Roads merry-go-rand

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The N4W is set to sign in March and will signal the third major toll road to reach financial close in South Africa. An assortment of smaller infrastructure deals have been noted over the last two years and with six further toll roads in the pipeline, the country's project finance market appears to finally be getting off the ground. The path has not been smooth, with a handful of high profile projects faltering along the way or even failing to reach completion totally. Nor is the end of the road in sight. Initial precedents have been set and facilitating bodies put in place. Domestic players are becoming more familiar with the notion of non-recourse financing, but there is still some distance to travel.

Until recently, financing the project way was not a route even considered by many in South Africa. A strong financial market, incorporating considerable liquidity, and industries dominated by a few giants meant that borrowing on-balance sheet was the norm. Relaxation of foreign exchange, the emergence of smaller players and a government pledge to draw on private money promised to change this. Many international banks set off for South Africa in pursuit but even now the anticipated explosion of project finance transactions can still not be seen clearly on the horizon. Rather, project finance has been taking root slowly, shaped by the wider economic and political context in which it is embedded. As Jose de Nobrega, head of global project finance at Investec, puts it, ?The government is caught between a rock and a hard stone. They want to provide infrastructure but also want to be seen as fiscally prudent. This conflict inevitably leads to the development of public private partnerships.? Project finance is taking off and it is likely that this year will see another 2 toll road tenders as well as a number of relatively smaller infrastructure deals. There are still, however, a number of barriers preventing the exponential growth once predicted.

Tolling the way

The toll roads have clearly been a success story and created a momentum for the development of project finance. The South African National Roads Agency (NRA) was set up in 1996 in an attempt to develop the country's road network. It has consistently focused on encouraging private sector investment to this end, with all roads stand-alone financings.

The R1.85 billion N4E was the first road undertaken by the NRA and also marked the first major project financing deal to come to the market in South Africa. Awarded to a consortium comprising Bouygues SA, Stocks & Stocks and Basil Read, the concession involves the upgrade of existing road and the construction of new sections between Pretoria and Maputo on the coast of Mozambique. Investors were shielded from true project risk, previously alien to financings in South Africa, by a government guarantee. Lessons taken from Mexico, Malaysia and UK as well as international players in the advisory roles also helped steer the deal to close.

The subsequent N3 and N4W have had the N4E's guarantee replaced by letters of comfort from the departments of finance and transport. All parties point to the steep learning curve on which they have successfully embarked. Rand Merchant Bank certainly made significant headway in successfully bringing the N3 to close. This deal has a number of interesting characteristics, including an up front payment of R1.28 billion to acquire the existing stretch of road from the Heidleburg (just south of Johannesburg) and Cedera (just north of Durban). The NRA will use this to pay off its inherited debt relating to the road. There are four separate EPC contracts in place. The most significant construction is a commitment at a future date to build a 100km stretch of new road through the De Beers Pass. This will not be a replacement to its existing counterpart, but rather an alternative. The date at which construction for this commences is conditional both on a stipulated level of traffic flow and on the capacity of the consortium to raise the necessary funds.

Moreover, Eugene Erasmus, regional managing director for LTA and project director whilst the deal was put in place, points to the fact that this road is highly commercial and thus potentially very lucrative. It links two of the country's largest cities, one of which is home to the largest port. Projecting and recouping revenues is relatively straightforward, particularly given the minimal construction risk.

Despite this and the fact that tolling is not an alien concept in South Africa, it has been conceded that on both the N4E and the N3, there was more public resistance than forecasting had predicted. Travellers on the N3 had previously had to pay a government inspired toll but since the private consortium took over, this has gone up by about 20%, meets with considerable protest. One banker closely involved in the deal attributed this to the failure of the government to support the project and embark on a successful PR campaign outlining its long-term benefits.

This socio-economic factor has weighed even more heavily on the architects of the N4W, which includes a stretch of busy commuter motorway between Warmbaths and Pretoria. In response to these concerns the Saturn traffic model was specifically upgraded and Nazir Alli, CEO of the NRA, emphasised that all estimates are based on very conservative projections. It was also stressed that the area around Pretoria will not be funding the majority of the road and that a complex discount system for commuters will be implemented.

These favourable conditions notwithstanding, the projects have been described by a representative from a major South African developer as very ?lender-friendly?. In addition to the governmental comfort letters, the NRA has provided a statuary statement covering obligations to the lenders. Allocation of risk between sponsors and lender is still a contentious issue. As one banker pointed out, the deals are getting done, so some level of balance must be in place, but it seems that hesitancy in moving forward is largely coming from the investor quarter. The whole process is certainly very developer driven, with the unsolicited bid system potentially a huge drain on resources with no guarantee of returns. As it stands, the sponsor puts forward a project proposal and then works with the NRA to develop it to tender stage. At this point the sponsor must enter a bid alongside any competing consortia and the only advantage it has is an option to re-enter with a second proposal at BAFO if it has been knocked out. Investors, in contrast, are not required to commit until the project has been clearly mapped out.

