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Europe's Investment Plan: How To Spend €315 Billion In Three Years

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Europe's Investment Plan: How To Spend €315 Billion In Three Years

As part of an ambitious plan to rejuvenate the eurozone's faltering economy through greater infrastructure spending, the European Commission (EC) has identified a pipeline of 2,000 projects worth an estimated €1.3 trillion. These projects will be financed primarily through the capital markets.

The projects are the backbone of the so-called Juncker Plan, named after the new EC president Jean-Claude Juncker. The EC formally adopted the plan on Jan. 13, 2015, following its endorsement by EU leaders at their year-end summit on Dec. 18, 2014 (1). With the goal of creating jobs and boosting growth, the plan aims to inject €315 billion into the European economy over the next three years.

Overview

- The European Commission's Juncker Plan aims to deliver €315 billion of investment over the next three years, mostly from capital markets, to boost Europe's economy and create jobs.
- We believe the plan, mainly for long-term strategic project investment but with a sizable portion ring-fenced for investment at SMEs and mid-market companies, is ambitious but achievable.
- Our analysis shows that increased investment in infrastructure can stimulate economic growth and create jobs as long as projects have a clearly targeted rationale and viable structure.
- However, we consider the plan's greatest challenge will be to open up the capital markets sufficiently in a relatively short three-year timeframe, given its aim to attract private-sector investors at a multiplier of 15x the EU's and EIB's investment both for projects and SMEs.
- To succeed, we believe the plan will have to attract substantial crowding-in of the private sector through scaled-up capital market funding with support and incentives from Europe's multilateral institutions, politicians, and policymakers.

Under the plan, the EC will establish a European Fund for Strategic Investment (EFSI) with an initial size of €21 billion--most of it for long-term project investments, while nearly a quarter will be ring-fenced to fund investment at small and midsize enterprises (SMEs) and mid-market companies. Of the facility's initial amount, the EU will provide €16 billion in the form of guarantees, and the European Investment Bank (EIB) will provide €5 billion. The EFSI will invest in riskier projects--or in more junior positions in low-risk projects--to help attract further private capital 15x greater than the initial EU and EIB €21 billion input.

Despite the plan's laudable aims, market observers have expressed many concerns about its feasibility, application, and ultimate ability to attract the necessary level of institutional capital.

Key Roadblocks And How They Might Be Overcome

We see three key challenges for the Juncker Plan:

- Attracting sufficient long-term institutional capital within a relatively short time frame;

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- Convincing the public that infrastructure investment will rekindle EU economic growth; and
- Converting a €1.3 trillion project wish list into a credible and investable pipeline.

In our view, these challenges are not insurmountable. We believe there is a strong case for increased investment in infrastructure--if properly targeted--acting as a stimulator for economic growth and job creation (see below). However, a clear economic rationale that justifies each investment is also important because a project's long-term viability will ultimately depend on it.

Market participants have been calling for a credible and comprehensive pipeline of projects across the EU. Upon initial examination, the EC's project list resembles more of a wish list than a fully worked-through pipeline of prioritized infrastructure projects.

More transparency and detail are required to prioritize the projects and make them attractive and viable investment propositions. In this respect, the U.K.'s and the Netherlands' work developing their own infrastructure pipelines could serve as useful templates.

To implement the plan, the EC has recognized that better regulation and deeper capital markets are essential for investment (2). To this end, it proposes to develop long-term investment plans and an EU-level website linked to member states' project pipelines. It also intends to provide technical assistance through an EU investment advisory hub and procedural standardization, such as for public/private partnerships (PPPs). It also wants to introduce value-for-money assessments to identify the most efficient project-structuring solutions and propose new financial instruments to advance viable projects that are not yet financed.

We believe the biggest hurdle to be overcome is opening up the capital markets to finance the plan, especially in the relatively short time frame of three years. Although we believe there is significant and growing institutional appetite for infrastructure investment--both debt and equity--more intervention is required to motivate this kind of step change in private-sector funding.

The main proposal of the plan is to set up the European Fund for Strategic Investment (EFSI), a managed account on the EIB balance sheet that will benefit from first-loss guarantees by the EU. The EFSI will invest in riskier projects--or in more junior positions in low-risk projects--to help attract further private capital.

