

Infrastructure's unbalanced equation

by Robert Bestani, Asian Development Bank



In the past two years, the financial markets have seen a virtual explosion of new investment funds designed to mobilise money for new infrastructure projects around the world. The list is long, but it includes such prestigious names as Macquarie Bank, the Carlyle Group, Barclays Private Equity, KKR, the Infrastructure Development Finance Corporation (IDFC), Dubai International-HSBC and many others. By one recent estimate, more than US\$160bn in new funds has been earmarked for such investments in the past 18 months, with the creation of at least 72 new infrastructure funds. Indeed, new unofficial figures suggest the number of these new funds now exceeds 100.

The traditional banks are also seeking to get back into infrastructure lending, a field that they shied away from for several years following the financial shocks of the 1990s. Bank after bank disbanded their project finance departments, leaving scores of bankers to find a new livelihood. But the pendulum is swinging back; suddenly the field is hot once again.

In addition, the multinational development banks (MDBs) are also rushing in to supply new funds for this sector. For much of the 1990s, the priority in most of these institutions shifted from infrastructure projects to social programmes like health, education, gender equality, good corporate governance, etc. But physical infrastructure has once again become the central focus of all the MDBs. After a 10 year absence, for example, the World Bank recently announced that it is returning back to this sector. The Asian Development Bank is deepening its long standing commitment to the sector with not only more monies from its own coffers but also through the creation of its own infrastructure fund.

On one level, this is fully understandable. The world's capital markets are now flooded with funds looking for investment opportunities – the current credit crunch notwithstanding. The sums are staggeringly large. McKinsey Global Institute estimates that there is now over US\$167 trillion (and counting) in surplus funds looking for investment opportunities. As a ratio of assets to cumulative global GDP, this figure is now at an all time high at 350%.² The US Treasury put the surplus funds figure even higher at US\$190 trillion and climbing.³

At the same time, the global need for new infrastructure projects is enormous in virtually every corner of the world. On one end of the spectrum, the US is slowly waking up to the fact that it has a looming infrastructure crisis as its ageing bridges, tunnels, roads, airports etc. show alarming signs of

long ignored neglect. At the other end of the spectrum, in the emerging countries of the world, the need for first time infrastructure projects are much greater still. In Asia, the historically unprecedented economic boom of the past 30 years faces the danger of being choked off by the inadequacy of the existing infrastructure. Virtually every country in the region now needs more power plants, expanded roads, new water treatment facilities, bridges, ports etc. In many countries, the needs are already at crisis proportion.

As such, the estimated spending projections seem to grow by the day. Three years ago, it was estimated that Asia needed US\$200bn in new infrastructure spending each year, for each of the next 10 years. That figure quickly moved up to between US\$250bn to US\$300bn and is now estimated to be in the range of US\$350bn per year. The Indian government alone just raised their estimates from a total spending need of US\$320bn over the next five years to US\$485bn.

These estimates clearly indicate an enormous pent up demand for the benefits of a well functioning infrastructure. Indeed, with the emerging countries now exhibiting a higher savings rate than the developed countries of the OECD, the profit margins that can be obtained for almost all infrastructure projects are much higher than in the advanced countries.

Taken together, it would seem that the market is working perfectly, rising up to meet the needs of the day. If only it were that simple!

The imbalance

As encouraging as this all sounds, there is a huge looming issue that always gets ignored in the discussion. One must specifically stop and ask: who will provide the needed managerial and technical

expertise to undertake all of these infrastructure projects? It is a sad fact that the sponsor companies that are needed to construct and operate the required power plants, water treatment facilities etc. are extremely hesitant to go (back) into the emerging countries – with good reason. Through much of the 1990s the American power companies and the European water companies, for example, sought to provide their services to the emerging countries around the world. Yet, despite best efforts, they almost all left, deeply frustrated and financially damaged by the impenetrable bureaucracy, their inability to enforce even the simplest contracts, pervasive corruption, and the ingrained native distrust of foreign capital, etc.

Equally as important, the financial risks of operating in the emerging countries pose their own set of issues. For any long term capital investor, the imperative is to define a project's financial risks upfront and to take steps to immediately mitigate those risks through the financial markets. Unfortunately, in most emerging countries the needed financial markets barely exist. It is virtually impossible to get long term local currency funding (in any size) to match the life expectancy of a project. Without such funds, a project manager is subjected to the daunting prospect of taking on the combined threats of exchange rate risk, refinancing risk, and interest rate risk. In the developed markets these are all considerable. In the much more volatile financial markets of the emerging countries, the underlying risk is much higher.

