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**Weather the Storm and
Prepare for the Future
*Impact of the
Global Downturn
On Infrastructure
Developments
In the GCC Countries***



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EXECUTIVE SUMMARY

The global economic downturn and sharp decline in oil prices are putting pressure on Gulf Cooperation Council (GCC)¹ governments' budgets and threatening to restrict regional infrastructure development. Given the region's rapidly growing population and economic growth, however, GCC countries cannot afford to put off investment in their infrastructure. Governments, banks, and other private stakeholders must collaborate to prioritize sector investment and provide or attract financing to enable infrastructure development to continue.

GCC governments must prioritize projects that take into account long-term strategic objectives and establish the right legal and regulatory framework to attract and foster private-sector investment. On that basis, the GCC can market both its attractive growth prospects and its commitment to continued infrastructure development to global investors and developers. The GCC governments also can support the creation of dedicated infrastructure investment vehicles within the region and structure deals that facilitate easier debt and private financing.

Banks, lending institutions, and private-sector investors will be passing up significant growth opportunities if they ignore GCC infrastructure project financing. Despite the tightening credit markets, an array of investment vehicles—government-guaranteed short-term financing, private finance initiatives, and public-private partnerships among them—are available to facilitate investment in GCC infrastructure development.

Key Findings

- Government spending on infrastructure, which had risen to as much as 30 percent of the budget in some GCC countries, is under pressure in this new era of lower oil prices and budget deficits.
- Governments must commit to the long-term economic development of their countries by prioritizing the projects that support strategic objectives—such as meeting a growing population’s demands for housing, water, and electricity, or contributing to GDP diversification in key sectors such as telecommunications or transportation.
- Banks and lending institutions need to participate in the financing of infrastructure projects to support the overall economy and thus their own long-term financial health.
- Industry players and other equity investors can secure a leading position in the GCC infrastructure market by investing time, effort, and capital during difficult economic times.

THE IMMEDIATE FUTURE OF GCC INFRA- STRUCTURE

Over recent years, infrastructure projects in GCC countries have increased at unprecedented rates, in both scale and scope. From 2002 to 2008 alone, GCC governments awarded approximately US\$720 billion worth of infrastructure projects, supported by rising oil prices and driven by each country’s strong commitment to developing and diversifying its economy and meeting the needs of its growing population (*see Exhibit 1*). Despite the substantial increase in infrastructure development over this period, spending has not always kept pace with the rapid growth of the region’s economy and population. Kuwait, for example, still lacks capacity for peak load electricity production, Saudi Arabia and other GCC countries face water shortages, and Dubai (one of seven emirates of the UAE) is experiencing overloaded sewage plants and congested highways.

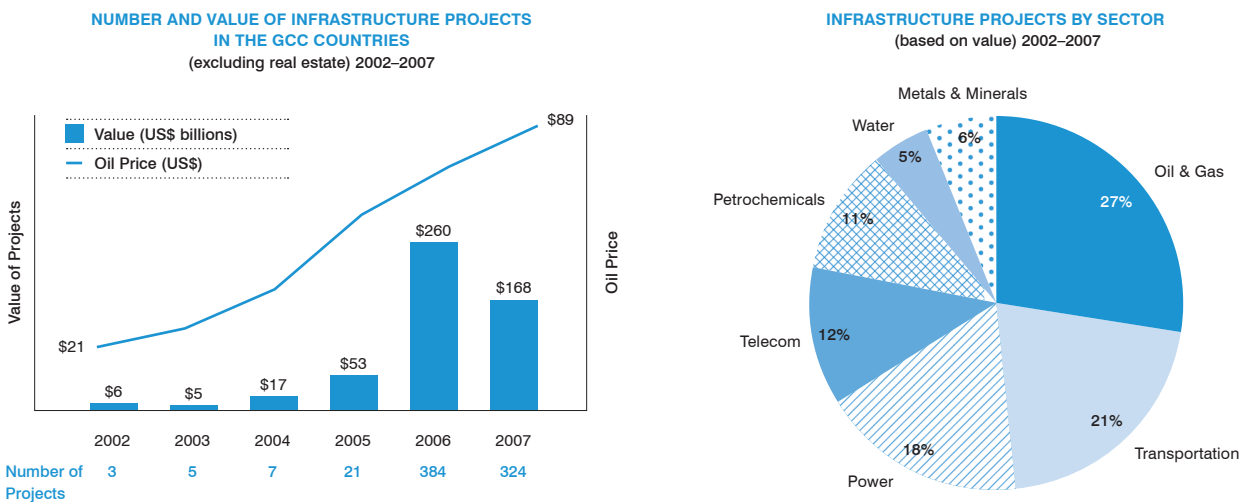
Although the GCC countries need to continue to modernize and develop

