Partnering for future prosperity
Delivering successful infrastructure projects to create globally competitive South African cities

Part 1: Evolving financing instruments and sources of funding
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1. Engineering cities that enable growth and competitiveness

“All progress is initiated by challenging current conceptions, and executed by supplanting existing institutions.”
- Shaw, George Bernard

In 2012, the Economist Intelligence Unit ranked the competitiveness of global cities according to their demonstrated ability to attract capital, business, talent and visitors. In this index Johannesburg occupied the 67th most competitive position out of 120 global cities, while Cape Town occupied the 73rd position and Durban 94th position respectively.

Infrastructure development is intrinsically linked to improving the competitiveness of cities and countries. It enables greater local and international trade, distribution and integration as well as improving the quality of life of its citizens and thereby attracting better qualified and more productive professionals and employees. Having effective, efficient, extensive and well maintained infrastructure contributes to socio-economic development and growth. For example, Transport Minister Sibusiso Ndebele advised that revitalising South Africa’s railway corridors, such as the Johannesburg-Durban corridor, amongst others, would improve road quality and safety, reduce road maintenance costs, create higher levels of reliability, reduce travel times and create an estimated 65 000 jobs. Investments such as this create a competitive economy that increases the ease of doing business, which further aids in attracting the necessary investment required to create more competitive cities. More competitive cities generally appeal to and develop talent, while also providing an environment that provides quality of life for its inhabitants and is attractive for visitors.

This paper is the first in a planned series of six publications that will focus on how cities and regions can increase their global competitiveness by improving their physical infrastructure. This first part deals with the infrastructure imperative and the current financing landscape for physical infrastructure and then goes on to look at some evolving financing instruments that can be further developed in South Africa to help make projects a reality.

The rest of the series will cover the following proposed topics:
• Infrastructure procurement methods
• Infrastructure funding models
• Capital efficiency
• Project portfolio management
• Asset lifecycle approach to infrastructure and capital projects management

The separate components of Procuring, Funding and Financing Infrastructure Assets

Procurement methods: refers to how the asset will be procured by government. Examples of procurement methods include Traditional Procurement, EPC (Engineering, Procurement and Construction) contracts (i.e.”Turn-key” contracts), and Public Private Partnerships.

Funding models: refers to the way in which the asset will be paid for, i.e. how will the revenue be generated to repay the financing raised for the construction and operation of the asset? Examples of funding models include: donor or grant funding, tolling imposed on roads, and unitary payments by government to the private sector operator under Public Private Partnership (PPP) agreements (such as annual lease payments in an accommodation PPP or payment per surgical procedure or bed-night in a Hospital PPP). Combinations are also possible, for example in the case of a toll road where the operator collects the toll fees, and government provides an underlying unitary payment guarantee based on guaranteed minimum daily vehicle numbers.

Financing instruments: refers to how the money will be raised to pay for the building of the asset. The broad categories of financing are equity and debt, and examples of financing instruments include project bonds, unsecured bonds, commercial bank debt, guarantees and shares issued.

These three components can and should be treated separately in making the strategic decisions around how a project should be structured. Most importantly, the concepts should not be confused. The methodologies and models for implementing each of these three aspects of infrastructure projects are evolving and this series will address the new evolving methodologies in each case.
2. The infrastructure imperative

Infrastructure, economic growth, improved education, job creation and skills development have all been identified as key focus areas in Government’s National Development Plan 2030.

Although South Africa’s infrastructure is amongst the most developed in Sub-Saharan Africa, much can still be done with regards to the enhancement and maintenance of transport, energy, water, sewerage and other physical infrastructure.