All three of the financing packages put together featured CPI bonds, well suited to toll roads for their long and structured maturity. South Africa does not have a history of these bonds, however, with the first ever and fairly unsuccessful government issue last year. The N3 had a particularly large number of them and although all were placed, it is believed that the majority were internally within the Rand group. Observing this potential resistance of institutions, the N4W includes a structure stipulating that the banks must underwrite the CPI tranche but that any bonds not sold can be converted into straightforward debt. Many of the institutions, wary of untested project risk, have also demanded wraps on the bonds.

There are six further unsolicited toll roads in developmental stage (see box) and given the sums of money typically demanded, funding capacity may become stretched. International banks are too sceptical of the currency and political risk associated with South Africa, particularly in view of the tenor lengths being demanded. Domestic appetite, however, will reach saturation at some point and in this instance, new sources of funding will have to be sought. Possibilities cited include the development of the capital markets or a heavier reliance on the EIB, which put up a project guaranteed tranche in the N3. New players would be welcomed by sponsors who cite the current lack of competition among funders. Brandon Doyle, corporate finance for Nedcor Investment Bank, suggests a likely division of banks into advisory and lending roles.

Access to equity will also have to be liberated prior to the development of a fully mature project market. The South Africa

Infrastructure Fund is the only one of any real substance. Set up by Standard Bank, with other investors including the African Development Bank, Old Mututal and Future Growth, the fund is a pure investment vehicle investing in infrastructure projects. It was noted by at least one banker that members are unwilling to invest over and above their contribution within the fund, creating an equity monopoly. Standard recently tendered the management contract, secured by a joint venture between Macquarie and Old Mutual.

Where to find further funding is likely to remain, for the near future, a theoretical debate. Varied views exist on which of the unsolicited bids are likely to be progressed, but a consensus does seem to have emerged that it will be some considerable time before all are ready for tender. Resource constraints of the NRA and developers suggests that it is unlikely that the markets will be confronted with more than two a year. Richard Abadie, head of project finance at PricewaterhouseCoopers stated that, ?Although the roads sector has been the greatest source of deal flow to date, the time taken to achieve financial close has been disappointing and protracted.?

The project finance market in South Africa does still have a long way to travel before being able to claim the maturity seen in other countries and initial precedents have yet to be complemented and superseded. Despite cynicism projected from the international arena, however, the toll road sector is undoubtedly active. Moreover, the development of necessary skills and acceptance of the market noted throughout the toll road deals will provide the catalyst required for diversification into other sectors.

Moving on from roads

Public private partnerships were hailed as the solution for the much-needed investment into South Africa's infrastructure and the implementation of toll road deals provided proof that private sector involvement could work. As first attempts were made to this end, however, a stream of ideological, administrative and legislative problems emerged blocking the anticipated flow of deals. In order to address these and progress project finance as a tool to be utilised by the government, a PPP unit was set up in July 2000, issuing a set of rules and regulations pertaining to the proposed model. With this playing an active role, it is hoped that PPPs may finally get off the ground.

Prisons were an obvious starting point for government tendered concessions because the need was so great and the potential for job creation considerable. The department of correctional services seized on the notion and 11 projects were initially suggested. 5 were subsequently put out to tender, with 4 reaching BAFO stage. At the last minute, however, 2 were cancelled due to insufficient funds of the department to make the annual payments. Cancellation at this stage, causing a considerable waste of time and resources for all parties involved, inevitably instilled a level of wariness. International sponsors recoiled and momentum was lost, with no sizeable deals from any departments having been successfully brought to tender since.

The root of this was a lack of work assessing affordability over the long term, which stemmed in turn from a lack of co-ordination between separate departments. In this instance, the department of correctional services, the department of public works and the ministry of finance. With the new unit and formal procedures now in place, there is a belief that these have been addressed and the will to drive forward a successful PPP practice in South Africa is strong. Michael Schur, who now heads up the PPP unit, has been in place for a year and a half, establishing the financing structure and regulatory framework. Its form was basically modelled on the UK unit, with members typically having strong private sector experience. ?It is important to note, however,? states Schur, ?That departments are currently not obliged to consider the PPP way route as a first option. In this respect, it is very much at the stage that the UK model was in the mid 1990s.?

