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JULY/AUGUST 2008

portstrategy

Vol. 1008 Issue 6

Insight for Port Executives



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Capital creator

Boudewijn Jansen and Paul van Eulem of consultant MTBS explain how Port Authorities can maximise returns when seeking outside investment

Value creation was the main driver behind European port development towards the Landlord model in the beginning of the 1980s. Today, public Port Authorities (PAs) are structured within governmental organisations and are financed on municipal or national budgets rather than having their own balance sheet.

Gradually governments are assessing the option of corporatisation PAs – separating PAs from their own organisation and changing them into more autonomous entities. This separation process is also driven by the search for value creation, but is it the best instrument to achieve better performance and create value?

In the 1970s, most PAs were organised according to the 'Service Port' model, which meant that the PA held responsibility for all port activities including stevedoring or cargo handling and investments in terminal facilities. At the beginning of the 1980s, a port reform process came into place where cargo handling was outsourced to private stevedoring companies, to create more efficient terminals. There was a realisation

that the infrastructure needs of ports would have to be met by both public and private sector investment.

This cargo handling outsourcing led to various public-private partnerships (PPP) alternatives such as operating contracts, regular concessions and build-operate-transfer schemes. Eventually Europe adopted to a large extent the Regular Concession structure in which the port investments were divided between the PA and the private stevedoring company. This meant the introduction of the so-called Landlord model. This port reform process triggered a range of efficiency improvements and new investments within the sector, which created value for both the private and public sides of a port.

Creating value

Public PAs are traditionally structured within governmental organisations and are financed on municipal or national budgets rather than having their own balance sheet. Over time, governments have assessed the option of separating PAs from their own organisation and changing them into more autonomous entities having their own governance structure, accountability and balance sheet. To create more autonomy, commercial management contracts are imposed between the shareholding alderman (or ministers) and the PA management board, a process often referred to as 'corporatisation'. This gradual separation between government and the PA creates

shareholders and therefore a new focus on shareholder value and financial performance.

By operating more on a shareholder value basis, the new corporatised PA (which we will refer to as 'PA Ltd') aims to have a better balance between risk and return by improving its investments, operational expenditure and financing. This leads to many challenges for the PA Ltd such as corporate restructuring, balance sheet restructuring and the re-defining of its strategic goals. In addition, new concession contracts might also require adjustments compared with existing contracts. All these corporate adjustments are driven by the search for shareholder value creation.

Another driver behind this separation process, or corporatisation, is the size of the current port investment plans. Many ports, especially those in Brazil, Russia, India, China, and Western Europe, are facing large capacity extension projects with investments of over a billion euros. This demands innovative financing structures, transparency, a business case approach and accountability. Municipalities may not want to have these large investments on their own balance sheet and therefore might favour corporatisation. However one should bear in mind that dividing budgets does not necessarily create any value.

Regions such as South America are already quite far into this separation process, where many PAs are corporatised and are even owned by non-governmental entities. In Europe, some major ports have recently changed their status from governmental body towards a more corporatised legal form such as a limited company. In our opinion, corporatisation will lead to a new port reform process in Europe, which will mainly be driven by two factors:

Easy money: corporatisation done well can be a virtual licence to print money



- 1) Procurement of financing (improving the financing structure)
- 2) Procurement of Opex (concession contracts and the outsourcing of port operations)