their infrastructure if they wish to achieve their long-term growth and development goals, the global financial crisis and economic recession has not spared them. The worldwide slump has manifested itself in sharply reduced oil prices, decreased liquidity, and falling share prices on the GCC stock markets. With respect to infrastructure developments, the

impact of the crisis is twofold: First, lower oil prices threaten the fiscal health of GCC governments, potentially impairing their ability to spend on infrastructure. Second, the tight credit markets and disruptions in the loan syndication market limit the availability of long-term financing for infrastructure projects.

This paper outlines the infrastructure funding requirements that were anticipated before the global economic crisis; analyzes the economic downturn's effect on infrastructure development; and proposes a way forward, focusing on the role that governments, banks, and private-sector investors can play in meeting and overcoming the challenges ahead.

Exhibit 1
Infrastructure Projects Awarded in the GCC, 2002–2008¹



¹Data for infrastructure projects as of April 2008
Source: Middle East Business Intelligence (MEED); Energy Information Administration, June 2008; Booz & Company Ideation Center analysis

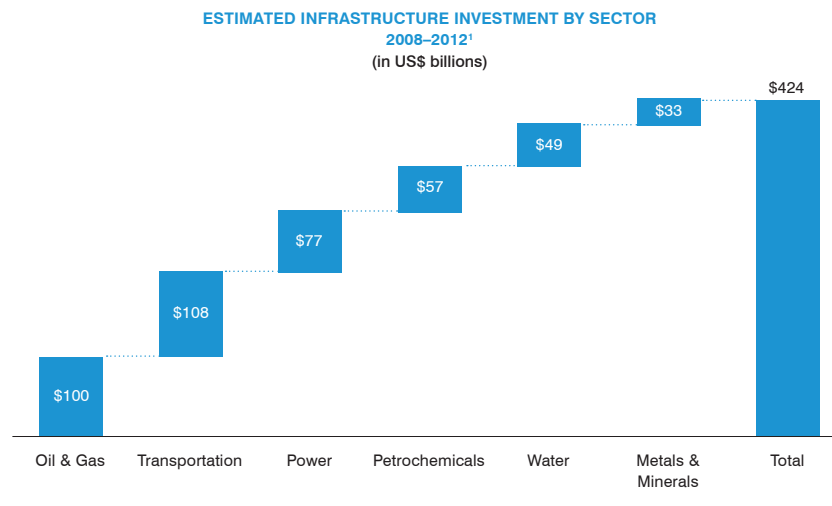
SIZING UP THE FINANCIAL REQUIREMENTS

Before the current economic downturn, regional analysts estimated that GCC countries would require new infrastructure investments worth approximately \$424 billion between 2008 and 2012 (see Exhibit 2). This estimate was in addition to approximately \$400 billion for projects that had already been awarded. In light of the current weakened world economy and the liquidity crisis, these estimates will likely be revised downward to reflect pressures on both private and public financing of infrastructure projects.

