ROLAND BERGER STRATEGY CONSULTANTS

think:act CONTENT

Fresh thinking for decision makers

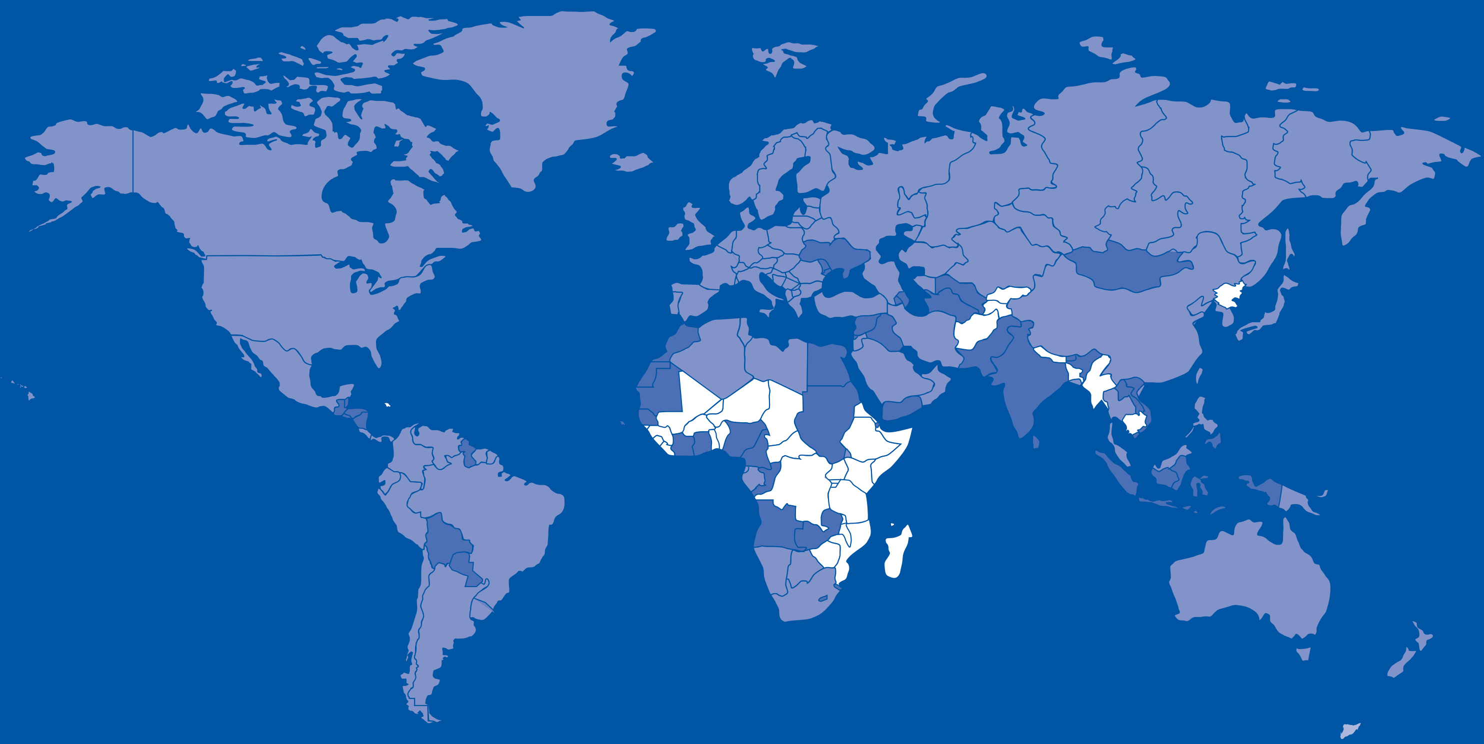
Profits through progress | How investors can help low income countries | Building infrastructure projects vital for growth | While reaping returns

SUMMARY OF OUR EXCLUSIVE REPORT ON FINANCING INFRASTRUCTURE AT THE REQUEST OF THE G20 LEADERS

JUNE 2012

RETHINKING RISK:

