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Infrastructure Spending Spurs Construction Boom in Emerging Markets; Risks Persist

Emerging markets will continue to be areas of focus for global engineering and construction (E&C) firms in the coming years. But while these markets are ripe with opportunity, construction firms must be mindful of the risks associated with expansion in these areas. Marsh's *Political Risk Map 2018*, based on findings from Fitch Solutions, is a good starting point for firms aiming to understand and navigate some of these challenges.

The global construction industry is forecast to grow at a robust rate over the next five years, largely driven by infrastructure investment plans in emerging markets, according to Fitch Solutions[1]. That growth, however, may be slowed in some less-developed markets, where major projects are susceptible to financing, bureaucratic, and construction delays. And in the most fragile countries, despite their acute need for infrastructure improvements, projects can be most dramatically frustrated by the economic and political realities on the ground – whether via payment default, unilateral cancellation, or even expropriation of assets. It is essential for those exploring such construction projects to understand the "host country's" level of political and socio-economic volatility, and how these may impact current and future projects.

1 Fitch Solutions. "Key Themes for Infrastructure 2018." available at https://www.fitchsolutions.com/infrastructure-project-finance/key-themes-infrastructure-2018-15-12-2017, accessed 22 October 2018.

Construction industry growth

Infrastructure development in emerging markets brings huge potential rewards for global E&C companies. Emerging markets will see an acceleration of growth in 2018 to 5.4% compared to 5.3% in 2017, according to Fitch Solutions's Industry Risk/Reward Index, which quantifies and ranks the investment attractiveness of countries within a sector on a globally comparative basis. According to the index, emerging markets in Asia, the Middle East, and Sub-Saharan Africa have higher potential rewards than those of developed markets. Furthermore, over the next 10 years, emerging markets across Asia, the Middle East, and Sub-Saharan Africa will be home to the fastest-growing construction industries in the world, according to Fitch Solutions. China is also investing heavily in infrastructure projects in Brazil, Chile, and Argentina.

Fitch Solutions forecast that growth in the global construction industry will accelerate in 2018, reaching 4.1% in real terms compared with 4.0% in 2017. Real growth is also forecast to average 3.8% between 2018 and 2022, largely fueled by ambitious infrastructure development plans across emerging markets.

Increasingly, the huge infrastructure needs in these regions are being met by expansionary investment from development banks and foreign governments, as well as private investors seeking high yields. The greater availability of financing from both public and private sources has encouraged governments to expand infrastructure development plans far beyond what would have been feasible using only fiscal expenditure. For example, China's One Belt One Road (OBOR) initiative to enhance connectivity and trade between Eurasian countries requires financing of nearly US$1 trillion for infrastructure projects across emerging markets in Asia, the Middle East, and Europe, according to the The Guardian[2] making it the costliest infrastructure initiative ever undertaken. As stated earlier, this initiative has now been expanded to incorporate Latin America and also the Caribbean.

2 The Guardian. "What is China's Belt and Road Initiative?" available at https://www.theguardian.com/cities/ng-interactive/2018/jul/30/what-china-belt-road-initiative-silk-road-explainer, accessed 23 October 2018.

Political Risk Score Updates

For Marsh's *Political Risk Map*, Fitch Solutions give countries a risk score ranked on a scale from 1 to 100. The higher the score, the lower the political risk. The short-term political risk index (STPRI) takes into account factors like a government's ability to propose and implement policy; social stability; immediate threats to the government's ability to rule; and the risks of a coup, among other things. STPRI is just one factor in determining a country's overall score.

