EMERGING EUROPE: BRAVE NEW WORLD

IN BRIEF

- Infrastructure in emerging Europe urgently needs updating and expanding.
- Emerging European countries prefer to use EU funds for infrastructure development.
- Turkey and Russia are using PPPs very aggressively to modernise infrastructure.
- The big challenge is the lack of capacity to structure deals that offer inadequate rates of return, given the risk.

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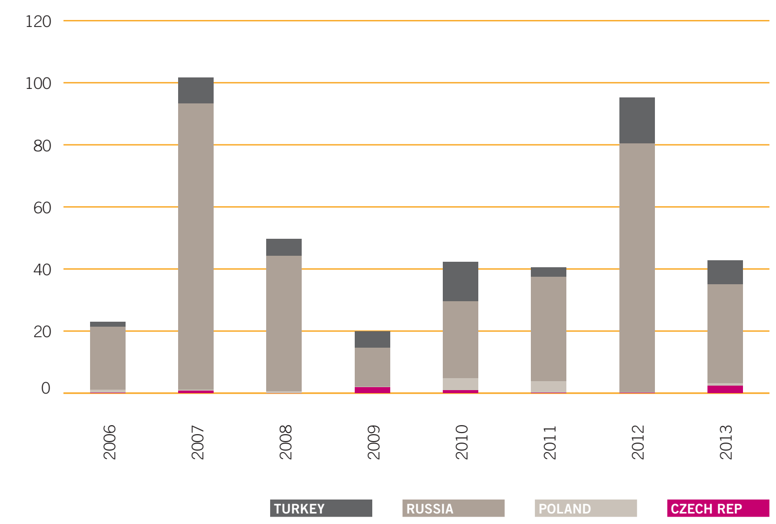
OPPORTUNITY

Fig. 5.1 Infrastructure M&A deals by value (US$bn)

SOURCE: LINKLATERS, THOMSON REUTERS



"It's a mistake to talk about the infrastructure gap," says Thomas Maier, Managing Director in charge of infrastructure at the European Bank for Reconstruction and Development (EBRD). "In fact, the real question is not about how much infrastructure is needed but about how much can be structured in a bankable way."

Turkey and the post-communist states of central and eastern Europe should have a strong argument for trying to tap into private financing available for infrastructure projects today. In many countries, infrastructure dates from communist times and urgently needs updating and expanding. Russia's Ministry of Transport estimates that the dire state of the country's roads knocks almost 9% off GDP.

Governments across the region accept that they do not have the funds to sort out problems on this scale by themselves. However, after a wave of privatisation in the 1990s, private finance is being used only lightly, especially for new-build work. Countries from Hungary to the Czech Republic experimented with PPPs in the mid-2000s, but have largely stopped launching new projects.

Russian organisations have been spending relatively heavily on infrastructure since the crisis. Infrastructure M&A in Russia has been more than twice as high as in the UK in both 2012 and 2013, virtually all of it domestic and much of it government money. Foreign investment has been missing.

"There's a lack of supply of well-structured and prepared projects across central and eastern Europe," says Thomas Maier, adding that the public sector in many countries lacks the capacity to structure and oversee complex PPP projects. Andrei Kiselev, Managing Director of Infrastructure Capital & Project Finance at VTB Capital, which has already invested in three big Russian PPP deals, agrees. "The biggest constraint on the market isn't money but the lack of people with the expertise to structure deals, especially on the public-sector side," he says. "Deals may take a long time, up to three years, to reach financial close."

There are two exceptions to this rule: Turkey and Russia, both of which have launched huge PPP programmes. Though some analysts question whether the plans are too optimistic, with many investors wary of corruption in Russia and unpredictability and cronyism in Turkey. But there is no doubting the ambition of these schemes, nor the promise they could hold for private investors keen to unlock more deals. ▸

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>
> **Thomas Maier**
> European Bank for Reconstruction and Development (EBRD)

TURKEY WANTS TO SPEND US$300BN ON INFRASTRUCTURE OVER THE NEXT FIVE YEARS ALONE

THERE'S NO SHORTAGE OF DEBT FROM LOCAL BANKS, BUT THERE IS A SHORTAGE OF EQUITY INVESTORS.
Zeynep Dereli
APCO Worldwide

Turkey's bold plans

Turkey wants to spend US$300bn on infrastructure over the next five years focusing on power plants, railways, airports, roads and hospitals, with 60% financed through PPPs. It has already begun several ambitious PPP programmes, including a US$13bn airport for Istanbul, two motorway projects costing US$10bn and 16 hospitals costing US$8bn. It is not only greenfield projects that Turkey is focused on, but the privatisation of government-owned infrastructure too. Following an amendment to legislation, the Turkish government will be able to relaunch the privatisation of its motorways and bridges.

However, recent corruption scandals around some of the projects, and growing political and financial upheaval, have cast some doubt over the viability of their plans. The challenge for Turkey has always been to find the private money for building on such an extraordinary scale – and recent instability only exacerbates that.

"There's no shortage of debt from local banks, but there is a shortage of equity investors," says Zeynep Dereli, Managing Director of APCO Worldwide, an Istanbul-based consultancy, who says the government wants at least 20% of these projects' value to be equity funded. Currently, the only foreign equity buyers are the contractors, with most financial investors wary of touching a country outside of the EU and with a relatively low credit rating. "Turkey is off the radar of many pension funds and financial investors for infrastructure projects. Contracts tend to be awarded to local companies backed by local banks, who can then sell on the stake to outside investors."