The perception of low and middle-income countries lags reality. It's time for investors and others to catch up so that they can help fuel growth, while taking advantage of new prospects



GROSS NATIONAL INCOME (GNI)
PER CAPITA IN USD

LICs
< 1,005

Lower MICs
1,005 - 3,975

Upper MICs
3,975 - 12,275

HICs
> 12,275

- 35 COUNTRIES WITH MORE THAN 800 MILLION PEOPLE ARE CONSIDERED LOW INCOME COUNTRIES (LICs)
- 110 COUNTRIES WITH AROUND 5 BILLION PEOPLE ARE CONSIDERED LOWER OR UPPER MIDDLE INCOME COUNTRIES (MICs)
- 70 COUNTRIES WITH 1.1 BILLION PEOPLE ARE CONSIDERED HIGH INCOMING COUNTRIES (HICs)

Source: Worldbank

Through a combination of internal dynamics and external trends, today's low and middle-income countries are growing on their own terms and not by mimicking the trajectories of mature markets. Still many investors have yet to notice. They apply outdated judgments about how to assess risk, ignoring the realities of fast changing economies across Africa, Asia and Latin America and missing out on promising opportunities for themselves.

That's because while low and middle-income countries have experienced high growth rates, they have done so despite the dearth of basic elements such as electricity and transportation. In the future these countries won't be able to continue supporting growth without tackling these dire infrastructural problems. And that's why it matters what the private sector thinks.

First investors must understand how to do business in places where traditional metrics and methods don't necessarily apply. In the past, infrastructure projects in low income countries such as building new dams and power plants or designing new airports has been the domain of public sector aid. But in light of the scale of the challenge and budget problems of developing countries, the solution needs to come with private sector help in the form of project financing.

Using such vehicles to construct major infrastructure projects brings together public and private sector players to support future growth. If successful, project financing has the potential to enable investment banks and other private players to help lift the fortunes of millions of people in emerging markets, while returning rewards to investors in a challenging financial climate.

SO FAR EMERGING MARKET COUNTRIES HAVE BEEN MISUNDERSTOOD AND UNDERESTIMATED

Before making forays into low and middle-income countries, investors will need to cast aside previous judgments. These countries have been seen as risky because traditional risk metrics haven't been available. Without personal connections and an understanding of the business culture, many of these countries seem remote and unstable. But that situation is slowly changing.

Increasingly reform minded countries are requesting ratings from international ratings agencies so that they can win the confidence of investors and issue public debt for projects. The number of rated LICs and lower MICs has more than tripled in the 12 years and these grades have been on par with other developed economies. Today 34 LICs and lower MICs have a BB grade, which is on the cusp of investment grade, compared with only 9 in 2000. The international sovereign bonds of Peru, Colombia, Philippines and Indonesia have been trading similar levels to Brazil since mid-2009. This rise in ratings shows investors that these countries are less risky than previously thought. Despite this progress financial markets are still overestimating the risk levels in LICs and MICs. In Africa, for example, the cost of capital is priced at a level that assumes that the rate of non-performing loans is 15%, when in reality the rate of loans not likely to be repaid is 8%. We estimate that in 2011 the disparity costs the continent USD 9 billion or 0.6% of GDP.

COST OF MISPERCEPTION

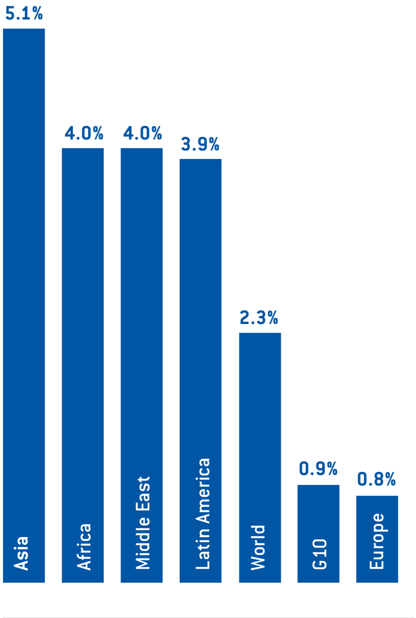
In 2011, the total cost of this misperception in Africa represented 0.6% of its GDP (USD 9 bn)