Such credit-enhancing initiatives are not new, and have had some success lately in helping stimulate capital market activity in infrastructure. Such is the case of the EC project bond initiative, which, since August 2013, has been successful in leveraging €3 billion of bond financing into five projects by providing just under €500 million in contingent liquidity support.

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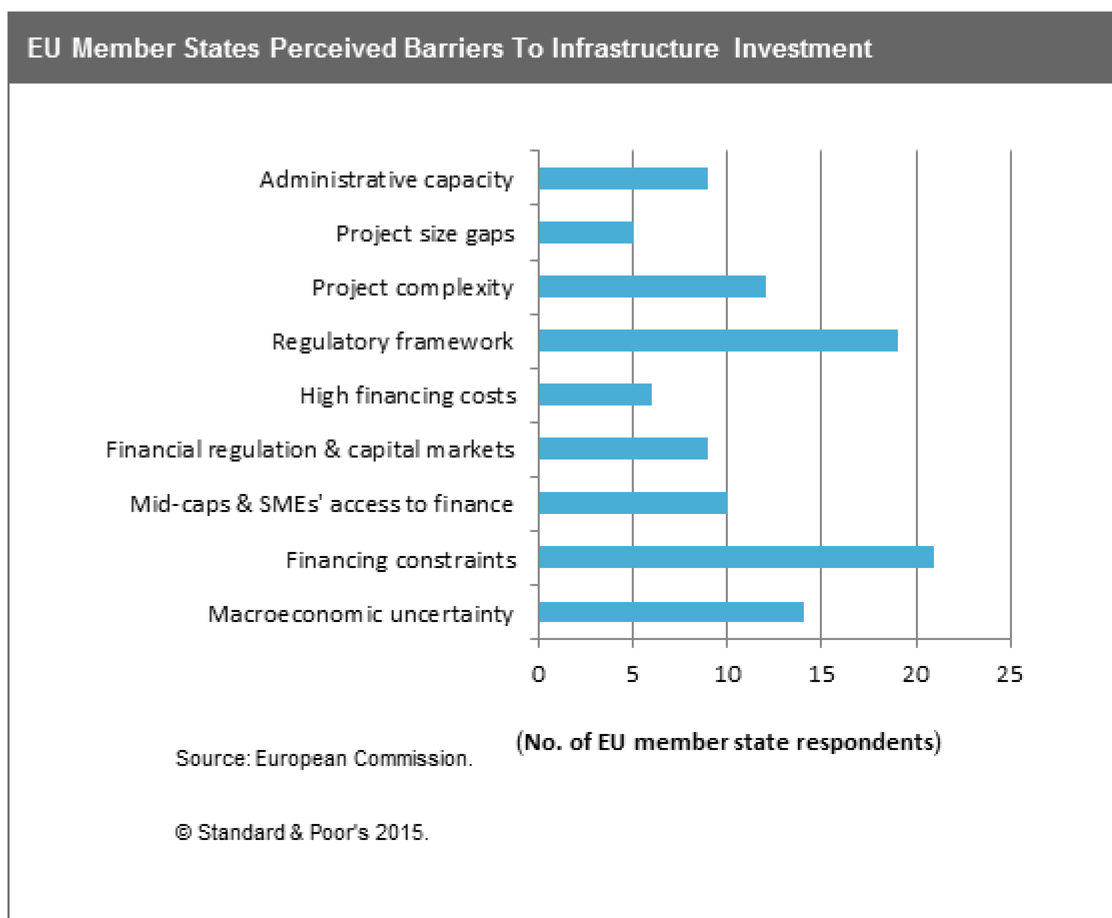
Chart 1



Nevertheless, scaling-up these early successes to the level envisaged under the Juncker Plan will, in our view, require more radical policy changes. For example, on Dec. 3, 2014, the U.K. announced a withholding tax exemption for private placements in infrastructure, which prompted six investment companies to immediately commit £9 billion to the sector. Allianz Global Investors alone announced it would allocate upward of £3 billion over the next three to five years. Replicated on a regional scale, and complemented by other support mechanisms, policy changes such as these could be the shot in the arm that is required to turn an EC wish list into EU reality.