Africa

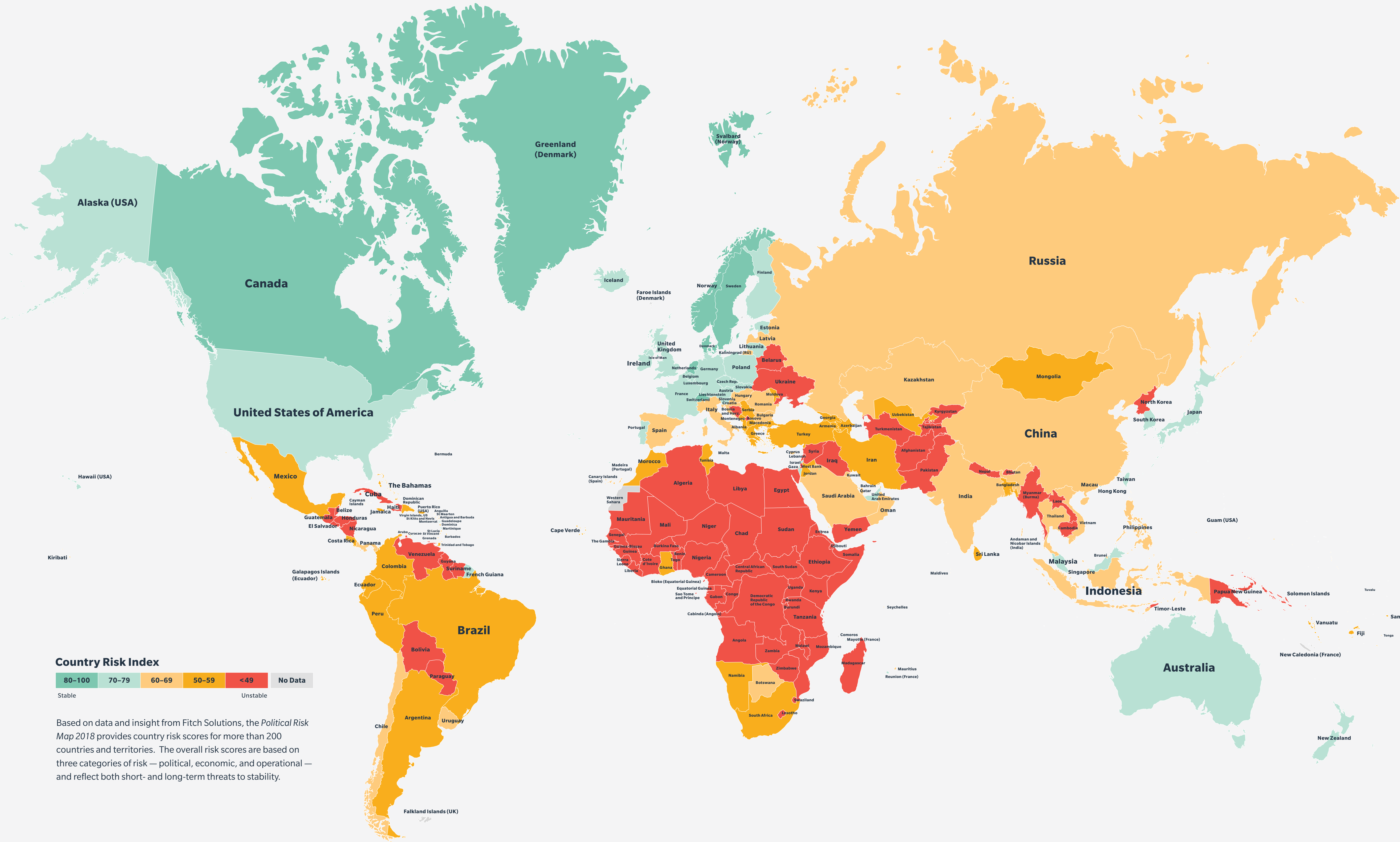
The Africa region saw some of the biggest improvements, but also some of the largest deteriorations in the risk scores for the *Political Risk Map 2018*. Succession risks stabilized somewhat in the region with, for example, Robert Mugabe resigning as president of Zimbabwe after 37 years in power, and the transition to President Emmerson Mnangagwa appearing to have gone smoothly. Zimbabwe's STPRI score improved by 7.7 points. President Mnangagwa has proposed a 25% increase in the country's' spending on infrastructure by 2020, including an upgrade to the country's flagship airport, construction of a parliament building, and the second phase of a high-performance computing center.

