Date: 23.03.2015
Source: Consultant-News.com (United Kingdom)

Infrastructure investments in the EU: A new framework is needed to mobilize private investors for important projects

Urgently needed private investments in infrastructure projects are virtually non-existent in the EU in spite of high levels of liquidity in financial markets.

Online Article

•The European Fund for Strategic Investments (EFSI) proposed by the European Commission now aims to mobilize at least EUR 240 billion in private infrastructure investments
•Structural obstacles like differing national regulations and the lack of investment project standardization remain, limiting the outlook for actual private investment
•Roland Berger and United Europe therefore recommend a holistic European investment model for infrastructure in order to turn the EFSI into a success story

Public sector investment in European infrastructure has been falling for years in the wake of the sovereign debt crisis, with the governments of the EU's 28 Member States investing some 11 percent less in 2013 than they did in 2010. That's not to say that there isn't an urgent need for investment in a range of infrastructure projects. In fact, infrastructure investment needs amount to approximately one trillion euros in key areas such as the expansion of broadband networks, energy grids or transport infrastructure in the period to 2018.

What Europe needs is more private investors who can put their capital into the financing of infrastructure projects to enable even heavily indebted EU countries to make investments in the near term. In spite of high levels of liquidity in the capital markets, private sector investments in EU infrastructure have been very limited so far. This is where the European Commission's initiative to set up the European Fund for Strategic Investments (EFSI) comes into play. The EFSI is the European Commission's new vehicle to provide EUR 21 billion in public funds to mitigate risks for investors in order to catalyze private financing. Its intention is to activate at least EUR 315 billion in private investments by 2017 – some EUR 240 billion of it for infrastructure projects and the remaining EUR 75 billion for investments in SMEs and mid-cap companies.

In their recent study, Squaring the circle: Improving European infrastructure financing, Roland Berger Strategy Consultants and United Europe examined the obstacles hindering the private financing of infrastructure in Europe and developed hands-on recommendations for a comprehensive European investment model. It aims to support the successful realization of the EFSI. "Not only do infrastructure investments make an enormous contribution to the economic growth of Europe, they also make the continent more competitive," commented Roland Berger Partner Heiko Ammermann. "If we're going to get capital mobilized for important infrastructure projects, public and private sector investors need to find a joint approach that is attractive to them both. The EFSI provides a good basis, but it's only a start and it needs to be embedded in a wider investment model."

Hurdles too high for private investors

Institutional investors, such as pension funds or insurance companies, have high levels of liquidity and are currently looking for investment alternatives that offer attractive returns in the current environment of low interest rates. Major infrastructure projects could be a good match, though most institutional investors have so far avoided any financial engagement in this area.

There are many reasons for private investors' reluctance to invest in infrastructure. One is that there is often a mismatch between the risk structure and the anticipated return. Moreover, the EU features a patchwork of complex national regulatory frameworks. Therefore, it is often difficult for potential investors to weigh up the opportunities and risks of an investment project from a business perspective. "In many countries, infrastructure projects are bureaucratic and highly complex, and the returns too unstable," criticized Stefan Schaible, Deputy CEO and CEO for Germany and Central Europe at Roland Berger Strategy Consultants. "If the regulatory environment changes, attractive investment options can quickly turn into a financial disaster. And that puts potential investors off."

In addition, the stricter equity and liquidity requirements of Basel III and Solvency II are increasingly restricting the investment decisions banks and insurers can take: infrastructure investments are often completely out of the question due to high capital requirements. Furthermore, there is a lack of effective control and governance solutions for infrastructure projects and standardized contract and investment models.

A new infrastructure investment model for Europe

There are many important infrastructure projects in Europe currently awaiting finance. The European Commission and EU Member States have already defined 2,000 projects that could be of interest to investors. "Europe finally needs an organized market for infrastructure investments," said Roland Berger Partner Heiko Ammermann. "Bureaucratic and political obstacles need to be swept out of the way and a professional investment process guaranteed." In a bid to help European infrastructure projects and private investors come together, the Roland Berger experts worked with United Europe to develop building blocks for a European investment model, incorporating six elements:

- Create a pipeline of investment-grade projects: The first thing to do is define sustainable revenue and cashflow models. It's important to incorporate and to combine various potential revenue sources for the infrastructure. These include aspects like usage charges, government-funded availability payments and funding from national and EU programs. In order to contain financing costs, risk-minimizing measures should also be put in place to mitigate non-payment risks. In addition to investments by the European Investment Bank (EIB) in risk-bearing subordinate debt tranches, official guarantees for projects with a high risk profile – furnished either from EU funds or by national governments – could help considerably here. Additionally, contract models should be standardized and cashflows separated from complex, national regulatory models.

•Stock the pipeline with existing infrastructure assets to kick-start the market: The lead time involved in getting new projects ready is very long. To facilitate investments in the short term, the possibility of transferring existing infrastructure assets into the EFSI should be examined. Operational projects with reduced risk and a clear return profile would thus present attractive investment possibilities for many investors with a conservative risk profile. This would take the financial burden off publicly owned operators; they could then use the equity that was freed up to move forward with new investment projects on their own balance sheets.

•Tailor risk/return profiles to different types of investors: It will be crucial for the success of the European investment model to establish a central financial intermediary to ensure transparency, reduce complexity and translate individual projects into marketable investment products. Individual projects will need to be bundled and structured in separate tranches corresponding to the specific risk/return profiles of different investor types. In light of the rising liquidity requirements imposed by Basel III and Solvency II, investors should also have the possibility to sell their investments in the event of a crisis. A reverse repurchase option, whereby investors can sell their infrastructure investments back to the EFSI at a predefined price, could be helpful here.

•Make private infrastructure investments economically viable: Private investors still expect high returns irrespective of the low interest rate environment, and that presents an obstacle to the private financing of many infrastructure projects. Risk-minimizing measures like government guarantees are possible ways of limiting the costs of financing. While this approach could help to involve private investors in earlier project stages, it is important to keep in mind that there are limitations to risk absorption. Eventually, private investors seeking attractive returns in a low interest rate environment will have to bear some of the risks associated with infrastructure investments.

•Establish a robust ownership and governance model: Private investors need planning security. This requires a comprehensive and transparent governance system that clearly defines the rights and obligations of national governments, investors and the European Investment Bank (EIB) and mediates in the event of any conflicts. What investors need most of all is more transparency and better information from the national project sponsors. The EIB's right to intervene as well as that of other investors also need to be clearly defined in case anything goes wrong in the project. The main aspect relevant from a national government perspective is the agreement on a potential right of repurchase on strategic infrastructure projects during or at the end of the contract term.

•Actively manage project risks: The planning and construction phase of infrastructure projects is especially fraught with risk. Complex large-scale projects are particularly in need of intensive project monitoring to mitigate these risks. More than cost control, what's required is comprehensive, ongoing scrutiny of the projects' technical, legal and financial aspects. The EIB could play a key role as a monitoring entity here given its expertise, thus helping to increase private investors' confidence in the soundness of projects financed under the EFSI.

"If Europe manages build an attractive environment for infrastructure investments and remove the obstacles currently in place, important infrastructure projects could become a real alternative to shares or bonds for private investors," said Roland Berger Partner Heiko Ammermann in summary. "Not only could investors seeking attractive investment options profit from that. Most importantly, the countries of Europe themselves could benefit significantly, as their future competitiveness heavily depends on modern infrastructure."