Privatization at what cost?

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The Turkish Privatization Administration (OIB) has set an ambitious end of May launch date for the start of the roads privatization process – if legal amendments already drafted for the sale are ratified in time by the Turkish parliament.

The sale is just one of a number of privatization programmes for 2008 that include the postponed sell-off of the 21 electricity distribution companies, the national lottery, Tekel Tobacco and the ongoing port privatizations (to date dogged by litigation and a bureaucratic tender process).

The sales, like all past Turkish privatizations, are a key element of Turkish economic policy with the cash raised used to offset a bulging current account deficit that has reached $40.4 billion in the 12 months to March 2008, compared with $37.6 billion at the end of 2007, and was equivalent to about 5.7% of GDP in 2007. The Central Bank has also raised its inflation forecast to 9.3% in 2008 due in large part to the rising cost of fuel and energy imports that are fuelling the Turkish economic turnaround.

But even with investor appetite for Turkey high, given the current international lending climate, the high leverage-bond take-out template favoured by some infrastructure investors – which, along with the influx of infra funds into the market has driven up infrastructure asset pricing globally – appears unlikely at best (not least because of the sickness in the monoline industry). Consequently, Turkish asset values for 2008 are going to be conservative and potential bargains for strategic investors looking to long-term returns.

Roads privatization launching

The roads sale is expected to generate between $4-$6 billion and has already attracted interest from Macquarie Infrastructure, Deutsche RREEF, Abertis, Brisa, Itochu Corp, Atlantia SpA (formerly Autostrade SpA) and locals Dogan and Dogus.

The road assets comprise 1900km of existing toll motorway – Edirne-Istanbul-Ankara, Pozanti-Tarsus-Mersin, Tarsus-Adana-Gaziantep, Toprakkale-Iskenderun, Izmir-Cesme, Izmir-Aydin, Gaziantep-Sanliurfa, and the Izmir and Ankara Beltways – and the Bosphorus and Fatih Sultan Mehmet bridges in Istanbul.

The mega project tender is one of three vast roads related packages that also include future roads BOT concessions – for example the Turkish Highways Directorate General recently issued a BOT tender for the Gebze-Orhangazi-Izmir highway project which includes the 3000 metre Izmit Gulf transition suspension bridge – and the Bosphorus car tunnel. Loose estimates put the total investment requirement at $10 billion for this year alone.

The existing roads sale will comprise a concession from the OIB and the transfer of operating rights for up to a 25-year tenor. The auction may be in one or two lots, but even with the size of each deal watered down, the timetable for the sale – expected to be closed by the end of 2008 – appears optimistic. According to Yildiz Koc, project group head at the OIB (privatization administration), "draft concessions could be out to prequalifiers in July." But bankers at the Project and Infrastructure Finance Conference in Turkey (hosted by Project Finance and Euromoney Seminars) were privately sceptical that financing would be in place before year-end.

Although the existing assets are relatively new and performance is measurable on historical toll data, the financing for the sale will still require some significant due diligence because while the concession agreements are to feature indirect guarantees that a second motorway won't be built on the same route, under Turkish law there must be a free alternative road on the same route.

There has also been no progress to date in tightening up the Turkish concession system – although a new PPP law has been drafted.

Contributing factors to pricing uncertainty

Much of the template for the roads programme has already been engineered in the airport and port markets – notably a step-in rights structure that overcomes issues foreign lenders have with Turkish force majeure clauses. But that structure only keeps lenders secure if every potential breach is outlined in detail in documentation, and the government still has the ability to cancel those step-in rights.

Sponsors will also face the problem of borrowing in hard currency and an income stream in Turkish lira and some financiers are suggesting that foreign exchange risk needs to be offset in the tariff structure along with an inflation-linked price mechanism – all documented in the transfer of operating rights agreement.

The predictable income of two of the key assets for sale – the bridges in Istanbul which raise around $500 million per year in toll revenue – is also made uncertain by a proposed third bridge and the co-joined Istanbul Strait road, which could be competing with the bridges for the same income stream depending upon where they are finally routed.

That kind of uncertainty is not good for a market where asset values already appear to be under pressure despite the broad claim – by bankers and government alike – that Turkey has not been hit by fallout from the credit crunch. For example, Turk Telekom's very recent 15% initial public offering (IPO), although vastly oversubscribed and with 60% of stock taken by foreign investors, was priced to go – the deal issued at a deep discount to other Turkish stocks and only raised $1.9 billion, well below the $3.1 billion initially predicted: At Tl4.6 a share, Turk Telekom will trade at 6.4 times 2007 earnings as compared to the 12.1 times of Turkcell stock.

