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Demand for new infrastructure in Latin America is growing – country credit ratings are improving and capital markets are deepening. And institutional investors with excess liquidity are paying close attention to these developments. By Philippe Valahu, acting director of operations, MIGA.

Bouncing bonds

Latin America has one of the more optimistic investment outlooks in recent memory. Several stock markets in the region have registered record returns, and rapid growth is contributing to rising tax revenues. Inflation, interest rates, government deficits, exchange rate, and sovereign risk premiums are all down. Meanwhile, oil and commodity prices, local currency markets, and liquidity are up. Combine this with the improved macroeconomic, monetary, and regulatory policy environment in many Latin American and Caribbean nations, and an interesting scenario for potential new infrastructure investment emerges.

Globally, private debt flows to developing nations are on the rise, driven by abundant liquidity, steady improvement in developing country credit quality, lower yields in developed nations, and expansion of investor interest in emerging market assets. In fact, according to a recent World Bank report, many developing nations have received credit-rating upgrades to accompany record-low spreads on their bonds, enabling them to raise \$131 billion in bond issues in 2005 – up from \$102 billion in 2004.

In Latin America, the risk premium on BB bonds has fallen 27bp since December 2004. “One of the stories in Latin America over the past couple of years has been the improvement of external and fiscal balances, coupled with the return of moderate growth,” notes Daniel Villar, senior risk analysis officer at MIGA. There are many reasons behind this trend, he says: “Improving terms of trade for most countries due to higher commodity prices, reduced spreads on external debt, new laws that emphasize governmental fiscal responsibility, and deeper domestic capital

markets.” Reflecting these trends, real GDP growth levels have increased for the region – to some 5% – and credit availability has improved.

Other factors have influenced the improvements as well. In some nations, such as Colombia, a strong government hand has been instrumental in improving public safety and in spearheading reforms that improve investor confidence. And Colombia’s new concession laws have made it easier for private investors to partner with the government on infrastructure projects. Other nations, like Uruguay, have succeeded in maintaining the economy, upholding contractual obligations, and respecting private property rights, despite some difficult times.

Foreign investors have been impressed by the public sectors in Brazil, Chile, Colombia, Mexico, and Peru, Villar says, for precisely this reason. “These nations have earned strong credibility by virtue of not interfering with private property rights or contractual obligations. Instead they have taken a stance as an impartial regulator of private economic activity.”

Other nations are cultivating private-led economic growth as well. In the Dominican Republic, changes in monetary policy have resulted in the creation of regulated pension funds. These funds are required to invest 25% of their capital in new construction projects, such as infrastructure or housing. The ensuing boom in construction has contributed to a strong growth rate, and a remarkable drop in inflation – from almost 43% in 2003 to an estimated 6% in 2006, according to Dominican officials.

Ports and road construction have picked up. Real estate developers are scrambling to put up luxury hotels in ►

◀ preparation for an anticipated uptick in business travel, as well as a growing tourist trade. “These improvements in infrastructure will open up the country to major foreign direct investment, now that DR-CAFTA has been signed,” observes William Russell, executive director of the Dominican American Business Initiative, and resident of Santo Domingo.

Russell notes that the signing of the Dominican Republic – Central American Free Trade Agreement has capped a remarkably positive period for this Caribbean nation. “The recovery in the Dominican Republic from economic political and social disaster has been nothing less than astronomical,” he says. Russell credits the government’s trade-friendly policies and reform-minded agenda for the nation’s turnaround. “When you have a strong leader, steering an administration toward better transparency and good regulation, this leads to investor confidence,” he says. “In the last six months, the risk premium on bonds has fallen from 9% to 4.5%. And investors are watching with great interest.”

New focus on infrastructure spells opportunity

Despite some of these remarkable strides, infrastructure investment has lagged. Following a rush to privatize infrastructure in the 1990s, private participation in infrastructure projects in the region has slowed. Total investment in infrastructure in the region is pegged at less than 2% of GDP.¹

But the combination of a strong growth outlook, reduced country risk and rising demand could entice private investors back into Latin American infrastructure projects. Despite some political resistance to privatization that is causing some nations, such as Bolivia, to nationalize previously privatized services, other nations are doing what they can to encourage new private investment – through policy improvements that clarify roles and responsibilities for concessions, and through fiscal strategies that are reducing country risk premiums.

