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What Kazakstan's first PPP could mean for infrastructure investors

Kazakstan, central Asia's largest economy and oil producer, is seeking to tap international finance for its first ever PPP.

The Investment and Development Ministry kicked off a tender for the concession of a toll road in Almaty, the country's business centre and former capital, at the beginning of 2015. The process sees five shortlisted consortia working to finalise their bids by mid-November. If successful, the Big Almaty Ring Motor Road, also known as Bakad, will provide the government with some room to develop an ambitious PPP project pipeline largely focused on infrastructure developments amid challenging economic circumstances.

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Public expenditure has been suddenly constrained by collapsing oil prices and growing fiscal deficits. At the same time, local banks, which have never fully recovered from the global financial crisis have yet to find their way out of the recent depreciation of the tenge in the currency market, which is leading to concerns over their asset quality and further constraining domestic credit. PPP schemes, perhaps even supported by infrastructure bonds, have thus emerged as one of the few options left available to develop key infrastructure projects and breath new life into a lacklustre domestic project finance market. International investors looking to diversify and grow their emerging market portfolios are at the door ready to step in should the Bakad project live up to their expectations.

The shortlisted consortia are the following:

- Alsim Alarko Sanayi Tesisleri Ve Ticaret (Turkey), Makyol Insaat Sanayi Turizm Ve Ticaret (Turkey), SK Engineering and Construction (South Korea), Korea Expressway Corporation (South Korea);
- IC Ictas Insaat Sanayi Ve Ticaret (Turkey), IC Ictas Altyapi Yatirimlari Ve Isletme (Turkey), Astaldi (Italy), Astaldi Concessioni (Italy), Intertoll Infrastructure Development (Netherlands);
- Vinci-BI Group, including Concessoc 21 and Concessoc 9 (Vinci, France) and BI3P Projects (BI Group, Kazakhstan);
- Corsan-Corviam Construction S.A (Spain), Gulsan Insaat Sanayi Turizm Nakliyat Ve Ticaret (Turkey), Egis Investment Partners (France);
- CITIC Construction (China) and KazStroyService (Kazakhstan).

"Kazakhstan is an investment-grade country, a new market for PPPs," Ekaterina Miroshnik, director for infrastructure at the European Bank for Reconstruction and Development (EBRD), which is supporting the ministry in the development of Bakad, tells InfraAsia. "It offers huge opportunities for investors, especially in the infrastructure sector where it needs to build new and rehabilitate existing infrastructure."

Techincal and financial details

The Bakad project entails the development of a tolled greenfield bypass to run along Almaty's northern half. The 66km road will have four to six lanes and serve up to two million people living in the city's metropolitan area. The project includes 12 intersections, 21 bridges and 19 viaducts alongside 23 entrances and 23 toll plazas. Costs are estimated at around USD 503m, with construction to last for 50 months.

Unique vehicles entering the motorway begin at 78,495 vehicles per day (vpd) in 2018 and rise to 112,650 vpd by 2038, according to government traffic forecasts. Average daily traffic is estimated at 27,308 vpd in 2018 and 44,344 vpd in 2038. Local commuters will account for most of the traffic flow, but the number of trucks is expected to grow over the years as the country develops a transport corridor linking western China to western Europe – trucks will make up 22% of total vehicles in 2038, from 12% twenty years earlier.

Kazakhstan's government teamed up with the International Finance Corporation (IFC) and the EBRD to make the project happen. The IFC is working as lead transaction advisor and brought on-board specialised international consultants such as Sweden's Sweco and Germany's Kocks Consult to figure out the project details. At the same time, the EBRD mobilised a EUR1mgrant to co-finance project preparation and lined up French/Russian law firm Gide Loyrette Nouel and Kazakh Colibri Law Firm to provide the government with legal advisory services.
Bakad's technical details have long been in place, but the Kazakh government had to go the extra mile to come up with a financial structure able to appeal to international investors.

"The legislation was there, but not good enough for international concessions," EBRD's Miroshnik recalls. "We provided advice to upgrade the law, and the government pushed through a series of amendments [in July 2014] introducing improvements such as step-in rights, direct agreement, international arbitration and adjustment of payments to foreign exchange (forex) fluctuations. All things that international investors generally expect in a concession agreement."

Incorporating many of these improvements, the Bakad 20-year, build-transfer-operate (BTO) PPP offers an enticing risk/reward combination. The government is assuming all the traffic risk. Toll revenues will be collected by the concessionaire and transferred to the government straight away. In turn, the government will pay a front-loaded availability payment to cover the capex, plus interest within the first 10 years of operation to mimic the debt repayment schedule. At the same time, opex, replacement capital expenditure (Repex), taxes, cost of capital and other costs will be covered throughout the whole operation period.

