

ASSET MONETIZATION IN THE MUNI MARKET: IT'S MORE LIKELY THAN YOU THINK

KEY TAKEAWAYS

- The scale of today's infrastructure decay, the declining fiscal health of the U.S. public sector and the growing demand from large institutional investors for infrastructure properties make asset sales more likely than in the past.
- State and local governments are poorly positioned to close the infrastructure funding gap, and sustaining a federal commitment to their infrastructure needs may prove challenging given mounting federal deficits.
- For investors, asset monetization has mixed credit implications and could marginally reduce municipal supply.
- Certain changes in the tax code, such as a change that reduces the value of the tax exemption, could meaningfully increase the incidence of asset monetization.

Over the next decade, a growing minority of state and local governments are likely to explore asset monetization. State and local governments own infrastructure properties of significant value and, despite a nine-year economic expansion, a subset of those governments remain fiscally pressured and unable to properly maintain their physical assets. Unlocking the value in public infrastructure has long been controversial, especially when it involves the outright sale of public goods. But the scale of today's infrastructure decay, the declining fiscal health of the U.S. public sector and the growing demand from large institutional investors for infrastructure properties make asset sales more likely than in the past.

In this *Perspective*, we argue that asset sales and transfers are likely to feature more prominently in U.S. public finance in the coming years. Our thesis is grounded in five key trends:

- The infrastructure funding deficit is large and growing.
- State and local governments alone are unlikely to close the funding gap.
- Federal assistance is unlikely to materialize in the size or shape needed, at least over the long term.
- Unusually favorable market conditions exist for asset sales.
- Despite many citizens' long-standing skepticism of asset sales, real-world examples appear to be increasing.

For investors, asset monetization has mixed credit implications and could marginally reduce supply. The big wild card for the pace of monetizations is federal tax policy. As the piece will explain, federal curtailment of the tax exemption or, alternatively, liberalization of private activity bond (PAB) rules could increase the pace of monetizations. Tax changes could accompany a federal infrastructure bill, which could decrease the pace. The piece will also discuss why municipal asset managers with both tax-exempt and taxable analytical capacity could benefit over the long term.

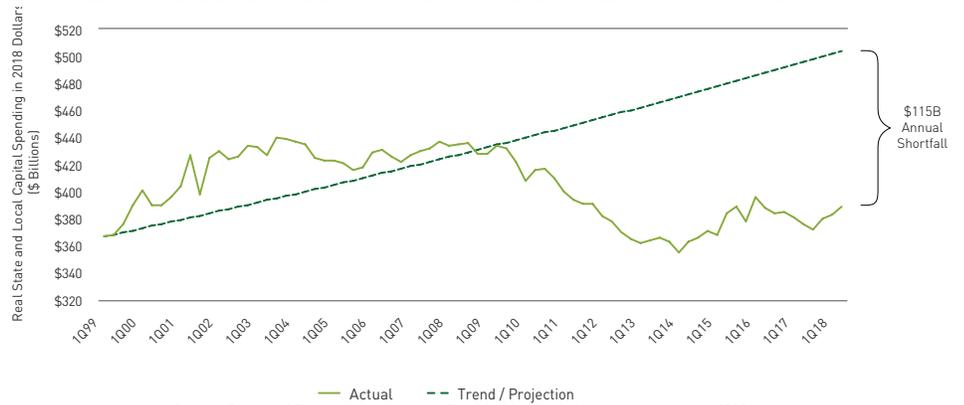
THE INFRASTRUCTURE FUNDING GAP IS LARGE AND GROWING

As Figure 1 illustrates, we estimate that in 2018, state and local governments will spend \$115 billion less than needed on infrastructure. This figure



represents the *annual* shortfall in spending across the U.S. The *cumulative* spending shortfall since 2009 likely exceeds \$800 billion, including the shortfall in 2018.¹

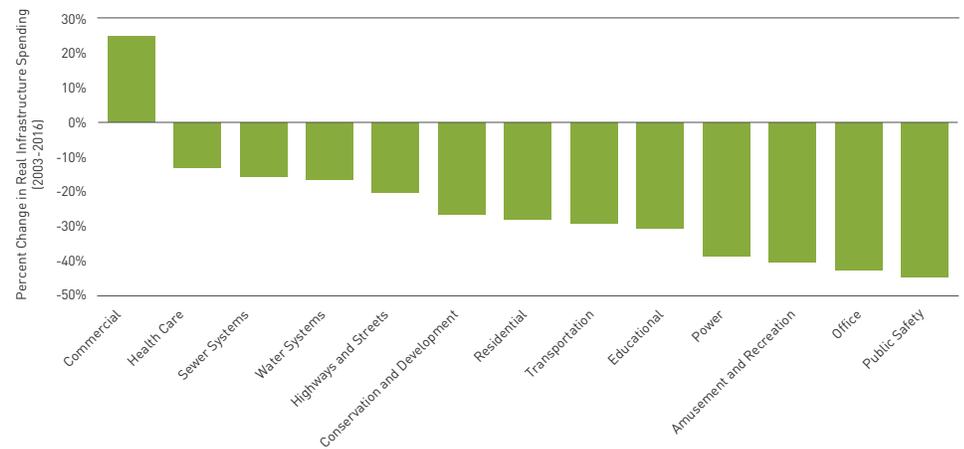
FIGURE 1: THE DEFERRED MAINTENANCE BACKLOG CONTINUES TO GROW



Source: Bureau of Economic Analysis and Breckinridge Capital Advisors, as of June 2018.