Building A Case: The Need For Infrastructure Investment

Does infrastructure investment always lead to economic growth? This premise has been challenged by CEPS, a Brussels-based think tank, which has argued that investment across the EU was probably above sustainable levels prior to the financial crisis due the pre-2007 credit boom. It argues that infrastructure investment might only be justified as a growth stimulator in countries that have high levels of efficiency (3).

However, our own economic analysis shows that infrastructure spending boosts output growth through demand in the short term and supply in the long term (see "Global Infrastructure Investment: Timing Is Everything (And Now Is The

Time)," published Jan. 13, 2015). The demand-driven effect depends on where an economy stands in its economic cycle; it's stronger at the low point in a cycle. At the same time, the supply-driven effects depend on how productive investments are, which, in turn, could be linked to how they're financed.

We believe that without growth, compliance with the EU's fiscal rules by the majority of its 28 member states will be almost impossible to achieve. Standard & Poor's Ratings Services has stressed that the macroeconomic environment across the eurozone remains stubbornly weak, with faltering growth and deepening disinflation (see: "Credit Conditions: The Eurozone Crawls Into 2015 With Weak Momentum," Dec. 4, 2014).

Our economic simulations show that each additional £1 spent on infrastructure in the U.K. alone in one year would increase real GDP by £1.9 over a three-year period. We also project that additional spending of 1% of GDP in the U.K. would add more than 200,000 jobs (see "Building For Growth: Can The U.K. Close Its Infrastructure Investment Deficit?" Nov. 17, 2014).

Other simulations by Standard & Poor's economists have estimated the benefit to various eurozone economies over a three-year period (2015-2017) of an increase in spending of 1% of real GDP in the first year. In the eurozone as a whole, we estimate the multiplier effect to be 1.4x, with Germany and France coming out slightly lower at 1.2x and 1.3x, respectively, while Ireland and Spain would benefit the most at 1.4x and 2.0x, respectively. For the U.K., the EU simulation produces a multiplier of 2.5x. The main reason for the additional boost to U.K. GDP is increased demand from its European trade partners. We also project that such investment would add more than 300,000 jobs in the same year as the increase occurred.

Although we estimate the 20-year accumulated investment deficit in the U.K. to be about £64 billion (3.7% of 2013 GDP), Bruegel--another Brussels-based think tank--has estimated the equivalent deficit across the EU-15 to be about €260 billion since 2006 (4). Even this could be an underestimate, according to other sources.

In November 2014, the EC and EIB commissioned a special task force that identified that EU investment in 2013 was 15% (€430 billion) below its pre-crisis peak in real terms (2). In some EU member states, the range was said to be between 25% and 60%.

At this stage, there is insufficient information from the list of 2,000 projects to identify which would be viable from the perspective of raising large-scale investment-grade debt. The projects are not prioritized, and there are scant details on procurement or financing methods (see "Sidebar: A Viable Project Pipeline Or An Overambitious Wish List?").

Nonetheless, the list contains a number of projects in sectors that have proved successful in attracting private investment, such as regulated power transmission grids and PPP road projects. However, there are others--such as offshore wind power and high-speed rail projects--that could prove problematic given their risk profiles and relatively short operating histories.

The Fund Will Also Support SMEs And Mid-Market Companies

The bulk of the EFSI will support infrastructure debt investments, but a meaningful portion will be dedicated to small and midsize enterprises (SMEs) and mid-market companies. In particular, we expect that the EIB and the EU will

provide €5 billion in the form of equity-type investments and loan guarantee facilities via the European Investment Fund (EIF). This aims to generate a total of €75 billion of funds over the period 2015-2017 for SMEs and mid-market companies through a 15x multiplier or through raising additional private capital on top of the €5 billion of EU and EIB capital.

How the money will be distributed will be decided by an administrative council jointly controlled by the EIB and the EC. Since the funds are supposed to support growth and the creation of new jobs, we expect that a higher percentage will be allocated to countries that have suffered most in the financial crisis. It remains unclear, however, which SME and mid-market companies specifically will benefit from this cheaper source of capital. The current "ring-fencing" of the €5 billion just covers SMEs and mid-market companies in general. From an economic perspective, the EU money would probably best be put to work by supporting companies that create the highest degree of innovation and the most jobs as they grow, and those that currently are cut off from external financing to realize their plans. This would most likely be start-ups, younger firms, and established SMEs with a growth focus. Should any of this EU money be allocated to companies that do not fit this business profile and that have access to external capital--either directly through extension of capital by the EIB or indirectly through EIB packages provided to commercial banks--the intended social benefits of the program might be reduced, in our view. The EU money would then simply become an additional pool of competitive funds for already plentiful funding liquidity by European commercial banks.