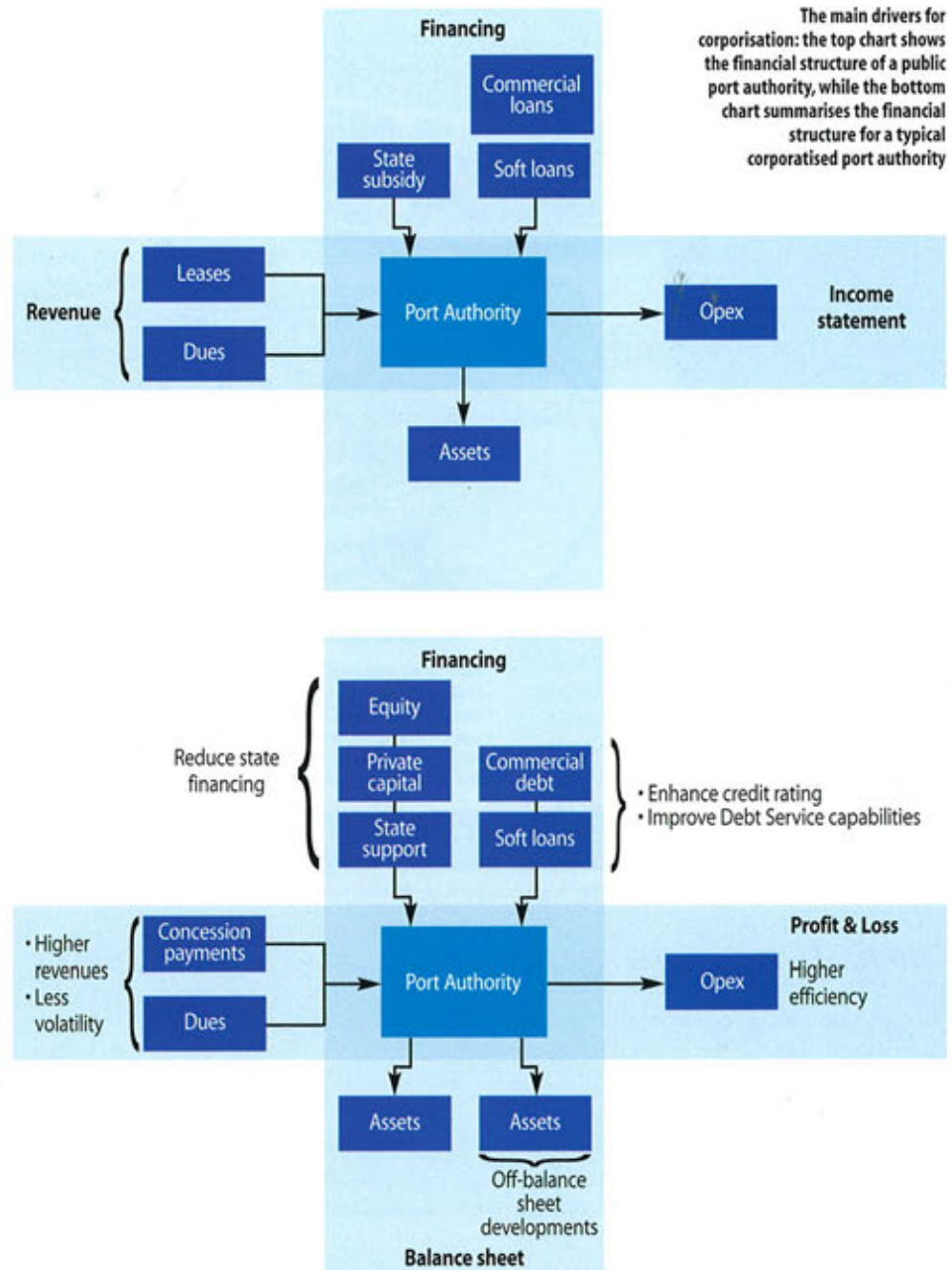
Know your market

Before describing the two drivers in more detail, some considerations regarding corporatisation should be mentioned. Corporatisation is only beneficial when efficiency gains outweigh the loss of public ownership. This means that where market competition is lacking, corporatisation might lead to an undesirable result; service levels might go down and prices tend to go up. Profit driven organisations can lose sight of the economic importance of services in a monopolistic market.

It is therefore important that when corporatisation is considered the market type should be assessed. The level of inter-port and intra-port competition is very important in this respect. Therefore, the market type determines the structure of the regulations governing the corporatised PA. This is why MTBS supports corporatisation when it is driven by value creation and implemented in markets with sufficient competition and market players. The budgetary reason to structure large projects outside of the balance of the municipality as explained above should not provide sufficient reasons for this process. Figure one shows the main drivers for corporatisation.