The government will also mitigate currency fluctuation risks and compensate for any devaluation-depreciation of tenge against the US dollar above 5%, a key provision in a country that has experienced a number of sudden monetary policy shake-ups over the last few years. The National Bank first devalued the tenge by 25% against the US dollar in the aftermath of the financial crisis in 2009, then pushed through another 19% devaluation in 2014. Amid growing speculation over the sustainability of the tenge peg to a basket of hard currencies – US dollar (70%), Euro (20%) and Ruble (10%) –, it eventually ditched the peg altogether and let the tenge free to float in August, prompting another 29% depreciation of the currency against the US dollar.

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Other key provisions include step-in rights for lenders, with the government required to sign a direct agreement with funders of the projects; international arbitration outside Kazakhstan is allowed even if the Special Purpose Vehicle (SPV) set up for the project is registered in Kazakhstan; provision of termination payments "in line with best practices", according to a project presentation footed by the IFC.
"Kazakh authorities made huge improvements in terms of legal and financial bankability, which was a prerequisite for the development of a national project finance market," Brice Laine, director at Egis Projects, which is in one of the five shortlisted consortia, tells InfraAsia.

In fact nine international consortia had originally expressed interest in the project. Their final bids of the five remaining consortia are due by mid-November, after they asked the government to push back an earlier date in September to adjust the contract to fast moving market circumstances, including the recent monetary policy changes.

Risks
Potential investors still face a number of uncertainties, which have been heightened by the tenge weakening in the currency market.

“Inflation is really a concern for this project,” Egis’s Laine notes. “The client is not keeping inflation risk on his side and inflation will increase with the recent monetary policy changes. All this economic and financial turmoil will make it more difficult to assess forex and inflation risk.”

Kazakhstan’s inflation appears under control with the domestic Consumer Price Index (CPI) growing by 3.8% y/y in August. Yet the sudden tenge depreciation will inevitably shore up short-term inflation pressure in a country that imports much of its goods, credit rating agency Fitch highlighted in a note in August.

“Besides, the tenge depreciation might make it more difficult for the grantor to get offers in line to its original budget because it prompted a mathematical shift in terms of the overall value of the project in local currency. We will need an additional effort from the government with regard to the original budget,” Laine adds.

The project original cost estimate stood at USD 680m, and was updated to USD 503.2m after monetary authorities abandoned the tenge peg.

Lastly, the country’s overall political and rating risk is on the rise. Kazakhstan stood out for years as one of the largest foreign investment recipients in the former Soviet Union — by far the largest in Central Asia, mostly thanks to its oil-powered economic growth and the relatively business-friendly economic policies introduced by long-serving strongman Nursultan Nazarbayev. Nazarbayev’s liberal economic approach gained the country an an investment-grade credit rating in 2002, making Kazakhstan the first country in the former Soviet Union to achieve it.

Yet this milestone may be under threat. “Further decline in commodity prices and the Russian ruble will add to the economic and financial pressures facing the country. Prolonged low oil prices could be negative for the sovereign rating,” Fitch stressed in its August note. In the medium-term the greatest uncertainty remains the succession of President Nazarbayev. Nazarbayev personally orchestrated some of the country’s largest deals involving foreign investors and his combination of multi-lateral foreign policy, business-friendly approach and internal stability gained the country its reputation. He turned 75 in July and is likely to be approaching the end of his tenure, but no clear succession plan has been unveiled. Concerns over Nazarbayev’s succession is high among local and foreign investors.

Central Asia: Recent Projects

	Sector	Location	Status	Date	Transaction Size	Sponsor
Burnoye 50MW Solar Plant	Solar PV	Kazakhstan	Financial Close	Jun. 2015	USD 135m	Samruk Green Energy, United Green
Erdent to Ovoot Rail Link	Rail	Mongolia	Preferred Proponent	May 2015	USD 1.2bn	Aspire Mining, China Railway Construction Corp.
Almaty Ring Road	Roads	Kazakhstan	Pre-Qualified Proponents	Apr. 2015	USD 680m	n/a
Yereymentau 50MW Wind Farm	Onshore Wind	Kazakhstan	Financial Close	Nov. 2014	USD 112m	Samruk Green Energy
Sainshand 52MW Wind Farm	Onshore Wind	Mongolia	Preferred Proponent	Feb 2014	USD 120m	Ferrostaal, ENEL

Source: www.Infra-Deals.com

Market maker
The consortia building these risks into their financial models before final bids are due in mid-November.