We also see some potential that commercial banks could be incentivized to use the EIB financing to support their own existing lower-risk clients instead of extending credit to high-risk start-up companies. Should the EU funds indeed flow into higher-risk start-up companies, the question would still remain whether €5 billion provided via the EIF would be sufficient to attract a further €70 billion of investments to achieve the overall total amount the plan targets.

High-risk start-up companies typically require a high equity cushion of approximately 40% or more. As a consequence, the overall capital raised might be lower than the intended €75 billion. Furthermore, given the current economic climate, the issue might be less that companies lack access to funding than that macroeconomic and fiscal uncertainties encourage them not to invest. In such an environment, companies might be unwilling to fully utilize the benefits of the additional EU funding.

However, if the EIB and EIF can successfully address these potential weaknesses, we believe that the SME and mid-market carve-out of the Juncker Plan offers a viable route to support growth and employment in Europe.

Financing The Plan

Key to raising the total €315 billion for all initiatives is the crowding-in of private investors into projects funded by the newly created EFSI. The facility size will initially be €21 billion. Of this amount, the EU is to provide €16 billion in the form of guarantees, and the EIB will provide €5 billion.

Out of the €16 billion of guarantees from the EU, we expect a large portion will guarantee investments by the EIB. The remainder will likely be allocated to cover equity or equity-like investments as well as SME investments through the EIF (for €2.5 billion).

But where will the rest of the money come from? Converting €16 billion of EU guarantees and equity investments from the EIB into €240 billion of real long-term investments over three years will be a challenge. We expect this 15x multiplier to be achieved by a combination of leverage and an element of crowding-in (incentivizing co-investment) from other funding sources. The EIB could deliver new loans, supported by a first-loss piece guarantee from the EU. These loans would then crowd in other investors to achieve the overall investment target.

EIB projects typically attract about 3x as much private investment as it finances through its loans for projects. However, the EIB believes it could significantly increase this multiplier by financing higher-risk (and higher-yielding) projects or being more junior in the structure of the project financing, as these projects will benefit from the first-loss piece guarantee from the EU.

The partial de-risking of transactions could well attract larger-scale investments from nontraditional sources of capital, such as pension funds, insurers, and other institutional investors, and so a multiplier of 3x is likely to be a lower bound.

We expect the EIB to prudently manage its additional risk arising from the EFSI. If we were to assess that the additional risk taken significantly outweighs the protection offered by the EU guarantees, this could put pressure on EIB's capital adequacy.

The EC points to €650 billion of existing sources of funding available (including co-financing from member states) at the EU level through programs such as the Connecting Europe Facility, which provides grants and financial instruments. However, deployment of finance through such sources and instruments has been slow to date.

Over the past years, the EIB already borrowed about €70 billion each year to support its lending initiatives (€72 billion in 2013). With the additional lending envisaged under the Juncker Plan, we would expect funding volumes to remain in this range.

The real aim of the fund is to attract large-scale private investment, especially from institutional investors. According to Linklaters, a law firm, approximately €800 billion could be available from private funds for investment in European infrastructure until 2023, provided there are enough sound revenue-generating projects for investment (5).

Although institutional investment in infrastructure across the region has been growing rapidly over the past two years--especially in debt instruments, such as bonds and private placements--the scale of institutional funding that the Juncker Plan envisages is still unprecedented.

According to Preqin, a data provider, infrastructure funds had raised about $27 billion globally through the third quarter of 2014, mainly for unlisted equity investments, with about 25% of these funds focused on Europe (6). Assuming global project bond issuance of about $37 billion as a proxy for institutional debt appetite, together with the €38 billion of institutional investor capital raised via funds in 2014, total nontraditional sources of capital are still only a quarter of what the plan requires on an annual basis.