Zeynep Dereli's comments were echoed recently by Levent Kirazoglu, Manager of Project and Acquisition Finance at Turkiye Garanti Bankasi, who said that 70% of the cost of these projects would be funded by Turkish banks. He was hopeful that international banks would help to fund the remaining 30%, with talk of project bond issues for some of the larger deals.

In fact, the reliance on local finance is opening the door to outside contractors buying their way into the market. One Asian contractor says that his firm is using export bank cash to offer funding at half the rate of Turkish banks allowing it to win some big PPP projects. The giant nuclear power tenders have been snapped up by companies from Russia and Japan – in the latter, Mitsubishi won the US$22bn contract to build a plant at the Black Sea town of Sinop, in partnership with Areva, a French multinational.

"In recent years, international investors have looked eagerly at the opportunities presented by the large Turkish market. Along with political concerns, the increasing difficulty in actually concluding deals in the country, has dampened their enthusiasm, but interest still remains," says Ian Andrews, a Linklaters partner in London, who has advised several foreign investors in infrastructure deals in the country.

Unleashing Russian growth

In Russia, the government has also identified creaking infrastructure as a limitation to growth and has launched an ambitious PPP programme to attract much-needed private finance.

"There was a pipeline of PPP projects, particularly in St. Petersburg, before the crisis and there has been a hiatus since then," says Matthew Keats, a Linklaters partner in Moscow. "But interest has been growing again. The Russian government accepts that a lack of infrastructure prevents economic growth and has recently announced a series of road and railway projects." He splits the market into two halves: federal projects revolving around things like motorway building, which are very big projects divided into bite-sized chunks often worth more than US$1bn and smaller projects launched by local governments and often involving utilities and social infrastructure.

"Regional markets are starting to take off," says VTB Capital's Andrei Kiselev, mentioning two big bridge projects out in the market at the moment. One, from Udmurtia in the Urals, which has recently reached financial close, and another from Yakutia in the north east of the country, which is at tender stage. His comments are echoed by Sergey Kerber, Managing Director of Leader, which manages assets of around US$15bn for non-governmental pension funds, including Gazprom's corporate pension fund. Like VTB, Leader will provide both debt and equity to PPP projects and Sergey says that its minimum deal size is just US$50m, perhaps 10% of the level for a big institutional investor in western Europe.

It is at the federal level that the really big projects are brewing. In June 2013, Russian President Vladimir Putin made infrastructure investment a key theme of his keynote address to the St. Petersburg International Economic Forum. He announced that the government would spend up to US$14bn on infrastructure projects from its sovereign wealth fund in an attempt to encourage foreign investment. While modernisation of the Trans-Siberian and BAM railways is unlikely to draw private financing and will instead be financed by the government, big road projects such as the ring road around Moscow will almost certainly involve private investors.

The government plans to launch around 10 new federal projects in 2014 using various project schemes. "Financial investors are likely to have more appetite for concession-type projects, as they envisage a higher proportion of private finance and hence greater reward," says Julia Voskoboinikova, a Linklaters senior counsel in Moscow. In fact, Russia has been successfully attracting private funding for its infrastructure development. For example, the construction of Pulkovo Airport and the central section of the Western High Speed Diameter motorway were built by Turkish and Italian contractors with backing from Russian banks including VTB, Gazprombank and Vnesheconombank, but also involving the EBRD and, in the case of Pulkovo, international banks.

In addition, the finance ministry of Abu Dhabi said in September 2013 that it would invest up to US$5bn in Russian infrastructure projects over the next seven years. Three months previously, another Abu Dhabi investor, Mubadala, had said it would spend US$1bn on Russian businesses in partnership with the Russian Direct Investment Fund (RDIF), a US$10bn state-backed fund set up in 2011 by Vladimir Putin. CEO of the RDIF, Kirill Dmitriev, says that he wants to tap into the big money available from China and the Middle East.

Add in the Russian infrastructure funds being set up by the likes of Macquarie, the Australian investment bank, and there are signs that Russia's belated infrastructure splurge will succeed in attracting international finance as well as international sponsors and contractors. "There's a lot of international interest in Russian infrastructure," says VTB Capital's Andrei Kiselev. He mentions that he is talking to contractors including France's VINCI and Bouygues, Italy's Astaldi and Germany's Strabag.

Questions remain, however. "There's a crucial risk/reward question for a country like Russia," says Matthew Keats. Some investors say that in recent projects they were offered too low a return. "The public authorities are unrealistic about their target rates of return for investors," says Leader's Sergey Kerber, "and they don't understand the idea of a partnership, meaning that they try to impose too much risk on contractors."

As in Turkey, Russia's huge infrastructure needs offer private investors an extraordinary opportunity and a huge pipeline of projects in which to invest. To capture and harness a share of the US$1trn available for investment in Europe's infrastructure over the next decade, the government needs to structure projects in a way that satisfies the international investors' risk vs. return requirements.

THE RUSSIAN GOVERNMENT PLANS TO SPEND US$14BN ON INFRASTRUCTURE PROJECTS FROM ITS SOVEREIGN WEALTH FUND

FINANCIAL INVESTORS ARE LIKELY TO HAVE MORE APPETITE FOR CONCESSION-TYPE PROJECTS, AS THEY ENVISAGE A HIGHER PROPORTION OF PRIVATE FINANCE AND HENCE GREATER REWARD.
Julia Voskoboinikova
Linklaters senior counsel in Moscow