The infrastructure funding gap spans infrastructure categories. Apart from commercial property investment (which makes up only 0.2 percent of state and local capital outlays), every category of state and local infrastructure has experienced disinvestment since the early 2000s (Figure 2). This includes the sectors that make up the bulk of state and local assets (Figure 3), which are highways and streets (34 percent), educational facilities (23 percent), transportation (7 percent), and water and sewer utilities (6 percent and 8 percent, respectively).

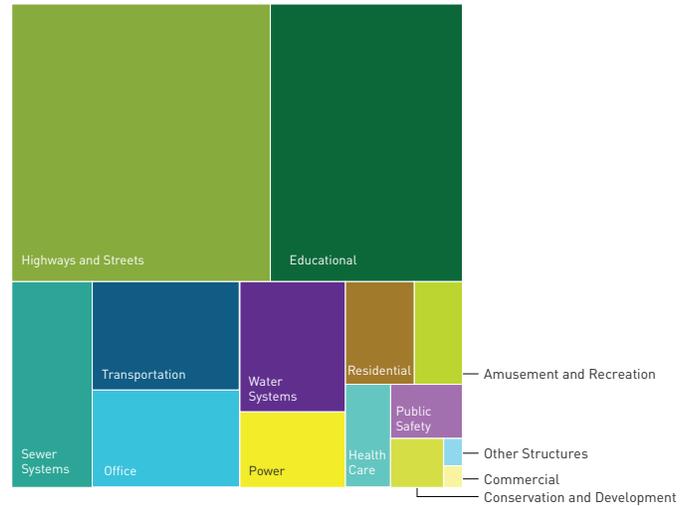
FIGURE 2: NEARLY ALL STATE AND LOCAL SECTORS EXHIBIT AN INFRASTRUCTURE SPENDING GAP...



Source: Bureau of Economic Analysis and Breckinridge Capital Advisors, as of June 2018.



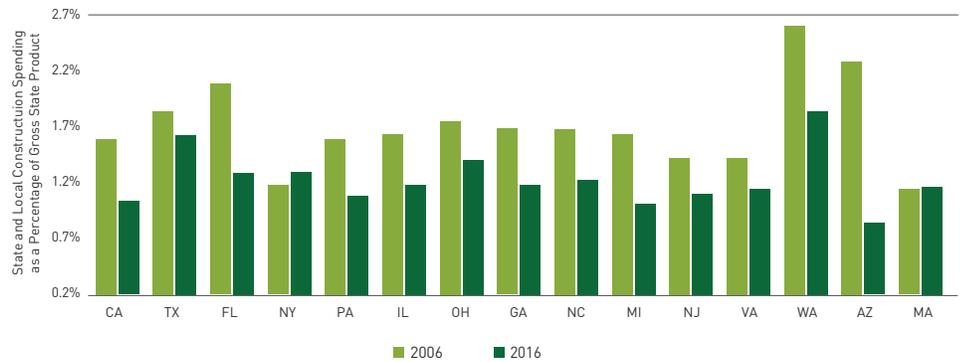
FIGURE 3: ...INCLUDING HIGHWAYS AND STREETS AND EDUCATIONAL FACILITIES, WHICH MAKE UP THE BULK OF STATE AND LOCAL ASSETS
(Value of Assets as a Percentage of All State and Local Assets)



Source: Bureau of Economic Analysis and Breckinridge Capital Advisors, as of September 2018.

The infrastructure deficit also crosses geographic regions. Since 2006, state and local construction spending has declined as a percentage of gross state product (GSP) in all but two of the 15 largest U.S. states (Figure 4). The exceptions are New York and Massachusetts, where spending increased by only 0.1 percent of GSP. Overall, infrastructure spending declined as a percentage of GSP in 37 states from 2006 to 2016.

FIGURE 4: INFRASTRUCTURE SPENDING AS A PERCENTAGE OF GROSS STATE PRODUCT HAS DECLINED IN MOST STATES



Source: U.S. Census, Bureau of Economic Analysis and Breckinridge Capital Advisors, as of September 2018.

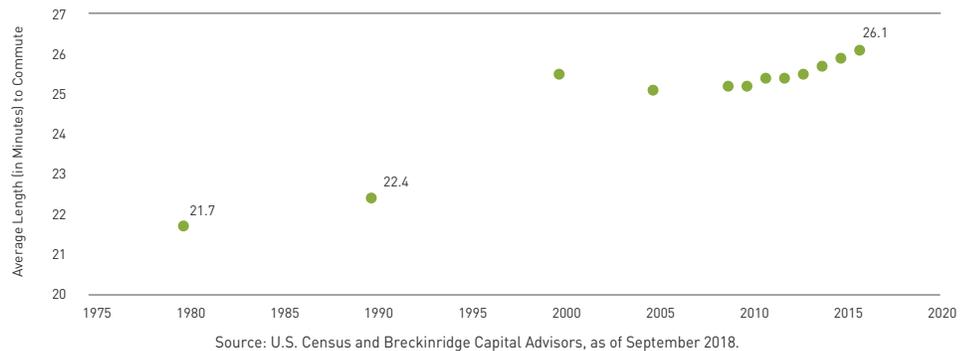
Professional research also gives evidence of an infrastructure spending deficit. In 2017, the American Society of Civil Engineers (ASCE) assigned an overall grade of D+ to the condition of U.S. infrastructure.² Of ASCE's 16 categories



of infrastructure, 12 received grades of D+ or lower. Rail received the highest grade, B, and transit systems the lowest, D-.

