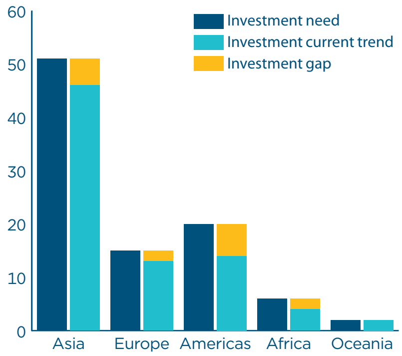
Infrastructure trends and opportunities in Latin America – getting the show on the road

Latin America is a region ripe for increased infrastructure investment. According to a recent report by the G20's Global Infrastructure Hub, the Americas ranks second to Asia as the region with the highest gap in infrastructure spending, being the difference between the current investment trends and actual needs – with much of that gap arising in Latin America. Mexico and Argentina need to approximately double investment to meet forecast infrastructure requirements, with demand most pronounced in the road and electricity sectors.

After a period of economic slowdown, governments in the region are increasingly looking to private sector financing as a way to close this infrastructure gap. However, there continue to be obstacles in attracting sufficient international investment. In this article, Juan-José Zentner of Herbert Smith Freehills' New York office analyses the key infrastructure trends in Latin America and outlines the pipeline for infrastructure investment in the region.

Total infrastructure investment, need and gap by region 2016-2040 (US$ trillion)



Global Infrastructure Factsheet 2017, Global Infrastructure Hub, Accessed 16th Nov 2017, <https://gihub-webtools.s3.amazonaws.com/umbraco/media/1530/global-infrastructureoutlook-factsheet-24-july-2017.pdf>

Innovative structures

Narrowing an infrastructure gap in an emerging market like Latin America necessitates creative solutions and structures. The local banking system has traditionally been relied upon to finance projects, but cannot increase available capital commensurately with infrastructure growth. Hybrid deals between local and international investors and governments (with the latter party providing support in the way of sub-market rate loans, tax-advantaged bond solutions or guarantees) can ease the pressure on domestic banks while providing short and long term funding. This leads to bespoke procurement and financing solutions tailored to individual projects and regions.

The absence of any "cookie-cutter" approach to Latin American projects means that the infrastructure pipeline is slower than in more established markets, while many local contractors, financiers and lawyers embark on a learning curve.

Growing popularity of PPPs

Latin American markets have been using public private partnerships (**PPPs**) as a procurement method since the late 1980s, with many countries now having established a legislative framework to support them and, in some cases, beginning to refine them. Chile and Mexico are considered the most successful programs in the region, especially in the transport sector. Brazil, Colombia and Peru also have an extensive track record of PPP projects, and Argentina introduced PPP legislation in November 2016, with tenders for three new prisons and projects in the health and energy sectors expected to be launched in 2018.

Although PPPs compete with other forms of private sector participation, including privatisations, they are well suited to addressing the region's infrastructure gap in roads, due to the economies of scale afforded and the ability to guarantee investors and financiers a source of revenue through availability payments or tolls.

> In 2016, Colombia's 4G roads initiative was the largest greenfield infrastructure program in the world.

The program includes 40 projects to build 8,000km in road infrastructure with a total investment of US$25 billion during the course of the next seven years. 96% of Latin American transaction volumes in 2016 (across greenfield projects, refinancings and acquisitions) came from transport projects, with nine of the largest deals closing between 2016 and Q1 in 2017 coming from Colombian roads.

Government announcements for future PPP projects suggest that after transport, the next wave of PPPs will focus on the social infrastructure sector, addressing the region's demand for schools, hospitals, water systems and correctional facilities.

Regional trends affecting investors

Local learning curves

While governments are supportive of PPPs and the pipeline of future projects looks strong, there remain barriers to its success as a procurement model in Latin America. In particular, unless international concession companies are involved, projects can suffer from delays caused by local contractors unfamiliar with PPP delivery, and may lack the credibility required to attract international project finance.

Striking a balance between international and local

A consistent theme among new entrants is that when entering new markets in Latin America, it is invaluable to have the support of a good partner or contractor (local or otherwise) that can leverage its experience in the region to navigate relationships with local communities, governments and financiers. A recent example of this is the collaboration between UK-based investment specialist Ashmore with Andean development bank CAF to set up a debt fund to invest in Colombia infrastructure financing efforts.

Financing

Despite significant growth since 2009, project finance remains relatively scarce in Latin America, with the exception of Chile and Mexico. Domestic banks are unable to finance the public infrastructure needs of the region alone, and currency risks either deter international financiers from participating altogether or drive up the cost of projects through the inclusion of currency swaps. Consequently, the role of institutional investors remains highly relevant, particularly for long-dated debt.