In short, the potentially high profit margins caused by the high pent up demand are swamped by the much higher risks of operating in those countries. Historically, the only way to entice would be investors, was for the government to bid up the price of a project until an unsuspecting operator was enticed by the lure of riches and dive into the deep end. All too often, however, when the full costs of the delivered electricity, water, etc. was apparent, the government would step in and abrogate the initial contract with the 'foreign profiteer' – to the wild cheers of the end consumers. Of course, these events immediately sent out a signal to the market that the country was, indeed, too risky and therefore not suitable for further investment. With each cycle, it gets harder and harder to find a new sponsor company.

It is now difficult to see how the available emerging country funds can be properly disbursed for the needed task. With good investments as the bottleneck, one has to ask what will become of various infrastructure funds that are targeted at the emerging countries. Having raised the funds, investment managers will be under a great deal of

pressure to employ them. That might result in monies being thrown at less attractive and low yielding projects or not being deployed at all – an overt failure. If this proves true, it will, unfortunately, add to the track record of failures, scaring off future investments in the emerging markets.

Fund managers are often judged by their investors not only on the monies they bring to the table, but also on what else they can contribute in the way of expertise, contacts, and other support services. Realistically, investment firms are not at all well equipped or staffed to work with the emerging country governments on needed reforms and regulations or to devote the time to this very long term process. Even if they did, such governments are always quite suspicious of such advice coming from the private sector, especially from off shore firms.

So what are the emerging countries to do? Their governments are still under enormous pressure to step into the breach. Yet once again, with the exception of several countries like China and India, their domestic state owned enterprises (SOE) are just not up to the challenge. In most countries, they must look abroad for the much needed support – support that is just not there for them. Without a doubt, the burgeoning coffers of the sovereign reserves are partially a result of the fact that the governments cannot spend what they would like to on their own economies. Despite enormous needs in their countries, they are thus being forced to maximise their yield by investing abroad. To quote McKinsey Global Institute:

“Cross-border capital flows into emerging markets have grown at nearly twice the rate of flows into developed countries. They reached a new height of US\$700bn in 2006 – but that is still less than 10% of the global total. Moreover, capital outflows from emerging markets now exceed inflows, making emerging markets net capital providers to developed countries.”⁴

As such, the greatest portion of funds currently earmarked for infrastructure investments are being targeted towards the advanced countries. With some notable exceptions, that leaves the emerging countries with only a small portion of the over all funds pool and the expectation that the investment size of each transaction will be relatively small. The result is that despite the twin peaks of the unprecedented sums of money currently available for infrastructure spending in the emerging countries and the desperate need for infrastructure projects in the emerging countries, there is an enormous gap between them. Something needs to bridge that gap.

Building the balanced bridge

Oddly enough, whenever the discussion of infrastructure comes up, the immediate and reflexive reaction is always to go back to a discussion of the money: how do we get more money to the problem? How do we repackage the money? If only we can get more money to the problem! If the reader takes away nothing else from this article, one would hope that the core message comes through loud and clear: *it is not about the money! It is almost exclusively about the inherent tension between the public sector and the private sector, which is complicated by the regulatory and financial risks of operating in the emerging countries. The solution to getting infrastructure projects going in the emerging countries must start here. If the incompatibility can be bridged and the risks mitigated, the world's financial resources will come rushing in like air into a vacuum.*

In the past six years, the Asian Development Bank (ADB) has pioneered a novel model for how MDBs can and should support developing countries facing a need for new infrastructure. The results have been enormously gratifying and encouraging. By every empirical measure, the evidence is supporting the validity of this model. In that time, the Bank's market based financings have grown by 40 times their 2001 levels, as has ADB's profitability. Its portfolio quality has also steadily improved with non-performing assets dropping from 35% of book value to less than 2%. More importantly, the banking community, project sponsors and member states are all clamoring for more. The biggest criticism the ADB receives today from its member countries is that the Bank is still not doing enough. They are right and the ADB's new Long Term Strategic Plan calls for private sector financings to be the focal point of the Bank's activities in the years ahead.