South Africa decision makers need to move at a rapid pace to ensure that South African cities maintain, and in due course gain, global competitiveness by ensuring a constant stream of infrastructure progress and development. To put this into perspective, South Africa is at risk of being eclipsed by other East African countries in terms of rolling out widespread, fast and enhanced broadband infrastructure. Kenya has made it clear that developing their information communication technology (ICT) sector is a key focus in their Vision 2030 planning document. Kenya is making strides in this regard, as it has invested in providing the second-fastest broadband on the continent after Ghana and the government has secured an additional US$55.1 million to scale up digital inclusion within the country\(^1\). This is relevant to note as there are numerous studies that have shown a strong correlation between broadband access and economic growth, job creation, increased efficiency and productivity. According to a 2009 World Bank study, a 10 percent rise in broadband penetration in low to middle income countries adds an extra 1.38 percent per annum to economic growth while another 2010 study indicated that every 10 percent increase in broadband penetration can contribute 2.5 percent to annual GDP growth\(^2\).

Increased investment in all forms of basic infrastructure (including hard infrastructure such as transport, water, sanitation, energy and public amenities and social services infrastructure such as housing, healthcare and education) can truly transform South Africa’s key cities into global city destinations for business, talent and visitors, which in turn enables increased growth, prosperity and better quality of life for its residents. In order to achieve this, however, the key challenge of financing needs to be addressed, as the demand for infrastructure development often outstrips the money that is available in city and state budgets to pay for its construction and maintenance.


3. The current infrastructure financing landscape

Governments are responsible for providing goods and services to their citizens, but the list of needs often far exceeds the amount budgeted or available to be spent. Similarly to its international counterparts, the South African government has historically funded a sizeable share of infrastructure development on balance-sheet, utilising the traditional methods of revenue collected from direct and indirect tax and sovereign debt raised on the local and international bond markets.

The South African Government has historically followed a process of establishing a host of State Owned Entities (SOEs) to implement large scale infrastructure development. Examples include ESKOM (electricity generation and distribution), Transnet (Rail, Ports and Pipelines), ACSA (Airports), SAA (National airline carrier), Telkom (Telephony), Rand Water, Umgeni Water, TCTA and others (bulk water treatment and distribution), SANRAL (National roads), Sentech and Broadband Infraco (ICT infrastructure).

Government provided the initial and in some cases ongoing periodic capital contributions to the SOEs. These SOEs (other than Telkom and for a period SAA) are 100 percent subsidiaries of Government. They are prohibited by statute from floating equity instruments and from attracting new private equity capital from private investors, as has been the evolution of this sector in many other developed countries. They are therefore dependent on debt finance to meet their infrastructure building and maintenance requirements. Many of these SOEs have focused on tapping the local and international bond markets (Eskom, Transnet, Telkom, Umgeni Water, SANRAL, etc) for a large share of this financing.

With the focus on bonds and traditional bank (senior debt) finance, the SOEs have largely ignored other available financing instruments and forms of structured finance that have evolved in recent years.

This approach has in some cases limited a larger-scale implementation of infrastructure due to budgetary restrictions and fiscal disciplines. While the local and international bond markets provide a deep and liquid source of debt financing, bonds are unsecured instruments dependent on the credit rating assigned to the issuer. The lower the credit rating, the more expensive the debt, and once the credit rating falls below investment grade, the cost goes up significantly, and the pool of lenders willing to lend decreases exponentially. As more and more bonds are issued, and the debt:equity ratio increases, the cost of servicing the debt (i.e. paying interest) increases and puts pressure on the credit rating assigned. There is thus a limit to how much bond finance can be raised by ‘SA Inc’ (Government plus its SOE subsidiaries) before the negative effect on the credit rating exceeds the benefit of raising further finance.

The National Treasury’s Budget Review 2012 report indicates that over 2012/13, Government’s net borrowing requirement is expected to reach R168.8 billion, while SOEs will, in addition to this, borrow an estimated R76.9 billion to fund their capital expenditure programmes. Development finance institutions will borrow a projected R13.9 billion to meet developmental funding commitments. After increasing in line with projected budget deficits, government’s net debt is expected to peak at 38.5 per cent of GDP in 2014/15.3
Looking at South Africa’s current pipeline of infrastructure projects being considered, or in progress (see table on the following page) that are to cost in the region of R3 203 billion, only 25 percent are said to be financed and are being implemented at the moment, while the remaining 75 percent are under-going assessment. National Treasury has acknowledged that not all the projects will be affordable for government to implement in isolation, and will require private sector financing in order for them to be considered for implementation.

