

# Mega deals, mega risks: the enduring relevance of PRI

By Philippe Valahu, Acting Director, Operations, Multilateral Investment Guarantee Agency (MIGA), World Bank Group

**The global investment scene is looking rather bullish these days, with capital markets flush with cash and investors displaying a newfound willingness to take on more risk. And companies are realising the potential in emerging market countries, home to growing middle classes, eager workforces, and reform-minded governments – all of which has led to a nice rebound in FDI flows to the developing world, following a difficult few years post 9/11.**

With the urbanisation of the world's population, the need for infrastructure continues to grow, creating strong investment opportunities. One recent study from consultancy firm Booz Allen Hamilton suggests that world infrastructure demand will top US\$40 trillion over the next 25 years. This figure is "roughly equivalent to the 2006 market capitalisation of all shares held in all stock markets in the world," note authors Viren Doshi, Gary Schulman, and Daniel Gabaldon.

In Asia alone, the study estimates that US\$15 trillion is needed to meet the growing appetite for water, power, roads, rail, and ports. Combined, the annual demand for infrastructure investment in the developing world currently amounts to US\$233bn. As macroeconomic recoveries in many of these nations set the stage for new business growth and increased prosperity for local citizens, the demand for better, more efficient services will grow as well.

This confluence of events means that project financiers are starting to pencil more deals in places previously deemed too risky due to political or economic

instability. Investors are casting an eye toward mega-deals in both middle-income emerging market nations and in frontier markets.

"We are absolutely seeing more private infrastructure activity in sub-Saharan Africa, in Asia, in the Middle East – challenging markets that no one would touch a few years ago," says Booz Allen Hamilton's Gabaldon, a principal in the consultancy's Energy, Chemicals and Utilities practice.

With baseline investments more than covered, there's some extra cash available for investments that are a bit less certain but that have the potential for stronger than average returns, since losses will not cause irrevocable damage to the financial position.

While average returns on infrastructure investments in frontier markets can be difficult to quantify, some estimates suggest that at a minimum, investors could double their returns on a well-structured deal. For projects in developed countries, the Booz Allen study pegs general five-year returns at 11% to 13% for airports, 10% to 13% for toll roads, 8% to 10% for rail passenger lines, and 10% to 14% for wastewater plants. Compare these figures with returns on African infrastructure investments, which are reported to range between 20% and 200%, according to Francois Bourguignon, World Bank Senior Vice President and Chief Economist.

Governments in many emerging market nations are doing their share to turn increased market attention into tangible results. They are focusing on business and regulatory reforms that will catalyse new private investment in such projects. For example, an overarching energy sector reform strategy in Uganda has helped pave the way for significant new private



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investment: a recently announced public-private partnership to construct the US\$800m Bujugali hydroelectric power plant, to meet demand in this rapidly growing economy.

## The PRI lynchpin

This return to the so-called riskier markets elevates the importance of risk mitigation. "Deals are happening today in places where the political landscape is uncertain at best," says Gabaldon.

And because lenders and credit raters tend to be a rather risk-averse lot, the cost of capital goes up when the perception of risk is higher. Additional protection, in the form of political risk insurance, reassures lenders, thus reducing the risk premiums.

"PRI can bring down the cost of a deal, which might have high risk premiums associated with the cost of capital," Gabaldon says. "The real issue is the reduction in the capital cost rather than actually collecting the insurance dollars should an event occur."

Some financial experts suggest that the current investment climate makes political risk insurance even more relevant today. "The demand for political risk instruments is very large, but we are only seeing part of it," notes Michael Freed, a Managing Director with DEPPA BANK. "As more emerging market and frontier nations realise plans for bringing in the private sector, the demand will grow."

Freed observes that project sponsors have more options for PRI today, as international financial institutions, private insurers, and credit agencies all offer some type of coverage. "The demand is such that there is room for all of these instruments," he says.

While the market for PRI products has grown more competitive – a good thing for firms shopping for coverage because it keeps prices down – there are some places that are considered so risky that commercial insurers may not offer coverage. These frontier markets, often nations emerging from conflict, are often where the business opportunity exists.

In such cases, the role of a multilateral insurer like MIGA can be invaluable, particularly given the added advantage of having the backing of the World Bank Group, in addition to the insurance policy.

As an agency of the World Bank Group, created in 1988 with the express purpose to promote foreign direct investment in support of economic growth and poverty reduction, MIGA is willing to go where other insurers

often do not venture: post-conflict countries with destroyed road and ports; to economically challenged countries with underdeveloped financial markets; extremely poor nations with little budget to construct water or power lines. As the pioneer in some markets, MIGA also sets an example, offering market reassurance and encouraging other insurers and financiers to follow.

"Today, companies are interested in going to countries where they've been long absent, and insurance is hardest to get in these nations. MIGA's participation can be powerful added comfort," Booz Allen's Gabaldon notes.

Adds Freed, "Private insurers aren't going to go to some of these markets, and MIGA will. MIGA's presence in some of these markets enables lenders and investors to become more comfortable with the risks and receive a commercial return on capital while reducing financing costs."