Table 1

Selected EU Infrastructure Projects & Corporates Rated In 2014		
Rating Date	**Companies or Projects**	**New Rating/Outlook**
January-14	Scot Roads Partnership Finance Ltd.	A-/Stable

Table 1

Selected EU Infrastructure Projects & Corporates Rated In 2014 (cont.)		
February-14	EMPARK Aparcamientos y Servicios, S.A.	BB-/Stable/--
April-14	Solutions 4 North Tyneside (Finance) PLC	BBB-(SPUR)/Stable
August-14	2i Rete Gas	BBB/Stable/A-2
August-14	V.Group	B/Stable/--
September-14	Dee Valley Water PLC	BBB/Stable/--
October-14	Domodedovo International Airport CJSC	BB+/Stable/B
November 2014	Western Power Distribution Ltd	BBB/Watch Pos/A-2
December 2014	Aberdeen Roads (Finance) PLC	A-(prelim)/Stable

SPUR--Standard & Poor's Underlying Rating. Ratings as of Jan. 15, 2015. Source: EIB/InfraNews, S&P.

Institutional appetite for infrastructure project debt has so far focused on 1) operational availability-based projects where regulatory and political risks are limited, and 2) social infrastructure (hospitals, schools, and housing). Projects that are in construction, rely on demand from users to generate revenues, or are exposed to general market risk have been less well supported. This could change over time as investors continue to hunt for yields typically found only in riskier projects.

The project bond credit enhancement (PBCE) instrument from the EIB--which has closed five transactions since August 2013--has demonstrated how contingent capital can be deployed to good effect in sectors such as gas storage, offshore transmission, and availability-based roads (see table 2). Still, so far the instrument has not been applied to riskier projects that are either in construction or are exposed to volume risk.

Table 2

Project Bond Credit Enhancement Transactions Closed Since August 2013

Project	Description	Bond Size	Ratings	PBCE	Pricing
Project Castor (Watercraft Capital S.A.), Spain	Offshore underground gas storage infrastructure project in Spain	€1.4 bil., publically listed	BBB/Stable (at issue)	€200 mil. initially	5.7% - 100 bps over sovereign at issue
Greater Gabbard OFTO, U.K.	Electricity transmission assets connecting wind turbines of the Greater Gabbard offshore wind farm to the U.K. onshore grid	£305.1 mil., publicly listed	NR	£45.8 mil.	125 bps over the benchmark U.K. gilt rate, or 4.317%
A11 Belgium	First green-field availability-based road transaction	€590 mil.	NR	€115 mil.	4.50%
Axione Infrastructures France	First PBCE project in the broadband sector and first PBI project in France	€190 mil., 11-year amortizing bond	NR	€38 mil.	2.622% 95.7 bps over 10-year 1.5% German bund
A7 motorway Germany	First PBCE project in Germany and second green-field project	€429 mil., 29-year amortizing bond	NR	€85 mil.	2.96%

bps--Basis points. Source: EIB/InfraNews, S&P.

We believe the EFSI--described by EU officials as "PBCE on steroids"--with clearer definition on how it will be targeted as well as how it will be structured could well succeed in attracting other sources of private capital. The need for greater infrastructure spending and the positive impact such targeted investment can have on the economy is relatively well understood. For the plan to succeed, substantial crowding-in of the private sector through scaled-up capital market funding will be essential and, we believe, ultimately achievable--as long as Europe's multi-lateral