The financial structures of public PAs and the corporatised PAs can be quite different, so it is worth looking at them in some detail. Figure one shows a financial structure of a public PA, with land lease fees and port dues as the main income components. The operational expenditure is the other component within the Profit & Loss account. The assets such as quays, access channel, roads and rail infrastructure are traditionally financed with state support, soft loans (loans with generous repayment terms) and commercial loans. This financial structure is typical for traditionally financed non-corporatised PAs.

In Figure two, on the other hand, a generalised financial structure is shown for a typical PA Ltd. It is clear that PA Ltd can be financed with multiple components such as soft and commercial loans, state support, private capital and equity. The introduction of equity, probably held by the state or the municipality, creates shareholders and thus shareholder value becomes



more prominent. This shareholder value approach will inevitably lead to an enhanced focus on financial and operational performance which will trigger a whole range of effects.

Equity is considered to be more expensive than debt, so when the newly-created PA Ltd considers the

concept of "optimal capital structure" it has the ability to maximise the value of the company. PAs are usually financed with conservative gearing levels: ratios between 20% to 40% debt are common; an average of five large European and two US ports indicated 35% debt. Thus, these use relatively high levels of equity, →

Measuring the worth of value creation principles

An example of a port that effectively optimised its capital structure is the Port of Sillamäe in Estonia.

This privately-owned landlord port located close to the Russian border was established four years ago.

In recent years, the construction of four new terminals has been realised:

Silport Oil Terminal, the Baltic Chemical Terminal, Tankchem and SilSteve. Development of a container terminal is in progress and it is expected to be operational by 2010. As common in the public sector, Silport (PA) uses tendering to optimise the value of the concessions with terminal operators.

Value creation principles were brought in to the project by the shareholders of the port authority, the Estonian company Silmet Group.

Through a 50-50 shareholder structure strategic Russian investors were brought into the project. In addition, bringing strategic investors

to the port feeds into opportunities for the commercial development of the port.

With the focus on financial performance, the port authority is able to swiftly respond to market requirements and to provide optimal services levels in the port.

especially at the beginning of the corporatisation process. Subsequently, PAs consider financing their new projects with debt to improve their gearing. This increases the balance sheet leverage and improves financial ratios such as Return on Equity.

The improved financing structure might have a positive impact on the PAs credit rating in the long term, and this will have a positive effect on interest levels. However, setting the government further away from the PA will have also a decreasing effect on its credit rating due to the solvency of the State.

Spreading the load

A second interesting difference between the public PA and the PA Ltd financial structure is the option to re-structure its assets. A part of the port assets can be set off-balance, due to their risk profile, financing requirements or non-core activities. If a PA wants to invest in large and/or risky projects it might consider setting up separate limited companies to limit the liability of the PA itself. By creating a separate subsidiary, the assets and liabilities are allocated to this new special purpose vehicle and the assets are set off-balance.

In addition, off-balance sheet can be employed for non-core activities such as strategic alliances with other ports or non port-related land development. With off-balance sheet vehicles, private equity can be attracted to divide the development risk between the investor and the PA.

Other alternatives are to create a subsidiary with specific activities and to divest this company to investors, possibly with a condition that after the investor exits, the PA again becomes the owner of the company.

To further lower its financing costs, the PA can improve the process of procuring financing. Creating a competitive bidding process where banks and other financiers bid for a loan may have a decreasing effect on bank fees and interest rates. Certainly, it is becoming more common to hire specialists to assist in finance procurement.

All these items, such as increased leverage, enhanced credit rating, off-balance vehicles and a competitive bidding process, decrease the finance cost in the long term and thus increase the value of the PA.

Investor demands

Many investors, both banks and private equity firms, have proved to be interested in the terminal sector over the last three years. An important condition is that the private equity firm is able to exit its investment after a certain period. This type of company usually aims to invest its capital for approximately five years. This is in contrast with port assets which can have an economic lifetime of more than 50 years. After the five-year period the private equity firm sells its shares back to the former shareholders (State) or to a third party. Therefore liquidity of shares is a vital topic.

