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ADDRESSING CURRENCY RISK IN ASIA

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Global infrastructure investors will only persevere in Asian emerging markets if they can tame the foreign exchange beast, reports Oliver Jones

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Volatile foreign currencies have long been a bugbear for investors wanting to own infrastructure in the wilds of Asia's emerging markets.

Exchange rate swings can interfere with the noble pursuit of stable cash flows from low risk, low return investments.

In theory, the long-term nature of infrastructure should mean that over time any decline in the value of a currency is offset by inflation. But in the short-term, the value of annual cash flows can vary significantly.

Governments too are wary of attracting foreign capital, in case a change in the external environment sees these investors withdraw.

"There is little doubt that lingering concerns over currency mismatch have played a part in the reluctance of many Asian governments to bring projects to the market," says Jordan Schwartz, World Bank director of Infrastructure, PPPs & Guarantees in an interview.

Strong flows of domestic capital mean that projects are often priced at a relatively low rate of return on a risk-adjusted basis, making it difficult for foreign investors to compete.

Currency fluctuations can make or break deals. Global Infrastructure Partners was successful in acquiring Equis Energy for USD 5bn because it could run the business as an integrated whole, rather than splitting off its power producers spread across Japan, China, India and elsewhere, according to an investment banker.

"The whole portfolio was too large for local IPPs to bid for," the banker added.

The portfolio of assets across markets offering a range of internal rate of return (IRR) – from below 10% equity IRR in markets like Japan and Thailand to mid-teen IRRs elsewhere. This "resulted in a low double digit IRR bid overall, which they could absorb as the benefit of diversification meant they could absorb risks like currency risk," the banker said.

"The good thing about our focus on [Central and Eastern Europe] is those assets are denominated in euros – it's easy to do hedging for Euro against the US dollar," says China Everbright Industrial Investment Holdings managing director Daniel Hu. "If investing in Turkey using the Turkish Lira then it's difficult, if we are talking about an asset in Poland then it's easy to do hedging," he adds.

"If we acquire more assets in Europe then we will do hedging. If we do more deals in Hong Kong, then the Hong Kong dollar is already pegged to the US dollar, so we won't do any hedging," adds Hu. To date, the mainland Chinese company's Overseas Infrastructure Fund has made two investments – Tirana International Airport in Albania and Top Express, which is building a fibre optic network in Hong Kong.

Hong Kong's telecom sector has also lured I Squared this year. Still, the USD 14.5bn the US fund manager paid for Hutchison Global Communications "beat [the sellers'] own internal expectations," observes Hu.

Investors point to the diversification benefits of investing in Asia, where companies have tended to take on more debt since the 2008 global financial crisis in contrast to the deleveraging trend seen in the West.

A 20% plunge in the value of the British pound against the US dollar in the wake of the Brexit vote has underscored the urge to venture beyond North America and Europe.

The Vietnamese dong has stabilized in recent years, attracting more investors to consider that market as an investment destination.

At a conference earlier this month in Hong Kong, DBS's head of project finance, Wee Seng Lim, observed the dong has depreciated by 9% against the US dollar over the past five years, less than the declines for the Indonesian rupiah (40%), Philippine peso (24%) and Singapore dollar (12%) over the same period. This is in line with the relatively more robust Thai baht's 8% loss in value.

"Involving foreign investors [in infrastructure investment] can be a vicious cycle," Lim says. "The challenge is that these investment decisions are usually premised on G3 currencies," he explains.

Vijay Pattabhiraman, JP Morgan Asset Management's CIO Global Real Assets - Asia infrastructure explains that there are three levels of foreign currency movements which impact an asset's value. The project's cost can fluctuate if equipment is imported from overseas, so his fund hedges this exposure.

But the local currency borrowings used to fund the infrastructure are typically left unhedged.

For the equity that overseas sponsors put in, a "long-term hedge plan is typically difficult for an illiquid asset," thus the manager typically plans for some currency depreciation.

The added risks of using foreign currencies can present a hurdle to competing against domestic bidders. For the funds he manages, he looks at the last ten years of history in currency movements, then factors in currency risk in the equity IRR target. He observes that Asian currencies are often stable for a period of time before a big one-off adjustment occurs.

Apart from including a currency risk premium in the target IRR, currency risks are not hedged. Instead, investors are provided with a quarterly report of the currency exposures of the fund, for them to hedge at the portfolio level.

The Investor Perceptions of Infrastructure 2017 survey undertaken by Global Infrastructure Hub and EDHEC Infrastructure Institute-Singapore found that asset managers require returns of between 16% and 18.7% for infrastructure investments in emerging markets.

In contrast, the mean IRR demanded by asset owners is between 17.5% and 22.9% according to the survey of 186 investors released this month.

EDHEC Infrastructure Institute director Frédéric Blanc-Brude says required returns revealed in the survey are unhedged, as respondents were asked to express what return they would seek in the local currency used.

Still, "the bid ask spread we find is likely to reflect differences in [business and liquidity] risk preferences rather than currency risk exposures," he says. "Some investors are happy to see infrastructure as a lower return/lower risk asset because they have a different balance sheet. That is, they are interested in long term value and do not intend to liquidate these assets".

Curiously, the survey revealed asset owners demand higher returns for investing in emerging market infrastructure than do asset managers. Conversely, asset owners demand a lower return (on average) for investments in OECD infrastructure than managers.

Asian currencies are typically stable for periods of time before shifting unexpectedly. This provides a window for boosting returns from selling an asset right before a big adjustment. An investor in JP Morgan's AIRRO's first fund notes that the fund benefited from the movement in the Korean won for an investment that it exited earlier this year. But, a drop in the Indian rupee in 2013 "really hurt them," making exits from assets in that market difficult, he said.

The Indian rupee has been relatively stable in recent years against the US dollar. Broadly, "fiscal management across the region is far stronger than it was back then," says the World Bank's Schwartz, referring to the pre-1997 Asian financial crisis era.

Still, "the total volume of PPPs that have come to financial close in the emerging markets of [East Asia Pacific] has never returned to the 1997 pre-Asia Crisis levels according to the World Bank's tracking of all infrastructure PPP projects," he adds, attributing currency risk as one of the reasons for this.

Schwartz identifies "some sub-sectors that require less hedging than others, or at least lend themselves to repayment that can cover hard currency equity and credit".

Revenue from port and airport terminal rents, cargo handling or passenger fees tend to be denominated in dollars or dollar-adjusted. Power purchase or off take agreements for energy generation or water and wastewater treatment plants are usually inflation-adjusted, if not dollar-denominated.

"When it comes to urban services and utilities, it is harder to hide from the risks of devaluation - especially in countries without a secondary currency market for hedging," says Schwartz.

Those countries include markets like Vietnam. Meanwhile, deals such as the Equis and I Squared transactions suggest an increased interest in Asian infrastructure is leading to transactions, especially where currency risks can be mitigated.

At the same time, the secondary market for currency hedging is deepening across the region, spurred on by record levels of US dollar capital raising.

In the ten months to end October, total regional USD Reg S issuance exceeded USD 170bn according to data from Australian bank NAB. That is triple the level raised in 2012 and already more than the USD 130bn full-year figure for 2016.

Proceeds of Reg S issues are converted to local currencies and put to use, leading to an increased need for investors to hedge these exposures. This in turn, boosts liquidity in foreign exchange markets.

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