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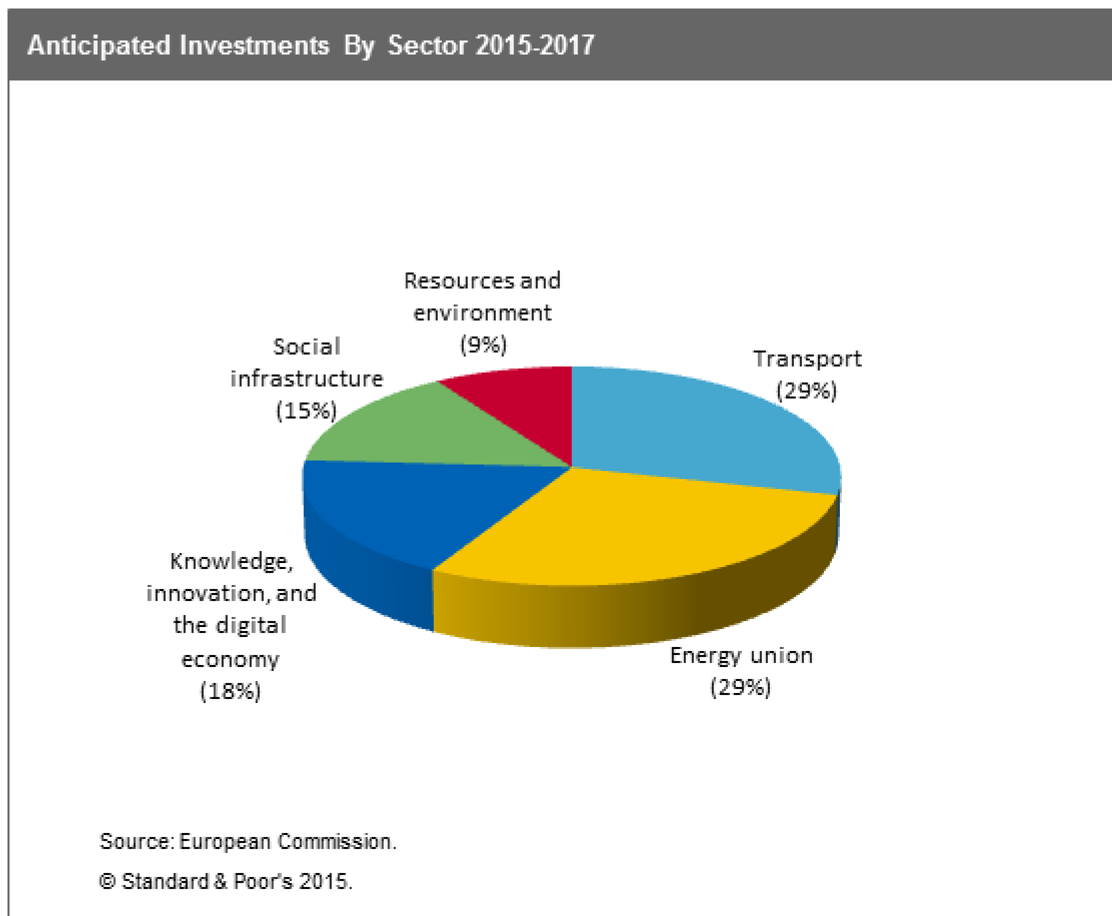
institutions, politicians, and policymakers provide sufficient support and incentives.

Sidebar: A Viable Project Pipeline Or An Overambitious Wish List?

