

The wave of the future: Capital markets financing for infrastructure projects

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Matching cash-rich institutional investors with promising infrastructure projects in need of a deeper financing pool creates the proverbial win-win situation, particularly in the developing world, where demand is strong but debt financing is expensive. Increasingly, governments and their private partners are turning to capital markets issues as a way to bring in a vast new array of investors while reducing the cost of project-related financing. Evidence suggests that political risk insurance can raise the ceiling on bond issues, improving their ratings and elevating them to investment-grade status.

Developing countries are making quiet progress in their efforts to build capital markets infrastructure and the regulatory framework that supports a well-functioning, broad-based financial system. This is not the kind of news that typically grabs headlines. But for those involved in financing expensive, public-private infrastructure projects, and for institutional investors with excess liquidity, this is, indeed, really big news.

The availability of new global investment options opens the doors for a broad new pool of funds, infusing new life into long-planned infrastructure projects that could not get off the ground because they were not deemed bankable. And as nations shore-up their financial frameworks, use of capital markets will grow. With each successful subscription, investor confidence will likely improve, potentially driving demand upward and stabilising the market even more.

Already, capital markets in developing nations are

supporting private commercial endeavors. In Latvia, for instance, a US-based firm has moved into the nascent mortgage market with the support of a securitisation consisting of US\$60m in financing structured in three tranches: senior notes, subordinated notes, and fully subordinated notes.

There does appear to be an opportunity for infrastructure investors as well. Currently, annual private investment in infrastructure is relatively low – around US\$60bn, worldwide. According to the International Energy Association, global demand for new infrastructure tops US\$33 trillion. In the developing world alone, annual demand for infrastructure investment amounts to US\$233bn. Average returns on these investments can be difficult to quantify. However, the World Bank has noted some remarkable results, 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%.

Institutional investors paying attention to infrastructure

Increasingly, fund managers are realising the advantage of infrastructure investments to balance and diversify their portfolios, which may be excessively liquid, or overly weighted toward short-term returns. For institutional investors, 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.

"There's a whole lot of liquidity out there. And liquidity will chase projects, especially future flow paper like infrastructure projects," observes Sam Fox, Senior Director for International Structured Finance for Fitch Ratings.

In the US for instance, California state pension fund officials recently introduced a landmark proposal to invest US\$15bn in support of infrastructure projects across the state. In a press release, California State Treasurer Phil Angelides explained the rationale behind the proposal, called *Cal-Build*: "*Cal-Build* will meet the double bottom line goals of achieving solid long-term returns for pensioners and taxpayers and building the infrastructure California needs to prosper in the 21st century." The first action of its kind in the US, approval could signal a sea-change in the way fund managers invest for their clients.

This new landscape could spell opportunity for infrastructure projects in developing nations – where the bankability of a project cannot be measured against the same standards that apply for projects in developed countries.

"It's the year of the single B for investors," Fox says. Typically, securities rated BBB- and above attract the interest of investors, but not in today's environment. For the first time in a long time, a single B deal can get placed, he notes. "These are unique times. And investors are saying that if it's rated B, it's an interesting deal," he adds.

For developing nations, even those with more mature capital markets and stable legal and regulatory systems, achieving the triple B rating can be a challenge. But as investors take a more flexible approach to what they view as bankable, infrastructure projects in such nations become more intriguing. In turn, successful financing of an infrastructure project through bond issues for an emerging market nation is a positive indication that its overarching financial system has improved. "If the deal gets done, it comments on the depth of the capital markets," Fox says.

Capital markets issues: More attractive terms than bank lending?

Due to the high cost of loan financing, particularly in developing countries where country risk premiums add to the cost of capital, some projects simply are not economically feasible, based on a traditional debt-equity

financing structure.

However, the tide could be turning. As sovereign and sub-sovereign public entities in emerging market countries develop their own capital markets infrastructure, they will make increased use of these markets to fund major public-private works projects. Also, as institutional investors look for new ways to balance their portfolios, capital markets issues are becoming an increasingly interesting option.

Banks might not see a rising competitive threat for their project lending from capital markets. After all, bank project lending hit US\$140bn in 2005, compared to bond issues of US\$12.5bn. However, 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 Yukiko Omura, Executive Vice President of the Multilateral Investment Guarantee Agency (MIGA). "At the same time, we're seeing more and more lenders eyeing bond issues and securitisations as a way of generating funds in less traditional markets, versus the syndication of loans."

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 Project Finance Consultant Claudia Wiegand. "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.

Developing country risks cloud sunny investment horizon

Of course, infrastructure projects no matter where they occur come with their own set of risks. Projects involve huge upfront costs, typically take longer to complete and are reliant on future cash flows to meet financial obligations and provide reasonable returns. Political resistance to private provision of services is also an issue, particularly in countries where a prior, poorly designed concession did not meet consumer expectations, such as use of frequent and drastic rate hikes to achieve cost recovery. Constant downward

pressure on consumer pricing clouds the profit picture even further. Add to this the uncertainties associated with investment in developing countries, and even getting a deal up to a B rating could prove difficult.