Perhaps the most salient indicator that U.S. infrastructure needs upgrading is the lengthening daily commute to work. Since 1980 the average one-way commute in the U.S. has increased from 21.7 minutes to 26.1 minutes (Figure 5). Much of this increase reflects the fact that commuters are spending more time enduring traffic. Roadway congestion is now estimated to cost the economy \$160 billion annually.³

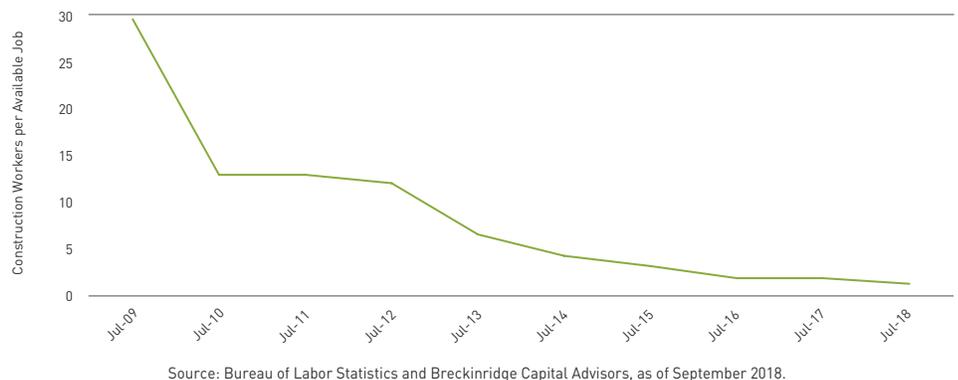
FIGURE 5: COMMUTE TIMES ARE LONGER THAN IN PRIOR DECADES, AND RISING



The infrastructure financing gap is likely to grow, as the construction labor market is tight and interest rates are creeping higher.

Unfortunately, the infrastructure financing gap is likely to grow. The market for construction labor is tight (Figure 6) and interest rates, although still low by historic standards, are inching up. Of late, asphalt prices, which are vital to roadway construction, have risen in concert with oil prices. It's also true that deferring infrastructure maintenance accelerates the cost of repair, and Figures 1 through 5 suggest that maintenance has been deferred to a significant degree.⁴

FIGURE 6: THE CONSTRUCTION LABOR MARKET IS TIGHT



Longtime observers of the municipal market can be forgiven for believing that the reported size of today's infrastructure deficit is exaggerated. Measuring infrastructure decay involves a level of subjectivity absent in other areas of



public finance (see *Infrastructure Accounting: A Blind Spot Facing Investors*), and lamenting the poor quality of U.S. infrastructure has been a policy mainstay for decades.⁵ In 1988, ASCE assigned a grade of C+ or less to all but three categories of infrastructure and warned that “...declining infrastructure inevitably will jeopardize the productivity of our economy and our quality of life. Failure to reverse this decline will exact a high price for the nation. ...”.⁶ Nonetheless, the data above suggest the problem is larger and more entrenched than ever, especially given the rate of disinvestment since the Great Recession.

STATE AND LOCAL GOVERNMENTS ARE POORLY POSITIONED TO FINANCE THE INFRASTRUCTURE GAP

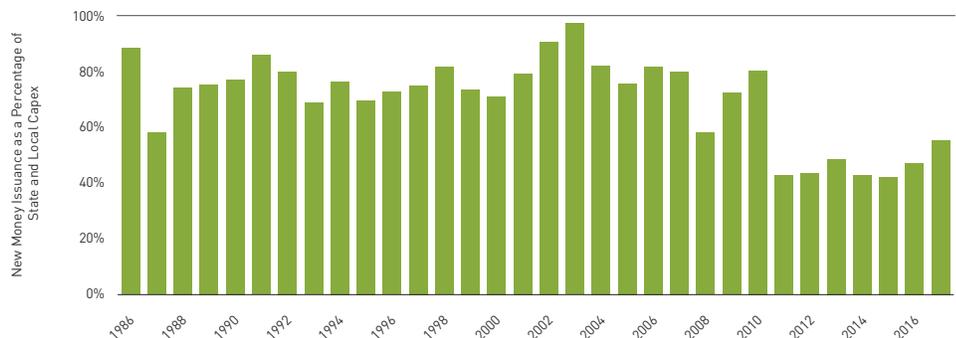
Financing the infrastructure backlog will likely prove challenging for state and local governments.

Many state and local governments finance capital spending on a pay-as-you-go basis, meaning that the current year’s revenues back capital projects. This makes funding infrastructure projects expensive from a cash flow standpoint. For example, states fund only 30 percent of their capital costs with debt,⁷ and at least five states (Alaska, Iowa, Missouri, Nebraska and North Dakota) finance infrastructure almost completely on a pay-as-you-go basis (Figure 7).⁸ Pay-as-you-go funding practices reflect voters’ long-standing aversion to debt and state-law constraints on borrowing. Pay-as-you-go rules keep debt levels low, but they also necessitate higher tax or fee increases in the near term.