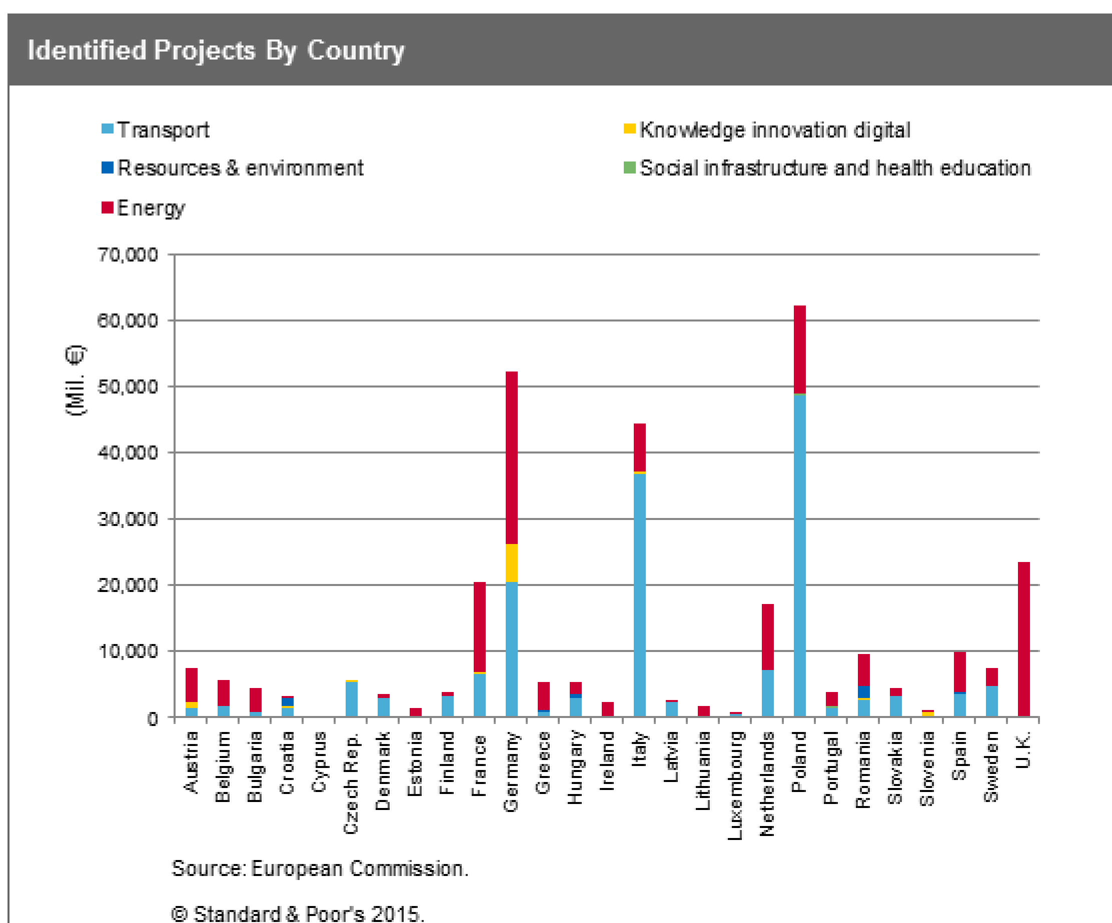
The commission has identified €1.3 trillion of potential investments (about 2,000 projects), of which €500 billion could be spent over the next three years (7). The list is based mostly on suggestions of national governments but also on recommendations from regional authorities, other public bodies, private investors, and the EC itself.

Chart 2



Transport and energy projects constitute 60% of the total (see chart 2). Electricity and gas interconnectors feature prominently on the list, with projects connecting Western European countries (such as France, Belgium, Spain, the U.K., and Ireland) but also between Central and Eastern European countries (such as the Czech Republic, Hungary, Slovakia, Romania, Bulgaria, and Greece) as well as between the Baltic countries (see chart 3).

Chart 3



The Europe-wide effort to integrate national power grids into an interconnected electrical system is a strong force behind the plan. The list includes large-scale schemes, such as a five-gigawatt (GW) power link between Spain and France costing up to €1.9 billion and a €1 billion two-GW Europe-Asia interconnector between Greece, Cyprus, and Israel. Spain alone is offering €12 billion of power grid projects.

The list includes offshore wind plans in the Netherlands (€12 billion) and Germany (€6.5 billion)—the latter also submitted more than €5 billion of offshore grid link projects.

Liquefied natural gas (LNG) facilities also feature prominently on the list as countries seek to benefit from plunging global LNG prices and also ease increasing concerns over the security of supply that stem from geopolitical tensions in Russia and the Ukraine.

Outside energy, the focus is mainly on transport links, with large-scale road PPP programs proposed for Germany (€10 billion), the Netherlands (€8.3 billion), and Italy (€12 billion). There are also a number of mega-projects, including the €6.2 billion Fehmarn Belt tunnel project in Denmark, the €3 billion expansion of Frankfurt airport, the €11.7 billion Turin-Lyon railway, the €12.2 billion Brenner railway tunnel in Italy, and two motorway plans in Romania costing €6 billion each. Some of these mega-projects have been on the drawing board for years and have already been allocated

EU funding but have not been started. The Romanian motorway investment project is already well under way--the government plans to spend about €4 billion, with another €5 billion from the EU--so in our view this is largely a recycling of existing projects for which funding has already been identified.

Although being on the list could accelerate the process, there remain doubts as to the need for some of these schemes. The Brenner tunnel, for example, has agreed EU funding but could ultimately be redundant given two other Alpine railway tunnel projects already under way. The rationale for the Fehmarn Belt tunnel is also weak, while the expansion of Frankfurt airport could quite feasibly be funded by its private owner, Fraport.

Related Criteria And Research

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7. Project List From European Commission, November 2014

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