The potential for rising cost of bank borrowing will also affect the asset prices achieved. Local bank cost of funding – currently fluctuating between 100bp and 200bp – could go up further as more Turkish bank export receivables become due for refinancing, thus pressuring on-lending rates and potentially forcing cost of local project debt above 350bp.

Securitizing their export receivables has become standard borrowing practise for lower credit rated Turkish banks, in that it provides cheaper medium- to long-term hard currency financing than borrowing from the money markets. But with confidence in the securitization market low, any refinancings are likely to be both more pricey and shorter in term.

That potential cut in term presents another hurdle for local lenders – a mismatch in tenor between what banks can borrow and the long-term project finance facilities required by investors.

According to some lenders the confluence of those pricing and tenor influences will have three effects. First, the international lenders will likely match the local margin increases – many of the Turkish banks are now foreign owned, it is difficult to put a project deal together without local knowledge, and even those banks without a local presence are more likely to opt for higher margins than buying market share with cheaper debt. In addition, given the size of the financings, deals will be done on a club basis.

Second, Turkish project tenors are going to remain static at around 10-12 years, irrespective of concession lifetime. And third even the potential rather than the reality of those influences will be enough to ensure that all bidders and financiers for the upcoming tenders will be watching their bottom line and bidding conservatively.

Electricity distribution back on sales block

The second major sale is the 21 electricity distribution companies, postponed last year by the general election.

Around 25 bidders pre-qualified for the auctions last year – Sabanci, Zorlu, Koc, Ciner, Dogan-Dogus-Anadolu Group, ENBW, Habas S?nai, Limak, Akenerji, Nurol Holding, Iberdrola-Calik Enerji Sanayi, Park, Eren, Hema, Yuksel, Barmek, AES, Novosibirskenergo Energy, Eksim-Kuveyt Turk Katilim Bankas? Ortak Girisim Grubu, Ic-Ictas Insaat Sanayi, Prisma Energy, Gama Enerji-General Elektrik Ticaret ve Servis, Ortak Girisim Grubu, Suez-Tractebel, E.ON, Enel and Enka – and all are still valid for the 2008 sale.

Winning bidders will be expected to invest large capex at the beginning of the concession to upgrade the existing systems to meet future power demand, expected to rise by 7% annually until 2020 and requiring around $130 billion of investment in both distribution and production. Network loss ratios are 18% on average and up to 62% in some parts of eastern Turkey (the OECD average is 6.5%).

Six regions – Meram, Trakya, Istanbul Anadolu, Istanbul Avrupa, Sakarya and Baskent – were proposed by the OIB last year for the first sale. But so far this year, from the original line-up, only the tender processes for Baskent Elektrik Dagitim and Sakarya Elektrik Dagitim have appeared along with Meram Elektrik Dagitim (MEDAS) and Aras Elektrik Dagitim.

Two of the initial 40-year concessions are the among lowest risk – Baskent has 2.8 million customers and supplies 8041 GWh in the centre west of Anatolia; Sakarya supplies 1.3 million customers in the north of Anatolia region with 4134 GWh and has a 4% market share, and, although the smallest in terms of output, is probably the most attractive, since it supplies Turkey's largest and growing industrial area.

The sale will involve a transfer of operating rights with the network assets remaining with stated-owned electricity distribution company TEDAS. The privatized electricity distribution companies will act as regional monopolies licensed and regulated by the Energy Market Regulatory Authority (EMRA).

In 2006 EMRA approved the end user tariffs and revenue requirements of each distribution company for the transition period until 2010 when full power market liberalization kicks in. Unfortunately for bidders the tariffs post-2010 are hard to predict, although putting them up to reflect the real cost of power, which is currently subsidized, will be politically fraught.

The four basic tariff components are retail sales, distribution, retail services and transmission, which are regulated in an unbundled fashion. The retail sales tariff has a price cap set at the average price of the energy purchased by the distribution company. Distribution and retail services have revenue caps that cover operating expenses and investment requirements related to distribution and retail services. Transmission tariff is a complete pass-through of transmission costs as charged by state-owned transmission system operator TEIAS.

How much the Turkish government expects to raise from distribution is unclear – particularly given the size of capital expenditure that will be needed. But indications are that the plan, first outlined last year, that involved selling just the choicest deals in the first wave has changed into a mixed bag with Istanbul, for example, being held back for better pricing.