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Investing in Water Infrastructure in Emerging Markets

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Criteria for International Investors and Financiers

International investors have billions of dollars available for investment in the water sector but only if their investment criteria are satisfied. The key criteria relate to:

- Location and Value Amount
- Asset Type
- Government Involvement
- Tariffs
- Due Diligence



Location and Value Amount

- The jurisdiction and location of the asset will impact on whether basic political, credit, commercial, legal, and financial criteria can be satisfied
- Typically, from the perspective of international investors, individual water plants do not have high values and a portfolio of plants or a complete system is regarded better
- The amount of the value of the asset will therefore need to meet the investor's minimum deal size criteria
- Opportunities for "roll-ups", or expansion of capacity or of the concession area, or tariff increases may mitigate smaller value assets

Asset Type

- A vertically integrated water company, which includes treatment plants (potable and wastewater), the distribution system and a direct relationship with customers is better than just treatment plants, from an investment perspective
- Stand-alone wastewater treatment plants / systems may not be attractive because of low tariff structure and / or collection issues
- A water treatment plant business is reliant on its purchasers and is susceptible to the underlying water purchase commitments being breached, potentially leaving the water treatment company with a stranded asset
- For a treatment plant business, a creditworthy industrial customer with a long term purchase commitment is ideal
- In an integrated system:
 - generally the interests of the municipal water authority are aligned with the new investor and it receives the cash flows directly from the customers, alleviating credit issues with the water authority
 - more opportunity to increase efficiencies, improve services and increase profitability



On-going Government Shareholder Involvement

If the investment is being made into a water utility, the water utility needs to be corporatised and to be operated on commercial principals

- ➔ It is clearly better for the government shareholder to continue with a meaningful shareholding and for the current management to continue
- ➔ The business strategy of the shareholder/board/management needs to be acceptable
- ➔ Government shareholder probably looking for private sector technical, operating and financial expertise
- ➔ Municipal, Provincial and State Government support and involvement of all Governments need to be aligned
- ➔ Unlikely there will be any Government guarantees available

Tariffs

Tariffs are generally well below the levels in Australia and other western countries. While most costs are also low now, many of the costs are increasing rapidly.

- Check whether the company can meet its outgoings, debt service and projected equity distributions from its own revenue base (i.e. without a subsidy)
- While a low tariff does mean that there is a lot more room for increases, it also signals that the consumers are quite poor and may be unable to accept increases
- Track-record for past tariff increases and timing and criteria to be applied to tariff increases (eg formula for return on assets)
- Check the level of transparency on the tariff-setting process
- Often a “public hearing” process
- Check if all the tariffs are received directly by the water company
- Check if the water company provides wastewater services and if so, how is the tariff for this structured
- Check the rate of non-revenue water and the level of bad debts



Due Diligence

Standard due diligence criteria include the following:

- Concession/Licence – check if the contractual and legal structure provide a degree of certainty to investors/lenders.
- Accounts – check if the audited accounts are available
- Level of debt and amount of equity and distribution policy
- Exclusivity, competitors, current distribution area and numbers and mix of customers
- Age and condition of assets and capital expenditure commitments
- Major foreign technology or equipment
- Term, scope (treated water/sewerage), certainty and price of raw water supply and electricity, environmental requirements
- Water meters and billing system
- Any long-term sale contracts
- Compliance with present and impending environmental laws
- Setting of water resource fees, raw water costs and operating licenses
- In some jurisdictions, IRRs, are guaranteed (sometimes in US\$)



Conclusion

- A strong appetite from international and local investors and water companies
- A number of failed investments in the past have resulted in both international institutional investors and trade players being wary
- With the right structures and approaches, there are many opportunities for partnerships and joint ventures between international investors and water utilities in emerging markets