Government and multilateral guarantees

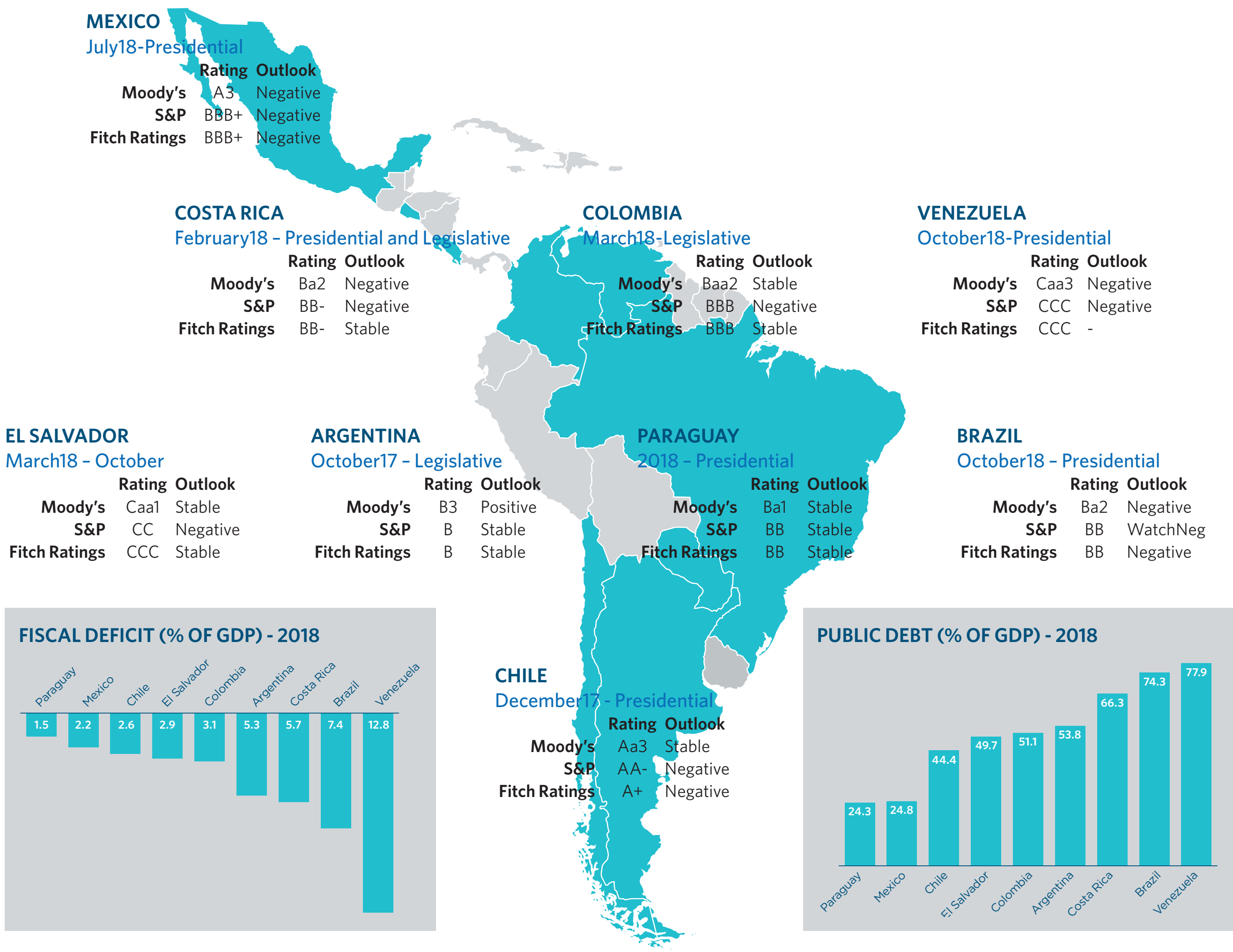
Until more projects are brought to market with a risk-allocation that is bankable by the private sector, governments, multilaterals and development financing institutions will continue to play a key role supporting institutional investors to address the risks and financing gaps in the region. Government decrees from Colombia and Chile have been instrumental in generating international investment in the 4G highway project in Colombia and the Mejillones-Cardones electricity transmission line in Chile. Additionally, the use of innovative government-backed bonds in Peru, coupled with strong macroeconomic performance, have caused a boom in infrastructure projects in recent years. To borrow some words from the Head of the Chilean Association of Concessionaires, Leonardo Daneri, it has never been more relevant for governments to realise that "only what can be financed will get built".

