In the blender

01/10/2005

There are several sponsors that will not touch Mexico. Its credit rating, at BBB/Baa1 (S&P/Moody's), is solidly, if low, investment grade. And investors persist in recalling the wave of toll road bankruptcies that afflicted the country in the mid-1990s.

But Mexico is attracting huge levels of interest, both from sponsors and banks. In part, this reflects the country's size and ties to both the US and Spain, respectively the home of substantial bank liquidity and toll road operating expertise. It also represents a concerted charm offensive on the part of the Mexican government.

The Hacienda, Mexico's finance ministry, has been heavily influenced by the example of the UK, a function of the fact that Partnerships UK and the three main accountancy firms – PwC, Ernst & Young and KPMG – have been promoters in Mexico of the PFI model. The transport and communications ministry – SCT – has been more interested in the possibilities of the Chilean model.

Out of the pens

The first PPS road, concession, however, has already been awarded – the La Piedad-Irapuato segment in Guanajuato. This 75km section of road has a total cost of roughly $85 million, and is looking for up to $70 million in project debt. The preferred bidder is Mexican construction firm ICA, advised by Santander.

The sponsor will be responsible for working on several of the issues that will need to be ironed out for the scheme to be a success. ICA is a fairly experienced sponsor, and certainly in the best shape of the sponsors that emerged from the toll roads crisis. It has recently completed a financing for a hydroelectric project – El Cajon – and a road concession in Panama.

Nevertheless, that a Mexican sponsor has again kicked of a round of infrastructure development gives some idea as to the attractions or otherwise of operating in Mexico. The PPS scheme follows the second wave of toll roads, a revamped toll concession programme that has so far only named Mexican construction firms as concessionaire. These operators have in turn largely used Banobras, Mexico's development bank, to fund construction.

The experience of the real tolls provides some insight into the issues that will decide the fate of PPS. One issue will be the acquisition of land rights. The example of the Autopista Circuito Exterior Mexiquense, a toll road in, and awarded by, the state of Mexico, is instructive. The project, a venture of OHL subsidiary, Conmex, raised $180 million equivalent in Mexican pesos to fund a road running to the east of Mexico City.

The deal, which closed in October 2004, used debt from Banobras, BBVA Bancomer, and the Instituto de Credito Official of Spain, which provided about $60 million apiece. The fundamentals of the road are strong, since it provides a way for north-south traffic to avoid the country's capital. But the first phase, while largely over land owned by the state water authorities, was delayed by squabbles and design changes forced by working with private landowners.

According to Jose Andres de Oteyza, the president of OHL Mexico, the process of buying land and negotiating rights of way should be complete by the time a financing is attempted. The first phase, Jorobas-Ecatepec-Penon, was delayed in this way, and the gap between this financing and those for the second and third phases can be explained by the need to gain the necessary permits.

The toll roads programme had looked heavily at the Chilean example, in terms of the ways that it might make concessions more attractive to sponsors. In particular, outside lenders and sponsors wanted to see if the SCT might be interested in providing minimum revenue guarantees or currency hedging. This is, as the head of the SCT's toll roads unit, Oskar de Buen concedes, unlikely to happen. "The experience of the roads sector with financial guarantees has not been productive," says de Buen, "and the treasury is unlikely to permit them. It may offer some provisions with regard to termination and to force majeure, but these will be specific rather than general."

Real and shadow

Which decisively pitches the question of the viability of real toll concessions back in the hands of traffic risk, and their financeability in the hands of the traffic forecasters. According to Robert Bain, an associate director at Standard & Poor's, their studies still show a strong systemic bias towards optimistic traffic predictions. This is part of an extended traffic study that S&P has been performing on the sector, and has alarming implications not just for real tolls and the period after their traffic ramps up, but also for shadow tolls, where users do not pay for their trips.

