

Shrem, Fudim, Kelner, Finance & Projects Ltd.

***Facilitating the Financing of PPP
Projects in Developing Countries &
Emerging Markets -***

Lessons from the Israeli Experience

I. EREL

June 2007

Shrem, Fudim, Kelner, Finance & Projects Ltd.

- An investment banking firm founded in 1999 specializing in Real Estate Financial Advisory, Project Finance, Structured Finance and Selective Corporate Finance services.
- The Leading Israeli Financial Advisors for BOT-PPP projects in Israel .
- Ranked # 8 globally in 2006 by Infrastructure Journal magazine for closed deals in project finance – transport sector .
- PFI Road 431 - selected in 2006 as Deal of the year for Europe Middle East region by Project Finance magazine
- Advisory activities in CEE & CIS regions (including Russia & Ukraine) and recently also in India .
- Financial Advisory in connection with Cross- Border Real Estate in connection with all Real Estate asset types (Residential , Commercial ,Retail and Hospitality, Logistics and Amusement parks)
- More than 15 professionals , multilingual – multicultural team

SFK Finance & Projects –Major Assignments

- **Jerusalem Light Rail Transit BOT project - US\$ 400M / CityPass consortium headed by Alstom**
- **PFI Free Toll Road #431 - US\$ 420M/ Danya Cebus**
- **Tel-Aviv Fast Lane project - US\$ < 100 M/ The Green Lane Consortium headed by Tahal-Kardan**
- **Tel-Aviv Red Line LRT BOT project - > US\$ 2Bn/The MTS Consortium headed by Siemens & Africa Israel (Joint Financial Advisor)**
- **Hadera 100M3 BOT Desalination plant - >US\$ 300M /Consortium headed by GE**
- **Ashkelon 50/100 M3 Water Desalination Plant - > US\$150M / Consortium headed by Ionics USA**

Main Topics

- **Structural & Strategic Financial Aspects in the Concession Agreement**
- **Promoting & Introducing Domestic Capital Markets**
- **Mechanisms for Mitigating Financing risks ;**
 - Interest rate movements
 - Cost Escalation risks
 - Currency risks
- **Encouraging the entrance and participation of Foreign Investors & Lenders**
- **Mitigating Political , Adverse Conditions & Discriminatory Risks**
- **Additional Facilitating Drivers**
- **PFI Road # 431 – Case Study Illustration**

The Need



Structural & Strategic Financial Aspects in the Concession Agreement

- Concession Law (general, sector, specific) or at least an appropriate Contract Law
- First Projects should be of the PFI type (Annuity Payment)
- Investment Grant, rather than periodical operating subsidy
- Progress Payment mechanism during construction period
- Revenue Risk Sharing mechanisms in BOT projects ;
 - Ensure stability of debt service
 - Reduce overall Demand Risk
 - Attract long-term lenders & Investors
- Non- competition and priority undertakings by Public Sector which are quantifiable
- Indexation of Revenues also to a Foreign Currency (partial/full whenever feasible)
- Termination & Step In clauses in case of Contract Breach by Concessionaire

Promoting and Introducing Domestic Capital Markets in PPP Projects

Background

Domestic Capital Markets in Most Developing countries are still dominated by local banks & biased to LC and therefore :

- Lack sufficient capacity
- Scarcity/ non- availability of long-term funding sources
- Lack of regulatory framework to support various types of players
- Lack of adequate hedging mechanisms in the private market
- Lack of liquidity/tradability
- Lack of know-how.

Result

- Costly Financing
- Refinance Risks
- Over Concentration of local Banking system
- Gap between lending parameters and Project's cash flow profile
- Reluctance to face Construction & Performance Risks

Promoting and Introducing Domestic Capital Markets in PPP Projects (Cont.)


- Invite & encourage local Institutional Investors to invest in senior debt of PPP projects (reducing thereby the proportion of Government bonds in their portfolio)
- Involvement of Local Credit Agencies to provide credit rating for Project's senior debt
- Incorporate in the Concession Agreement State Hedging based on long- term Interest reference rates (e.g. Gvt bonds Yields)
- Promote PFI projects with predictable stream of CPI indexed payments rather than BOT schemes
- Devise Strategies/Mechanisms to shield from Construction risks

Mechanisms For Mitigating Financing Risks

Background

- Volatility of Macro Economic Factors (e.g. changes in base interest rates in LC , costs/availability of medium- term currency swaps, cost escalations linkage)
- Public Sector should assume these risks from bid submission until construction completion
- Many bidders involved in PPP projects underestimate the impact of adverse changes caused by such Macro Economic factors