Ultimately aiming to facilitate PPPs through providing technical assistance and feasibility recommendations, the unit currently has 26 projects under its command. These are in varying stages of development but Schur states that the unit has succeeded in instilling confidence within the private sector. Following the bad press surrounding the cancelled prisons, developers are now willing to climb back on board.

PPP contracts under the direction of the unit incorporate management contracts, leasing, build-own-operate tenders and full concessions. The projects currently in developmental stage include 3 IT, 4 government accommodation, several health care projects and 3 eco-tourism initiatives. Already out in initial tender stages are an equipment supply and facility management concession for the Luthuli hospital, a facilities management contract for the department of education's head office and an IT concession for the department of labour. A contract for the fleet management of the government garage in the Northern Cape is hot on the tail of these and due to launch shortly. These deals are likely to be scrutinised closely by developers from around the world, watching to see whether lessons have been learnt correctly.

Greg Ansermino, project finance at Standard Corporate and Merchant Bank, suggests that there could well be a bright future for project finance within IT deals. There is a strong but concentrated pool of skill in the sector, which could be valuably diffused through the promotion of private finance initiatives. Moreover, IT projects lend themselves more easily to stand alone financings, thereby providing an ideal source of wealth and job creation without demanding payments or guarantees from the government's already very stretched resources. Greg Ansermino points to the national lottery deal recently arranged by Standard as an example of such an IT infrastructure deal.

The PPP unit then, although not actively seeking potential projects within departments does play a role in progressing the notion of public private partnerships through the government. Michael Schur pointed to the fact that regular training programmes held for government officials have displayed a considerable interest for the model from within the private sector. Initial resistance from some quarters to the notion of private sector involvement in public affairs is giving way to a realisation of the benefits that can be achieved through partnerships.

Resistance has not been so easy to dispel within some domains, particularly with respect to private sector charge of provision of services seen as fundamentally a public responsibility. Attempts at water concessions have not been widely regarded as successful project finance transactions. The first BOT in the Dolphin Coast region to service 40,000 to 50,000 residences was financed on balance sheet by Saur International SA. The R1.3 billion Nelspruit tender was hailed as a first for limited recourse financing in the sector. Despite its tiny size the markets rejected it, leaving the Development Bank of Southern Africa put up the whole amount. Failure in this instance was largely due to legislative obstacles. Currently, it is stated that the minister can reset all water tariffs at his discretion and commercial banks are simply not prepared to lend on those terms. This is being addressed but Brigette Baille, partner at Weber Wentzel & Bowens suggests that the problem is more deeply rooted than this. She says that in South Africa, purely commercial legislation can be pushed through very quickly, as was the case in facilitating the prisons. However, when it is perceived to be bound up in issues concerning human rights, it often faces large and vocal opposition. Privatisation is a very young concept in South Africa and it is taking time for many bodies to come to terms with its realisation.

Water is managed at a municipal level and thus the PPP unit, which issues tenders on behalf of national and provincial government, plays no role in facilitating potential involvement of the private sector. A separate body, the Municipal Infrastructure and Investment Unit has been set up to this end. Formed in 1998, it is a group with a projected life span of only five years. It actively aims to promote private sector involvement through municipalities, but this does not necessarily mean PPP. It helps the municipality to identify and package a solution to its needs. Under its guidance, Johannesburg water authority has entered into a five-year management contract with Suez Lyonnais. Cape is planning to follow suit and Durban is likely to bow to the majority movement. Thus project finance proper is unlikely to be seen on any real scale for the next five years within the water sector. However, at the end of these contracts, the environment, both in administrative and ideological terms may be ripe. Restructuring of the sector is likely to be part of this transitional stage. The government has pledged to provide water to all but this could surely only happen under a concession if wealthy areas are bundled together with those currently without.

Opportunities within the government infrastructure sector certainly exist. In fact, a program of public private partnerships is necessary if the government is to provide the facilities and services promised. A learning process is in place, with the problems identified and addressed. Shaping it within the wider political environment is the key to success.

High hopes

The international banking community is likely to take a spectator role within this sector during its development. There may be roles for them to play within an advisory capacity but the relatively small size of the first deals are likely to deem their services too expensive. Moreover, domestic banks have largely developed the skills necessary to play the part themselves.

Sights from an international point of view have been set on larger deals forming on the horizon. Power initially caught the attention of many. Following a government pledge to embark on a ?rural electrification programme?, it was expected that IPP licenses would be tendered.

There are two possible IPPs pending. A license has been granted by the NER for a 17MW CHP plant sponsored by Mondi. The offtaker is to be a paper mill at Merbank near Durban, for which it will provide about 15% of requirements. Although signifying a shift in attitude within an environment historically dominated by a monopoly, this does not note significant development with respect to introducing competition into the market. Promising to make this step is a joint venture between AES and Johannesburg Council. The license for this is still under consideration.