Political risk

2017-2018 is a time of political uncertainty in Latin America, with international ratings agencies closely watching the presidential elections scheduled in Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay and Venezuela. With the exception of Venezuela, all countries will see a new leader taking on the role, paving the way for changes to economic and infrastructure policies which may shape international appetite for investment.

Latin America's new election cycle

The challenge of fiscal consolidation in Latin America



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Corruption scandals

High-profile corruption scandals have had a pervasive impact across the Latin American infrastructure industry, but it is not all negative. Although the Odebrecht scandal has affected financial closures, caused the cancellation of numerous tenders and prompted the withdrawal of numerous sponsors from brownfield investments, this market turmoil is likely to pave the way for a more level playing field full of opportunities for new market entrants in both greenfield and brownfield investments.

Addressing currency mismatch

Local currency-denominated revenues present an ongoing barrier to international financing due to foreign exchange fluctuations throughout the region, which can be severe. Certain jurisdictions are addressing the issue head on through a variety of strategies. Colombia has used a hybrid public-private funding agency (National Development Financing Agency – FDN) to foment local currency sources of finance and reduce reliance on foreign finance. In addition, Colombia's 4G program allows concessionaires to opt for up to 50% of availability payments from the government to be made in US$, and the recent airport privatizations in Brazil have also contemplated the local government assumption of currency risk, at least in part.

The pipeline

Argentina: In September, Argentina called for expressions of interest to develop US$9.5 billion of water projects, many of which are greenfield projects. With regional authorities unable to fund more than a few of these projects, they are likely to become some of the first projects to be procured under the new PPP model introduced in 2016 – although local law is flexible enough to accommodate O&M (operate and maintain), DBFOM (design, build, finance, operate and maintain) and turnkey models. Argentina's pipeline includes US$169 billion of investment in infrastructure, including US$48 billion in roads and US$34 billion in the energy sector.

Brazil: In August, the Brazilian government announced its plan to raise US$14.10 billion by the inclusion of 57 new projects in its investment partnerships program, of which 32 will be privatised, concessioned or evaluated for privatisation, including airports, highways, ports and state-owned companies. Among the projects to be privatised are the Congonhas airport in São Paulo state, and the government stakes in Cuiabá, Santos Dumont and Recife airports (with the São Paulo terminal accounting for 10% of all Brazil's air traffic).

Colombia: As a result of the massive 2016 4G highway program (49% of which was funded by local banks, 22% by international and multilateral banks, and 21% by institutional investors), the local debt market in Colombia is drained, paving the way for increased participation in local infrastructure from international investors and lenders. There is also hope that the international players involved in the 4G highway program will draw on the country-specific experience gained there to take up other opportunities in the market. Colombia is therefore perfectly positioned to see an increase in both supply and demand for upcoming infrastructure projects.

Chile: The current pipeline of infrastructure projects, particularly in the water sector, is experiencing delays due to bills regarding a new centralised concessions authority and a US$9 billion infrastructure fund which are stuck in congress and are unlikely to be approved prior to the November 2017 elections. Encouragingly, several candidates have outlined infrastructure plans and committed to building 150km of new subway lines in Santiago at a cost of approximately US$15 billion (although some of these lines could be built by Chile's state-owned Metro company itself or through a PPP tender process).

Mexico: Mexico has an attractive infrastructure pipeline, with the government announcing 12 new highway and hospital PPPs worth approximately US$1.1 billion in aggregate. The government has ramped up its infrastructure spending in the last year of its political term, although this belies a trend toward increased private sector financing. 2017 has seen the tender for Mexico's first privately-financed transmission line projects, forming part of a larger pipeline of investments in transmission projects. In September 2017, the Ministry of Energy announced a new contracting model for transmission projects in which the government will not assume payment obligations, nor provide any credit support.

Peru: Peru has continuously updated its PPP laws since their introduction in 1991, and the model of procurement is not only supported on both sides of politics, but also used extensively (76 PPPs were awarded between 2004 and 2016). However, Peru's activity has recently slowed, with investors wary of poor quality projects and recent corruption scandals. The latter affected financing prospects for the 1,025km Southern Gas Pipeline (Gasoducto del Sur Peruano) (with Odebrecht having a 75% interest in the consortium) and ultimately led to its termination.

Conclusion

Despite the regional challenges, Latin America is a "must-watch" region for investors and banks looking to diversify their portfolios by seizing on the clear opportunities in energy, infrastructure and mining. Although local financing constraints and the need for innovative structuring issues can cause the infrastructure pipeline to move slowly, those willing to wait to capitalise on the "right" opportunities can de-risk projects and do very well by strategically partnering with experienced contractors, banks and lawyers with knowledge of the market.

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