At the same time, there were sharp increases in political risk in some African countries, driven in part by uncertainty around elections and political succession. In Kenya, for example, contested elections played a role in the country's' STPRI score dropping by 8.4 points. Construction firms should note that Kenya President Uhuru Kenyatta has pledged to make infrastructure growth a hallmark of his leadership, launching the Kenya Vision 2030 program, which proposes building new roads, railways, ports, and more.

Middle East

The *Political Risk Map 2018* highlighted the persisting threat of violence in the Middle East, including in Syria, Iraq, Bahrain, and Yemen. Qatar also continues to face a diplomatic crisis that began in 2017 when several countries, led by Saudi Arabia, cut off diplomatic relations with the country citing its alleged support for terrorist organizations. This has posed problems for Qatar's ambitious infrastructure plans as it prepares to host the 2022 FIFA World Cup football tournament. Labor shortages resulting from the diplomatic crisis are one risk to the country's plans for related projects worth more than US$100 billion, including state-of-the-art stadiums, railways, hospitals, and hotels. The crisis is likely to be minimized by Qatar's strong financial position, which is demonstrated by its AA- sovereign rating with Fitch and S&P.

Fitch Solutions also noted heightened tension between Saudi Arabia and Iran, which could affect several high value Public Private Partnership projects that are planned or underway in Saudi Arabia, including water sanitation and transportation initiatives. The Riyadh metro, which is slated to begin light operation next year, has taken investment of about US$22.5 billion. Neom City — a transitional city and economic zone — is scheduled to be ready for phase one by 2025 and is taking investment of about US$500 million.



Based on data and insight from Fitch Solutions, the *Political Risk Map 2018* provides country risk scores for more than 200 countries and territories. The overall risk scores are based on three categories of risk — political, economic, and operational — and reflect both short- and long-term threats to stability.

To explore the interactive version of the map, visit www.marsh.com/uk/campaigns/political-risk-map-2018

Asia

There were continued tensions between China, South Korea, Japan, and Vietnam about disputed islands in the East and South China Sea, Fitch Solutions noted, though this situation did not worsen in the latter part of 2017.

In 2017 the government in Vietnam approved significant infrastructure development to support the country's industrial hubs. The government approved a US$921 million investment plan to support the improvement of infrastructure relating to industrial parks until 2020. The investments are focused on transportation infrastructure, water treatment plants, and drainage works. Additional investment – and private sector support – is needed for energy and telecommunications infrastructure.

One Belt One Road

China's One Belt One Road (OBOR) initiative, which aims to create a 21st Century maritime and land-based trading route linking Asia and Europe, provides opportunities for global engineering, procurement, and construction firms. The initiative, announced by the Chinese government in 2013, aims to link 60 countries across Asia, Africa, Europe, and the Middle East by road, train, and maritime routes. By 2050 it is forecast that the countries will contribute about 80% of global gross domestic product (GDP) growth, according to McKinsey Global Institute research[3].

There are, however, some notes of caution.

The United Nations has raised a red flag over certain economic, financial, social, and environmental risks associated with the initiative. A UN study found significant financial risks in countries in southern and central Asia, where the announced investment value under the OBOR is high in relation to the size of the recipient country[4]. For example, the US$15 billion investment deal signed with Uzbekistan in 2013 is roughly equivalent to a quarter of the country's GDP. And a US$24 billion deal with Bangladesh, signed in October 2016, is roughly equivalent to 20% of the country's GDP.

The UN report also highlighted that social unrest and ethnic conflicts could escalate in areas where the management of OBOR projects is viewed as lacking in fairness. Social unrest, political volatility, and global pressures, could all prove to be challenging hurdles for construction firms over the course of OBOR.

