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Contractor equity risk

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Not all equity is the same: When contractors become equity investors

By Eric Wolfe, KPMG in Canada

As public-private partnerships (PPPs) get larger and capital costs continue to rise, new equity investors and equity structures are starting to play a larger role in infrastructure delivery. But while these new sources of capital are clearly welcome, they also create potential risks down the road, not only for procurement authorities but also for other members of the consortium. Thankfully, there are a number of ways to help safeguard the alignment of risk and reward for owners and stakeholders.

New investors welcome

Around the world, the fight for private capital is becoming fierce. Infrastructure pipelines are bursting and governments are working hard to attract capital to their projects. At the same time, projects are getting larger. In North America alone, the average capital cost of a PPP project is nearing US$500 million. Most expect the size of projects to expand quickly as more transportation projects move into development.

While project sizes increase, the amount of private financing required has not necessarily increased proportionately as public sector authorities look for innovative payment structures to reduce the cost of private financing on a project and drive value for money. This has created a competitive environment for private financing on these projects; from an equity perspective, some investors may look to lower their return on investment in order to reduce financing costs over the term of the project.

Perhaps not surprisingly, it is the contractor industry that has responded with the greatest enthusiasm. Many contractors now operate fairly sophisticated investment arms, focused solely on investing equity into longer-term PPP projects. The benefits for contractors are clear. By taking a financial stake in the project, contractors can protect their business interests while also ensuring a steady stream of work for their construction arms. This has been a particularly popular approach in the transportation sector where construction companies often play a role in the operation and maintenance of the asset and can have a vested interest throughout the entire term of the project. It has been less common in social infrastructure sectors where contractors tend to play a much smaller role post-construction.

In the more mature PPP markets, however, this has started to change. In Canada, for example, contractors now contribute significant equity to social infrastructure projects. In fact, every social infrastructure project that closed in Canada in 2015 included at least one equity provider that was also a key team member in the construction of the project. In each case, their equity investment ranged from 20 percent to 50 percent of the total equity contribution.

While this may be great news for governments, owners and consortiums delivering social infrastructure projects, the addition of this type of capital does come with a number of risks. And unless they are appropriately managed, they could lead to a misalignment of risk and reward, diluted returns and, potentially, even project failure.

Understanding the risks

There are two main reasons why contractors may have misaligned incentives as equity partners. The first is that contractors are often able to build profits into the construction cost of the project. In doing so, a contractor

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that is also an equity provider can earn returns on both the work performed during the construction period and also its investment in the project. Despite having an incentive to earn good returns from both, there is a risk that the contractor could maximize its total return by shifting its projected profits from one stream to the other (shifting fees into the capital costs, for example, and then arguing for lower equity returns in the future).

The second challenge relates to a mismatch between risks and investment periods. Pure equity sponsors would typically be invested in a project for the mid to long term. But construction companies may not be willing to remain invested in a project through the operating period if they have limited involvement in maintaining the asset. Given that the construction period is typically the riskiest period for the project where significant sums of capital are tied to the successful delivery of the asset, this creates challenges for other longer-term investors in the consortium.

As a result, infrastructure projects that include construction companies are much more likely to end up on the secondary market shortly after operations start. In fact, of the 30 secondary market transactions that have occurred to date in North America, the vast majority have been driven by developers or other 'long-term' equity investors exiting the market. The average 'hold period' for those projects was just 5 years.

The problem is that these potential differences in investment goals and incentives could create issues for not only the equity investors in the project, but also for the public sector authority responsible for delivering the project in the long term. What happens, for example, when construction-related issues occur after the contractor sells their equity position? And how will other investors and users be compensated for disruptions or loss of revenues related to potential construction defects?

Ultimately, it is the authority's role to ensure that the public is receiving an asset that is performing to the specifications outlined in the contract over the term of the agreement. To that end, these authorities should look for ways to minimize any disruptions by having a well-structured contract that provides an appropriate amount of control over the identity of the entities providing the services, particularly during the early years of operations.

Safeguard the alignment

Our experience suggests that there are multiple ways that procurement authorities and equity investors can help improve their risk and reward structures to protect the interests of everyone — investors, procurement authorities and consumers — when working with shorter-term equity partners. In the more mature PPP markets, three main methods are emerging, each with their pros and cons.

1. **Equity retention periods**: Mandated through project agreements or loan agreements, these require all or certain investors to maintain their equity participation in the PPP project for a specified period of time.
   - *Pros: Locks in investors and improves accountability during operations.*
   - *Cons: May limit market competition or be viewed as limiting investment flexibility.*
2. **Equity breakage fees:** Similar to an equity retention period, this approach sets a breakage fee (generally a percentage of the total equity investment) that will be paid to the public sector authority if the investment is subsequently traded on the secondary market before the expiration of a pre-established holding period.
   - *Pros: Offers some investor flexibility and allows procurement authorities to price their tolerance for secondary market transactions.*
   - *Cons: Does not fully address the long-term risk and may lead bidders to price the breakage fee into their submission.*
3. **Independent third-party asset manager:** Representing the interests of all shareholders bilaterally, an independent asset manager acts as a single point of contact with the authority and lenders. The focus is on ensuring that the construction and maintenance strategy that is developed by the consortium for the asset is transparent to all investors and conducive to their goals.
   - *Pros: Neutralizes the potential conflict of interest with no additional cost to the authorities while providing transparency, competencies and flexibility to investors.*
   - *Cons: May represent additional costs for investors and may be less effective if engaged later in the project development process.*

There is no doubt that — in today's capital constrained infrastructure environment — developers and construction companies will continue to play an important role as equity partners. And procurement authorities, policy makers and debt investors should be working hard to attract and retain new and stable equity sources to help unlock their infrastructure pipelines.

But they will also need to enter into these agreements with a clear understanding of the potential risks that these new partners may bring to the long-term viability of the project. Safeguarding the alignment of risk and reward for PPP owners and stakeholders must be a key priority.

*Statistics referenced in this article are based on complete InfraAmericas 2015 data.

Contact us

Dane Wolfe
Senior Marketing Manager
Global Infrastructure
KPMG International
T: +1 416 777 3740
E: dmwolfe@kpmg.ca

Pranya Yamin
Marketing Manager
Global Infrastructure
KPMG International
T: +1 416 777 8094
E: pyamin@kpmg.ca

kpmg.com

kpmg.com/socialmedia

kpmg.com/app

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