Ten years ago, Mozambique was one such market. Recently emerged from a devastating civil war, the nation lay in shambles. A key to Mozambique's remarkable turnaround following years of violence and conflict is the economic development that began in 1998 with Mozal. The massive, US\$2bn aluminum smelter, sponsored by a consortium of international firms, received political risk guarantees from MIGA.

The project also helped stabilise a fragile peace by providing work for those seeking an alternative to conflict and by signaling to international and domestic investors that it was safe to do business there.

"Mozal had a huge effect that cannot be fully captured in any economic analysis that measures job creation, taxes and the like," notes Greg Binkert, the World Bank's Lead Specialist in Mozambique. "To bring economic development to a conflict area is absolutely essential to peace, which in turn is the basis for rapid and sustained growth." The company's success has directly contributed to nationwide economic improvements: Mozambique's export earnings increased from US\$230m in 1997 to around US\$2.4bn in 2006. Today, the investment climate is strong, and FDI is flowing. But without MIGA guarantees, the Mozal project might not have gone through.

**"Investors don't want a claim paid. They want to keep the project going."**

While a number of private insurers are starting to offer political risk insurance products, there is a difference



**World Bank Group**  
Multilateral Investment  
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# REDUCING THE RISK PROFILE OF INVESTMENTS



MIGA, a member of the World Bank Group, offers **political risk insurance** (guarantees) to investors and lenders for the following risks:

- Expropriation
- Breach of contract
- Currency inconvertibility and transfer restriction
- War and civil disturbance, including terrorist activity

Also provides **added value** to investors through:

- **Credit enhancements.** Improved access to financing, increased tenors of capital, and often reduced capital and financing costs.

- **Greater confidence.** The World Bank Group “umbrella” has a deterrent effect against government actions that could disrupt investments. MIGA can influence the resolution of potential disputes between investors and host governments, thereby preventing claims.
- **Extensive knowledge.** Clients are offered unparalleled knowledge of emerging economies through the extensive resources of the entire World Bank Group.

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between private firms and what public insurers like MIGA can offer.

As a member of the World Bank Group, MIGA's dialogue with governments can mean that conflicts are resolved before claims must be paid. And the bottom line for project sponsors and companies in the midst of a project, says an executive with Standard Bank: "Investors don't want a claim paid. They want to keep the project going," he says. "In both cases, you're getting a policy, but one is more than insurance. With MIGA, you get the World Bank on your side."

The very ownership of the agency is part of the benefit. "MIGA is owned by sovereign nations, so its level of access to governments is useful as a deterrent to problems, to mediate claims or to avoid claims entirely so the project continues. This is the value that enables investors to make a return on the transaction without putting the cost of financing too high," Freed explains.

In fact, of the 850 contracts written over the course of the agency's 20-year history, MIGA has only had to pay three claims. In a typical year, MIGA is able to resolve a handful of disputes that arise between insured parties and host governments, before claims are paid. So everyone can get back to work and the project can resume.

Policy costs remain stable over the course of a longer lifetime, too. Because MIGA policies come with longer tenors than those of private insurers, clients can lock in a rate, which won't change even if the risk environment deteriorates. A shorter-term policy, if available, might mean that at renewal time, companies wanting to re-insure will have to pay a higher cost for the same insurance.

That said, there's room for both public and private political risk insurers; the increased availability of insurance products keeps costs low, and gives companies added incentive to include political risk policies as part of their deal structure.

MIGA's political risk insurance products are guarantees to investors and lenders, covering the risks of expropriation, breach of contract, currency transfer restriction, and war and civil disturbance. MIGA's expropriation and breach of contract coverages can protect the investments from both sovereign and sub-sovereign risks. In-house sector experts help insure that deals are sound, projects are viable, and expectations are clear on all sides.

MIGA's guarantees are well-tailored to support the PPP model. The agency offers cover for a variety of contractual structures, ranging from Build Operate Transfer (BOT) contracts to maintenance (O&M) contracts; from management agreements to performance bonds.

Since its inception, MIGA has issued more than 850 guarantees for projects in 95 developing countries, totalling more than US\$17bn in coverage. Of this amount, close to US\$5bn in guarantees has gone for infrastructure projects, accounting for 29% of its portfolio.

MIGA insures new cross-border investments originating in any MIGA member country, destined for any other developing member country. New investments associated with expansion, modernisation or financial restructuring of existing projects are also eligible, as are acquisitions that involve the privatisation of state-owned enterprises. Other investments may be eligible as well and are considered on a case-by-case basis.

Types of foreign investment that can be covered include equity, shareholder loans and shareholder loan guarantees, provided the loans have a minimum maturity of three years. Loans to unrelated borrowers can be insured, provided a shareholder investment in the project is insured concurrently or has already been insured. Other forms of investment, such as technical assistance and management contracts, and franchising and licensing agreements, also may be eligible for coverage. To qualify for MIGA coverage, projects must be financially and economically viable, environmentally sound and consistent with the labour standards and other development objectives of the host country.