Projects in the GCC are typically financed using debt for between 65 and 80 percent of total funding. As governments move away from leverag-

ing their budget surpluses to finance infrastructure projects, public-private partnerships (PPPs) are emerging as the preferred vehicle for GCC infrastructure development. The split between private and government equity participation varies across countries and sectors. In Saudi Arabia, for example, government participation in new water desalination projects is limited to 49 percent, whereas in the United Arab Emirates (UAE), the government maintains majority stakes in all basic infrastructure projects. Kuwait allows for very little private-sector involvement in water production, whereas Bahrain has awarded a concession in the power sector that calls for 100 percent private ownership.

Exhibit 2
GCC Estimated Infrastructure Investment Needs by Sector



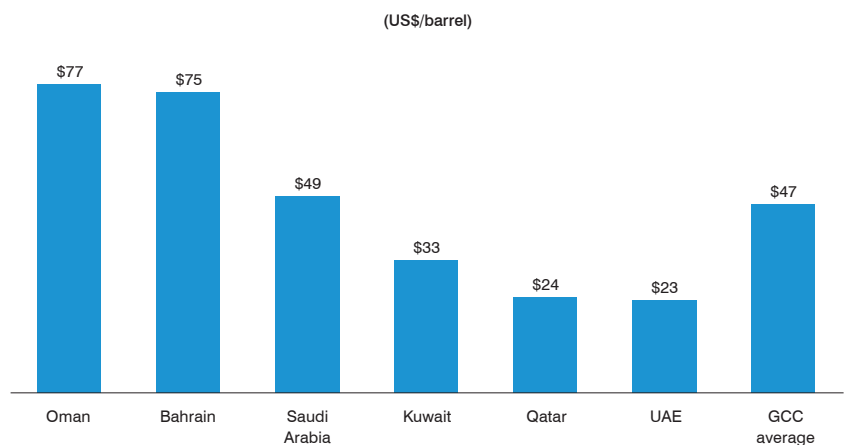
¹ Figures for 2008 represent planned projects for the year as of April 2008
Source: MEED; Zawya; Booz & Company Ideation Center database and analysis

THE IMPACT OF SHARPLY REDUCED OIL PRICES ON GOVERNMENTS' INFRA-STRUCTURE SPENDING

Despite eight years of strong economic growth and efforts to diversify their economies, GCC governments continue to rely substantially on oil exports for the bulk of their revenues. Across the GCC, oil revenues account, on average, for nearly 70 percent of government income. The high oil prices of recent years allowed GCC governments to fund major development activities, including infrastruc-

ture investment, even while generating comfortable budget surpluses. Over the past year, however, oil prices have deteriorated below the level needed for a balanced budget in many countries (*see Exhibit 3*). As a result, GCC governments face the possibility of running fiscal deficits. Government spending on infrastructure had risen to as much as 30 percent of the budget in some countries, and in this new era

Exhibit 3
Break-even Oil Prices for Fiscal Accounts in the GCC



Source: Economist Intelligence Unit; International Monetary Fund; Credit Suisse First Boston

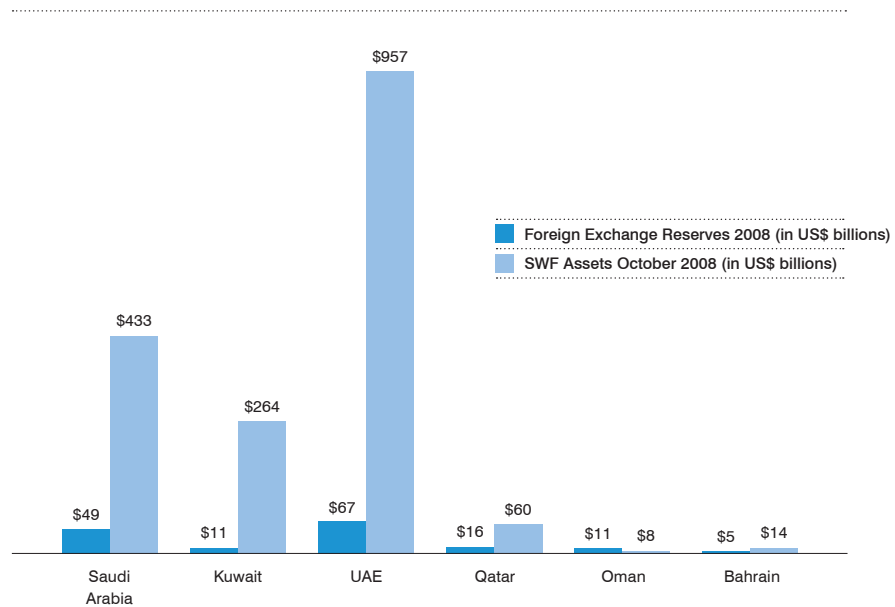
of lower oil prices and budget deficits, that spending may be reduced.

