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GCC Report: Cash in the attic

01/11/2006

Wider economic buoyancy, growing liquidity, the need for portfolio diversification – all have combined to spark interest and development of longer term infrastructure funds for both inward and outward investment.

For the first time GCC-based private equity investors see an opportunity to get involved in both greenfield projects and the secondary trading of assets. Furthermore – the GCC private equity fund base is expanding, the number of funds and volume being raised having trebled in 2006.

The new teams

The basic strategy is for international investors to team up with regional players – giving a local flavour to infrastructure funds. For example, in 2005, Dubai headquartered Emirates National Oil Company (ENOC) teamed up with GIB and Standard Bank to co-sponsor the GCC Energy Fund. Subsequently, Saudi Arabian General Investment Authority (SAGIA) teamed up with Swiss private equity house and investment bank Swicorp to form Swicorp Joussour Company, commonly known as Joussour.

Meanwhile Dubai International Capital, Oasis International Leasing, and HSBC have linked up to form the MENA Infrastructure Fund. And advisors are also setting up specialised units to help private equity access the region. Earlier this year Washington DC based oil & gas advisory firm Taylor DeJongh announced that it was participating in the setting up a new investment bank, First Energy Bank, which will focus on private equity investments in the energy sector.

There is good potential for private equity and infrastructure funds in GCC projects – including greenfield IPP and IWPP projects. "GCC projects are currently very heavily bid, but as the project pipeline moves faster, we are likely to see principal finance coming in as an additional source of capital, either from private equity funds or from banks also arranging the debt financing," says Tony Humphrey, partner at Allen & Overy.

In addition to power and water, the capital requirements in the petrochemicals sector are vast, as GCC states try to add value to their oil & gas production chain. And areas such as transportation are also viewed as promising.
One of the newest start-ups is the $500 million MENA Infrastructure Fund, which was originally announced in March, with Dubai International Capital (the international investment arm of Dubai Holding) and HSBC providing fund management services as well as contributing equity. In September, the ownership base was expanded to include Oasis International Leasing.

Abu Dhabi based Oasis was established in 1997, and has established itself as a major lessor of commercial aircraft, since diversifying into the leasing of equipment to the infrastructure sector. Though the company still sees aircraft leasing as its main focus, the investment in the MENA Fund signals a diversification of its interests to take advantage of its extensive contacts across the infrastructure sector.

"This is clearly a capital rich region, so it is important that the Fund is not just providing capital, but also adding our expertise to the bidding process in a way that is beneficial to the consortium," explains MENA Infrastructure Fund CEO Robert Swift. "The main focus of the Fund will be to invest in greenfield projects, but we may also invest in assets that have already been developed and are in operation."

"Dubai International Capital, Oasis International Leasing and HSBC each have a $50 million investment position in the fund, and we are in the process of bringing in institutional investors as limited partners," says Swift. "The Fund is arms length from HSBC, but clearly one of the big advantages is our close relationship with HSBC, and their knowledge of projects across the region," he adds. "There are likely to be some projects where HSBC is involved as debt arranger, but we will also be working closely with the other major project finance banks in the region."

MENA Infrastructure opened for subscription in late September, looking for both high net worth individuals and institutional investors. Once the fund has invested a substantial amount of its $500 million, the way will be open for follow-on funds to be launched.

The Swicorp Joussour Company is much bigger, aiming to invest up to $5 billion in energy related projects, mainly in Saudi Arabia. Equity has already been committed by partners including The Savola Group, Asseer Company, Saudi Bin Laden Group, and Gulf Power Company.

With the help of Swicorp's expertise, Joussour will seek to invest in Saudi Arabia, primarily in midstream and downstream petrochemicals, energy intensive industries, power generation, and ancillary businesses to the oil & gas and petrochemicals sectors.

The Boston Consulting Group has been advising Swicorp in establishing Joussour's investment strategy, and will also help win business using its global network of contacts with leading corporations and multinationals. Joussour will structure deals with local players, as well as joint ventures with major international players.

Islamic funds

Shari'ah compliant funds are also growing and many institutions across the region have found Islamic funds are a more popular product (although bankers expect to see both more conventional and Islamic funds being launched).
In May regional private equity company Abraaj Capital set up a $2 billion Infrastructure Growth Capital Fund (IGCF) alongside Ithmaar Bank and Deutsche Bank. It will be managed by Abraaj Capital.

