

## INFRASTRUCTURE

## Global infrastructure investment

BY CLAIRE SPENCER



General economic conditions may be a concern for investors in today's global market, but things are beginning to look up for those willing to play the long term game. The value and volume of infrastructure related deals are comparatively strong in comparison with overall global M&A. The prospects for future investment in emerging markets are particularly bright, since much of their critical infrastructure needs to be extended and updated. Unless they improve roads, ports, power, waste management, education, telecoms and health services, the economic growth of developed nations will be under threat. But governments in emerging markets are facing huge financing demands to accomplish this, which leaves a gap that private investors are eager to fill. The potential for solid returns is clear, but investors still have some reservations about pouring funds into emerging economies.

The M&A figures speak for themselves. In 2007, there were 1971 infrastructure deals with a total value of \$495bn, according to Dealogic. From January to the beginning of August this year, the figure is almost \$243bn across 1223 deals, suggesting that interest in this sector

continued despite the credit contraction. The biggest transaction last year was the acquisition of Endesa by ENEL SpA and Acciona for \$52.6bn, followed by the \$43.7bn TXU buy-out completed by KKR, TPG and Goldman Sachs Capital Partners. In 2008 to date, the top announced deal is Gas Natural SDG's \$35.8bn bid for Union Fenosa. Recent infrastructure deals have encompassed everything from power stations and transport to prisons and sports stadiums. Several major deals have been driven by company reorganisations, including the spin-off of France's Suez Environnement and the merger of Russia's Unified Energy System with RusHydro, which occurred after all the former's subsidiaries were spun off to private investors.

Recent trends suggest that investors are focusing more attention on emerging markets, which need to update their infrastructure to preserve high growth rates. The rise of the middle class in emerging markets and an increased global demand for natural resources have also increased demand for infrastructure capabilities to sustain the transport of a larger number of people and goods. But governments

are falling behind, and pressures such as growing deficits and other capital constraints have actually led to a reduction in infrastructure spend in some countries. According to an OECD survey, low-income countries should be spending 8 percent of their GDP on updating their infrastructure to sustain growth. In reality, they are spending around half that. This means that areas such as Latin America, India and China are seeing a lot of interest from savvy investors.

### Regional focus

In its April 2008 report, 'Emerging Markets Infrastructure: Just Getting Started', Morgan Stanley predicted that 67 percent of the \$21.7 trillion forecast to be spent on infrastructure over the next decade will be in Asia. Of that \$14.5 trillion, 43 will be spent on China and 13 percent on India. They are two of the world's largest and fastest growing economies, and their governments and domestic investors are struggling to keep up. Of course, the value that overseas private investors can create in Asia varies on a country-by-country basis. For example, places like China are unlikely to allow them to take control of strategic or politically sensitive assets, which will limit opportunities.

India is considered to be more open in this respect and has a strong urge for foreign investment. Congested airports, poor roads, insufficient power and delays at ports make India's infrastructure shortcomings evident. In its annual economic survey, the Finance Ministry estimated that that India will need over \$500bn in investment up to the fiscal year 2011-12 if it wishes to maintain 9 percent growth. However, the Indian finance markets are not always easy for private investors to negotiate, and the Indian government will need to address this in order to attract capital to where it is needed.

But it is not just Asia's emerging economies that will seek private infrastructure financing. ►►

Australia is a developed market but still faces many of the same infrastructure issues seen in emerging markets. "Insufficient capital spending by the state and federal governments over the last 40 years has resulted in an increased demand for both social and economic infrastructure, particularly nationally critical infrastructure," observes Chris Mitchell, partner and head of infrastructure at Blake Dawson. "The Australian federal government has, in the past year, created a national body called 'Infrastructure Australia', to facilitate the planning, regulation and development of infrastructure and the commitment to spend and contribute significant public funds on critical infrastructure may make these target investment areas." Toll roads have generated the most success for investors in the past, although not without the odd failure. Also popular is social infrastructure comprising health, education and prisons.

Latin America is another quickly expanding region that is set to ramp up its infrastructure investment. Although demand for capital here is widespread, Sergio Galvis, a partner at Sullivan & Cromwell LLP, notes that one country in particular is leading the pack. "We have seen increasing opportunities for infrastructure investment in Brazil as it continues to modernise in an effort to keep up with global demand for natural resources and a burgeoning middle class. It is expected that this trend will continue, just as it is expected that infrastructure investment opportunities will grow throughout Latin America, as other countries seek to keep pace with maturing economies and larger populations," he says. With its sheer size and capacity for development, Brazil represents a major market for private infrastructure investors.

Mexico is also poised to become a hotbed of activity. According to the World Economic Forum, Mexico ranked 64th out of 125 in its Infrastructure Competitiveness Index. It lies 65th in railways, 64th in ports, 55th in airports, 73rd in telecommunications and 49th in highways. The Mexican government is taking action to improve on these placings. By implementing the National Infrastructure Program (NIP), its goal is to get Mexico into the top 20 percent of the Infrastructure Competitiveness Index by 2030 and become a leader in Latin America by 2012. "Infrastructure is synonymous with economic, social and human development," says David Enríquez, a partner at Goodrich Riquelme y Asociados. "The Mexican government has set forth, under the

2007-2012 NIP, an ambitious infrastructure development plan aimed at increasing the coverage, quality and competitiveness in various strategic sectors. The NIP establishes the main objectives, goals, strategies and actions to be undertaken to increase the effectiveness of the infrastructure system."