With this as a backdrop, ADB management believes that the new business model is one that all the MDBs should consider adopting as they seek to help their member countries attract investment capital for infrastructure and other capital improvements. Where this model has been (inadvertently) used by them, the successes have been tangible. To date, however, the ADB is the only institution that has fully embraced this new approach as the core operating strategy of their private sector financings, although others are beginning to gradually adopt the approach.

When the MDBs were originally created, there was a great deal of debate as to the appropriate structure of these development institutions; should they be think tanks, advisory institutions, trusts, etc? After much debate, it was concluded that they needed to be banks to lend directly to governments

since it was believed that the principal impediment to growth was the lack of investment funds – the so called 'financing gap' theory. But this theory was heavily criticised as early on as the early 1970s and is now very much out of favour with all development economists. But the historic structure of the MDBs endures even though the importance of that role has been progressively eroded over the years. This has never been truer given today's unprecedented supply of global capital relative to global GDP. The MDBs are repeating a classic business mistake: they have become 'product driven' (i.e. the cash they are used to lending) instead of becoming 'solution or demand' driven (i.e. by what their member countries now need). As such, they are being forced to lend at deeper and deeper discounts to the market to get their monies out the door.

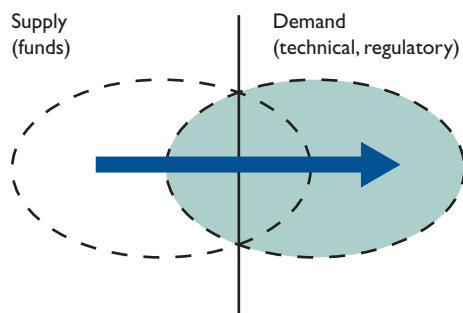
In today's world, money is no longer their core product, except perhaps to the smallest and poorest countries. Yet like all organisations, the MDBs tenaciously cling to their old and comfortable role as their *raison d'être*, even though they are being progressively disintermediated or squeezed out of the market with lower and lower lending margins. If in the past, 90% of their attention has been on the supply side of the development problem, in the future, 90% of their attention should shift to the demand side of the problem. That is where they are now needed. They must begin to focus, to a much greater extent, on the policy, technical, regulatory and risk reasons why the money is not getting used.⁵ It is not about the money!

Past and future roles of the MDBs

In most of the emerging countries the biggest risk today is the regulatory failure associated with working in those markets. The regulatory framework is either not there, it has major shortcomings or it is ineffectively implemented and adhered to by the government. Fortunately, the MDBs have a unique and critically important role to play in today's world, albeit a very different role to that which they have played historically. They are in a perfect position to help mitigate those regulatory risks.

With this in mind, the ADB's private sector operations has a policy of only taking on projects exhibit high political/regulatory risks and low commercial risks.⁶ Infrastructure projects are very much in this vane. Gone are the days of playing the lender of last resort – always a very dubious proposition. Manufacturing projects are rarely at risk in the emerging countries. Hence, there has been an extraordinary shift in recent years of the world's manufacturing capacity to the emerging countries. With this in mind, ADB management sees no unique role for itself in this sector. Therefore ADB is rarely

Figure 1: The role and function of the multinational banks



Source: Author

seen, for example, working in manufacturing, agriculture or hotel development.

But in those market segments that require a close working relationship with the government and the regulatory authorities of an emerging country, ADB occupies a unique niche. The MDBs are the only institutions that have the time, expertise, credibility, and/or political standing to firstly, help protect long term capital investors from what they see as 'capricious government intervention' and secondly, to help them make the case for regulatory change. The ADB can and does operate as the 'honest broker' that can bring the parties together in a fair and equitable manner.

Because the ADB is owned by 67 countries, because it speaks with the voice and authority of those countries, because its values reflect the highest aspirations of the international community (i.e. environmental cleanliness, openness, transparency, good governance, etc.), and because the ADB is created solely to help emerging countries develop and emerge from poverty, the Bank has a standing and a voice that no other institution can offer.⁷

The market based financings that the ADB provides serve to give the ADB what lawyers call 'standing' in the project. The ADB can thus effectively step forward should contracts or repayments be threatened with one sided re-negotiation. With this standing, the ADB can and has repeatedly been able to act as an effective buffer between numerous infrastructure and other high capital investors and regulators in such countries such as China, Thailand, Indonesia, Sri Lanka, etc.