With governments facing tighter budget constraints, sovereign wealth funds (SWFs) and government-owned investment companies (GOICs) may step in to finance infrastructure projects. Some GCC countries have

accumulated significant SWF overseas assets as well as foreign exchange reserves, and these might provide a cushion for critical infrastructure projects already under way (*see Exhibit 4*). However, infrastructure projects might have to compete for funding against other pressing requirements, such as bailouts of

banks and other crucial companies, International Monetary Fund (IMF) support, and opportunistic overseas investment in undervalued assets. In addition, many SWF assets have been affected by the downturn, thus reducing the amounts available for infrastructure investments.

Exhibit 4
Estimated Government Assets



Note: Figures for Oman and Bahrain are in millions.
Source: Economist Intelligence Unit; International Monetary Fund; Credit Suisse First Boston

THE IMPACT OF THE CREDIT CRISIS ON INFRASTRUCTURE FINANCING

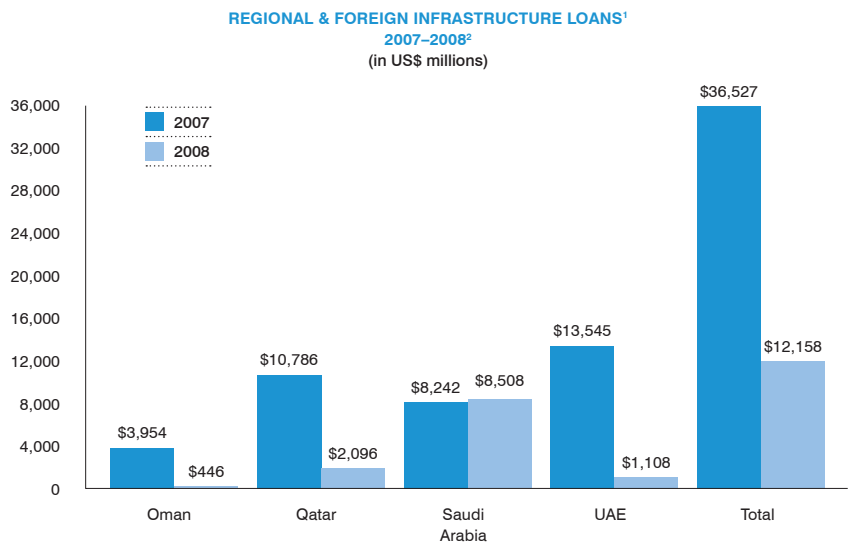
In recent years, loans granted by both regional and foreign banks to provide PPP infrastructure financing rose to unprecedented levels, fueled in many cases by governments' willingness to back these loans. In 2007 and 2008 alone, infrastructure loans from regional and foreign banks totaled more than \$48 billion in GCC countries (see Exhibit 5). High oil prices and increased liquidity drove growth in local bank deposits from both governments and wealthy individuals, allowing these banks to extend infrastructure loans. But the demand for infrastructure funding rapidly outpaced local banks' available funds, requiring participation from foreign banks with larger capitalizations. In Saudi Arabia, the UAE, and Qatar especially—where many mega-infrastructure projects

have been initiated—European, Asian, and U.S. banks have provided most of the debt financing for government-sponsored and privately sponsored infrastructure projects.

