News
AMERICAS

ARGENTINA 8
BRAZIL 10
CANADA 10
CHILE 13
DOMINICAN REPUBLIC 13
PERU 14
TRINIDAD & TOBAGO 14
UNITED STATES 14
VENEZUELA 17

The question among attendees at the CG/LA Infrastructure Latin American Leadership forum in Washington DC last week was -Where is the equity? By **Nicole Gelinas**.

In search of LatAm equity

There are plenty of smart advisers and lawyers willing to go to great lengths to create new debt products to mitigate sovereign, regulatory and currency risk, and there are even some lenders, multi-lateral and commercial alike, willing to try the new products out. But what about equity?

There are plenty of smart advisers and lawyers willing to go to great lengths to create new debt products.

After various LatAm economic and regulatory crises over the past four years, few publicly-traded American or European companies are willing to take anything but technical risk on projects in most Latin American countries, unless those projects have a clear export-based revenue stream. The problem is that projects that would serve Latin America's most pressing infrastructure needs don't have such export revenue streams: Most are in the power, toll-road, and water and wastewater services sector and are structured around domestic revenues only.

LatAm central and regional governments as well as multilateral and commercial lenders agree that infrastructure projects in Latin America are likely to be structured around private-public partnerships (PPPs) for the next decade, as such partnerships lend themselves to local-currency financing and clearly detail the risks that the private and public sector partnership will each assume or share. Brazil, Chile and Mexico are all rolling out ambitious infrastructure schemes or extensions of previous investment programmes based on the PPP model.

The move toward the PPP scheme for small and medium-sized projects, rather than the 1990s model of huge foreign investments in large-scale projects, is an opportunity for new financing structures.

Because many projects will be financed through local institutional and commercial bank investment rather than international debt tranches, some observers expect that local interest rate risk will soon replace foreign currency devaluation risk on projects: Local investors are not currently comfortable investing in long-tenored debt because of local currency interest rate risk.

Multilaterals are considering ways to mitigate this risk, such as through special reserve accounts that would smooth out interest-rate fluctuations over the life of a project. For example, the reserve funds could be sized initially based on historical interest rate volatility in a particular nation.

Enticing local investors to take longer-tenored debt through this type of interest-rate risk mechanism would also reduce the asset-liability mismatch at locally financed projects, as long-term infrastructure projects are best funded through medium-term or long-term debt, not the short-term instruments currently available.

Commercial banks are also getting used to the idea of working more on a fee-based advisory basis for Latin American projects, rather than on an underwriting or syndication basis, as only institutions with huge local-bank presences in emerging markets, such as Citibank and some European banks, will have competitive access to local institutional investors. Local investors have a limited understanding of structured finance so can still benefit from American and European advice, even without the possibility of US dollar or euro-based financing on some projects.

But multilaterals and project-finance advisers are now targeting some new risk-mitigation products on PPPs toward mitigating risks for equity owners, not just lenders. Officials from the US Overseas Private Investment Corp (Opic), the World Bank, the International Finance Corp (IFC) and the Inter-American Development Bank were heard talking about possible insurance products and other lending umbrellas that would assume regulatory risks for equity investors on specific private-public infrastructure projects.

Such products would include backstops of a regulatory agency's guarantee to index tariffs to inflation, or a guarantee on a government's pledge to increase tariffs by a particular benchmark each year. The World Bank, for example, is considering more local currency guarantee facilities for infrastructure projects, as well as new partial credit guarantees to finance or backstop a government's share of a PPP. These products could mitigate political and regulatory risk in some sectors such as power and water and lure private-sector investors back to a shunned market.

Another idea bandied about that would protect both lenders and equity investors from political risk in particular is a multilateral subsidy

of tariffs in essential infrastructure services such as water and power in some poorer nations.

Consumers would pay tariffs indexed in local currency directly to the private-sector power or water services distributor, but a government would index the revenues to the sponsor in a hard currency by providing an operating subsidy above the consumer tariff to fund that indexation. This would somewhat insulate sponsors from political risk, as consumers would not have the same incentive to protest tariff increases when a country's currency devalued, and a multilateral guarantee of the government's pledge to provide the operating subsidy would mitigate regulatory risk.