“I expect a contract to be awarded early next year, even by the end of this year because they really want to advance it, realistically in January or February next year,” EBRD’s Miroshnik says.

If successful, the project could pave the way for more PPPs.

“Kazakhstan is an appealing market because of its rating and its growing economy [annual economic growth was 4.3% in 2014, but slowed down to 2% in the first half of 2015],” Egis’s Laine says. “To properly accompany the growing needs of the population and make development happen, they need different skills and infrastructure.”

The Kazakh government has long emphasised its commitment to make the country a bridge between western China and western Europe and become a key piece of the Chinese vision of a New Silk Road. Authorities are thus developing an international road transit corridor with the support of international institutions such as the EBRD and the World Bank. The 8,445km transit corridor will represent the quickest on-land and be among the most cost-effective options to Europe for Chinese producers. It will take a container 27 days for a round trip between Shanghai and Germany, and cost USD 15,000, according to figures from Dubai-based logistics company DP World.

The Kazakh stretch of the transit corridor extends for 2,787km and has to be built almost completely from scratch, with a few parts meant to be developed under concession agreements, including Bakad. Besides, the government has already taken onboard DP World to develop a dry port in Khorgos at the Chinese-Kazakh border, and another port in Aktau, on the Caspian Sea, where containers coming from China on an existing railway corridor will be sent to Azerbaijan, on to Turkey and eventually eastern Europe. Airport infrastructure will also be upgraded to shore up the country’s transit potential. Kazakh authorities are also considering the development of PPPs for civil infrastructure such as hospitals, prisons and schools.

“Transport infrastructure will certainly remain a major focus of the government PPP project pipeline, alongside healthcare, and we are also discussing PPPs for correctional facilities,” Galymbek Mamrayev, deputy CEO at the Kazakhstan PPP Centre, a public body tasked with developing PPPs across the country, tells . Mamrayev adds that the government is ready to streamline a number of PPP projects in 2016, including a USD 385.5m light rail transport (LRT) and a USD 289m railway bypass in Almaty, and two 300-bed hospitals in Aktau and Ust-Kamenagorsk, East Kazakhstan.

However, Kazakh authorities have tried for years to develop this ambitious project pipeline, with little success.

“Many projects have been announced, but there are several problems,” Yelzhan Birtanov, CEO of the PPP Advisory Centre, another quasi-public body involved in the development of PPPs, tells InfraAsia.

“There is no established criterion for identifying good projects. Sometimes projects are offered as PPPs just because authorities weren’t able to develop them under public funding schemes, and they do so with little understanding of a project’s real bankability and economic value. We have to establish clear criteria first to develop a good PPP pipeline.”

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Another problem is the “lack of understanding of the complexity of project preparation and promotion”, Birtanov says. “Especially at a local government level, authorities have little budget and they try to do it fast and cheap, which makes projects unattractive.”

The little appetite of Kazakh lenders for PPPs represents another constraint for the development of a local PPP market.

“Everything is new for Kazakh banks, first they have to see some projects closed to become interested,” EBRD’s Miroshnik says. “Besides, local banks mostly have short-term funding available but lack long-term funds, which is why international financial *market-maker deal...*

institutions are mostly involved in local PPP projects rather than local banks."

In order to address the issue, authorities are mulling over ways to provide long-term financing for PPPs by asking the state-owned Development Bank of Kazakhstan (DBK) or the national pension fund managed by the National Bank to underwrite infrastructure bonds to be issued by companies involved in infrastructure developments, PPP Advisory Centre's Birtanov says.

Infrastructure bonds may oil the Kazakh PPP wheel one day.

"The success of one big project like Bakad really is the missing piece at the moment," Laine notes. "If they make it happen, it will mean the client has been able to understand the force of reality of modern project finance developments. If successful, Bakad will indeed become a market-maker deal."

Bakad may be such a deal not just for Kazakhstan, but perhaps for the whole region. Mineral-rich Mongolia's government is also betting on PPPs to develop much-needed infrastructure and has just signed a USD 1.3bn Build-Own-Operate-Transfer (BOOT) contract with a consortium led by utility group Engie (formed GDF Suez) for the development of a 450MW thermal power plant in capital city Ulaanbaatar; and another USD 1.3bn build-operate-transfer (BOT) contract with Northern Railways, a subsidiary of Australian mining firm Aspire Mining, for the construction of a railway line to cater to the needs of coal mines in the northwestern Khuvsgul province. Other countries in the region have expressed their interest in PPPs, including oil-rich Azerbaijan, and Kyrgyzstan. Nonetheless, with the general appetite for investment in emerging markets gradually weakening, more than ever the quality of rules and projects will draw a sharp line between successful PPP developments and wishful thinking.

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