It remains to be seen in the medium and long term whether China's political objectives as conceived through OBOR are practically achievable given the real-world realities of economics and politics in the countries where such projects have been proposed. Critics have suggested that the sustained tendency within China over the last decade to build domestic infrastructure, even in situations where the underlying rationale for a project may be uneconomic, is simply being exported abroad to maintain a deal pipeline for Chinese E&C firms. The huge scale of OBOR also suggests a need for the involvement of non-Chinese contractors and providers of capital, who are likely to apply more traditional filters of commercial logic and sustainability to the selection of which projects move forward, and which ones are held back.

3 Center for International Relations and Sustainable Development. "Building the Right Silk Road - China and the 'One Belt, One Road' Initiative." available at https://www.cirsd.org/en/horizons/horizons-summer-2015--issue-no4/building-the-right-silk-road---china-and-the-%E2%80%98one-belt-one-road-Initiative, accessed 22 October 2018.

4 *Journal of Infrastructure, Policy and Development* (2018) Volume 2 Issue 1; "The Belt and Road Initiative: Maximizing benefits, managing risks—A computable general equilibrium approach" available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=2ahUKEwik47nW3pzeAhUhzYUKHSWjAOMQFjAAegQICRAC&url=http%3A%2F%2Fsystems.enpress-publisher.com%2Findex.php%2Fjipd%2Farticle%2Fdownload%2F140%2F116&usg=AOvVaw3XWUk_FucGqil3DZOJsPSk, accessed 22 October 2018.

Navigating The Risks

Contract frustration risks

If political risks are not managed correctly, they can translate into credit issues and financial losses. Political instability, for example, can delay a project or derail completion. Changes in government can result in previously awarded contracts being challenged, contract terms being renegotiated, and the termination of contracts by governments. Sovereign credit risks can also be a concern as countries may default or delay payments. In addition, restrictions may be placed on overseas payments.

These risks can be managed by structuring milestone payments in such a way as to ensure that the contractor's cash flow will always be cash-flow positive. Firms can also insist upon secure payment terms such as letters of credit. However, employing these measures may not win E&C firms very many contracts in the current hyper-competitive market.

Contract frustration insurance can also be used by E&C firms as a solution to tolerate customer credit risks and manage cash flow negative gaps in contracts, sometimes negotiated by bidders to enhance the competitiveness of their proposal. Such cash flow gaps can also be caused by late payments by the customer, while the contractor feels obligated to continue performing (to keep the project on schedule) and incurring project costs.

Credit and Political Risk Insurance

Contract frustration insurance is a type of credit and political risk insurance. This type of insurance can be tailored to the risks involved in participating in emerging markets. Coverage can extend from offshore procurement packages payable in hard currency, to the local works settled in local currency. Engineering, procurement, and construction firms can transfer risks — including outright payment default — to the blockage of hard currency transfer by a government, as well as more typical political risks such as those associated with civil war. Coverage can be tailored so that policy terms match the contractual duration of long-term projects.

Surety

Surety bonds protect owners, lenders, and investors against contractors' failure to deliver a project. Surety underwriters will issue performance bonds backing contractors' contractual promises after a rigorous prequalification process which includes credit scoring, review of historical performance records, and a thorough understanding of the underlying contract conditions. Surety bonds are issued by well-capitalized insurance companies that are often better rated than banks, with whom the surety underwriters compete for bonding business. The surety industry is financially healthy, driving over US$14 billion in premiums yearly. Surety bonds are gaining acceptance as performance security in many developing markets; where surety bonds cannot be issued, surety underwriters can deliver bonding commitments through banks either as syndicated partners in a risk participation agreement or through a fronting arrangement.

Using the Marsh Political Risk Map

Drawing on data and insight from Fitch Solutions, a leading source of independent political, macroeconomic, financial, and industry risk analysis, Marsh's Political Risk Map can help engineering, procurement, and construction firms begin to identify the political risks present in countries where they are considering doing projects.

Visit www.marsh.com to access the interactive map.

For more information please get in touch with your usual Marsh contact or:

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