At current financing rates, we estimate that state and local issuers would have to raise \$52 billion to finance this year’s \$115 billion infrastructure deficit.⁹ That’s equivalent to a nationwide increase in property, sales, personal income and corporate income tax collections of 3.6 percent, or a doubling of state and local gas taxes.¹⁰ While theoretically possible, these tax increases are nonstarters, politically. They would be permanent and would come on the heels of recent sales and gas tax hikes in many states and localities. Since 2013, 28 states have raised gas taxes.¹¹ Importantly, they would address only annual needs and *none* of the 2009 to 2017 backlog.

The large tax increases required to finance the \$115B infrastructure deficit are nonstarters, politically.

FIGURE 7: A SMALLER PORTION OF THE MARKET IS FINANCED WITH BONDS



Source: Bond Buyer and Bureau of Economic Analysis.



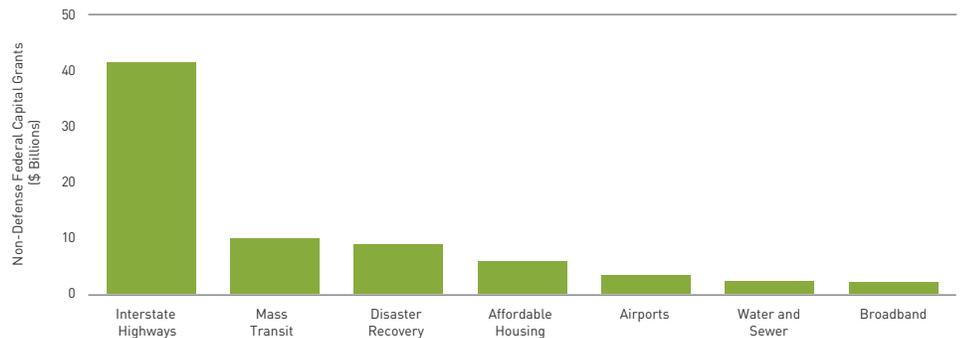
State and local government infrastructure spending will also increasingly compete with other essential needs for scarce budget resources. Rising contributions for pension and retiree health care obligations are beginning to crowd out state and local infrastructure spending in some places.¹² Public school funding and Medicaid are also pressuring capital budgets. Additionally, many states are still working to replenish reserves in advance of the next recession.¹³

FEDERAL AID CAN HELP BUT IS UNLIKELY TO BE A PANACEA

An increase in federal infrastructure aid would help reduce the state and local infrastructure funding gap. However, several factors suggest that any new federal infrastructure proposal will fall short of actual needs.

First, it's unclear where the federal government would spend additional infrastructure aid. Federal aid currently makes up roughly 23 percent of state and local infrastructure spending.¹⁴ The federal government's funding role is mostly relegated to the nation's highway system (Figure 8). So-called "trillion dollar" infrastructure packages, which promise \$100 billion in direct aid annually, ignore this reality.

FIGURE 8: FEDERAL AID IS MOSTLY DESIGNATED FOR THE INTERSTATE HIGHWAY SYSTEM



Source: Analytical Perspectives, Federal Budget, 2018, and Breckinridge Capital Advisors, as of August 2018.

Second, sustaining a federal commitment to state and local infrastructure needs may prove challenging given mounting federal deficits. For example, since 2006, general fund transfers have been necessary to keep the federal highway trust fund (HTF) solvent.¹⁵ The Congressional Budget Office (CBO) estimates a \$20 billion annual gap between dedicated HTF revenues and expenditures by FY 2021. Passage of a recent *proposal* to raise the federal gas tax over a three-year period and then index it to inflation would have been enough to close this deficit, but the plan has failed to come to a vote.¹⁶ And even if gas taxes are eventually raised, experts expect that reduced motor-fuel consumption due to more-efficient vehicles will pressure the long-term viability of the HTF to fund highway needs.¹⁷

Third, there is likely an upper boundary to federal involvement in state and local infrastructure policy. States appreciate financial assistance from the federal



government but generally seek to avoid restrictions on aid. Notably, legislation to devolve responsibility for building and maintaining highways and public transportation systems has been proposed in every Congress since the mid-1990s.¹⁸ The now-defunct Advisory Commission on Intergovernmental Relations (ACIR) recommended a form of devolution as far back as 1987. An austere fiscal environment may amplify voices that favor these kinds of approaches.

Finally, bipartisan support for a federal infrastructure bill extends mostly to *more-efficient* spending of federal infrastructure aid, not to a substantial *increase* in aid. Lukewarm support for an increase in federal aid stems, in part, from a realization that public infrastructure in the U.S. is often more costly than necessary. Rules around procurement, permitting, labor, environmental reviews and contracting practices sometimes lead to higher costs.¹⁹ A December 2017 article in *The New York Times* highlighted the problem for a broad audience, noting that the recent expansion of a subway line in New York City cost five times more than a comparable line in Paris.²⁰ High costs are just one reason that the infrastructure plans of both Presidents Trump and Obama (introduced in 2018 and 2015, respectively), proposed broader use of public-private partnerships (P3s, see inset) and accelerated permitting times.²¹

WHAT IS A PUBLIC-PRIVATE PARTNERSHIP (P3)?

There is no widely accepted definition for the term “public-private partnership (P3).” Common features of P3s vary by credit sector. For example, the degree of risk-sharing and private involvement in the water utility space may differ from that in the toll road or university-housing space. However, most P3s do all of the following:

- Transfer risk to the private sector from the public sector
- Combine multiple phases of the procurement lifecycle, and
- Transfer some public sector responsibilities onto the private partner.