The NIP seeks to modernise Mexico's infrastructure. The government is looking to boost its oil production and maintain natural gas production. It wants to keep a reliable electricity supply and increase effective generation and service coverage. The NIP calls for the development, expansion and modernisation of Mexico's ports to take full advantage of its geographical position. The country's extensive highway system also needs to be modernised and expanded. High levels of investment are required in the telecommunications, water supply and airport sectors. Achieving these targets calls for multi-billion dollar projects. "Private investment is essential," says Mr Enríquez. "The Mexican government expects infrastructure investment to reach US\$226bn dollars by 2012, with the oil sector capturing most of the investment, followed by electricity, refineries, gas and petrochemicals, and highways. Mexico, consequently, is seeking private enterprises that compete within the appropriate legal framework and reforms. We certainly consider this program as one of the most important and interesting in decades in our country," he adds.

#### **The prizes and pitfalls of infrastructure investment**

Investors search for growth prospects and good returns, and a sound infrastructure investment can provide both. The nature of investment in this sector is a powerful draw, especially for investors keen to reduce risk in the portfolio. "Infrastructure investment is a growing area of interest and can offer a source of steady and predictable return, yielding higher capital value and lower price volatility than equity investments over the longer term. The tendency for low operating cost and risk is also an attractive feature," notes Mr Mitchell. "In Australia, the investor profile is changing. Infrastructure investment was traditionally the domain of large companies, consortia and institutional investors, but retail investors, particularly Australian superannuation and retirement funds, are becoming more involved to diversify and enhance their portfolios' defensive capabilities," he adds.

In emerging markets, where infrastructure

may be inadequate or missing, investors are taking advantage of government demand for private capital, and investment is growing. Yet commentators believe the inflow of foreign private capital has not reached its potential. The slower pace of activity may be connected to global economic uncertainty and the possibility of a prolonged downturn in developed markets. Most investors are taking their time and proceeding cautiously. "Investors are not necessarily holding back from infrastructure projects as much as they are carefully evaluating each individual investment opportunity," says Mr Galvis. "Of course, there are issues that they are monitoring closely as they evaluate each project. These include fluctuations in commodity prices, availability of credit and levels of interest rates, all of which can impact the expected rate of return for any given project." He adds that, in particular, the global energy crisis is a factor considered by the market for transportation related infrastructure projects, as investors weigh the impact of oil prices on usage.

There are also general challenges associated with investing in emerging markets, which may deter private investors, according to Mr Mitchell. "Investors may hold back from involvement in emerging and frontier market infrastructure as a result of limited historical information to establish market performance. Other factors may include interest rate risk, political risk, the tendency for projects to be inadequately scoped, rising development costs, significant upfront capital outlays and the industry-wide skills and expertise shortage," he says. Furthermore, investors must also be prepared to manage the portfolio of legal and regulatory risk that they are likely to face.

Mexico is one country that has come under criticism for not creating an environment that attracts foreign private capital. Although the country enjoys price stability, low inflation, a stable democratic political system, an independent central bank and numerous free trade agreements, levels of economic growth have not met expectations. According to the Mexican Central Bank, the real causes of low growth in the Mexican economy are insufficient investment in human and physical capital, a corresponding slowness in the absorption of modern technology, and an inadequate institutional structure that imposes very high transaction costs on economic agents, impeding them from fully realising their productive potential. "Investors often complain that Mex-

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ico's government procurement procedures are not transparent, even though major steps have been taken to alleviate this problem and streamline domestic laws with international standards," points out Mr Enríquez. "In its efforts to modernise its legal system, Mexico has been advised by several think-tanks and international organisations, such as the World Bank and the OECD, to foster competitiveness and productivity through transparency in order to achieve higher investment rates."

Despite the potential pitfalls, private equity firms are demonstrating an appetite for infrastructure investments. Buyout houses have made a series of fundraising announcements this year, which points to a rise in activity over coming months. KKR is reportedly raising a \$10bn infrastructure fund. Its founders released a joint statement in August 2008 describing infrastructure as "a multi-trillion dollar global marketplace with enormous need for private investment" based on its important contribution to the growth of both developed and developing economies. Global Infrastructure Partners, created by Credit Suisse and General Electric, closed its first fund on

\$5.64bn to target investments in single assets, portfolios of assets, as well as companies in the energy, transport, water and waste management sectors. Morgan Stanley has also weighed in with a \$4bn fund for global infrastructure investments.

Other private equity firms plan to concentrate on specific regions. India is high on the agenda, with Macquarie Capital Group and State Bank of India (SBI) raising a \$2bn fund, 3i closing a \$1.2bn fund and Vision Global Investments closing on \$1bn. UBS AG and Abu Dhabi Investment Co formed a joint venture firm which raised a \$500m fund to target infrastructure investments in the Middle East, North Africa and Turkey. "Fund managers are keenly aware of the social impact these investments can have in emerging markets by facilitating local access to transportation, energy, waste management and other critical infrastructure needs, all of which will help continue the modernising trend in emerging markets and ensure future global access to natural resources," says Mr Galvis.

Developed markets are also in the mix. Babcock & Brown recently closed a European-fo-

cused fund on €2.17bn and Carlyle announced its first infrastructure fund, Carlyle Infrastructure Partners, on \$1.15bn, which will invest in transportation facilities and water and waste disposal projects in the US and Canada. There is plenty of capital waiting to be deployed in infrastructure assets. But these private equity firms can expect to face intense competition, from both strategic buyers and giant sovereign wealth funds, as they chase assets in this space.

There are always risks when doing business in emerging markets, but infrastructure investment tends to offer a lower risk profile than other sectors, by virtue of its stable, long term returns. Emerging market governments cannot hope to develop unless their infrastructure is up to scratch, and realise they need foreign capital to make that happen quickly, efficiently and adequately. From the investor's point of view, the recent market volatility has taught them the value of long term investments with predictable returns, and as the global market picks up, we could see an explosion in infrastructure investment levels. ■



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