crucial to develop the secondary market where the invested projects are divested. This is the reason why European and American companies have been aggressively promoting PPP projects taking on more risk in the development of infrastructure.

INFRONEER is aiming to be like them. We have grown our skills and knowledges in the construction and development of infrastructure, and we are proud of our expertise in engineering. Based on our experience, we are willing to take risks, develop social infrastructure, and make them long-term income-generating projects as well as maintain their operation and management but eventually sell out the equity to our investors such as pension funds.

If we can make this ecosystem work, it would be able to accelerate the improvement and the renewal of aging infrastructure and ultimately improve the pension financing as well.

GPIF has begun showing their interest in infrastructure investment. We need to generate more projects for their future investment.

I promise INFRONEER will be a pioneer to develop such market.