A key distinction between traditional infrastructure projects and those developed under a P3 arrangement is that under a P3 arrangement, a private party may design, build, operate, maintain and/or finance a project all on its own, in exchange for some flow of payments from the public-sector partner. The private party has an incentive to build with durable materials and to operate the infrastructure efficiently because any savings over the lifecycle of the asset accrues to the private party.

By contrast, traditional state and local project delivery is costed without an analysis of a project’s lifecycle cost. In many jurisdictions, the government solicits bids for design of the project, and then for construction. Lack of a long-term view may contribute to higher costs down the road.

While P3s can save governments costs over the long term, they are not risk-free endeavors. Private infrastructure companies lack access to the tax-exempt bond markets and this can increase financing costs. Also, poorly drafted P3 agreements can put taxpayers at risk.



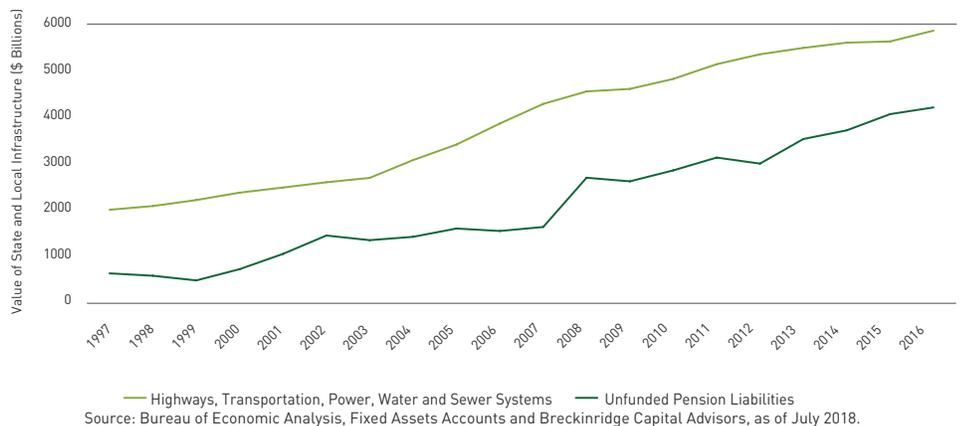
In 2016, the fair market value of the interstate highway system exceeded \$3.4 trillion.

UNUSUALLY FAVORABLE CONDITIONS FOR ASSET SALES MAY INCREASE THEIR APPEAL

Against a backdrop of significant deferred maintenance and challenging state, local and federal funding conditions, more state and local governments are likely to explore asset monetization. If they do so in the near term, these governments will encounter unusually favorable conditions for sales. Consider the following:

Low interest rates mean that public assets carry high valuations. Today’s low interest rates have inflated asset prices for homes, stocks and bonds. The story is no different for public infrastructure. For perspective, in 2016 the fair market value of state and local transportation, power, water and sewer properties was over \$2.4 trillion, and the value of the interstate highway system exceeded \$3.4 trillion (Figure 9). These valuations far exceed state and local unfunded pension liabilities (although they exclude any deduction for the debt associated with the assets).²² The high valuations suggest that more issuers will explore capitalizing their pension plans by selling assets.

FIGURE 9: THE VALUE OF STATE AND LOCAL INFRASTRUCTURE ASSETS EXCEEDS PUBLIC PENSION DEBT



Importantly, policymakers are cognizant that low interest rates have created an ideal environment for asset sales. At least nine states now have “fair-value” laws for prospective sales of water and sewer utilities,²³ up from five in 2016.²⁴ Fair-value statutes empower utility purchasers to recoup, through fees, the full price paid for an infrastructure asset. States without fair-value laws limit purchasers’ cost recovery to the depreciated cost of the assets purchased, even if they paid more for a property.²⁵ Fair-value legislation has led to more and higher bids for water and sewer infrastructure where enacted. According to private water CEO Christopher Franklin, “Since the fair-market legislation has begun to pass in various states, we’ve just not seen this level of interest and activity for many, many years.”²⁶ Franklin is CEO of Aqua America, a water and wastewater utility serving eight states.



Enactment of fair-value laws reflects a bona fide need to upgrade poorly maintained facilities and import labor expertise that cannot be sourced locally. It also results from lobbying efforts on behalf of private infrastructure companies.

Lawmakers have also been busy enacting legislation to promote P3s. Although many P3s fall short of outright privatization, some involve upfront payments or long-term lease arrangements that, in substance, have the feel of an asset sale. As of 2017, 39 states had enabled laws for P3s.²⁷

Investor demand for infrastructure properties is growing. Global demand for infrastructure investment is on the rise. In particular, pension funds and insurance companies that serve advanced and aging economies are searching for new ways to meet return targets and fast-approaching liabilities in a low-interest-rate world. Infrastructure is believed to offer value as a “new” uncorrelated asset class, with hybrid returns that mix characteristics of real estate, private equity and bonds.²⁸ Private equity firms are expected to raise a record amount for infrastructure in 2018.²⁹ At present, most demand for U.S. infrastructure is focused on privately held assets such as telecoms, rails and pipelines. But that could change.