The global liquidity crisis has ushered in a new era, in which the credit and loan syndication markets have lost their appetite for long-term project finance deals. Banks are reluctant to underwrite loans for large infrastructure projects, fearing the syndication overhang that might result from the sheer size of such projects in a world of constricted liquidity. At the same time, the cost of debt has risen, affecting the financial viability of many projects.

Tight credit conditions have already affected projects in the GCC, such

Exhibit 5
Infrastructure Loans from Financial Institutions



¹ Figures refer to transaction debt by both domestic and foreign financial institutions; excludes real estate and construction
² Figures for 2008 are partial year data
Source: Infrastructure Journal 2008

as the \$2.6 billion Shuweihat 2 IWPP and \$5 billion Ras Al Zour IWPP concessions, awarded respectively by the Abu Dhabi Water and Electricity Authority (ADWEA) and Saudi Arabia Water and Electricity Company (WEC). In both cases, the lead banks that arranged the commercial debt reopened negotiations, invoking the “material adverse change” exit clause. Banks are seeking risk-sharing solutions that will be satisfactory to all parties, which in the case of the Shuweihat 2 project reportedly involves short-term lending with guarantees from ADWEA and the project’s sponsors.

In this difficult environment, lenders in general are far more selective. Even if they do not walk away from deals that are now less viable, they will likely demand guarantees from project sponsors, as well as revenue guarantees from governments. Developers are having difficulty securing competitive underwritten loans, and, should the crisis persist, they will be more reluctant to commit to new projects. Because of this, a wave of planned infrastructure projects relying on syndicated infrastructure loans will probably be set aside, re-tendered (in the case of concession awards), or delayed until the credit markets recover.

THE WAY FORWARD

The global downturn may affect not only the growth of infrastructure projects in the GCC region, but spending priorities as well, as governments reassess their project portfolios. In this environment, infrastructure stakeholders need to take immediate measures to support infrastructure development.

Governments

GCC governments face pressing short-term needs, such as propping up struggling stock markets, financing the IMF, or bailing out banks and companies whose health is crucial to their countries’ economies. With falling oil revenues threatening government budgets throughout the GCC, these are particularly daunting challenges. Infrastructure spending may appear to be an appropriate area for cutbacks, but governments cannot afford to overlook the fact that continued infrastructure spending is crucial to long-term economic development in GCC countries.

During times such as these, when available capital is limited, GCC governments need to prioritize infrastructure projects, taking into account the

degree to which those projects align with strategic objectives such as meeting a growing population's demands for housing, water, and electricity, or contributing to GDP diversification in key sectors such as telecommunications or transportation. This exercise offers governments a clear framework for prioritizing infrastructure projects and aligning regulations, incentives, and capital toward those deemed most critical.

Once infrastructure projects have been prioritized, GCC governments should affirm their commitment to these areas by maintaining and in some cases boosting investments in the projects. This may require diverting investments from short-term, more liquid assets. GCC pension funds, for example, are primarily invested in equities, but they could diversify their portfolios while at the same time supporting economic development in their region by investing in infrastructure financing.

Governments also need to make sure that they have the appropriate legal and regulatory framework in place

to foster private-sector investment, decrease risks to lenders and developers, and provide required incentives, especially to the emerging class of regional infrastructure and private equity funds. Steps to take include:

- Establishing clear and transparent foreign direct investment and concession laws tailored to attract private-sector investments under PPPs and public finance initiative schemes
- Granting sovereign guarantees to both lenders and developers in order to limit their exposure to default risk and improve the bankability of infrastructure deals
- Making favorable, secured offtake commitments in concession agreements, and more generally establishing frameworks that minimize the private sector's long-term demand risks, in order to guarantee adequate returns.

