FINANCIER WORLDWIDE .COM corporatefinanceintelligence

Infrastructure Opportunities In Emerging Markets

Pauline Renaud, September 2009

Emerging markets are facing numerous challenges in the current financial climate, but sustaining economic growth remains a priority. Building or updating existing infrastructure is a critical element of growth, and such initiatives have received strong government support as a result. But the enormity of the need, combined with tight credit conditions, means that foreign private investor capital is essential to developing and sustaining infrastructure projects. Consequently, there are many opportunities for such investors. Indeed, according to Booz Allen Hamilton estimates, $7.8 trillion will need to be invested into emerging market road and rail infrastructure in the next 25 years. China, for example, is planning to lay 25,000 kilometres of track over the next five years. Nonetheless, the investment environments can be challenging for foreign investors, particularly for those that are not familiar with the local rules and regulations of the country they plan to invest in. But for savvy, cash-rich investors, emerging market infrastructure can be an area which provides long-term and profitable opportunities.

Greater calls for infrastructure investment

With growing populations in most emerging markets, and an increasing percentage of those living in cities, it is crucial for these countries to develop infrastructure assets such as mobile communications and transportation, as well as industries that supply materials to construct infrastructure. This is notable in Central and Eastern Europe (CEE), explains Peter Swiecicki, managing partner of the Warsaw office and the head of the Infrastructure Practice in Central Europe at Squire, Sanders & Dempsey. "These emerging markets remain saddled with legacy assets from the inadequate investment and maintenance strategies of the communist era. Improving this infrastructure is key to creating economic efficiencies, attracting investment, and creating further opportunities such as the 2012 European Football Championship. Some of the projects are favoured by the national governments; others are championed by local and regional authorities," he says.

Indeed, the need to meet commitments associated with events such as Euro 2012 is a main driver behind infrastructure investment. In Brazil, for example, the government will need to launch a series of projects to comply with requirements set out by the Fédération Internationale de Football Association (FIFA) for the World Cup in 2014. Brazilian infrastructure development has also been stimulated by the upcoming general election. Other drivers include the need to enhance health and safety, particularly in areas such as waste water treatment, flood control, bridge reconstruction and environmental protection. And there are other benefits – developing infrastructure assets can create jobs, a desirable outcome in a global recession. Furthermore, it is essential to help countries comply with targets set by supra-national bodies, such as the European Union, regarding, for example, carbon emissions and other legislative requirements.

As such, there are already a number of government initiatives designed to improve infrastructure facilities. Looking at Brazil, the government has launched the Plano de Aceleração do Crescimento (PAC) and provided a total of 113bn reais (€41bn) to expedite infrastructure projects in general. Other notable projects from around the world include the $30bn Beijing-Shanghai high-speed railway, due for completion by 2013, the Mexican government's 2007-2012 "Let's build a better Mexico" national infrastructure program, as well as the Russian government's plan to modernise the electricity and power network. But government intervention is often not enough. This is clear in India where "the government estimates the need for $320bn in infrastructure spending over the next five years," says Kartik Ganapathy, a partner at Nishith Desai Associates. It is inconceivable that this could be provided by the Indian government alone, and steps have been taken to address this. "The eleventh Five-Year Plan of the Indian government focuses on harnessing private sector efficiencies either by way of fully private projects or public-private partnerships," continues Mr Ganapathy.

Several other countries have made similar moves to help bridge their infrastructure funding and expertise gaps, albeit by offering different sorts of incentives. "To attract foreign investment, the Brazilian government has approved new rules for the infrastructure sector regulatory agencies, privatised the reinsurance sector, and has made dedicated efforts towards expediting the process of environmental licensing of projects," notes Henrique Dias Carneiro, a partner at Dias Carneiro Advogados in association with Uría Menéndez. "But a great effort is yet to be made in modernising the public procurement regulations and reducing taxes on civil works, as well as on infrastructure investment funds," he adds. Other governments have also changed existing regulations or implemented new ones to complement initiatives. This recently occurred in the Ukraine. "First of all, the primary Ukrainian laws regarding concessions – especially road concessions – housing supply and construction of utilities were amended and supplemented with up-to-date provisions," notes Oleg Y. Alyoshin, the head of the PPP and Infrastructure Practice at Vasil Kisil & Partners. "Secondly, a number of laws aimed at overcoming the financial instability were adopted. A specific law on general principles of public-private partnership was passed as well. Along with legislation changes, a number of new infrastructure tenders were announced by the central government and local municipalities," he explains, citing the Kyiv ring road, Lvov airport, Odessa sea port and the new stadiums for Euro 2012 as examples.

Experts have suggested that multilateral financing institutions, which often allow for strong governmental support mechanisms otherwise difficult to obtain, may play a key role in attracting foreign investors. Also, Ukrainian authorities have taken steps to attract finance from international banks, such as the European Bank for Reconstruction and Development (EBRD), and the European Investment Bank (EIB). In addition, the recently adopted "Concession for Construction and Exploitation of Automobile Roads" laws provide for more unusual financing instruments. "The infrastructure bonds may become one of the key instruments for development and financing of the central and regional infrastructure," explains Mr Alyoshin. "We expect further activity from the relevant market regulators to create a mechanism for issuing infrastructure bonds that would differ in its structure and trading characteristics from the other types of securities. This instrument must be structured in such a way that it satisfies the quite strict requirements of the state budget and the requirements imposed on instruments subject to state guarantees."