The main focus of the fund will be to take stakes in greenfield projects, while also participating in privatisations. The main sectors will be oil & gas, petrochemicals, telecoms, power, water, roads and education. Investments can either be directly in infrastructure projects, or taking stakes in companies that work in these sectors.

Dubai Islamic Bank is also launching infrastructure funds, to be managed by Millennium Finance Corp. And Gulf One Investment Bank, which is a Shari'ah compliant institution, is also focusing more on the infrastructure sector to provide both financing and advisory, plus structuring investment vehicles giving investors access to sectors such as energy, water, transport and petrochemicals.

The size of individual funds is also growing – the $500 million buyout fund launched by Abraaj last year was considered large at that time, but Abraaj has since launched a $2 billion fund. "This trend mirrors recent developments in the US, where $6 billion is no longer considered a very large fund, and where multi-partner, multi-billion Dollar funds are increasingly common," says Robert Varley, partner in the Dubai office of law firm Walkers. The speed at which those funds are placed is also very quick – full drawdown is often within 18 months.

Varley notes that there is great interest in the region from outside investors, suggesting that outside players will continue to partner with local institutions to produce Islamic products. Meanwhile, Islamic banks that enjoy a strong reputation in other sectors will look to redeploy their expertise in private equity, making even more capital available.

Rates of return

One problem that all these new funds will have to face is the soaring engineering, procurement and construction (EPC) costs, which are eating into internal rate of return (IRR) calculations.

Cost inflation in raw materials such as steel is one problem, but the GCC region has been particularly badly hit by rising costs of skilled engineering personnel. Where a project in the United States may have to offer a higher salary because of staff shortages, in the GCC the effect has been much more acute given the tradition of bringing in expatriate engineers on generous packages.

"It appears that the low cost feedstock advantage, typical of a GCC project, is nullified at the marginal increase in EPC cost levels of 12%," comments one project advisor. "Given the current construction industry environment in the Middle East, such marginal EPC cost increases are highly likely."

The fall in share prices across Middle East stock exchanges also increases the potential for private equity funds to invest in secondary market assets that might otherwise have gone the Initial Public Offering route.

GCC equity acquisition trail

Just as private equity is targeting the GCC region, so investors from the region are looking at their own private equity investments around the world. The tremendous liquidity across the region as a result of high oil prices is generating tens of billions of dollars looking for suitable investments, and there is a natural desire to diversify portfolios by investing outside the region.

Dubai Investment Capital (a wholly owned subsidiary of Dubai Holdings) was set up in 2004, and has since led the way with a series of company acquisitions, and is now targeting infrastructure as well.

In 2005 DIC acquired a $1 billion stake in DaimlerChrysler, and subsequently paid £800 million to acquire The Tussauds Group in the UK. And in November of this year DIC acquired UK precision engineering group Doncasters for $1.2 billion from Royal Bank of Scotland Equity Finance. DIC was advised on that deal by HSBC.
Dubai Ports (which is owned by the government of Dubai) this year acquired ports and ferries group P&O in a £3.9 billion deal which caused controversy in the US.

Meanwhile Qatar Investment Authority was one of the bidders in the recent sale of Thames Water in the UK, though it eventually lost out to a £8 billion bid from a consortium led by Macquarie. And in November Bahrain based investment group Arcapita acquired Northern Ireland's biggest electricity supplier, Viridian Group, for £3.6 billion.

Standard & Poor's recently reported on what it called the breathtaking rise of infrastructure funds generally, and described them as the new dotcom sector for the financial makets. And like the dotcoms, aggressive bidding and unrealistic asset valuation may cause problems down the line.

But for the moment, with GCC funding requirements running into the hundreds of billions of dollars, private equity could soon become a much needed source of new capital alongside the overstretched industrial companies that currently sponsor projects, and returns may trend upwards.

There had been talk of a coming imbalance in supply and demand for project equity in the GCC, and the involvement of private equity may be the perfect way to plug the gap. Not only is the number of projects in the pipeline growing, but projects are also getting larger, so there will be plenty of opportunities for financial investors in the coming years.