This supports the contention that innovative new funding models and financing instruments need to be developed, and new pools of infrastructure investors and financiers sought, in order to deliver the required infrastructure needs.

### South Africa's major infrastructure projects in progress and being considered

<table>
<thead>
<tr>
<th>Infrastructure sector</th>
<th>Project name</th>
<th>Total project cost</th>
<th>Major Infrastructure projects in concept, pre-feasibility and feasibility stage</th>
<th>All projects</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Energy</strong></td>
<td>Kusile power station</td>
<td>R 520 billion</td>
<td>Nuclear fleet build</td>
<td>R 876.8 billion</td>
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<td></td>
<td>Medupi power station</td>
<td>R 121 billion</td>
<td>Grand Inga</td>
<td>R 300 billion</td>
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<td></td>
<td>Grooteveld</td>
<td>R 7.8 billion</td>
<td>Imported hydroelectricity options</td>
<td>R 52.2 billion</td>
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<td></td>
<td>Komati</td>
<td>R 12.9 billion</td>
<td>Closed cycle gas turbine</td>
<td>R 200 billion</td>
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<tr>
<td></td>
<td>Ingula pump-storage scheme</td>
<td>R 21.4 billion</td>
<td>Closed cycle gas turbine</td>
<td>R 13.6 billion</td>
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<td></td>
<td>Renewable energy</td>
<td>R 120 billion</td>
<td>Coal Three</td>
<td>R 111 billion</td>
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<tr>
<td></td>
<td>Open-cycle gas turbine</td>
<td>R 15.4 billion</td>
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<td></td>
<td>Distribution backlog</td>
<td>R 27.5 billion</td>
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<td></td>
<td>New transmission lines</td>
<td>R 95 billion</td>
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<tr>
<td><strong>Transport</strong></td>
<td>Passenger railways</td>
<td>R 166.5 billion</td>
<td>Moloto rail</td>
<td>R 378 billion</td>
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<td>National road improvements</td>
<td>R 80 billion</td>
<td>Manganese rail and terminal</td>
<td>R 10 billion</td>
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<td></td>
<td>Rolling stock and locomotives for freight rail</td>
<td>R 45.4 billion</td>
<td>Iron-ore line</td>
<td>R 18 billion</td>
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<td></td>
<td>Provincial road improvements</td>
<td>R 7.7 billion</td>
<td>Coal line</td>
<td>R 37 billion</td>
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<tr>
<td></td>
<td>Ngqura container terminal</td>
<td>R 9.7 billion</td>
<td>High speed rail</td>
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<tr>
<td><strong>Water</strong></td>
<td>Lesotho Highlands water project phase II</td>
<td>R 45.3 billion</td>
<td>Mzimvubu water resources</td>
<td>R 20 billion</td>
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<td></td>
<td>Komati</td>
<td>R 1.7 billion</td>
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<td></td>
<td>Mokole-Crocodile water augmentation project</td>
<td>R 15 billion</td>
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<td></td>
<td>Olifants River water resources development project</td>
<td>R 16.1 billion</td>
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<td></td>
<td>Sedibeng regional sanitation scheme</td>
<td>R 5 billion</td>
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<tr>
<td><strong>Housing</strong></td>
<td>Comubia housing development</td>
<td>R 5.1 billion</td>
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<tr>
<td><strong>Telecommunications</strong></td>
<td>Digital terrestrial television</td>
<td>R 1.8 billion</td>
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<td></td>
<td>National wireless broadband network television</td>
<td>R 0.8 billion</td>
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<tr>
<td><strong>Liquid fuels</strong></td>
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<td>R 211 billion</td>
<td>Oil and gas exploration on the west coast</td>
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<td></td>
<td>Oil and gas exploration on the west coast</td>
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<td></td>
<td>Project Mthombo</td>
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<tr>
<td><strong>Education</strong></td>
<td>Mpumalanga University</td>
<td>R20 billion</td>
<td></td>
<td>R20 billion</td>
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<td></td>
<td>Northern Cape University</td>
<td>R10 billion</td>
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<tr>
<td><strong>Health</strong></td>
<td></td>
<td>R30 billion</td>
<td>Limpopo Academic Hospital</td>
<td>R6 billion</td>
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<td></td>
<td>Nelson Mandela Hospital</td>
<td>R6 billion</td>
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<td></td>
<td>Chris Hani Baragwanath Hospital</td>
<td>R6 billion</td>
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<td></td>
<td>Dr George Mukhari Hospital</td>
<td>R6 billion</td>
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<td></td>
<td>King Edward VIII Hospital</td>
<td>R6 billion</td>
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</tbody>
</table>