Demand for infrastructure assets also reflects growth in sustainable investment mandates among institutional investors.³⁰ Unlike many other kinds of investments, infrastructure properties can have a direct and measurable impact on communities. Conversely, infrastructure is also directly affected by climate change. This makes infrastructure, as an asset class, unusually well-suited for sustainable-oriented investors, including those who integrate environmental, social and governance (ESG) risks into their investment decision-making. In 2016, the U.S. ESG market reached \$5 trillion in assets, up from \$1 trillion in 2005.³¹

New public sector labor rules should make asset sales more amenable to workers. Traditionally, public unions have strongly opposed asset sales. Sales threaten jobs and benefit packages, and they often result in the contracting-out of services.³²

However, the recent Supreme Court case *Janus v. AFSCME* may create incentives for unions to favor asset sales, in some instances (see [Judging the Janus Decision](#)). *Janus* effectively established a right-to-work law for state and local employment throughout the U.S. Over time, the decision is widely expected to reduce the percentage of unionized state and local workers. This reality may create an opening for private infrastructure operators. In the private sector context, 22 states remain non-right-to-work. It's now possible that private unions in these states have a long-term advantage over their public sector counterparts. Unlike public unions, private unions can continue to collect agency fees and, over time, may have a greater ability to negotiate better pay and benefits. Notably, the workforce for the largest private water operator in the U.S., American Water, is over 46 percent unionized.³³ That compares to a 34 percent rate for public sector workers nationally and a 6.5 percent rate for private sector workers.³⁴



ASSET MONETIZATION IS LIKELY TO REMAIN UNPOPULAR AND INFREQUENT, BUT RECENT EXAMPLES SUGGEST A CHANGE IS AFOOT

To be clear, monetizing public assets is likely to remain controversial in most places where it is proposed.

To be clear, monetizing public assets is likely to remain controversial in most places where it is proposed. Asset sales often result in higher costs for customers, especially if the buyer is a private entity. Privately owned infrastructure companies lack access to the tax-exempt bond market and finance some of their capital and operating needs with expensive equity. They must pay property and income taxes and, by design, they are beholden to shareholders. In egregious situations, customer needs may be subordinated to shareholder profits.

Examples abound of asset sales gone wrong. In 2003, Atlanta bought back its water system after ratepayers became disenchanted with a private operator.³⁵ The city of Nashua, New Hampshire, did the same in 2012.

After Chicago famously sold its parking meters in 2008 for a bargain price, hourly parking rates in the downtown area increased from \$3 an hour to \$6.50 an hour.³⁶ Just this year, North Carolina officials proposed undoing a 2014 P3 involving a toll road. At the polls in the upcoming midterm election, Baltimore voters are likely to pre-empt a water system privatization at the ballot box.³⁷ Pittsburgh officials have expressed concerns about selling that city's water system despite pressure from the state and a backlog of capital needs.³⁸

Monetizations are also likely to remain uncommon. Ideal sale candidates are often small utilities, underutilized real estate, infrequently driven toll roads or loss-leading enterprises owned by struggling rural or ex-urban local governments. In these places, populations are often aging or declining and the long-term value proposition for buyers is limited.

Still, the tailwinds for asset sales are strong and unlikely to abate. Among other things, issuers are exploring asset sales to replenish pension shortfalls, transfer infrastructure funding and maintenance risk to the private sector, and to limit the public's exposure to disruptive technologies. The examples below illustrate that a trend has begun:

Replenishing pension funds. A growing number of issuers have sold, or have considered selling, infrastructure assets to top up ailing pension funds. The list includes several issuers in Illinois, Pennsylvania, New Jersey and Connecticut, where unfunded pension liabilities are a fiscal challenge.

- In Illinois, the City of Alton in April 2018 entered into negotiations to sell its sewer system to Illinois American Water and Management for \$53 million.³⁹ Proceeds will be used to capitalize the struggling city's \$113 million unfunded pension liability for police and fire employees. Alton's sale is unlikely to be the last. In August 2018, the Illinois Water Systems Viability Act was reauthorized for another 10 years.⁴⁰ It includes fair-value language



to promote sales at higher prices. It also removes a cap on the size of water systems that can be purchased.⁴¹

- In Pennsylvania, the City of Allentown in 2013 entered into a long-term lease of its water and sewer utility to another public entity, the Lehigh County Authority (LCA). Allentown received an upfront payment of \$220 million in exchange for LCA's right to operate the utility and charge fees for water and sewer use. The exchange enabled Allentown to replenish its severely underfunded pension plans with \$158 million.⁴² Similar transactions involving private water companies have occurred in Scranton, Fairview Township, Limerick and McKeesport.
- In New Jersey, officials are likely to explore a transfer of the New Jersey Turnpike to the state's underfunded pension system. The state's recently formed Economic and Fiscal Policy Workgroup recommended such a transfer and estimated that it would reduce unfunded pension liabilities by \$15 billion to \$18 billion.⁴³ In 2017, New Jersey transferred its lottery enterprise to its pension system, a transaction expected to ensure \$1 billion in contributions to the pension fund annually.
- In Connecticut, policymakers are considering asset transfers similar to New Jersey's. Connecticut's Commission on Fiscal Stability and Economic Growth recently recommended transferring infrastructure assets to its pension systems, including in-kind transfers of land, buildings, airports, roads or health-care facilities.⁴⁴

Connecticut policymakers are considering asset transfers similar to New Jersey's.

Monetizing infrastructure assets for the benefit of public pensions, in particular, may win public acceptance at a higher rate than other monetizations. Unlike a private sale, transferring an asset to a public pension fund avoids the political taint of a "privatization." It is less threatening to workers' jobs, and it increases the likelihood that governments will keep their pension promises to those same employees. Economically, there should be no meaningful difference between privatizing an asset or transferring it to a pension fund. In either case, the owner must generate a sufficient return to justify the transaction.⁴⁵ But maintaining transferred assets under public ownership is likely to prove more palatable to voters.

