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Mexico looks to private sector for infrastructure solutions

Finance Minister Luis Videgaray's decision to cut annual infrastructure spending by $1.15bn in his January 2015 budget was unfortunate considering how much needs to be spent on the country's inadequate roads, railways, ports and power facilities. Philip Moore reports on whether the private sector can help fill the infrastructure finance gap.

By EuroWeek Editor 1   20 Jul 2015

The Volkswagen plant in Puebla, 120km southeast of Mexico City, is the biggest of its kind in the Americas. Spread over three million square metres, in 2013 the facility employed almost 16,000 people and churned out 516,000 vehicles and 786,000 engines.

The factory is, however, not big enough to satisfy North America's voracious demand for Volkswagen cars. Having already invested $8bn in its Mexican operation between 1964 and 2014, in March 2015 Volkswagen announced that it was investing another $1bn in its Puebla factory.

Volkswagen is by no means the only auto giant that is investing heavily in Mexico. Between 2010 and 2014, according to numbers published by Congressional Research Services, exports of motor vehicles from Mexico to the US rose from $27.5bn to $46.4bn. Over the same period, exports of motor vehicle parts increased from $23.6bn to just over $40bn.

America, it seems, can't get enough cars and car parts from Mexico, and the world's largest auto manufacturers have been responding accordingly. According to the Center for Automotive Research, a US-based think tank, since 2009 eight new assembly plants have been announced in Mexico, compared with none in the US or Canada.

The snag, say economists, is that Mexico's crumbling infrastructure may soon be unable to cope with the demands of the country's exporters. In 2013, the government forecast that cargo travelling through Mexico's ports would increase by 80% during its administration, from 282m to 508m tonnes. At that rate, it is only a matter of time before bottlenecks build up at Mexico's major ports, slowing export growth.

It's not just Mexico's ports that are in urgent need of rehabilitation. Road density is just 0.11km per square kilometre, compared with 0.4km in China and 0.67km in the US, while fewer than 40% of Mexico's roads are paved.

Road blocks

The country's inadequate roads and railways, together with its congested airports and run-down power facilities, are a major contributor to Mexico's unflattering and deteriorating position in the World Economic Forum's global competitiveness rankings. Having ranked 53rd in 2012-13, and 55th in 2013-14, Mexico slipped to 61st in 2014-15, which is below Panama and Costa Rica. While Mexico was positioned 53rd in the macroeconomic ranking, it was a lowly 65th in the league table for infrastructure.

It is not just that Mexico's transportation infrastructure is in a serious state of disrepair. Mirroring the broader structure of the economy, its quality differs markedly from region to region, which has important implications for investment, productivity, wealth distribution and social stability across Mexico.

"Five to 10 years ago, it was mainly the border states which saw inflows of investment, which is unsurprising, given how much they benefited from Nafta," says Alejandro Díaz de León, head of public credit at Mexico's finance ministry. "We're now starting to see more FDI coming into some of the central states, but there is still a big gap between the north and the south in terms of productivity, which we need to address through infrastructure improvements."

He adds: "Although we're still focusing on improving the efficiency of highways, ports and crossing points with the US, we also face a significant challenge in terms of better integrating the regions and the country as a whole, which is where infrastructure investment needs to play a key role."

As an example of an area where infrastructure investment could enhance economic integration and attract new inflows of FDI, Díaz de León points to the Istmo region, which is the largest in the south-western state of Oaxaca. He says this can be described as Mexico's third border, as it covers the southern part of the isthmus of Tehuantepec, which is the narrowest point in the country between the Atlantic and Pacific oceans.

"Of course the most efficient way to transport goods from the Atlantic to the Pacific is via the Panama Canal," says Díaz de León. "But we believe that the Oaxaca/Veracruz region could be a viable alternative. We also think it's worth encouraging some investment into maquila operations (manufacturing operations in the free trade zones) in this region targeting the US East coast, because if you're planning to ship goods to New York or Boston, it is cheaper and quicker to do so from Veracruz than from the border region. For this to happen, we will need to reconstruct the railway that President Diaz built 100 years ago linking the Atlantic and Pacific coasts."

NIP nipped

The response of President Enrique Peña Nieto's government to the humbling and uneven state of Mexico's infrastructure has been the announcement of an unprecedented, all-guns-blazing National Investment Programme. This calls for total investment between 2014 and 2018 of $596bn, or more than 8% of GDP, in almost 750 projects. Energy accounts for just over 50% of the total, followed by urban development and housing (24%), and communications and transport (17%).

This may need to be just the beginning of a multi-year infrastructure investment programme if Mexico is to deliver on its ambitious longer term growth objectives. Assuming a GDP target of 3.5% per year, McKinsey estimates that it would take $923bn to build the infrastructure necessary to support economic growth between now and 2025.