Wiegand, former Executive Vice President of 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.

Other financial risks to project financiers include ongoing maintenance expenses, and what's known in the industry as 'leakage' – 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 the developing world can drive up borrowing costs between two and six percentage points, depending on country and region.¹

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 in some parts of the world, 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.

To protect against such problems, project

fundamentals have to make sense from the very beginning. This includes a sound deal structure as well as sufficient insurance to guarantee the safety of the investment. Also critical is a clear and transparent negotiation process. Contracts must be written so that roles and responsibilities are clearly defined – not just for the parties involved, but for the general public as well. Plus the involvement of a neutral third partner, like MIGA, can move the negotiations forward in a fair and even-handed way, so that all issues are addressed and nothing is left to chance.

Insurance coverage enhances credit rating, protects investment

Use of risk mitigation instruments such as political risk insurance can smooth out some of the uncertainties associated with such expensive investments in nations where the perception of risk is high. Certain coverages are more relevant than others, however.

"Protection against transfer restriction or currency inconvertibility mitigates only a narrowly defined risk and has a limited ability to improve a credit rating," Fox explains. The reason: fewer issues over currency restrictions have arisen in recent years, despite some well-publicised exceptions, such as in Argentina.

From the rater's perspective, as with a project player like Transcore, which has supplied highway toll collection systems in close to 40 nations, the critical issue is the contract. "If the project comes with guarantees that protect against a government party that won't honour the agreement, then the deal becomes a lot more interesting to us," Fox says.

Also, strong projects underwritten by appropriate insurance coverages – including breach of contract – can receive a significantly enhanced rating. "If a deal is structured properly, PRI can have a great and positive effect on the investment rating," Fox says. "Even if the deal structure is just OK, PRI can still have some effect."

Credit ratings firms also look at the agency providing the political risk coverage when they assess the rating. When an organisation like MIGA, as an arm of the World Bank Group gets involved, says Fox, "this has a very influential and important impact on the way we view the deal." Fox also says that the agency's claims payment history impacts the decision. "MIGA, for example, has a fantastic claims paying history, and that speaks to us. This can move a project into investment grade."

Multilateral insurance products complement private insurers

As project financiers look at capital markets in developing countries more carefully with an eye toward bond financing, additional concerns arise. These concerns – such as the risk of default on the bond – might not be mitigated by traditional political risk insurance products.

Private insurers can provide additional risk mitigation tools that can expand the level of protection. Monoline insurers can 'wrap' a bond, guaranteeing that purchasers will receive payment even in a default situation, regardless of who the issuer is. The presence of monoline insurance improves a bond rating further, often elevating it to the highest investment grade credit rating, AAA. With the risk premium substantially reduced, the cost of financing is lowered as well.

However, monoline insurers might not consider underwriting a project that does not start out with an acceptable rating. "Monoline insurers only get interested in an emerging market deal if it is investment grade," says Fox. Use of MIGA guarantees could improve the rating to investment grade, or BBB. "Once you raise the rating with PRI, you can go to a monoline and get it wrapped so it becomes AAA. And this makes for an exciting deal," he says. The amount saved in cost of funds exceeds the cost of the PRI and the wrap combined, he adds.

Dominican Republic toll road bonds 40% oversubscribed with PRI

A recent 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 106 km toll road, has been on the books for years. Numerous financing attempts fell flat due to 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 US\$220m, AdN contributed US\$30m in equity and the government agreed to a US\$30m equity stake. However, that left

US\$162m to finance. An initial attempt by the sponsor to secure a bank syndicate was not successful in producing the required loan durations.

In an unusual move, AdN and the Dominican government went to the capital markets with a US\$162m bond issue.

Credit rating agency Fitch reviewed the deal carefully 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. "In essence, this project was one of those 'if you build it will they come' questions," recalls Fox, who was part of the Fitch project rating team.

MIGA was then brought into the picture.

Investors hoped that the deal, underwritten by MIGA's political risk coverage, would now receive an investment grade rating of BBB-, providing them with significant reduction in the cost of capital. While this would have made a great end to the story that is not what happened.

Fitch was not prepared to significantly improve the rating, given the situation. With an investment grade seemingly unachievable, the parties returned to the negotiating table. "Even with guarantees in place, the breach of contract only covered the main agreement, and not the amendments, and this added to the level of uncertainty," says Fox.

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 represents its first coverage of a capital markets issue to finance an infrastructure. MIGA's guarantee amounts to a combined gross exposure of US\$103m.

Even with a B rating, the US\$162m in senior secured notes, maturing in 2026 with a 9.39% quarterly coupon, was oversubscribed by 40%.

Bottom line, says Elena Palei, a MIGA infrastructure underwriter: "In the DR, 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."

After years of discussion, and numerous unsuccessful attempts to make the road a reality, this important highway – linking a major tourist destination with an urban population increasingly interested in leisure activities – will finally get built.

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 who are encouraged by the increased availability of funding sources.

Note:

¹ Antonio 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.

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