The ADB has, moreover, invented a unique and elegant way of providing long term, fixed rate, local currency financing even in those countries that do not yet have capital markets or in those countries where the capital markets lack sufficient depth to finance large-scale, capital-intensive infrastructure projects. Local currency financing will significantly

reduce the financing risk of infrastructure projects. In the past, project sponsors have been forced to absorb the currency risks associated with financing a project in hard currency, yet accepting payment in local currency – a major risk.⁸

With these two risks significantly mitigated, the tariff rate (paid by users for power, water, or passage along the roadway) associated with an infrastructure project can be significantly reduced, reflecting a much lower risk margin. Hence the price to the consumer is lower, increasing the prospect of long-run sustainability and success for the project.

The balanced two way bridge

The ADB has also found that this risk mitigation theme plays well with – and for – the senior government officials employed by the emerging country governments. For many years countries have talked about the possibility of privatising their highly inefficient state owned enterprises. Yet, in the emerging countries once a state owned enterprise is privatised and operating profitably there are inevitable complaints that the government 'gave away the national treasures.' Government officials generally have no recourse but to bow to the political pressures and demand a clawback. The assurances of fairness by hired foreign investment bankers carry very little weight.

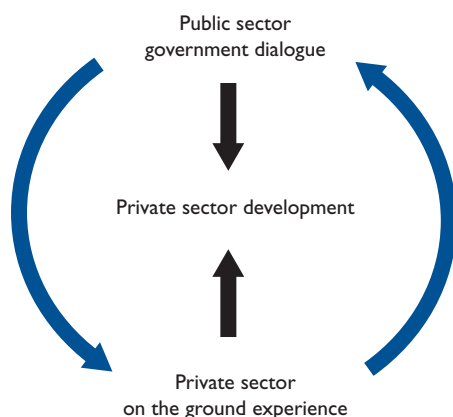
Here again, the honest broker voice of the MDBs can go a long way towards mitigating the associated political risks of the transaction by shielding the government officials from undue political criticism.

The road forward

It seems clear that if the enormous mountains of monies that are available for infrastructure projects and other high capital investments in the future are to be properly employed in the emerging countries of the world, they need to surmount the associated political and regulatory risks. This calls for a close alliance between the sponsors, the financial community and the MDBs.

All true development must be focused on private sector development. The government has a unique top down approach to this subject, ideally providing the much needed enabling environment. The private sector, grounded as it is in the day to day realities of transactions, can provide valuable feedback on what is working versus what is not working and this feedback can point to areas where reforms are needed. Unfortunately, in many societies there is little dialogue or trust between the two. It is here that the MDBs can perform a vitally important mechanism to ensure proper communications between the two sectors.

Figure 2: Public private partnership for development



Source: Author

True public private partnership

No other set of institutions can bridge this gap. In so doing, they can perform an invaluable service for the societies in which they work and promote true private sector development which is the cornerstone of true development. The MDBs themselves can benefit from this arrangement by a much needed rebirth of relevance that many commentators have argued has been lost. For the business and banking communities, the involvement of the MDBs in supporting true partnerships can go a very long way towards ensuring the success and profitability of their future investments. With that, will come ever more investments and more development.

Notes:

- ¹ The Rise of Infr Funds, Ryan Orr Global Infrastructure Report - June 2007, http://crgp.stanford.edu/publications/articles_presentations/Orr_01_Infra_funds_2007pfie.pdf
- ² http://www.mckinsey.com/mgi/publications/Mapping_Global/index.asp

³ Robert Kimmitt, Foreign Affairs Quarterly, January 2008

⁴ http://www.mckinsey.com/mgi/publications/Mapping_Global/index.asp

⁵ The MDBs have found that their developing member countries rarely want this advice when it comes from their public sector units. As such they have had to step up their concessionary lending to 'encourage' such reforms. However, when much the same advice is associated with tangible private sector flows the advice has been much better received, albeit slowly.

⁶ This helps explain the low risk profile of our portfolio.

⁷ See also "The New Key to Asian Financing Today" Euromoney Yearbook 2005, <http://adb.org/PrivateSector/Finance/New-Key-Asian-Finance.pdf>

⁸ See also "The Local Currency Financing Revolution". Project Finance International, April 2004, http://adb.org/documents/others/local_currency_financing.pdf

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