

A tour of global hotspots

Professionals from Deloitte explore the dynamics impacting key infrastructure markets around the world

Australia: Clouds in a blue sky

Australia has become the centre of global attention for the infrastructure asset class. James Riddell, Deloitte Australia's leader of Corporate Finance and Infrastructure M&A leader at Deloitte Touche Tohmatsu Limited (Deloitte Global), hopes that political uncertainty will not tarnish that hard-won status

"ASSET RECYCLING" IS fast becoming a very efficient approach that enables governments to fund desperately needed infrastructure development in those OECD economies where levels of current borrowings make debt-funded or tax revenue-funded development difficult.

Asset recycling involves solely utilising the proceeds from the sale of publicly-owned energy and transport infrastructure assets ("old assets") in the development and operation of new infrastructure assets ("new assets"), a concept that has recently been expanded upon - and in fact actively incentivised - in Australia. It has helped Australia become what Riddell describes as "the current global focus for financial investors, including infrastructure fund managers, sovereign wealth funds and pension funds to deploy significant amounts of capital in a highly sought-after sector".

With its originally touted A\$80 billion (€57 billion; \$62 billion) privatisation wave, and notwithstanding aborted processes for the sale of poles and wires and port assets in Queensland and new-built toll road projects in Victoria - both due to political opposition - Australia is still expected to stay on investors' radars for a while yet.

And, as more and more high-profile transactions come to fruition, so the significant capital allocation set aside grows ever higher. Riddell points to the establish-



James Riddell

ment of "Restart NSW", a fund established in 2011 by the current New South Wales government which has been set up solely for the purpose of funding new infrastructure development, and has seen more than \$A7.5 billion in proceeds pour into its coffers so far.

Moreover, Riddell believes that the asset recycling model is transportable to other markets, particularly some OECD economies that remain asset rich, but funding poor. He thinks it could even possibly displace the public-private partnership (PPP) model which - while still having a big future in emerging markets, he believes - is falling out of favour in many

mature markets due to a perceived lack of effective risk transfer to the private sector, which means higher leverage structures. It is also often the case, says Riddell, that "the private sector capital at risk is a very small quantum of the overall project cost".

'BANG FOR BUCK'

He also believes that, compared with PPPs, large asset recycling deals offer much more 'bang for your buck'. "The majority of financial investors that have large capital allocations to infrastructure tend to have minimal exposure to PPPs because you simply can't deploy enough capital for the project size based on the usual capital structures utilised. By contrast, with something like major GDP-linked assets like ports and airports, or regulated assets like electricity, gas or water utilities, you may be able to deploy multiple billions of dollars in one transaction."

This all sounds good in theory, but anyone familiar with recent political developments in Australia will be aware that nothing should ever be taken for granted. The new state government in Queensland ran a very vocal anti-privatisation campaign in respect of the planned sale of regional port assets and their poles and wires assets as their major policy platform, so much so that nearly A\$40 billion of proposed infrastructure asset sales have now been taken off the table. Moreover, these fears remain in relation to the planned privatisation via long-term leases of similar poles and wires assets elsewhere.

"In Queensland, the opposition party ran a very successful anti-privatisation campaign arguing against the merits of asset sales to fund infrastructure development

and this proved successful with the electorate,” Riddell reflects. “As a result, capital set aside by financial investors for the planned A\$40 billion of infrastructure asset sales will now have to find a new home. This outcome has left a sour taste in the mouths of many financial investors which had allocated significant resources, relocated teams and made a very significant decision to invest in Australia.”

Riddell worries that the Queensland precedent – especially if followed by further negative developments – could see the tide begin to turn in Australia. “One of the things I have learned over the last 15 years is that the capital allocated by financial investors in infrastructure is very mobile and indiscriminate, and will not hesitate to move to other markets as new opportunities present themselves,” he says. “Queensland was a body blow, but not the death knell. However, if this trend continues, that would be problematic.”

Having said this, he thinks that – even as some large privatisation deals have ended up being shelved – other investment opportunities may present themselves for long-term capital deployment in the Australian market. “Capital optimisation via divestments of non-core assets by strategic investors, particularly in the energy and resources sector, were previously expected to be delayed as financial investors focused on government asset sales. But now some of these other private sector investment opportunities may be brought forward as financial investors look to fill the gap.”

As an example, he cites the liquefied natural gas (LNG) pipeline sector. In December last year, BG Group sold an LNG pipeline to APA Group, Australia’s largest gas pipeline owner – in a \$5 billion deal. This LNG pipeline was the first of three LNG pipelines being built in Queensland to reach financial close. The remaining pipelines are sponsored by consortia led by Origin Energy and Santos Limited and it is possible that these assets will come to market to fill the void left by the Queensland election

outcome. These pipelines are likely to also sell to financial investors for multiple billions of dollars.