This and any further progress within the power market is stalled by pending restructuring of Eskom; the state owned giant dominating the electricity industry. Distribution is currently managed very inefficiently by municipalities. Plans outlined include re-organising distribution, bundling generation capacity with a view to introducing competition, the regulation of tariffs by the NER and a separate, state-owned body for transmission. Detailed proposals and time frames, however, have not yet been made clear and significant private sector involvement is highly unlikely until this time.

Part of the reluctance of Eskom to commit to specific plans stems from resistance within Cosatu, the union group making up a large proportion of ANC's support base. Any plans perceived as stepping towards privatisation is met with considerable resistance. Transnet, another state owned giant incorporating Portnet and Spoornet, is in a similar stage of restructuring. A project and structured finance department has recently been established within this but its head, Chris Strydom, stated that there is still a lot of work to be done before projects begin to roll out. South Africa already has a well-developed infrastructure, meaning that opportunities for BOT concessions, which would really facilitate the job creation and skill transfer desired, are not abundant. However, Chris Strydon claims that economic development will give rise to opportunities and claims that opportunity in respect of port, rail and pipeline developments may be forthcoming in the near future.

Project finance opportunities within the traditional stomping ground of Eskom and Transnet will only emerge very slowly then, as part of the long drawn out process that is restructuring of state owned enterprises. Greg Ansermino suggests that a major project finance transaction attracting international investors may well arise with the awarding of a second fixed line network when Telkom's monopoly runs out in 2002. If this is going to be a success, however, investors and sponsors alike are going to want strong assurance that there is not going to be a repeat of what was described as the ? debacle that has been the mobile license tender.? On Friday 20 February 2000, it was announced that Cell-C, a Saudi-led consortium had secured the license. This comes a year after Cell-C was originally chosen as preferred bidder, during which time legal challenges, procedural delays and accusations of corruption and political interference have abound.

Mining may hold more immediate promise of project finance on an international scale. Traditionally this has been financed on-balance sheet but as players diversify, project finance transactions are emerging. Often denominated in $ and based on an established market, it is an attractive option for investors who may otherwise be wary of political and currency risk. Deutsche Bank and Standard Bank currently have a $100m, split currency financing in general syndication for Avgold's Target gold mine. Many of the South African banks are also moving further afield within Southern Africa to exploit mining opportunities.

Social obligations

A key component entwined in the development of project finance in South Africa is its employment as a tool for the promotion of economic empowerment and skill transfer amongst previously disadvantaged groups. Thus in all government awarded tenders, a minimum per cent of the concessionaire must be made up of so-called black empowerment groups. In the prisons, for instance, the stipulation was 40%. This on its own, as pointed out by Robert Gumede, executive chairman of Gijima Technologies Ltd., will not achieve the desired end since it is at the contractor and subcontractor level that skill transfer really takes place. He believes that the government should also stipulate a minimum of 50% of previously disadvantaged enterprises at operations level. Brigitte Baille goes on to outline that a complicated point system has been put in place in an attempt to address this. Points are awarded for the inclusion of certain groups at certain levels, with stipulations rising over the life of the project. Failure to meet these will meet with heavy financial penalties.

The government is very committed to the progression of this through private finance initiatives. Transnet has stated that it is a central aim of their project finance department. FBC, an empowerment bank and Weber Wentzel and Bowens formed the notion of community trusts. These were put in place in the toll road and prison deals in order to channel a portion of funds derived from the project directly into surrounding communities. In the Manguang prison deal, 3 empowerment groups, one of which was a community trust, made up 60% of the consortium. An obvious problem is securing funds for the equity of such groups. In this instance the other two developers involved, Group 4 and Murray & Roberts, put it up. This is obviously a considerable strain on sponsors, who would like to see more of the risk being taken on by investors.

It is too soon to say whether the empowerment blue print currently in place really will succeed in its aims and the government has deliberately kept the stipulations vague in order to allow room for refinement as projects roll out. Projects outside government control, such as in the mining or gas sector, are not subject to the empowerment legislation but it is hoped that over time skill transfer will diffuse successfully all the way across industries. The PPP unit states that they are not a vehicle for black economic empowerment but they do try and promote the concept through commercially viable projects.

South Africa, although not quite at the speed that many international onlookers had hoped, is developing a solid project finance market. Further waiting is inevitable before projects begin rolling out at the rate they do in countries with established project finance practices. But South Africa's has been shaped within and tailored to the wider environment and had undoubtedly thrown up valuable lessons for other developing countries.