This relatively brief timeline is an issue in case of terminal investments, but especially when it concerns

PA investment opportunities. PAs have strategies with long term planning schemes which may not be in line with the quarterly return focus of private equity firms. Governments are aware of the key role ports play in society. Ports are considered as strategic national assets and therefore governments are reluctant to let go of control. Also investors acknowledge the long term aspect of ports and some investment banks have indicated that they will extend their usual term in order to enter into port-related projects.

Therefore to allow a good integration of private investors in PAs, the following should be considered:

- Risk bearing capital may be appropriate for PAs when applied:
 - in non-core PA activities
 - at subsidiary level (the PA maintains in control of core activities)
 - in off-balance sheet projects
- Private investors demand high yields and it is relatively easy to turn a profit in growth projects at a subsidiary level
- The exit timeline should be defined at the beginning of the process
- Private capital is an interesting alternative when a PA is looking for partners to share developing risk
- In addition to capital, private investors can also introduce management tools.

It is clear from the above that the corporatisation and thus the constitution of PA equity provides an opportunity for the investors, but only when structured thoroughly from both the perspective of the PA and the investor.

Eye on returns

A key principle of a shareholder value approach is that an investment should generate a financial return, above the cost of capital. However, many PAs do not always achieve return on investments of more than 8%. In these cases, PAs are not able to generate sufficient revenue to cover their investments. The low PA returns are especially interesting when we consider that the port costs are generally not more than 3% to 5% and thus form a relatively small part of the overall transport costs. This means that the overall port fees should be based on a cost recovery system or the value of concession contracts should be more evenly distributed.

On the other side of the concession, private terminal operators achieve on average sufficient returns above their cost of capital. This is partly caused by ever-increasing container volumes. Again, 2007 was a good container year with a global increase of 8%. If the volume increase is combined with reasonable handling fees and continuously improving efficiency it can lead to profitable terminals.

So, occasionally terminal assets are awarded below their actual value. This applies more for European port concessions than for concessions outside Europe, where concession fees tend to be higher. A concession contract should distribute items such as revenue, costs

and risks evenly between the PA and the operator. In this case, the PA aims to structure a concession contract which generates a financial return above the cost of capital for both the PA and the operator.

Concession values

To prevent under-valued port assets the PA has to be aware of the true value of their concessions. Public PAs tend to focus on revenues derived from these concession contracts, instead of the value the concession contract generates for the operator.

PAs do not always have a detailed insight and understanding of the operational, investment, revenue and risk structure of terminal operators. The 'deal-driven' public PA focuses on closing the deal, instead of the contract value and how to distribute this value between the PA and the operator. True knowledge regarding the profit levels of the terminal operators provides a guideline on setting the level of concession payments.

PAs have altered their methods of concession awarding to obtain more valuable concessions. The first step was to change from direct award systems to competitive driven tender procedures. The second step was to design tenders with multiple qualification steps including the best and final offer system observed in Europe.

Applying a more competitive based selection procedure has resulted in a concession contract with a more balanced value between the PA and terminal operator. Various aspects are important in this process, including execution of the tender according to international standards and proper marketing of the concession.

Finally, when structuring the concession it is important to arrive at a balanced concession contract. This includes applying key performance indicators, considering volume guarantees, allocating risks to the most suitable entity, structuring market risks in the concessionary payments and determining the optimal concession term. Structuring of the concession contract should be driven by a business case and support the value goals of the PA.

Today, we are seeing more and more governments assess the option of PA corporatisation, with value driven concessions becoming the centre of the discussions. At MTBS we acknowledge the advantages of corporatisation given three conditions:

1. There is a suitable competitive and regulatory environment.
2. PA governance accords a structure which safeguards the crucial role ports play in society.
3. Tools, such as balance restructuring and value driven procurement, are employed.

By applying these three conditions, it is our view that corporatisation can release additional value for the PA. **PS**

■ Boudewijn Jansen is senior advisor and Paul van Eulermis is co-founder and director of Netherlands-based maritime and transport consultant MTBS.