Already, some of the wind has been taken out of the investment programme's sails by the fall in the oil price. At the end of January, Finance Minister Luis Videgaray announced Ps18.1bn ($1.15bn) of infrastructure spending cuts as part of a broader fiscal retrenchment in the federal government's 2015 budget. Probably the highest profile casualty of those cuts was the Ps44bn ($2.8bn) project to build a high speed 210km train line between Mexico City and Queretaro, which had also been beset with controversy and allegations of corruption. Another passenger rail project, the proposed Yucatan line linking Merida and Cancun, has been suspended.

Bankers say that projects such as these are unlikely to be the last to be cancelled or scaled back. "I'm not sure that all the projects in the National Investment Programme will make it to market," says Ricardo Cano, former head of DCM at BBVA Bancomer who is now principal at the Miami-based Gateway Capital Advisors. "I would expect a higher rate of success in the energy sector than in some of the others where the economic rationale of some of the projects may be less compelling or financing may be tougher to obtain."

Others agree. "We are in a period of transition at the moment as the government re-evaluates where to spend its money and where to prioritise the promotion of private sector investment," says Eugenio Mendoza, president and CEO of the Mexico City-based Latam Capital Advisors (LCA). Mendoza describes LCA as a UK-style merchant bank which is focused chiefly on providing debt, equity and M&A advisory services in the infrastructure arena, covering all areas ranging from oil and gas to toll roads and airports.

Mexico City's new airport: X marks the spot for financing blueprint

As anybody who has had the misfortune to travel through Benito Juaréz airport recently will testify, the sooner Mexico City opens a new international airport, the better. According to Mexico's Secretaría de Comunicaciones y Transportes (SCT), annual passenger and cargo growth between 2009 and 2013 was 5.4% and 5.2% respectively, comfortably ahead of GDP growth over the same period of 3.5%.

It's not just that the congestion at Benito Juaréz airport is a source of such discomfort for its beleaguered users. The sub-standard facility means that Mexico is increasingly missing out on the economic potential created by the region's plentiful transit passengers. According to SCT's data, Panama's airport now handles twice as many transit passengers as Mexico City.

The result of the airport's increasingly visible inadequacies, the SCT recognises, is that it "limits Mexico's growth potential as one of the 15 largest economies in the world".

Little wonder that a new airport is the showcase project in Mexico's ambitious infrastructure investment programme.

X-shaped

The first development phase will see the construction of three runways and a X-shaped terminal, increasing the airport's annual capacity to 50m passengers. In a subsequent phase, three more runways will be added, bringing total annual capacity to 120m passengers.

According to SCT, the new airport will call for a total investment of Ps169bn (almost $11bn), of which Ps98bn will come from the national government with the remaining Ps71bn provided by private sector investors. The lion's share of this total, Ps127bn (just over $8bn), is earmarked for the airport's core infrastructure. Of the balance, Ps20.5bn is for design, engineering and project management, with Ps16.4bn earmarked for hydraulic works and Ps4.7bn for social works.

While some market participants question whether the project will go ahead as originally planned, most are ready to accept Finance Minister Luis Videgaray's public pledge that the airport will not be affected by spending cuts of 0.7% of GDP announced in this year's budget.

"I don't believe the project will be scaled back," says Adrian Javier Garza, analyst at Moody's in Mexico City. "The government has confirmed the project will be built. The financial structure might change though, to increase private participation."

The first phase of the financing was a $1bn loan arranged by BBVA Bancomer, HSBC, Citigroup and Banco Inbursa backed by the airport usage tariff generated by the existing airport. The longer term funding plan calls for this to be refinanced through a series of long dated bond issues.

This financing blueprint is one that could be replicated across large swathes of Mexico's infrastructure programme, says Alejandro Díaz de León, head of public credit at Mexico's finance ministry. "There is a lot of potential in using mature projects and securitising some of their income flows to generate funding for greenfield developments," he says. "This is precisely the model that is being used for the new airport, where landing fees and other resources are being leveraged to support the greenfield project. We're now in the evaluation phase to see how other mature projects directly or indirectly in the public domain can be used to finance new infrastructure."

Private sector opportunities

Even though the overall National Investment Programme may need to be scaled back, its sheer size dictates that there will still be abundant opportunities for investors, as well as for developers and suppliers of all sizes — and for their financiers. "Whenever major projects are auctioned you usually see a handful of the largest companies involved," says Cano at Gateway in Miami. "But behind those large construction companies are dozens if not hundreds of mid-sized suppliers, which don't have such easy access to capital." Identifying funding options for these companies, he adds, will provide challenges and opportunities for boutique firms like Gateway.

Mendoza says that despite the pressures on the federal government's budget, there is no shortage of international and domestic liquidity attracted by opportunities in the Mexican infrastructure sector. That is just as well, because bankers think that the government may need to reappraise its original plan of providing 63% of the funding for the infrastructure programme, with the private sector stumping up the remaining 37%, or some $220bn.