“With depressed commodities prices, it opens up opportunities for energy businesses to sell off non-core infrastructure assets to investors with lower costs of capital,” Riddell points out.

ASIA: ‘SLOW BURN’

He also suspects that financial investors that have relocated to Australia may well begin looking at other investment opportunities in the region, including New Zealand as well as Asian markets such as China, Japan, India and Southeast Asia. “Financial investment into Asia will be a slow burn but more people will be looking at opportunities there as and when they arise,” says Riddell.

This prompts further consideration of how investment into Asian markets is likely to develop. In many of these markets there is a history of government funding infrastructure needs without any private sector help. Riddell explains: “You have governments that are not debt constrained, run low debt-to-GDP ratios, and are well financed due to historically strong economic growth.”

In this environment, governments have had sufficient capital to develop new infrastructure on their own without the need to tap the private sector. However, Riddell expects funding in the future will likely consist of a combination of public and private sector financing, particularly if economic growth slows.

“In the future, not all new infrastructure development will be financed by governments simply writing cheques. In some emerging markets, we are seeing the green shoots of PPP markets develop and this is what you would expect because PPPs, particularly in Asia, tend to have more balanced capital structures reflecting an appropriate level of risk and return.”

However, Riddell points out that infrastructure development via PPPs has slowed in developed markets like Australia and the UK due to a shift towards lower pri-

vate sector risk, more availability-type structures and as a result, increased leverage and lower capital deployment. This still works for the smaller social infrastructure projects, such as schools and hospitals. But big-ticket investments via PPPs, particularly in the transport sector, are becoming increasingly rare as projects are de-risked by governments (effectively resulting in a relatively expensive form of borrowing).

In Asia, an added complexity is the need to address the difficulties in some jurisdictions for foreign financial investors to extract yield. “It’s generally quite hard to take yield out in Asian projects,” Riddell reflects. “You have growing, wealthy governments and markets that are less experienced in dealing with the needs of foreign financial investors and their requirement to extract yield in a timely and efficient way.”

For the time being, he says, encouragement arises from the tentative steps being taken towards developing Asian PPP markets. The next logical step in his view would be for these markets to explore the role that investors could play in asset recycling. But that may be some way off yet.

At the end of the day, the important thing for governments to understand is that financial investors, while having a healthy appetite for infrastructure investment, need to ensure their key investment criteria of investing in capital intensive, transport and energy infrastructure assets requires:

- Manageable sovereign risk;
- Access to long-term predictable yield either via contractual, regulatory or market protections;
- Alongside governance rights that enable financial investors to protect and direct their investment capital.

This is true no matter what markets investment opportunities are being assessed. ■

James Riddell is the Deloitte Global Infrastructure M&A leader and leader of Corporate Finance for Deloitte Australia

MENA: On the up as oil price falls

Governments in the region have been cautious about private sector involvement in infrastructure, but the assumption that they can provide all the required funding is now being challenged. David Brazier and Umer Ahmad of Deloitte Middle East examine the landscape

HAVING BEEN BASED in Saudi Arabia for the last eight years, David Brazier – a director with Deloitte Middle East’s Infrastructure & Capital Projects team – has been actively involved with government procurement efforts and has helped governments in the region with the creation of ‘enabling’ models which seek to foster more effective private sector engagement in public services and the provision of public assets. As such, he is well placed to judge the progress being made as the private sector seeks ways of helping Middle Eastern states to meet demand for new infrastructure.

In Saudi Arabia, he has noted the creation of large infrastructure programmes – including in rail and integrated urban transport – but also the unwillingness to give private financiers the sort of role they would have in similar programmes in Western Europe or Australia, for example. “In Saudi Arabia, the government has been the main financier and has only looked for private sector involvement around the edges. There is a culture change that is required to increase private sector involvement in critical projects,” he says.

SEEDS OF CHANGE

He observes that there are concerns from governments across the region about losing control over projects and of value disappearing offshore. While some countries such as Saudi Arabia have material cash reserves, he also thinks, however, that the falling oil and gas prices are sowing the seeds of change in some jurisdictions and accelerating pre-existing trends in others. The changed fiscal landscape is forcing a different outlook – essentially, less oil or gas revenue means governments have a greater incentive to consider alternatives to self-funding all of the majority of projects.