But while many of these structures are worthy, and debt investors and multilateral agencies alike evidenced interest in trying them out, players noted unanimously that the opportunities to work with brand-name sponsors in target markets just don't exist. Equity investors and their shareholders saw profits erode over the past half-decade at their investments in Latin America; economic crises and regulatory mishaps respectively in just two relatively developed nations - Argentina and Brazil – have soured corporate boards of directors on new investments in the region as a whole.

Players noted unanimously that the opportunities to work with brand-name sponsors in target markets just don't exist.

Lenders and private equity investors openly and privately groused at the conference that Fortune 500 utility companies did both their own shareholders and developing nations a disservice in the 1990s, when they jumped into emerging-markets countries and immediately assumed interest rate risk, devaluation risk, regulatory risk and political risk without understanding any of those risks. The huge companies crowded out smaller investors from these markets – investors who did understand those risks and possibly would have structured tighter, smaller deals around them.

Other attendees noted that equity, even when it does work, is very expensive – and private equity, the only kind to be found these days in Latin America, is particularly expensive. One question that arose was: Why bother with equity at all?

Indeed, PPP contracts can be structured so that European and American companies that once would have been private sector equity investors can now serve as long-term operating contractors, assuming only technical risk (particularly if multilateral institutions and lenders can assume the political and regulatory risk on payments for services). To preserve an upside, PPP contracts can also contain a performance-based payment mechanism – higher payments to sponsors for work done above benchmark levels or faster than expected, for example.

As multilaterals help to widen local-currency investor markets, this investor interest, and a need for diversified local-currency investments, provides an opportunity for domestic contractors in LatAm countries to raise and provide their own long-term financing for projects and further reduce the need for international equity.

Mexico, Brazil and Chile all boast experienced, brand-name contractors – such as ICA and Odebrecht – that can bid on and operate infrastructure projects on a long-term basis. Multilateral partial credit guarantees for local currency corporate bonds issued by these firms (see Brazil section, below) could allow the contractors to raise their own project financing in local currency markets on a corporate basis.

Argentina

Energy crisis looms

A looming power and gas crisis poses a serious risk to the recovering Argentine economy this year, Merrill Lynch analyst Frank McGann warned last week. The key reasons are that demand for power and gas is rising as the economy recovers; several major infrastructure projects are behind schedule; weather conditions for hydropower generation are unfavourable; and transportation and storage capacity to import energy are limited.

McGann notes that as the economy recovers, gas consumption is already up 18% over its 1993–1998 average, when private sector companies were pumping money into the sector to keep up with demand.

But private sector operators watched gas prices plummet from US$1.20mcf before the 2001 devaluation to US$0.35–$0.45mcf after the crisis set in and the government cancelled their dollar-indexed tariffs. Since then, the private sector has refused to invest more money in the sector, and gas pipeline capacity constraints are reducing supply reliability for industrial and commercial clients even as low prices encourage consumers to use more. Now, low rainfall is adding to the problem, as gas-fired power plants must produce a greater share of electricity.

The government is now slowly adjusting tariffs for private sector gas pipeline operators to encourage new investment. With industrial price increases of 35% and 16% set to take place in May and July respectively of this year, prices by July 2005 should be "essentially back to pre-devaluation levels", McGann said.

But even as prices rise, financiers are leery about funding two key expansion projects in the gas sector: **Transportadora de Gas del Sur SA (TGS)**, the southern system, and **Transportadora de Gas del Norte SA (TGN)**, the northern system. Long-planned expansions are set to add nearly 5m cmd to the networks' combined 160m cmd capacity. While the expansions were once scheduled to be complete before Argentina's winter begins in June, they are not likely to be ready now until after the peak winter months. Furthermore, the expansions will not keep pace with expected demand increases.

While the sponsors have bought the pipe and begun construction on each expansion project, financing for one project was finalised just last week. Each project must be financed as a special-purpose trust, and banks are still leery of signing off on any new money to Argentina not based on export revenues.

TGS, part-owned by Perez Companc, will carry out its US$200m project with US$200m in loans to be provided by Brazilian development bank BNDES; that figure was increased last week from US$142m and will go mostly toward the export of Brazilian products to be used in the pipeline.

TGN, owned by a consortium made up of France's Total, US-based CMS Energy and local investors, would expand its own northern pipeline system at a cost of about US$200m, also with about US$70m in BNDES money. It is not clear yet where the rest of the money will come from.