The opportunity appears strong for infrastructure investors as well. According to the International Energy Association, global demand for new infrastructure tops \$33 trillion. In the developing world and emerging market nations, annual demand for infrastructure investment amounts to \$233 billion. Average returns on these investments can be difficult to quantify. However, the World Bank has noted some remarkable results, even in some of the world’s most underdeveloped nations. At a recent conference on economic development in Tokyo, Francois Bourguignon, World Bank senior vice-president and chief economist, pointed out that returns on African infrastructure investments are reported to range between 20% and 200%.

Activity in Latin America is picking up as macroeconomic recoveries create new business growth, and as new businesses demand better, more efficient services. In western Mexico, for example, a new dam will soon generate

750MW of electricity. In Ecuador, a public-private concession is expanding the Quito airport. And in the Dominican Republic, a new toll road between Santo Domingo and Samana in the northeast has opened up broad new possibilities for tourism and logistics activities in a well-located but unconnected strategic corridor. Three new natural gas plants, operated by a private concessionaire, are introducing a new level of electricity reliability in the country, a nation formerly plagued by daily, hours-long outages.

Institutional investors eyeing infrastructure

With evidence suggesting that private infrastructure activity in some nations is slowly picking up, it is interesting to note that the standard model of debt and equity financing could be on the verge of changing.

Institutional investors are looking closely at the potential for strong returns from infrastructure projects. For institutional investors flush with cash, these infrastructure assets can provide longer-term, relatively stable returns that are less sensitive to business cycle fluctuations or stock market volatility. Returns are often positively correlated with inflation, another important hedge for the portfolio.

This presents a financing opportunity for infrastructure projects in the region, as pension funds, in particular, are looking for medium- and long-term issues to balance and diversify their portfolios, which may be excessively liquid or overly weighted toward short-term returns. “In Latin America, fund managers of pension and health funds – privatized since the 1990s – are searching for private issues in local currency,” observes Villar.

In Chile, for instance, the combination of well-developed capital markets and a pool of large institutional investors has yielded private financing for most of the nation’s recent \$8 billion investment in new transportation networks and water treatment plants.²

Capital markets could lower financing costs

“We see tremendous potential in capital markets as a source of project funding,” says Yukiko Omura, executive vice-president of MIGA. “This is especially the case in sectors that require heavy financing, such as infrastructure, where many investors have been burned in recent years and are looking for alternatives to anteing up their own cash,” she adds.

The advantage for those trying to finance infrastructure deals: capital markets issues can cost less than loans. “Capital markets can be a cheaper source of money. Repayment is usually at a lower interest rate than what you would pay on a loan,” explains Claudia Wiegand, an independent project finance consultant. “And when a subscription is sold out, it shows faith by the business community that this is a viable project.” In turn, this faith enhances the project fundamentals, and can pave the way for future streams of lower-cost financing.

In Latin America, the interest is there, experts say. “The

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irony in most Latin American capital markets is that there are more investors than there are investment instruments," Villar notes. "In general, institutional investors are open to the idea of investing in infrastructure projects, if only to diversify their own portfolios," he adds.

Banks might not see a rising competitive threat for their project lending from capital markets. After all, bank project lending hit \$140 billion in 2005, compared to bond issues of \$12.5 billion. But the potential for more attractive terms and lower cost of project capital provided by capital markets issues for developing countries, when covered by risk mitigating instruments, could impact this emerging rivalry in the future.

"Today's marketplace is clearly moving away from a focus on equity and looking more towards lenders as a key source of finance," says Omura. "At the same time, we're seeing more and more lenders eyeing bond issues and securitizations as a way of generating funds in less traditional markets, versus the syndication of loans."

The growing interest in capital markets financing also indicates additional maturing of the overall financial sector, a critical barometer of investment potential. "The development of the financial sector is vital for the economic development of a country as it provides the necessary funds to finance investment and growth," explains Nandita Reisinger-Chowdhury, deputy head of country and bank risk management for RZB. "Without a viable banking sector, business activity on a global standard is extremely difficult. The development of capital markets is equally important, providing alternative sources of funds for investment."