Moving away from Europe, in India, there are currently several proposals under consideration to improve access to long-term risk capital from foreign sources, including dedicated infrastructure funds and permission for venture capital involvement. However, in most emerging markets, the incentives on offer leave room for improvement. This can be the case with regards to risk sharing in public-private partnerships (PPP). In such situations, the creation of a special purpose vehicle (SPV) is advised, which can serve to isolate the parties from potential issues. Other challenges related to investments in emerging countries may also occur, due to the fact that those markets are likely to be more volatile than developed ones, more likely to be exposed to political unrest, and may lack regulatory clarity.

Mitigating risks and potential exposures

Of course, these risks can be mitigated. Thorough knowledge of the regulations in the country targeted is a must, as is familiarity with the parties involved in the deal. This can be achieved through a combination of advice from local professionals and a comprehensive due diligence process. But this often easier said than done and, as such, investors would be well advised to prepare for long negotiations. In Brazil, for example, "because most of the infrastructure projects are locally financed by the Banco Nacional de Desenvolvimento Economico e Social and more recently also by the Caixa Economica Federal, foreign investors should be prepared to face tough negotiations and conditions, particularly in terms of the guarantees requested by the BNDES," explains Mr Dias Carneiro. "As public entities, BNDES and CEF conduct the process of financing at their own speed, which is the result of a very complex internal structure with many levels of decision-making to be observed." Private investors should also be prepared to face tax issues, as well as legal and regulatory challenges. In Brazil, laws exist at three different levels: federal, state, and municipal, and interference of the federal government in the work by regulatory agencies is common, and can result in conflict. Mr Dias Carneiro maintains therefore that, to conduct successful investments, investors should consult local advisers with regards to their relations with the Brazilian client, the relevant governmental agencies, and the BNDES and the CEF.

Land issues are also common in infrastructure projects. "In Ukraine, the land regulations are quite poorly integrated into those governing public-private partnerships. It could easily be the case that, when having won the infrastructure tender, the investor is required to pass certain land allotment procedures and even additional land auction," warns Mr Alyoshin. However, he adds that "the new PPP law provides for obligation of the initiator of a public tender to resolve the land issue simultaneously with the choice of a private investor." In such cases, additional land auctions are unlikely to be required. Indeed, the CEE region as whole has taken some important steps towards clarifying the tender process, necessitated by their acute need for road improvements. "First, the limited number of private vehicles in communist countries meant that under-investment in the road sector did not use to be a problem. But now, that under-investment means there is more catching up that needs to be done," explains Mr Swiecicki. "Second, Hungary has shown that road deals can be structured with efficient tenders and sufficient transparency, creating a model that can be re-used. Slovakia also made an excellent effort to make its R1 and D1 road tenders efficient and logical." In those countries, rail and renewable energy projects are also expected to continue being sources of interesting deals for foreign investors.

In Europe as a whole, one of the most common regulatory challenges is environmental compliance. This needs to be carefully addressed, particularly within the European Union, as recently ascended countries have started applying EU guidelines. Another challenge is state aid compliance. Indeed, the potential delays in obtaining EC clearance regarding state aide, when considering carrying out a project, should not be overlooked. Furthermore, and despite noted improvements, the tendering and/or procurement process continues to be a challenge in many European markets, observes Mr Swiecicki. “An overly formulistic approach to procurement can result in many bids being rejected as non compliant. It is critical to have a full understanding of the local legislation, as well as dynamics surrounding the tendering governmental agency. A key issue on the legal side is to be sure that the concession or term of the project will be such as to ensure an appropriate return on the investment,” he says.

Other legal and regulatory challenges that can arise include corporate compliance, employee benefits, intellectual property, HR law compliances and foreign exchange compliances. As such, with so many potential issues, investors should be prepared for the possibility of being involved in disputes and having to resolve them. Mr Ganapathy suggests that “dispute resolution should be an independent jurisdiction, and preferably by arbitration.

Insurance covers for the projects, as well as appropriate risk management, and document retention policies are vital to both managing risk, and dealing with potential exposures.” And limiting such risks is essential, as the appetite of foreign investors is getting larger in response to the signs of recovery seen in some markets. “In spite of the crisis, we have seen an increasing participation of foreign companies in bids for infrastructure projects in Brazil, mainly in highways and railway projects,” confirms Mr Dias Carneiro. “It has been reported that a number of European companies are preparing themselves to bid for the high-speed train project that will connect Rio de Janeiro and São Paulo, as well as for projects related to the 2014 Football World Cup.”

Ultimately, deals where the demand risk, as well as the construction and availability risk can be minimised will always be sought by investors. “Also, in India, low sovereign risk, shorter gestation periods, quicker cash flows, and beneficial government involvement are all significant positives to investment,” confirms Mr Ganapathy. Indeed, increased direct government support is to be a feature seen across the majority of the emerging markets, in order to further essential projects, while encouraging job creation and minimising the impact of the current downturn. Furthermore, it is likely that these countries will see further regulatory change, which should encourage investment. These developments, combined with the acute need for improvements in clean technology, transport, public health, education, and sport facilities in preparation for some large sporting events, suggest that infrastructure investment in emerging markets is, on balance, an excellent value-generating avenue for wise investors.