9 000 000 000 USD

Source: Roland Berger

LIC'S GROWTH HAS OUTPERFORMED DEVELOPED COUNTRIES BY FAR

GDP, real change p.a., 2005 - 2012



Source: EIU

Misperception is costly for investors as well. Investors who applied worn out risk assessments underestimated the potential of telecommunications technology to revolutionize sub-Saharan Africa. While the dot-com bubble was bursting in the developed world, it took off in Africa and investors who took time to understand the market reaped huge rewards. They knew that without fixed phone lines, people in lower income countries would jump at the chance for a mobile phone. Using models that fit local needs such as prepaid subscriptions boosted mobile phone penetration in Tanzania from 5% in 2001 to 51% in 2011 and in Benin from 2% to 87% over that same time frame.

DESPITE SKEPTICISM LICS AND MICs ARE TAKING OFF AND SOARING

While perceptions are only slowly improving, however, growth in LICs and MICs has taken off even as mature markets stagnant amid the financial crisis. Even with continued challenges with poverty and lack of education, growth rates in LICs and MICs will remain steady. The International Monetary Fund predicts growth in Africa countries will be about 4% over the next 5 years compared with 1.5% for Europe. Driving this growth is a dynamic particular to low and middle-income countries not being played out in developed countries. In contrast to what is happening in North America and Europe domestic and external demand in Asia, Africa and Latin America is being fuelled by demographic changes, rising investment and exports and growing productivity.

Demographic changes are fuelling domestic demand

Internally population growth, previously seen as a drag on emerging economy growth, has actually been laying the foundations of development by building strong domestic markets, creating new customers and workers. Africa's population, already the youngest in the world has doubled between 1980 and 2010. Thanks to the developing transition, LICs and MICs will very soon benefit from the 'demographic dividend', i.e. the decrease of the dependency rate which is defined as the ratio between active and inactive population. Indeed, whereas in 1980-1990, the dependency rate in Africa was the highest in the world – less than a working person for a dependant person (elderly or child) – it is now beginning to decrease with declining fecundity rates, and will continue to do so for the next forty years. By 2050, the dependency rate in Africa will be identical to that which allowed the Asian 'economic miracle' in the 1980s.

Not to say challenges don't remain. Youth unemployment needs to be reigned in to maintain stable civil society and literacy and education rates need to be vastly improved. But progress has proven that growth and development are not only possible – they are happening.

Developing countries are also seeing more money from abroad

External factors are also fuelling development in LICs and MICs. The growth of emerging markets and the resulting commodities boom have improved trade terms for these countries and supported demand as growth from developed economies slows. Money is also pouring into emerging countries in the form of both foreign direct investment and remittances. From 2001 to 2010 FDI to LICs has grown 15% a year reaching USD 24 billion in 2010. Remittances from friends and relatives doing well abroad, meanwhile, represent almost 10% of GDP in many developing countries.

Harnessing both internal and external demand is the key to investment
Internal growth is giving people in low and middle-income countries additional money to set aside. In fact gross domestic savings rates in developing countries are higher than in OECD countries: 27% in East Asia and the Pacific, 23% in South America and 16% in sub-Saharan Africa compared with 16% in the OECD countries. In addition FDI and remittances bring additional cash flows to the financial sector of emerging economies.

When harnessed into deposit accounts, these savings and external cash flows provide a deep well for investment and capital-intensive projects. And while the penetration of financial services institutions still remains shallow at about 15% in low-income countries, growth is ahead. The balance sheets of African banks have been growing at 42% a year and in Morocco banking penetration doubled to 50% over the last decade. As banks grow and become better able to harness internal and external funds for growth, they will fuel development, providing firepower for capital intense sectors and enabling private sector investment.