David Brazier

“There is a growing realisation that PPPs are not just about capital, they are about expertise and value for money”

David Brazier is a director in Deloitte Middle East’s Infrastructure & Capital Projects team and is based in Saudi Arabia; **Umer Ahmad** is head of project and infrastructure finance for Deloitte Middle East and is based in Dubai

This nascent development has also been picked up on by Umer Ahmad, head of project and infrastructure finance at Deloitte Middle East. “Meetings with government entities in the region show more focus on doing social infrastructure public-private partnerships (PPPs) for the first time; this could be partially driven by falling oil prices,” he says.

Ahmad says that there are “really interesting dynamics” in the region but agrees with Brazier that private finance has so far had only a limited role, at least as far as social infrastructure and transport is concerned. But “there is growing realisation that PPPs are not just about capital, they are about expertise and value for money.”

The region has its bright spots and areas of further potential. Ahmad points to Egypt and Kuwait as examples of countries which have ratcheted up their PPP efforts through PPP units and the attempted creation of suitable legal frameworks and documentation. Progress has not been easy for either country, with Egypt, for example, buffeted by economic volatility and social unrest. However, it has completed some social deals while Kuwait has seen one successful energy project.

“Kuwait said early on it was not just about the money, as it was cash-rich,” notes Ahmad. “It understood there were other drivers for PPPs that were more important.”

NON-STANDARD

Ahmad notes that there has been a social housing PPP in Bahrain and university PPPs in the United Arab Emirates (UAE), though they have had some non-standard features. In power and utilities, there has been plenty of activity in countries such as Oman, the UAE, Qatar and Saudi Arabia, while Morocco and Jordan have been at the forefront of renewable energy deals. Egypt is also showing lots of potential in the energy space and he also believes that opportunities will become increasingly apparent in Iraq at some point.

But while Ahmad believes Export Credit

Agencies (ECAs) are well placed to bring capital and other forms of support to transactions in the region, he is less clear that it represents a fertile playing field for infrastructure funds. While a decent number of funds set up shop in anticipation of opportunities, they have found it hard to add value as part of consortia where they are not the only parties able to provide equity.

Furthermore, while there have been some opportunities to buy assets in the secondary market, funds find themselves at times competing with sovereign/quasi-sovereign entities which may be able to offer a high price as they may be more driven by political and/or strategic considerations.

The result of this is that a number of the funds which originally established operations in the region have since packed up and left. For those which remain, Ahmad notes a tendency to favour a wide investment mandate. However, he wonders whether this will go down well with investors who will expect a high internal rate of return (IRR) to compensate for the risk.



Umer Ahmad

THE ROAD TO COMMERCIALISATION

Having said that, deal flow may be showing signs of expanding. Although he is reluctant to estimate how soon it will happen, Ahmad suggests the possibility of privatisations as governments look to find ways of commercialising assets and he also notes the use of the design, build, finance (DBF)

model, including for some roads in Dubai. Again, though, Ahmad ponders whether the boxes of fund managers are being regularly ticked and hints that there may be a bigger role for the ECAs rather than funds.

For those firms which are looking to commit to the region, Brazier stresses the importance of socio-economic factors. “Governments have received a lot of push-back for not doing enough for their populations, including when it comes to job creation. Successful investors will be those which demonstrate a wider competence in supporting the economic well-being of the places they are working in.”

But despite the challenges, Ahmad remains upbeat about prospects. “There are some massive positives in terms of underlying medium-to-long term economic growth and the level of demand,” he says. “Changes are taking place that will drive the further use of private finance. In the meantime, traditional energy, utilities and renewable energy deals are all keeping private capital flowing.” ■

UK is ‘first port of call’

When investors examine opportunities in Europe it’s still the UK that tends to catch their eye, says Jason Clatworthy of Deloitte UK. He also runs the rule over the Nordic markets and Germany

THE RECENT £585.1 million (€808.9 million; \$858.2 million) sale of a 40 percent stake in Channel Tunnel rail service Eurostar by the government – with Canadian pension La Caisse taking 30 percent and UK asset manager Hermes Infrastructure 10 percent – was one very visible illustration of the continuing attractiveness of the UK market.

“It’s as busy on the UK buy side as it’s been for the last several years. Over the last year, activity has been very strong and it’s still an extremely attractive market for both fund managers and direct investors,” says Jason Clatworthy, a partner at Deloitte UK and European infrastructure M&A leader.

He adds that, for those investors looking to do deals within Europe that are



Jason Clatworthy

based outside the region, the UK will typically be their first port of call. Transactions have been particularly notable in sectors such as train rolling stock companies (ROSCOs), regulated assets and renewable energy.