Once priorities and policies are in place, governments must make a strong effort to market the region's

positive economic growth prospects in general, and targeted infrastructure projects in particular, to global investors and developers. For example, in 2009, Saudi Arabia and the UAE dedicated billions more dollars in government expenditures than they had in the previous year. This is the sort of government action that needs to be well publicized throughout the world to demonstrate to international investors and developers that the region is committed to using its accumulated surpluses to advance economic growth.

The governments also need to support the creation of dedicated infrastructure investment vehicles that are managed for profit. The goal of these vehicles should be to facilitate access to infrastructure financing in the region, so that necessary projects can move away from overreliance on foreign banks for funding. These vehicles can be used to attract financing from a variety of sources, including local and global banks as well as alternative sources, such as the infrastructure and private equity funds that are emerging in the GCC region. Although those

funds haven't yet played a significant role in GCC infrastructure financing, they are multiplying. In 2006, nine funds were created in the GCC, and almost twice as many were set up in 2007 and 2008. For example, Macquarie Group and the Abu Dhabi Commercial Bank (ADCB) recently reported that they expect to raise \$1 billion for an infrastructure fund focused on the GCC region.

Finally, GCC governments must structure deals that facilitate easier debt financing and private financing. To do this, governments can break projects into smaller pieces or phases in order to make them more digestible to the credit markets and accessible to single developers. Recent successful deals in western Europe's renewable power sector suggest that smaller projects are most likely to obtain financing in the current economic environment. It's important to note, however, that when breaking projects into smaller pieces,

governments need to ensure a continuity mechanism through public-private financial agreements. Governments can also facilitate the financing of projects by allowing for incomplete debt syndication, with the remaining debt requirements being covered by sponsor-guaranteed bridge financing, and by avoiding projects that require competing underwriting bids, which limits the pool size of lead arrangers.

Banks and Lending Institutions

Although governments create the framework for infrastructure projects that is favorable to debt financing, banks must also do their part in promoting and facilitating infrastructure financing. Infrastructure development is key to the long-term growth of GCC economies; therefore, banks need to participate in the financing of infrastructure projects for the sake of their own long-term financial health and growth. These projects do require the creation of large volumes of debt

at lower margins, but because of their government support, they carry the benefit to banks of proportionately lower risk than other types of loans.

To successfully and profitably support necessary infrastructure developments, banks and financial institutions should consider taking the following actions:

- Banks should disintermediate themselves, taking a proactive approach to financing of infrastructure projects and relying more on the capital markets in this regard.
- Given the challenge borrowers face in securing large amounts of long-term debt in the current environment, banks should step in to provide short-term financing where necessary, provided that they receive government and sponsor guarantees. This action can help kick-start necessary projects that have achieved

the conditions for financial close but that cannot at this difficult time secure long-term financing.

- Banks should participate in state-sponsored infrastructure investment vehicles to reduce their overall risk while providing good investment return opportunities. This is most important for smaller banks, whose ability to participate in syndication of financing for large-scale projects is limited. Smaller banks participating

in investment vehicles can gain exposure to the infrastructure sector, thus diversifying their current lending operations.

Private Infrastructure Developers and Other Equity Investors

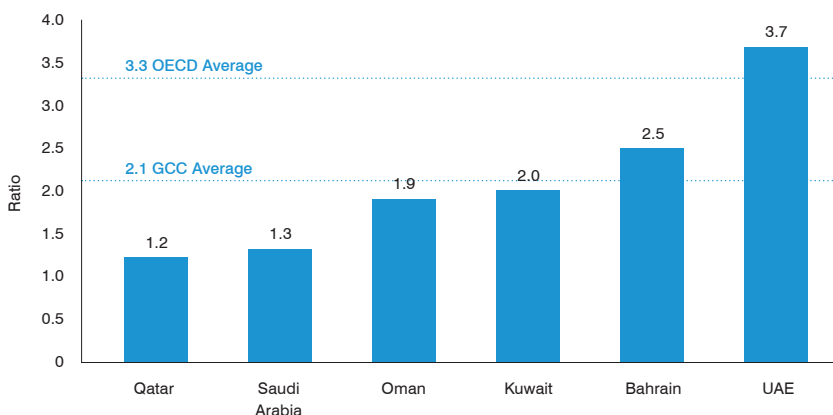
In recent years, the average ratio of private to government expenditure in GCC countries has been below the Organisation for Economic Co-operation and Development (OECD) average (see Exhibit 6).