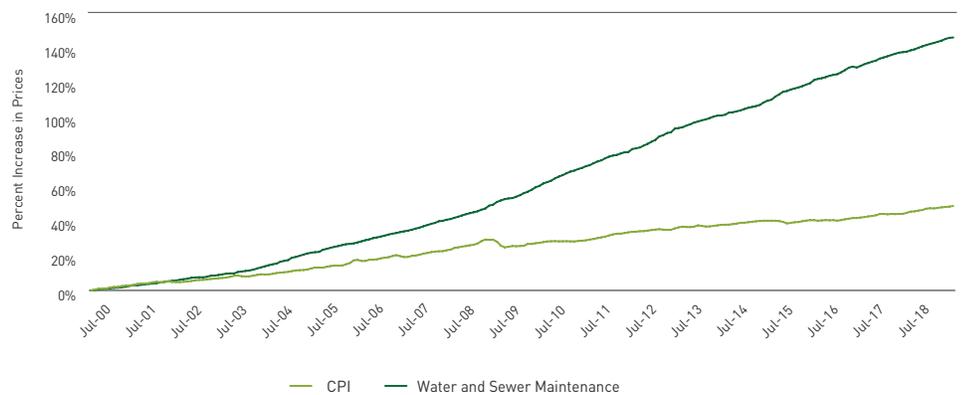
Transferring funding and maintenance risks to the private sector. Some governments have pursued asset monetization to de-risk. Over the past two decades, numerous counties in New York and New Jersey have divested their nursing home operations to stanch deficit operations in what had been publicly run health systems. More recently, many local governments are taking an inventory of their public buildings to determine if underutilized properties should be sold. In Danbury, Connecticut, officials have made clear that "city government should not be in the business of holding onto assets unless it serves a public purpose."⁴⁶ That sentiment is shared by many policymakers at the state and local level.

Going forward, asset monetization may be employed to depoliticize necessary



rate and fee increases. Annual operating, maintenance and capital costs are rising for many kinds of infrastructure, and politicians may seek to share this risk with private actors, where possible. As Figure 10 illustrates, residents across the country have been asked to finance fast-growing costs in the water and sewer space. This trend is expected to continue.

FIGURE 10: WATER AND SEWER RATE HIKES CONTINUE TO RISE FASTER THAN INFLATION



Source: Bureau of Labor Statistics and Breckinridge Capital Advisors, as of September 2018.

Limiting exposure to disruptive technologies. In the electric utility space, some system operators have explored asset sales, at least in part to avoid owning a stranded asset (see *Fossil-Fuel-Free Investing: Process and Perspective*). Officials for Jacksonville, Florida’s electric utility, JEA, recently commissioned a privatization study because “the outlook for the future of ... the electric utility industry ... is uncertain ... [and] continued change could make the utility industry more volatile and riskier than it has been in the past.”⁴⁷ Anchorage, Alaska, recently entered into an agreement to sell its electric utility for \$1 billion anticipating “declining demand from more efficient technologies.”⁴⁸

INVESTMENT IMPLICATIONS (HINT: TAX POLICY WILL PLAY A BIG ROLE)

Credit. An increase in asset monetization is likely to have mixed credit implications. On the positive side, asset sales can contribute to near-term credit stabilization for some struggling issuers. Shortly after Allentown sold its water and sewer system, Moody’s Investors Service removed the negative outlook on the city’s A3 rating.⁴⁹ Anchorage’s sale of its electric utility is likely to buoy its ratings, as well.

In addition, where an asset sale is accompanied by a private operation of an infrastructure asset, it may save money in certain instances. Savings can be achieved in a variety of ways, including through risk-transfer and/or reduced operating and maintenance costs over the life of an asset. For example, Indiana entered into a long-term lease of the Indiana Toll Road in 2006 in exchange for \$3.8 billion. Several years later, the toll road proved unprofitable, and its losses



In most cases, the mere decision to monetize a public asset is likely to reflect some baseline level of credit weakness.

were incurred by the private operator rather than the state.⁵⁰ Several studies indicate that properly structured P3 arrangements can save costs over the lifecycle of an asset even after accounting for higher capital costs, taxes and large upfront payments.⁵¹

However, in most cases, the mere decision to monetize a public asset is likely to reflect some baseline level of credit weakness. Central to our thesis is that ongoing pension stress, infrastructure needs and growing costs for other essential services are likely to *compel* more issuers to consider sales, long-term leases and transfers of infrastructure. This may prove especially true during the next recession. Few governments are likely to sell essential properties in the absence of budget pressure.

An uptick in asset monetizations may also introduce more willingness risk into the municipal market. The public often views private sector involvement in infrastructure with skepticism. When unexpected costs are incurred, residents and lawmakers may be less willing to honor contractual obligations. Kentucky recently flirted with a rating downgrade when concerns arose that the state might fail to meet certain commitments under a P3 contract.⁵²

Supply. In theory, tax-exempt supply should decrease if more issuers opt to sell public assets, either through outright privatization or via long-term lease arrangements. The private companies involved in these transactions cannot easily avail themselves of the tax-exempt bond market. The tax code's PAB provisions curtail the use of tax-exempt financing for the benefit of private entities.⁵³

However, the incidence of asset sales is likely to remain quite small relative to the size of the market as a whole. Many of the sales referenced above involved small issuers that could no longer properly maintain their physical plants and needed cash. The largest issuer cited above, JEA, merely considered a sale. It issued a total of \$90 million in revenue bonds in 2017.⁵⁴ That compares to over \$400 billion in marketwide issuance during the same year.