INFRASTRUCTURE INVESTMENT WILL ENABLE DEVELOPING COUNTRIES TO CONTINUE BOOSTING GROWTH

Lack of Infrastructure is the main bottleneck
Low and middle-income countries are now at a critical point in their growth trajectories with infrastructure the main bottleneck that will choke off sustained growth unless it is addressed. Businesses in emerging economies consider the lack of necessary infrastructure their main business constraint and estimate that it lowers productivity by up to 45%. More than 20% of the firms operating in LICs and lower MICs identify transportation as the biggest problem. For instance, it takes two days to transport a container from the Kenyan port of Mombasa to Nairobi, which is almost the time needed to transport this same container from Singapore to Mombasa. Transporting a container overseas from Tokyo to Mombasa costs USD 750, whereas it costs USD 2,100, almost three times as much, to transport it within the continent from Mombasa to Kigali.

Just as importantly, people, not only businesses, are struggling with lack of efficient infrastructure. With rising incomes and more city dwellers, populations in emerging economies will need better solutions to solve the dearth of efficient energy, functioning transportation and clean water. Countries in sub-Saharan Africa are most affected, with the least developed infrastructure assets worldwide. For example only 60% of the African population has access to clean water sources compared to 88% in Eastern and South Asia and 95% in the Central Asia region. Electricity only reaches 30% of the sub-Saharan African population compared to 62% in South Asia and 93% in Latin America and Caribbean.

Lack of infrastructure has dire consequences for emerging market economies.
Deterioration of quantity and quality of energy infrastructure between 1990 and 2006, for example, removed 11 basis points to per capita growth in sub-Saharan Africa. Africa's infrastructure funding gap has been estimated at USD 31 billion per year, with systemic inefficiencies draining an additional USD 17 billion per year, showing that there is a major need for new investment to keep GDP growth from lagging.

LACK OF INFRASTRUCTURE
lowers productivity in LICs and MICs by up to

45%

INFRASTRUCTURE INVESTMENT

needed in the future by sector in Africa, Asia and Latin America (USDbn per year)

317
Electricity

199
Water and Sanitation

163
Transport

81
Informaton and Communication Technology

38
Irrigation

851
Total

Source: World Bank Group, Strategy update 2012-2015, Roland Berger Analysis

Project Finance is the key to growth

Much of this underinvestment in infrastructure projects is due to the fact that these projects have previously been the domain of strapped public entities. LICs need to spend about 7.5% of GDP on infrastructure investment and maintenance, but spend only less than 2.5%. Meanwhile private players have so far been reluctant to step in. That's because infrastructure projects tend to be risky with high barriers to entry, requiring large amounts of upfront capital. Even though infrastructure projects end up having predictable incomes and are resilient in the face of economic downturns, they can also involve cost overruns, delays and changing market conditions because they are built over a long time horizon. In addition because they provide functions essential to the economy and society, they are highly regulated.

As a result even though essential infrastructure assets such as power, water and basic transportation are essential to the functioning of an economy and society, private players have been reluctant to invest in them. Instead they have stuck to infrastructure development projects that provide less risky profits such as telecommunications. In sub-Saharan Africa, for example, the private sector is financing 80% of the investment made in wireless telecommunication infrastructure compared with 10% in electricity and transport.

There is a solution, however. Involving the private sector through project finance is the key to building critical infrastructure projects. By pooling various lenders through an independent special purpose project company, project financing enables investors to participate in infrastructure projects that they would not be able to underwrite on their own. It brings together public agencies with investors, lenders, contractors, operators and customers to undertake these large scale, yet essential infrastructure projects. Financing is based on the project as opposed to the borrower. Lenders are paid by project cash flows and project assets provide them collateral in the case of failure. This ensures that lenders are protected because they can recoup costly assets if project risks bear out. In addition public entities will not have to worry about losing their assets if things do not go according to plan.

A variety of tools can help investors manage risks

No project, however, regardless of its location is risk free. In major long term infrastructure projects risks continue to exist as it develops. Risks start as soon as a project is conceived, with uncertainty over whether the project will materialize. Once construction is underway risks are at their high point. Protracted projects are subject to costly delays or unreliable contractors. And once completed uncertainty takes over again: the project has been paid for, but the question over its returns remains lingers until operations start.