This suggests strong potential for more private-sector involvement in infrastructure development.

Governments can play an integral role in boosting private-sector investment, through encouragement and support, but it is the strong long-term outlook for such investment which will do most to attract private investors. The GCC's positive economic growth prospects position it as an attractive market for private investment, and governments have pursued multiple strategies to encourage that investment, including privatization of government assets and initial public offerings of public-sector infrastructure companies.

Government efforts to encourage private investment in infrastructure projects, coupled with the difficulty of obtaining financing from traditional sources during the current credit crisis, present an opportunity for the growing number of private equity and infrastructure funds operating

Exhibit 6
GCC and OECD Ratios of Private to Government Expenditure
(Average over 2000–2007 Period)



Source: Economist Intelligence Unit

CONCLUSION

The global downturn is an important challenge for GCC governments working to build the infrastructure required to support future economic growth and social development. Because infrastructure development is vital for GCC countries, sector investment needs to be clearly prioritized, and collaboration among public and private stakeholders must be promoted and encouraged. Governments should take immediate action to support prioritized infrastructure sectors, by creating a healthy and sustainable framework for investment that encourages PPPs and other alternative funding sources. Banks and lending institutions must adopt a proactive, creative approach to financing solutions and participate in state financing vehicles so they can benefit from the long-term growth that will arise from infrastructure development. Finally, private infrastructure developers and other equity investors have an exceptional window of opportunity right now to step in to secure a leading position in the promising GCC market. In order to take advantage of the opportunity, they must find ways to secure and provide infrastructure financing, depending less on banks and more on capital markets.

in the GCC to step in and fill the vacuum created by the drying up of long-term credit and loan syndication markets. At the same time, private infrastructure developers willing to demonstrate their commitment to the region by investing time, effort, and capital during difficult economic times have the chance to secure a leading position in the GCC infrastructure market. The financial upside of participation now for those that can secure financing is the chance not only to establish market share, but also to reap the benefits of debt recapitalization once the credit markets ease.

Just as governments need to prioritize sectors and projects in the current environment, private-sector companies need to select specific sectors and projects based on their potential for financial performance and competitive advantage. To do this, companies need to rigorously construct fact-based industry perspectives to help them anticipate the post-recovery structure of these industries and position themselves for future growth opportunities.

When it comes to financing, the private sector should consider tapping into the capital markets in order to

obtain additional and cheaper sources of financing and reduce dependence on syndicated bank loans. One avenue for entering the capital markets is engaging in private finance initiatives (PFIs), which allow the raising of funds in the capital markets through the sale of corporate bonds issued by the company running the PFI. PPPs can also go this route, with the project company issuing bonds or *sukuks* directly. In cases where bank lending is unavoidable, developers may need to find ways to give extra reassurance to lenders in order to secure credit: Developers should consider reaching out to secure sovereign guarantees or putting their own balance sheets on the line by deviating from non-recourse project finance schemes.

Finally, debt financing support may be obtained by private entities from foreign funds or export banks, such as the Japan Bank for International Cooperation or the China Exim Bank. This type of bank has an interest in helping major equity players from its own country take part in GCC infrastructure developments. Arrangements such as this require attracting foreign players into local infrastructure developments through such vehicles as joint venture collaborations.

Endnotes

¹ The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

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