Tax policy. A change in the tax code that reduces the value of the tax exemption, curtails tax-exempt issuance or, alternatively, expands the market for tax-exempt bonds by broadening eligibility rules for PABs, could meaningfully increase the incidence of asset monetization. Such changes would level the playing field for financing between projects owned and operated by public entities versus private ones.

Another round of tax reform is quite possible over the next few years. Federal deficits are projected to grow, and individual income tax cuts enacted in the Tax Cuts and Jobs Act (TCJA) of 2017 are scheduled to phase out after 2025. Notably, recent tax reform bills have included a variety of changes to the tax exemption that would have reduced the relative advantage of tax-exempt borrowing to taxable borrowing. This includes taxing municipal interest at a 10 percent rate (former House Ways and Means Chairman Dave Camp, 2014), capping the value of the tax exemption at a 28 percent rate (President Barack Obama, 2013 to



2017), reinstating a version of the Build America Bonds program (Rep. Richard Neal, 2015), or expanding eligibility for PABs (Presidents Trump and Obama).

There is even a possibility that Congress tinkers with the tax exemption in 2019 or early 2020 in conjunction with an infrastructure bill. Recent polling suggests that the makeup of the next Congress will include a Democratic House and Republican Senate.⁵⁵ In that scenario, there may be an avenue for compromise on an infrastructure package. Over 80 percent of registered voters support increasing federal spending “for roads, bridges, mass transit and other infrastructure.”⁵⁶ The president and Congressional Democrats generally support more federal spending on capital needs. Notably, Richard Neal (D-Mass.) would be the House Ways and Means chairman if the House transitions power to Democrats.⁵⁷ Like the president, Neal supports extending eligibility for the tax exemption to more PAB financings. He has also been a proponent of Build America Bonds.⁵⁸

To the extent that future tax reform contributes to more privatization (or at least more private involvement in public infrastructure), municipal asset managers with both a tax-exempt and taxable analytical capacity should benefit. Tax-exempt bond portfolios might increasingly have direct and indirect exposure to the financial health of large private infrastructure and construction companies. Conversely, taxable bond portfolios might include companies with exposure to large P3 projects with significant political risks. Public and private bond issuers might also begin to face similar risks and opportunities across major sectors like transportation, utilities and healthcare, among others. Breckinridge’s investment team, consisting of a mix of corporate and municipal professionals, is well-positioned for this possibility.

CONCLUSION

The municipal market is likely to witness an increase in asset monetizations over the next several years and beyond. The fiscal condition of state and local governments, as well as that of the federal government, suggest that a growing number of issuers will look to the private sector to assist with the delivery of essential services where possible and to provide upfront payments when necessary. In some cases, issuers are likely to transfer existing assets to ailing public pension funds. Demand for infrastructure assets is high and likely to remain so. Interest rates are low by historical standards and infrastructure properties offer large institutional investors relatively steady, long-duration and low-volatility returns. With some changes to tax and infrastructure policy, the incidence of asset monetization is likely to grow. There is an outside chance that these changes materialize, in some shape or form, as soon as the next Congress.



FOOTNOTES:

1. Bureau of Economic Analysis. This estimate is based on inflation-adjusted state and local capital spending trends going back to 1999.
2. American Society of Civil Engineers' 2017 Infrastructure Report Card.
3. "Fragile Foundations: A Report on America's Public Works," *National Council on Public Works Improvement*, February 1988.
4. Andrew Teras, *Infrastructure Accounting: A Blind Spot Facing Investors?*, Breckinridge Capital Advisors, November 2016.
5. GASB rule 34 permits state and local governments to accrue depreciation expense for infrastructure assets or to use the "modified" approach, which is permitted to the extent the government has in place an asset management system. However, even if two governments choose the same approach (depreciation or modified), each can differ on the initial valuation of the assets in question, the time frame for depreciation, or the inclusion of those assets in the government's definition of "capital assets."
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45. It is also possible that a public pension fund would be prohibited from borrowing in the tax-exempt bond market for the purpose of financing an infrastructure asset. Borrowing tax-free and reinvesting the proceeds in public infrastructure projects might run afoul of the anti-arbitrage rules under 26 USC 148. We are not sure. A bill in the 115th Congress (HR 6276) suggests that public pension systems cannot borrow tax-free to fund infrastructure improvements if the systems own the infrastructure. However, it is almost certainly legal for a public entity to borrow in the tax-exempt market and then to transfer its annual "profits" to a pension system.
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53. As a rule, a private activity bond is defined as a municipal security for which either (a) 10 percent of proceeds benefit a private business and 10 percent of the proceeds are secured by or payable from property of a private business or (b) more than 5 percent or \$5 million in bond proceeds are loaned to a nongovernmental borrower. There are many exceptions to the rule above but, under most of those exceptions, interest on bonds is subject to the alternative minimum tax.
54. JEA's FY 2017 financial statements.
55. Based on likely House and Senate election outcomes as projected by *FiveThirtyEight.com*.
56. 87 percent of registered voters support increasing federal spending "for roads, bridges, mass, transit, and other infrastructure" per a Quinnipiac University Poll, February 2-5, 2018. The poll's margin of error was +/-3.3 percent.
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