Mexico's real toll programme

Name	Investment ($ million)	Length (km)	Lanes	Mexican State
Matehuala Bypass	37	14	4	San Luis PotosÕ
Amozoc Ð Perote	150	103	2	Puebla/Tlaxcala/ Veracruz
San Blas Junction Ð Escuinapa	230	151	2	Sinaloa/Nayarit
Mexico City Northern Bypass	700	220	4	Mexico/Hidalgo/ Tlaxcala/Puebla
Morelia Ð Salamanca	150	81	2	Michoàcan/ Guanajuato
Laguna Verde Ð Gutierrez Zomara	250	127	2	Veracruz
Santillo Ð Monterrey	223	40	4	Nuevo Leon/ Coahuila
La Piedad Bypass	34	17	2	Michoacàn
Teacpan Bypass	n.a.	4	2	Guerrero
Arriaga Ð Ouxocuautla	n.a.	4	2	Chiapas
Compostela Ð Las Varas	n.a.	15	2	Nayarit
TOTAL	1,774	776		

Source: HSBC, SCT

This last point will be key in driving the PPS roads programme. The road concessions are likely to be fairly similar to the UK and Canadian models – with revenue from a mix of availability payments and traffic-related payments. The split is likely to be roughly similar to that on recent British Columbia P3 concessions – with shadow revenues equivalent roughly to 15% of the total revenue, and thus the equity in the concession.

The Mexican government will likely not be too perturbed if the road concessions do not feature much in the way of outside talent, but its plans go a great deal further. In the works are several hospital and school projects, which would likely require not only more advanced construction capabilities, but also skills in facilities management that would not be highly evolved in Mexico.

The shadow PPS road programme

Project	Investment ($ million)	Length (km)	State
Nuevo Necaxa-Avila Camacho (Segment:Acapulco Ð Tuxpam)	500	35	Puebla
Nueva Italia- Apatzingan	600	30	Michoacàn
Macuspana-Entronque Palenque (Segment: Peninsular de Yucatàn)	600	40	Tabasco
Arriaga Ð La Ventosa (Segment: Circuito TransÕstmico)	600	137	Oaxaca/ Chiapas
Mitla-Tehuantepec (Segment: Puebla-Oaxaca-Cd. Hidalgo)	600	163	Oaxaca

Tapachula Ð Cd. Hidalgo (Segment: Puebla-Oaxaca-Cd. Hidalgo)	50	45	Chiapas
Apizaco Ð Calpulalpan (Segment: Altiplano)	60	51	Tlaxcala
QuerŽtaro- Irapuato	100	100	Guanajuato
Irapuato Ð La Piedad	85	75	Guanajuato
TOTAL	1395	676	

Source, SCT, Hacienda, HSBC

In theory, concessions can be structured around the services available, although some in government believe that this can be achieved with the available domestic skills base. Said Artureo Perez Estrada, general director of infrastructure at the department of health, "the quality of Mexican providers is present, and the important thing is to find a counterpart in government capable of making it clear to what services are to be provided."

Credit carriers

Nevertheless, Mexican contractors and service providers will also need to prove to lenders that they have the financial wherewithal to fulfil contracts. There are some ways of building a concession round this, including the use of build-lease transfer structures, of a type similar to that for El Cajon, but more particularly on municipal water projects. Moreover, as HSBC's director of investment banking in Mexico, Felipe Vila, notes, the water sector, which employs build-lease-transfer structures with revolving credit lines to provide liquidity support, might provide a useful model.

But the issue of construction risk is not entirely one that the contractor can resolve. As S&P's Bain points out, according to the agency's research, cost overruns, while frequently the results of inadequate planning at contractors, could also be the result of unforeseen problems with the ground on which a project is built. Bain suggests that lenders and sponsors pay more attention to independent engineers' reports. There are indications that the Mexican government's approach will be to offer as much time and access to bidding consortia as possible, whilst avoiding providing blanket guarantees.

The government's main difficulty in pursuing PPS, however, is that it will have to make commitments to PPS projects several years down the line. This issue with multi-year commitments is one innate to the Mexican political process. Providing the necessary comfort to lenders to PPS projects is the main task for the Hacienda's PPS Unit.

According to Luis Alerto Ibarra, the head of the unit, the government is likely to propose that PPS payments designated for the following year's budget be given priority above all other expenditure. This would assuage lenders, although they would also likely prefer some kind of letter of support from the central government. This would be a second best to some kind of constitutional amendment to allow multi-year budgeting.