Still with variety of tools essential infrastructure projects can be made far safer for private investors. In addition to managing risks through traditional tools such as insurance and guarantees, involving private local partners including local lenders provides a hedge against political and currency risks. Detailed market analysis and feasibility studies keep unwanted surprises at bay. Multilateral organizations such as the World Bank typically act as co lenders or provide loan guarantees. Investing in already established Brownfield assets also provides more predictability and less risk than investing in new Greenfield projects.

Finance, despite being vilified in the recent financial crisis, also has a large role to play in amassing and channeling funds to where they are needed. Financing projects using bonds with differing maturities provides investors flexibility, while asset backed securities and high yield bonds bring in more investors leveraging bank capital.

The public sector still has role to play in fostering infrastructure development
The public sector still remains the key to ensuring that investment makes it to critical infrastructure projects safely and smoothly. As this issue is unlikely to reverse course soon, forward thinking countries and government entities have sought to encourage convergence of public and private sector activity. Formal contracting structures through active Public-Private Partnership ('PPPs') supported by recent government initiatives and Multinational development banks (MDB) have made progress in encouraging private capital investment in infrastructure.

Multinational development banks, meanwhile, have been used to directly providing loans, but they even they are now pulling back decreasing overall funding from USD 70 billion in 2010 to USD 55 billion by 2015. But MDB, even with this pull back in funding, are better suited to supporting private capital with expertise and guarantees. This shift requires them to evolve from simply being a creditor. As an enabler MDBs can better leverage funding and promote more private sector involvement. In addition non-governmental organizations can do their part, by helping to provide more information about developing countries will ease concerns of investors and help them better understand local markets. We also believe that public entities can support road shows to allow investors to directly meet local partners and understand their needs.

CONCLUSION

Today between 70% to 80% of all infrastructure projects worldwide are run by the state. Yet in many low and middle-income countries, infrastructure development is sorely lacking. Roads, power plants and clean water supplies, among other necessities, are being degraded slowing the ability of these emerging countries to achieve future growth. Without these vital projects low and middle-income countries, which are already making tremendous gains despite this lack, will fall behind. Forward thinking governments, however, are seeing that there is a better way.

They are encouraging private investment by structuring public private partnerships that use project finance to create benefits all around. Not only do these partnerships based around project finance help emerging economies achieve growth goals, they also have the opportunity to draw in new types of investors such as insurance companies, pension funds and endowments providing returns to them. The key, however, to realizing these benefits and involving the private sector is to rethink the riskiness of investing in low and middle-income countries. Through these combined efforts private investors can take advantage of promising new opportunities, while supporting infrastructure development through project finance, helping more countries eliminate poverty and meet growth goals. In return for a little risk, they will see enormous rewards.

G20: THE PREMIER FORUM FOR INTERNATIONAL COOPERATION ...

... on the most important aspects of the international economic and financial agenda

18 and 19 June, Los Cabos

IF YOU HAVE ANY QUESTIONS, PLEASE FEEL FREE TO CONTACT US:

Charles-Edouard Bouée, Partner
charles-edouard.bouee@rolandberger.com

Hakim El Karoui, Partner
hakim.elkaroui@rolandberger.com

Nicolas Teisseyre, Partner
nicolas.teisseyre@rolandberger.com

think:act CONTENT
Editors:
Dr. Martin C. Wittig, Charles-Edouard Bouée
Overall responsibility: Dr. Torsten Oltmanns
Project management: Dr. Katherine Nölling
Design: Roland Berger Media Design

Roland Berger Strategy Consultants GmbH
Am Sandtorkai 41
20457 Hamburg
+49 40 37631-4421
news@rolandberger.com
www.think-act.com

Would you like to get your copy of think:act CONTENT faster?
Send your e-mail address to us at global.marketing@rolandberger.com and you will receive the next issue in advance!

Roland Berger
Strategy Consultants