Already, there are a number of indications that the private sector is prepared to step up to the plate in the Mexican infrastructure market. Among domestic investors, fast-growing private pension funds (Afores) see infrastructure as a promising way of enhancing returns, increasingly as co-investors with international infrastructure specialists in Certificados de Capital de Desarollo (CKDs). Regulated by Comisión Nacional Bancaria y de Valores, the financial regulator, and traded on the Mexican Stock Exchange, CKDs are trust certificates designed to allow pension funds to invest in assets perceived to be illiquid such as real estate, private equity and infrastructure.

Opportunities for them to do so will increase as more international infrastructure specialists establish and expand their footprint in the Mexican infrastructure market.

One recent entrant is Canada's Caisse de Dépôt et Placement de Quebec (CDPQ), which has formed a joint venture with Mexico's largest infrastructure company, Empresas ICA, which will initially operate four toll highways. Díaz de León says that the CDPQ also plans to co-invest with a local partner in a new infrastructure-focused CDK.

One of the most successful of the existing CDKs is the Macquarie Mexican Infrastructure Fund (MMIF), which was launched at the end of 2009, raising Ps3.4bn from seven local pension funds. This gave the Afores an initial 66% interest in MMIF, whose other investors are Macquarie and the national infrastructure fund, Fonadin.

Macquarie Infrastructure and Real Assets (Mira) Mexico is the largest institutional manager of real assets in the country, with some $2bn of equity assets under management and a team of about 40 local professional staff, according to Jon Walbridge, managing director of Mira and CEO of MMIF.

Mira's principal focus in Mexico is on opportunities in the energy sector, but it also has holdings in several other infrastructure assets ranging from highways to telecommunications, according to Walbridge.

"Within Mira Mexico, we are currently focused on equity investment," says Walbridge. "While we'll look at instruments such as mezzanine and preferred, the bulk of our holdings in infrastructure assets are in ordinary equity, where our participation ranges from 100% investments to significant minority holdings with negative controls. The size of our holding is driven by our perception of the risk profile of each investment on a project-by-project basis, and where execution risk is high we look for strong strategic partners such as construction or energy companies, or major local developers to come in alongside us."

Walbridge says that he is comfortable with the legal and regulatory regime governing infrastructure investment in Mexico. "Generally speaking, the contractual framework of the legal system is good," he says. "Archaeological, environmental and land ownership laws are for the most part similar to those in developed markets. But when we're structuring a project, especially on the greenfield side, we do a lot of work with our advisors to understand risk allocation between key counterparties."

“The risk profile of institutional investors like ourselves, international pension funds and sovereign wealth funds probably still differs slightly from some of the local vehicles,” Walbridge adds. “Over time, as the National Investment Plan progresses and the energy reforms come through, I expect the weight of international capital to become more dominant, purely by virtue of the size of some of these transactions. Then we’ll probably see greater alignment in terms of risk profile.”

New and improved PP law

Other market participants say that Mexico’s new PPP law is a substantial improvement on previous versions. According to a briefing published by the law firm, White & Case, the four key changes in the new law are “a thorough, transparent bidding process”, minimum mandatory terms, clearer rights for investors and dispute resoluion via arbitration.

The new law, adds White & Case, is “well structured, based on proven models from other jurisdictions, and there is momentum and appetite to ensure the success of the new regime.”

The result of this more robust legal framework, twinned with deeper and more mature capital markets, is that the structure of project financings put forward today is an incalculable improvement on the formula used in the toll road programme introduced in 1989. The good news, for Mexico, was that the highway concession programme doubled the length of the country’s toll highways between 1989 and 1994. The bad news was that many of the roads were empty and loss-making.

According to the White & Case briefing, the programme of 52 toll roads was plagued by problems which included “errors in traffic-volume estimates, relatively short 15 year concessions and poor project planning.” As a consequence, adds White & Case, many were unable to meet their US dollar denominated debt payments and were rescued by the federal government agency, Farac, which has since re-privatised some of them on a much sounder financial footing, generally on 30 year concessions with peso denominated debt.

These more robust structures, says Díaz de León, attest to how far the Mexican capital market has developed over the last 25 years. “In the late 1980s and early 1990s Mexico had a fixed exchange rate regime and its history of financial instability meant that it was almost impossible to raise long term local currency debt,” he says. “We’ve now had two decades of stability and nine years of issuing 30 year bonds in pesos.”

Díaz de León believes the capital market could certainly play a more active role in financing infrastructure in Mexico — as it could around the world. “Capital and liquidity ratio requirements are making life increasingly hard for traditional project finance lenders,” he says. “This is creating an opportunity for institutional investors to plug what we call the infrastructure financing gap, but the challenge is to find ways of making instruments appealing to institutions in terms of risk and return.”

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