Result

- High risk environment for both Lenders and Shareholders
- Sponsors require higher returns  Increased costs to State /End Users
- Reluctance of Institutional Investors to participate
- Increased chances of default and recourse back to the State during construction / Operation
- Deferral of Financial Closing/New Tender

Mitigating Financing Risks

Adjust Price to changes in Reference Long-Term Interest Rates

- Determine a reference interest rate as benchmark basis for State hedging with respect to the senior debt
- Ensure adequacy of derived definitions in connection with such Reference Interest rate
- Establish hedging mechanism that adjusts Project's price to changes in the chosen Long-Term reference Interest between bid submission date and one of the following alternatives ;
 - Financial Closing Date
 - According to actual loan drawdown program
 - Effective completion date (including smooth commissioning)
 - Medium term refinancing date

Mitigating Financing Risks

Adjust Price to changes in Costs Escalation Indices

- CPI indexation does not offer sufficient correlation with material hikes in certain cost categories (e.g. Steel, Environmental measures ,Skilled Workers)
- Private Sector, especially EPC Contractors and shareholders in the Concessionaire are increasingly exposed to cost escalation issues from bid submission ,throughout financial closing, until final completion.

Solution

- Determine a basket of appropriate Cost Adjustment Indices as benchmark and basis for State hedging
- Ensure adequacy of linkage indices such as CPI in the respective LC/FC, Indices of Construction costs , Labor cost
- Establish hedging mechanism adjusting Project's price to changes in the chosen mix of linkage indices between bid submission date and one of the following alternatives ;
 - Financial Closing Date
 - According to predetermined time sections during construction period
 - Effective construction completion date

Encouraging the entrance and participation of Foreign Investors & Lenders

Developing Countries and Emerging Markets are often in shortage of Projects' sponsors, technology vendors and operators ,private equity capital and competitive Foreign Currency lending sources that are vital for promoting and funding PPP projects.

Result

- Inability to roll down PPP projects
- Scarcity of funding resources
- Limited choice of financing products
- Lack of competition among candidate players ↔ Expensive Project
- Increased Performance risks

Encouraging the entrance and participation of Foreign Investors & Lenders (cont)

Few Triggers & Catalysts

- Enable whenever feasible partial/full linkage of Project's revenues to "real" FC (i.e. indexed to its respective CPI)
- Select High value – high necessity projects
Start with Infrastructure PFI schemes for relatively large scale projects whereby the payment risk is perceived as sovereign obligation .
- Start with PPP projects that have an inherent capacity to generate actual FC /FC linked revenues such as Ports ,Airports ,Highway that link several countries
- Apply large proportion of Investment Grant to finance funding viability gap – easier for Foreign Lenders to provide Bridge/Construction Finance compared to Long-Term Finance .

Mitigating Political , Adverse Conditions & Discriminatory Risks

- **Compensation/ Restoration Arrangement following Terrorist Acts and Weather Catastrophes (floods & storms) that cause major physical damage and loss of revenues**
 - Expensive and capacity constraints in the Private Market Insurance
- **Tailored contingent solutions that are triggered under specific material adverse event/conditions that cause a continuing harm to the project revenues**
 - Vulnerability of Mass Transportation systems
- **Compensation/exit & Buy Out options based on Fair Market Value when Public Sector is unable to update tariffs or apply enforcement measures (mainly Utilities)**
 - Inability of Concessionaire to Pursue Investment & upgrading programs
 - Additional Economic burden on existing facilities
- **Impact of Discriminatory Action**
 - Extended Definition (including State ,Municipalities & all relevant Public sector organisms)
 - Compensate & Remedy for full economic impact

Additional Facilitating Drivers

- **Proposed additional items that could have a fostering economic effect [to be incorporated in the Bid documentation]**

Few Tips

- **Compensation formula based on a Fair Market Value that restores Concessionaire IRR in case of Termination due to Government breach**
- **Put [Buy Out] Option for Concessionaire if certain key parameters in the Project's economic & regulatory environment change without matching adjustment in the CA.**
- **Stimulate O&M - PFI tender schemes based on Infrastructure constructed by the Gvt**
- **Generous compensation for # 2 bidder and reimburse for increased costs due to protracted bid submission period**
- **Establish Currency Bridging Liquidity Facility to cover part of the potential mismatch between Project's revenues denominated in LC and in FC denominated Debt**

ANNEX

PFI Highway # 431 – Case Study

(Concessionaire - Hayovel Lines Ltd)

Nis 1.8Bn, 22 km Suburban 6 lanes Highway in the south of Tel-Aviv Metropolitan Area based on a 25 years concession period including 3 years construction period. Project Income consist of a State Grant in the amount of Nis 448M payable in three installments during construction period and fixed semi annual indexed payment of Nis 64M plus a small shadow toll depending on traffic volume.