## Dominican Republic toll road

A recent toll road project in the Dominican Republic illustrates the power 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 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. But that left US\$162m to finance. An initial attempt by the sponsor to secure loans from the commercial banking market was not successful in producing the required loan durations.

In an unusual move, AdN and its financial advisers, with the support of MIGA, approached the capital markets for a US\$162m bond issue. Credit rating agency Fitch was brought in to rate the transaction.

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 was then brought into the picture**

MIGA agreed to a partial guarantee of 51% of the 144a bond issue, including breach of contract coverage, representing first-time four-point cover (expropriation, breach of contract, transfer restriction, and war and civil disturbance) of a capital markets issue to support an infrastructure project. This allowed Fitch to rate the transaction higher than it would have otherwise been rated. This resulted in a 40% oversubscription.

The benefits to the sponsor were twofold: (1) the cost of capital was reduced; and (2) the amount of principal requiring PRI coverage was also reduced. And according to Armin Garcia Acuña, chief executive officer of AdN, with MIGA guarantees in place, the company was able to extend the tenor of the payback period, to 20 years, another key issue for a project with large upfront costs.

"For us, the presence of MIGA was the critical factor in finishing the financing process. Without MIGA, the project would not have happened," says Garcia Acuña. "Nobody believed in the financial stability of this project because of the economic situation in the Dominican Republic when we started." When financiers saw that MIGA had endorsed the project, the financing doors began to open, he says.

Garcia Acuña notes that MIGA's involvement plays a more subtle role as well: "We are now in the construction phase, and everyone is abiding by the

terms of the contract because they don't want to be in default with a company involved with MIGA."

With completion slated for May of 2008, the toll road helping to catalyse development in the Dominican Republic: the country's GDP growth rate is the highest in the region, and new communities and other tourism developments are popping up in Samaná, linked by the road to the airport.

The project's success also opened the door for additional bond issues: in November 2006, Cap Cana, a new resort community along the east coast, completed the country's largest international corporate bond issue to date, US\$250m in seven-year bonds, receiving a B3 risk rating.

### **Phu My 3**

Half a world away from the Dominican Republic, in Vietnam, MIGA is playing an important role as insurer of a massive power plant.

The plant, known as Phu My 3, is one of the first Build-Operate-Transfer (BOT) projects in the country's power sector. The US\$386m project is a joint venture between BP, SembCorp, Kyushu Electric Power Company, and Sojitz (Nisho Iwai), a Japanese trading and investment house, with financing from a syndicate of commercial banks and from development banks.

Putting together such a complex deal would not have been possible without the appropriate mitigation of risks, both commercial and noncommercial, according to executives involved in the deal. MIGA provided several guarantees: US\$43.2m for the equity investment, US\$75m for a nonshareholder loan, and US\$15m to cover a financing swap agreement arranged by Calyon, the inter-creditor agent.

"Vietnam is still a high-risk country from a private investor's or project company perspective," says Hisashi Toyofuku, Phu My 3's Chief Financial Officer. "When we started the project, of course we had to consider competitive pricing. Our shareholders and the project company are fully aware that MIGA plays a very important role in terms of obtaining competitive pricing, and thus encouraging lenders to lend money to us. This helped us get the project going faster."

Others involved in the project said that MIGA played a catalytic role, helping to mobilise additional sources of financing with a cost structure that would not have been possible otherwise.

"The involvement of MIGA alongside the ADB, JBIC,

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and NEXI was instrumental in the success of this ground-breaking financing in Vietnam," says Frederic Beaujean, the Vice President for Project and Structured Finance Asia at Calyon. "It allowed this entirely private project to tap the international commercial bank market and to close a limited-recourse financing at very competitive conditions."

The project involved a huge amount of financing and a lot of actors, notes Annick Paccioni, Calyon's Operational Support Manager. "And the main question for lenders is risk. MIGA's guarantee was very important for the lenders to have the security and expertise needed to protect the loan, and for future loans as well. This allows banks to diversify."

The company's 20-year Power Purchase Agreement with the government of Vietnam allows it to sell capacity and net energy output to Electricity of Vietnam, which operates the national grid and distributes electricity to end-users. The agreement involves a fixed capacity charge with a yearly fixed subscription paid by EVN to Phu My 3, as well as a variable charge based on net energy output.

## Looking forward

With growing demand for political risk instruments, insurers will need to provide flexible offerings to meet new and unique client needs. The investor pool is

changing as well. "There is a new generation of players, such as investors from India, Malaysia, and the Persian Gulf, and their tolerance for risk is higher," observes Gabaldon. "It will be an interesting challenge for PRI providers to develop products that will resonate with these new players because they are the ones going to the markets where the perception of risk is highest," he adds.

MIGA is actively exploring new ways to meet these needs going forward. MIGA focuses on providing solutions tailored to specific sector risks and on enhancing coverage to address emerging threats such as terrorism. And products are designed to address the needs of the broader investor pool, from capital markets to bank syndicates.

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