A stress test for Gulf infrastructure

The GCC region's ambitious investment plans are under renewed pressure, writes Christopher Watts.

When Saudi Aramco, the largest oil company in the world, announced in early November that it was to launch a critical review of its long-term project pipeline, it was a dramatic signal that the effects of global financial turmoil are hitting the Gulf region's ambitious plans for infrastructure investment. The state-owned Saudi Arabian group's planned USD 25 billion petrochemicals project at its vast Ras Tanura site is one that is likely to come under scrutiny; and the review is likely to include other investments the group has lined up for the coming five years—worth a whopping USD 100 billion.

Company executives would not be drawn on details of the review. But it's likely that Saudi Aramco's management will re-visit the group's plans to finance its bold expansion strategy in the light of tight credit conditions resulting from the ongoing financial market crisis; and it's possible, too, that management will examine the viability of some of these investments, given that oil prices have tumbled to about USD 60 per barrel from a high of almost USD 150 last July, ahead of a widely expected global economic slowdown.

Widespread project delays and cancellations—by Saudi Aramco and others—would serve a heavy blow to the GCC states. Across the Gulf region, there's a shortage of transport infrastructure such as ports, roads, railways and the like, and of utilities infrastructure including power generation plants, water desalination facilities and so on. And there's an urgent need for so-called soft infrastructure such as schools, universities and hospitals. In all, according to MEED estimates, there are USD 2.2 trillion of infrastructure and real estate construction projects planned or underway in the region—up almost 50% from a year ago.

Why the strong demand for infrastructure in the Gulf? Much of it reflects regional governments' efforts to cut dependence on oil and gas by diversifying local economies; and some is coming from strong population growth, which is largely being driven by immigration. Dubai, for example, expects its population to balloon to three million by

2015, from 1.4 million at the last census in 2006, and perhaps two million today. As it races to keep up with growing demand, the Gulf region's power generation sector alone may need investment of USD 50—100 billion in the coming 5—10 years. Some of these investments hold the key to others: "Power and water projects are often a bottleneck in the completion of real estate projects," says Jan Willem Plantagie, managing director for project finance at rating agency Standard & Poor's.

Despite the pressing need for fresh infrastructure spending, the past year has been tough for those planning and investing in infrastructure projects. Galloping prices for cement, steel, and other materials led to spiralling project costs: According to data from Dealogic, the mean GCC-region project deal size in the first three quarters of 2008 jumped to USD 2.5 billion, in contrast to steady averages of around USD 1.6—1.8 billion in the period 2005—2007. Skyrocketing costs dampened estimates of future returns on investments, which in turn raised the spectre of project delays and cancellations. Fortunately, the latest word from industry analysts is that project cost pressures are easing as storm clouds gather over the economies of the US and Europe.

In its place though, another obstacle has emerged: Funding. The availability of project financing has taken a direct hit from global financial market turmoil. "There's been a considerable belt-tightening among banks," says Tim Holder, who runs the Middle East office of Taylor-DeJongh, an independent firm that advises on infrastructure finance. Holder points out that 46 commercial banks were reported to be active in the Gulf infrastructure finance market in 2006; today it's down to a dozen or less. Those banks that remain are certain to be more picky now than they were even just six months ago. It's probable that banks will take on less risk and will negotiate stricter terms. Deals are set to take longer to close as they come under closer investor scrutiny.

But while banks are slashing their loan books, other sources of finance are coming to the fore. For many investors, infrastructure is an attractive asset class: It offers long-term visibility, with largely dependable revenue streams and cash flows (sometimes supported by long-term supply contracts and off-take agreements with local governments). And in the Gulf, many projects have sovereign backing because of their strategic importance for the region's economic diversification. "Some Gulf infrastructure projects with robust revenue streams have characteristics akin to bonds issued by sovereign entities in the region," says Mark Lemmon, CEO of the Dubai-based Middle East and North Africa Infrastructure Fund, a USD 500 m investment vehicle.

Investors in infrastructure include specialised infrastructure funds such as the Middle East and North Africa Infrastructure Fund. Such infrastructure funds are set to raise around USD 90 billion in fresh funds this year, up from USD 35 billion in 2007, according to Infrastructure Journal's worldwide estimates. Sovereign states themselves continue to generate significant cash surpluses from oil and gas revenues, even at the lower prices now being seen; some may choose to hand over more cash to keep infrastructure development on track. Qatar and Abu Dhabi, for

example, already invest in infrastructure development, directly or indirectly, via their sovereign wealth funds. And then there are export credit agencies that provide direct loans or else credit guarantees. Mark Lemmon of the Middle East and North Africa Infrastructure Fund, for his part, sees a positive outlook: “It’s likely investment in infrastructure will continue apace in the GCC,” he says. “There’s a lot to build here.”