Project's sponsor ;Danya Cebus, subsidiary of Africa Israel

EPC Contractor ; Danya Cebus

Sole Financial Advisor ; Shrem,Fudim,Kelner Finance & Projects

Lead Arranger ; Bank Hapoalim

Legal Advisor to Concessionaire ; Herzog,Fox & Neeman

Legal Advisor to MLA ; Yehuda Raveh & Co

Debt Amount (in Nis)

- Construction Loan : 1,222 M
- Grant Bridge Loan : 449 M
- Equity Loan : 72 M
- Long-Term Loan : 1,275 M

ANNEX

PFI Highway # 431 –Case Study (Concessionaire - Hayovel Lines Ltd)

ISSUE/DRIVER	Strategy/Innovative Approach	Outcome / Remarks
Securing competitive LT Funding in LC	Introduce syndicate of Institutional Investors	4 Local Financiers committed to finance the LT debt during operating period
Concerns of Inst Investors derived from Construction Risks	Banking system extends construction loans while Inst. Investors lend at take out – i.e. construction completion	Optimizing risk allocation between financiers & their respective cost of funds
Facilitate Introduction of Inst Investors	Credit Ratings undertaken by local credit agencies for the whole Project and operating period	Two differentiated credit ratings
Securing refinancing of ST financing upon Financial Close at reduced risk margin	Full Refinancing on <u>Financial Close</u> of LT Loan due to improved credit rating	Improved Credit rating during Operating Period - AA+

ANNEX

PFI Highway # 431 –Case Study

(Concessionaire - Hayovel Lines Ltd)

ISSUE/DRIVER	Strategy/Innovative Approach	Outcome / Remarks
Introduce Foreign Banks to Israeli Infrastructure Lending	Borrow against Bridge Finance – Sovereign risk payment	HSBC lent more than Nis 400 M in short term financing in Nis
Applying Costs escalation Indices during construction till completion	Usage of a basket of three eligible indices	Adjusting SA fixed payment
Applying Reference LT interest Rate hedging mechanism to cover against local market volatility of base rates from bid submission throughout construction period	Usage of a mechanism offered by the State to adjust SA Fixed payment	Adjustment to SA payment based on effective weighted average interest rate. Comfort to senior lenders & sponsors

Preset Tables (Full Year 2006)

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Top Transport Financial Advisors (Closed Deal)

Rank	Company	US\$ (mil)	Deals
1	PwC	4,877.28	4
2	KPMG	2,806.74	4
3	ABN Amro	2,269.97	2
4	Ernst & Young	1,714.00	4
5	Babcock & Brown	1,494.57	1
6	Deutsche Bank	1,304.00	1
7	Toronto Dominion Bank	900.00	1
8	Shrem Fudim Kelner	892.00	2
9	Societe Generale	865.00	2
10	BNP Paribas	695.00	2
11	Depfa Bank	605.00	1
12	National Bank of Greece	597.00	1
13	ING Bank	498.00	1
14	TASC Strategic Consulting	496.00	1
15	Espirito Santo Investment	475.00	1
16	Calyon	397.00	1
17	BDO Stoy Hayward	396.00	1
17	TASC	396.00	1
18	Macquarie	390.00	1

Top PPP Financial Advisors (Closed Deal)

Rank	Company	US\$ (mil)	Deals
1	PwC	10,756.92	13
2	KPMG	5,464.33	17
3	Ernst & Young	3,776.93	16
4	Citigroup	2,982.64	1
5	ABN Amro	2,652.97	5
6	Investec	2,480.98	2
7	Grant Thornton	2,265.80	11
8	Babcock & Brown	1,494.57	1
9	Societe Generale	1,482.00	4
10	Deutsche Bank	1,472.75	2
11	Macquarie	1,225.70	8
12	RBC Capital Markets	932.84	5
13	Toronto Dominion Bank	900.00	1
14	Shrem Fudim Kelner	892.00	2
15	HSBC	808.00	3
16	BNP Paribas	794.50	3
17	Dexia Group	733.25	3
18	Deloitte	700.94	7
19	ING Bank	638.00	2
20	CIBC World Markets	637.34	1