A change in the constitution is unlikely. This outlook will be familiar to lenders to the country's oil and gas and power sectors, where outside investors have long agitated for a more friendly legal framework. But while PPS excites a much lower level of distrust than outside involvement in energy, such a change would likely bring more scrutiny, and certainly drag PPS to the front of the election agenda.

Thinking local

But, ultimately, for PPS to succeed on a larger scale some measure of political and financial reform will be required, as many speakers suggested. In the mean time, however state level PPS may be a much more certain prospect. The federal nature of the Mexican political system gives states a wide amount of leeway in terms of how they pay for essential services, as well as a large degree of freedom in lawmaking.

According to Charles Nottebohm, a director at Protego, there could be more willingness in the local congresses than at the federal level to discuss changes to laws that would be necessary to foster private involvement in infrastructure. So far the executive branches of the states of Sonora (represented at the meeting by Ricardo Bours Castelo), and Durango (represented by Jorge Herrera Caldera) have sent to their respective legislatures proposed new laws to facilitate PPS.

Moreover, the state of Mexico, by far the country's largest and most populous, has recently elected a government much more sympathetic to the private sector. Luis Videgaray, the state's new secretary for finance, comes from the private sector, and brings an investor's sensibility to the process. As he notes, "at the moment, the biggest obstacle to pursuing PPS at the state level is the states themselves. We need to look carefully at what risks we can and can't persuade the private sector to take."

This state-level boom in PPS has huge potential – 80% of states' expenditures typically go towards health and education, although roads, given their relative ease to construct and the poor state of many regional routes, are likely to receive disproportionate attention. But states still have to contend with how to account for PPS deals, whether as debt or capital expenditure, and how lenders will respond to their credit.

Most Mexican states have credits in the BB region, at least on the international scale, which makes the involvement of players such as monolines difficult. Not impossible, however, since MBIA completed a $210 million note issue in December 2004 for the state of Nuevo Leon. That deal was dependent on revenue from state-owned toll roads, rather than a state credit, and the proceeds were used at the state's discretion rather than a particular project, but the template is a useful one.

Lengthened and strengthened

The monolines will also highlight the 25-year maturity on the Nuevo Leon issue as a useful selling point – most states would achieve a tenor roughly half that length. The pitch, a familiar one to sponsors elsewhere, is that infrastructure assets demand such maturities if they are to be affordable. According to Franklin Minerva, a managing director in the global infrastructure group at MBIA, the monolines are also likely to make a market for nominal-currency fixed-rate Peso debt more achievable, even if current inflation levels make it hard to persuade the afores – Mexico's pension funds – to bite.

The afores are key to progress in PPS finance, and have given few clues to date as to their interest in the sector. One afores participant said simply that they look for legal clarity, portfolio diversification, a good quality credit, and to get a clearer idea of the programme's framework. All but the last factors are common to institutions the world over, while the last is the government's to address.

But institutions are likely to hold back from an initial foray into the PPS and infrastructure market. This will be comforting to the lenders circling the market – at Santander, Dexia, BBVA, Citigroup, HSBC, Nord/LB and ABN Amro, to name only the most prominent. When Ken Kryzda, a director in HSBC's corporate and investment bank in Mexico, describes his bank's role as being a "catalyst for capital investment", much of his bank's business will be in providing bridge loans and construction financing to concessionaires.

Ultimately the PPS programme could have a beneficial effect on the Mexican construction industry. As S&P's Bain notes, "Mexico really could take the failed first wave of toll roads and turn it into an asset. They wouldn't be alone – Hungary, Indonesia and even Portugal have dealt with shocks from their toll road programmes."

This is a sentiment that Geoffrey Spence, HSBC's global head of infrastructure, shares, noting that the UK's construction industry has consolidated thanks to the requirements of the PPP process, and that several players have benefited from the input of foreign investors, and have in turn become international financial investors. ICA, the nearest thing that Mexican construction has to a national champion, will be watched carefully on it's pioneering concession.