FUND SALES

While demand appears to be stronger than supply, the first signs are emerging that sales from first-generation infrastructure funds in Europe will help drive future deal flow. Many of these funds, Clatworthy points out, have been weighted towards the UK and he expects to see a range of assets – including airports and water companies – to be placed on the sale block over the coming couple of years.

Clatworthy believes that good regulation is one of the reasons the UK is so popular. “People see the UK as one of the best regulated markets,” he says. “People generally remain nervous about regulators. However in the UK, even though there has been some noise around the water sector, investors are of the view that regulation is much more challenging in other parts of Europe.”

He does note however that some funds have been asking questions about the possible impact of a change of government arising from the upcoming general election. There are, for example, some uncertainties around the general tax environment beyond 7 May.

Perhaps the biggest downside for the UK has been an inability to convert green-field potential into delivered projects. Clatworthy says the Thames Tideway project – which includes government guarantees – is “quite an interesting model” that has kept “more investors interested than would otherwise ordinarily have been the case”.

The UK’s public-private partnership (PPP) market, meanwhile, has been “pretty quiet” although appetite in the secondary market remains strong. Fund managers which have developed strong track records in the UK are now beginning to export their expertise into emerging PPP markets.

MOMENTUM IN THE NORDICS

Meanwhile, Clatworthy sees the Nordic region as “the only European region close to rivalling the UK” at the moment, in terms of infrastructure deal activity. This view was highlighted by the recent €6.6 billion sale (subject to regulatory approvals) of its Swedish electricity distribution business by Fortum Corporation to a group of investors led by Canada’s Borealis Infrastructure.

“The region is very active and newer entrants to the market are very keen to understand more about it,” he says.

He expects to see more deals in sectors such as regulated assets, transport, renewable energy, district heating and airports. “Everyone’s up there having a look – the

“It’s as busy on the UK buy side as it’s been for the last several years”

big direct investors, fund managers and new entrants,” says Clatworthy.

He says that Sweden is currently the most active of the Nordic markets, having taken that mantle from Finland. In Denmark, despite high hopes, there has not yet been a regular flow of deals. Indeed, deal flow could potentially become an issue throughout the region. It needs to be remembered that, viewed individually, these are relatively small markets and, over the course of time, may struggle to live up to the expectations of the large number of direct and fund investors that are now scouring the terrain. However, when looking at the Nordic region, the combined potential with respect to deal flow remains high.

The PPP market has been a little more productive than in the UK. The number of completed PPP deals in Denmark has close to doubled in the last two years, but the market remains fairly sedate in Sweden and Finland.

In Sweden there have been some concerns over the uncertainty of tax treatment of investments although Clatworthy points out that there has at least been visibility over proposed changes which means they can be modelled. In conclusion, he expresses the opinion that there are “a lot of positives” in the Nordic region.

GERMANY ‘CHALLENGING’

The same cannot so easily be said of Germany where, according to Clatworthy, “regulation and taxation can be very challenging and yield is hard to find. It’s a challenging market.”

Germany saw a number of deals from utilities selling off non-core assets a few years ago, and has also seen quite a lot of renewable energy deals. However, there is

now uncertainty in the renewables sector and assets available to buy are now typically at the smaller end of the market. PPPs, meanwhile, are “very complex and there is not a lot of government support except for the education sector”.

Clatworthy sees Germany as a market where fund managers are likely to be more in evidence than direct investors, since the latter cannot find sufficient big-ticket deals and have gravitated to the Nordic markets instead. “Even when opportunities in Germany crop up that you think might be of interest to them, they are too busy elsewhere,” he notes.

Elsewhere in Europe, Clatworthy notes that Spain is “on the radar again” after that country’s post-Crisis woes, while investors are also doing a lot of homework on Poland. With a combination of distressed sellers, good assets and greater visibility on Europe’s economies, it appears that the region as a whole offers much promise. ■

Jason Clatworthy is a partner at Deloitte UK and European infrastructure M&A leader

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the “Deloitte Network”) is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

Deloitte provides audit, consulting, financial advisory, risk management, tax and related services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte’s more than 200,000 professionals are committed to becoming the standard of excellence.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

Looking for the next hot market?

Our team is as international as your aspiration

Deloitte's global infrastructure M&A teams provide a comprehensive range of transaction-related services to help enable financial investors in infrastructure to make the most of new investment opportunities with an unwavering focus on structure, cash extraction and governance protections.

With specialists across major and emerging markets, we provide in-depth local knowledge as well as leading global infrastructure experience.

www.deloitte.com/infrastructureinvestors

Deloitte.

© 2015. For information, contact Deloitte Touche Tohmatsu Limited.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