In Latin America, the markets do appear to be developing – and returns are strong. A look at the markets in several nations reveals remarkable improvements: in Colombia, the market posted a whopping 740% increase between 2003 and 2005. Peru's total market return increased 355% in the same time period. Chile's returns grew by 250% and Mexico's by 270%, according to the World Bank's Global Finance Report 2006.

Opportunities and challenges

Capital markets financing of infrastructure comes with some practical difficulties, however. "Most of the projects with private participation in infrastructure require some sort of a contractual relationship between the investor and the state, and thus are subject to potential disputes which typically take a relatively long time to resolve; however, what bond holders are concerned with is payment on a certain date," explains Villar. Such difficulties may need to be addressed on a case-by-case basis. Proper insurance coverage can help as well. For instance, a monoline can wrap a bond issue, in essence, protecting against this risk of default.

Of course, infrastructure projects, regardless of the financing model, feature a unique set of risks, unlike other commer-

cial investments. Add to this the uncertainties associated with investment in developing countries, and even getting a deal up to an investment grade rating could prove difficult.

Wiegand, former executive vice-president at global toll collection and transportation systems provider Transcore, details the issues. "The risk for investors is that the concessionaire might not make enough off the project to pay the government for the lease, or to pay off construction costs," she says. The inability to pay could result from overestimating demand for the service, a complex calculus that requires forecasting out several decades. "It's a challenge to project accurately what the demand is going to be," she says.

In an emerging market country, estimating demand becomes complicated by the sometimes unstable nature of the political landscape. "If there is political unrest in that part of the country, the service, like a toll road or an airport, might be underused because no one wants to go there," Wiegand says.

Politics and public sentiment play a role as well, often creating a difficult environment for private providers of services. Several Latin American nations, in a popular backlash against privatization, have nationalized services such as water provision and energy.

Other financial risks to project financiers include ongoing maintenance expenses, and leakage – or the theft of services. In India, for instance, the energy ministry estimates that close to 40% of New Delhi's energy sources are pilfered, to power illegal manufacturing businesses or for individual homes.

Experienced investors in infrastructure projects also know that breach of contract, particularly when partnering with a sovereign or sub-sovereign government, is a major concern. Some studies suggest that the perceived

potential for breach of contract in emerging market nations can drive up borrowing costs between two and six percentage points, depending on country and region.³

Sub-sovereign governments, which frequently manage provision of services such as water, power or transportation, might lack the sophistication or the skill to partner with global corporations. While graft and corruption can be an issue, the bigger problem is simply lack of knowledge. "You've got a worldly corporate entity dealing with a fairly unsophisticated local government partner. And that's why you need a very well-written contract. If the contract becomes subject to interpretation by local authorities, there could be trouble," says Wiegand.

PRI can mitigate risks

This is precisely where the backing of a multilateral institution like the World Bank, and instruments such as political risk insurance, can help. MIGA, a member of the World Bank Group, is uniquely suited to the role of political risk insurance provider. The agency offers coverage against the risks of transfer restriction and inconvertibility, breach of contract, expropriation, and war and civil disturbance – ►

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◀ including sabotage and terrorism. As an arm of the World Bank Group, MIGA's members include virtually every nation in the world. As signatories to MIGA's convention, nations often are less inclined to act in ways that could jeopardize MIGA-supported investments and result in a potential claims situation.

"The fact that the World Bank accepts an active role in a project gives it a higher level of awareness and credibility, and this may become vital for the project's realization," says Reisinger-Chowdhury.

MIGA's involvement can ease institutional investor concerns as well. "MIGA coverage can respond to institutional investor concerns about timely bond payment through a speedy arbitration and payment mechanism, with guaranteed award within a particular quarter. Thus, the dispute would fall within two coupon payments and not lead to a potential nonpayment," Villar says.

PRI can reduce project costs

Even for investors who feel confident about the opportunities in the region and remain undaunted by potential uncertainties, there is another unpleasant reality they may face: it could cost more to access project finance for investments in Latin American nations than in North America or Europe.

While the reality is that the country risk factor is levelling off in many Latin American nations, the perception of risk remains. Financial institutions, based on ratings ascribed by agencies such as Moody's, assign a country risk premium to capital destined for nations perceived to have increased potential for problems such as transfer restriction, expropriation, civil disturbance, or breach of contract. The premium attached can send project costs so high that the deal becomes economically unfeasible. But financial institutions take into account mitigating factors, such as political risk insurance (PRI), when they determine cost of capital.

"Political risk insurance serves to reduce the country risk premium," and hence, the cost of capital, notes RZB's Reisinger-Chowdhury.

A study conducted by MIGA bears out this observation. "While the sample was limited and the study is a couple of years old, the results were encouraging in the sense that the cost of financing fell significantly more than the cost of the premium, when project sponsors took out PRI coverage," Villar explains.

AdN – brings in interest

One recent toll road deal in the Dominican Republic illustrates the power – and the limitations – of PRI protection. The project, a 30-year concession for the construction, maintenance, operation, and transfer of a 106km toll road, has been on the cards for years. Numerous financing attempts fell flat due to investors' perceptions of the perceived risks. Transportation and tourism experts alike said that the project held great potential. Usage would be high, since the road would connect Santo Domingo and the Samaná peninsula, a burgeoning tourist destination with only one existing connector – an unpaved road that was inaccessible during the rainy season.

In 2005, Autopistas del Norte (AdN) tried again. With total project costs estimated at \$220 million, AdN contributed \$30 million in equity and the government agreed to a \$30 million equity stake. But that left \$162

million to finance. An initial attempt by the sponsor to secure a bank syndicate was not successful in producing the required loan durations.

AdN and the Dominican government went to the capital markets with a \$162 million bond issue. Credit rating agency Fitch reviewed the deal and registered concerns about government support for the concession. The project came with additional uncertainties that might have rendered it completely unbankable. The greenfield project was located in an untested highway corridor. And, while the models showed that a new highway would improve access to a promising tourist destination, there was no real way of knowing whether the location would actually attract more visitors, even with the road in place.

MIGA's enhancement

Investors hoped that the deal, underwritten by MIGA's political risk coverage, would receive an investment grade rating of BBB-, providing them with significant cost of capital reduction. But even with PRI coverage, Fitch was not prepared to significantly improve the rating, given the uncertainties. With an investment grade seemingly unachievable, the parties returned to the negotiating table.

Finally, negotiators hammered out a compromise. MIGA agreed to a partial guarantee of 51% of the investment, including breach of contract coverage. Fitch enhanced the rating by one notch – to B. In February 2006, MIGA insured the financing package with the political risk guarantee. MIGA's guarantee, for a total gross exposure of \$103 million, represents its first coverage of a capital markets issue.

And even with a B rating, the \$162 million in senior secured notes, maturing in 2026, was oversubscribed by 40%.

Bottom line, says Elena Palei, a MIGA infrastructure underwriter: "In the Dominican Republic, a project that was four notches below investment grade was still oversubscribed by 40%, because the risk/reward balance had been achieved. And this was due in large measure to MIGA guarantees."

This landmark project illustrates the feasibility of non-traditional financing structures when risks are properly mitigated. The success of the placement has led to a growing interest in PRI from institutional investors seeking to broaden the range and scope of their financial activities. It has also piqued the interest of direct investors in infrastructure projects, encouraged by the increased availability of funding sources.

To be sure, one oversubscribed bond issue for an infrastructure project in a small Caribbean nation does not necessarily foretell a strong future trend for the entire region. But it could be a harbinger of things to come, as veteran Latin America watchers predict continued macroeconomic stability. There is a cautious optimism about growth prospects in the region as a whole – and with growth comes demand for more infrastructure. ■

Footnotes

¹The Economist, June 17, 2006, p.41

²IBID, p.42

³Antonio Estache and Maria Elena Pinglo, "Are Returns to Private Infrastructure in Developing Countries Consistent with Risks Since the Asian Crisis?" World Bank Policy Research Working Paper No. 3373, Aug. 2004.