Source: National Treasury, Budget Review 2012
4. Laying down a new foundation for financing large projects

“When any real progress is made, we unlearn and learn anew what we thought we knew before.”
- Thoreau, Henry David

If an asset is not financed through the National Budget, how else can it be paid for? Project specific financing is one technique used widely in developed markets, allowing entities to raise ring-fenced funding for specific projects without impacting their core balance-sheet credit rating. The need for project specific financing comes at a crucial stage for the infrastructure development programme. Increasingly this mechanism is emerging as a preferred alternative to traditional forms of on balance-sheet (unsecured) finance. A project finance transaction provides the ability to ring-fence project assets, operations and cash-flows, to procure private sector funding secured by the forecast strength of the project specific cash-flows, rather than the balance-sheet strength of the project promoter.

The financing package generally used in developed markets, is to fund the development phase of a project using an equity contribution from the project promoter plus debt in the form of Project Bonds, which carry the development risk on the project and thus a higher interest rate than traditional senior debt. Once the project is operational and has a proven operating track record and cash flows, the Project Bonds are typically refinanced, using a package comprising an equity investment by one or more infrastructure funds, plus senior debt in the form of bonds and senior bank loans. This debt will usually price cheaper than the project bonds, as the development risk on the project has fallen away now that it has a proven track record.

Determining the most effective financing instrument, or mix of instruments, for any particular project requires careful consideration. This pool of available financing instruments enables tailoring of a bespoke financing package, based on each unique capital project and its specific features and requirements. The financing instruments and sources of funding referred to above are discussed as follows.
## Infrastructure Funds

**In brief:** An independent entity typically used to raise investments from institutional investors, that is then invested in financing instruments issued by a pool of infrastructure projects. This spreading of investment risk across a diversified pool of projects theoretically ensures a more stable return to the investors. Infrastructure funds can provide debt and/or equity to a project depending on the nature of the fund.

### How they work:
Infrastructure funds started as a niche market offering but have now transformed into their own asset class.

The fund is usually incorporated as a limited partnership, limited liability company or equivalent which is domiciled in a tax-advantaged location. In the early phase of operation the fund is usually heavily reliant on Development Finance Institutions. In some instances institutional investors may also be early investors but they usually prefer the fund to build up some sort of track record before committing any cash. Later stage investors include pension funds, sovereign wealth funds, insurance companies and other infrastructure funds.

Infrastructure funds predominantly operate on a closed basis where the fund manager will look to raise a defined amount of capital to commit to investment opportunities. After the fund has defined its investment criteria, and analysed the various investment opportunities, making sure they are in line with the mandate of the fund, it then deploys the cash. The draw downs are usually done on a pro-rata basis. Investors will commit the capital contributions for a defined period, on average between 10 to 15 years but usually will have the option of receiving capital back that has not yet been invested after an initial commitment period ranging from 5 to 7 years. The fund manager is compensated by way of a management fee. Investors are paid by the fund manager from cash received from the investments made. Capital contributions are repaid in full plus an annual agreed rate of return which is compounded from the initial date that draw down was made from the individual investor.

Exit strategies include an initial public offering (IPO), (i.e. listing the fund) where capital markets are sufficiently developed, corporate bond issues or by selling the existing assets to other infrastructure funds or investors. Fund managers may even roll the assets into a different investment product like an open-ended fund. These funds are used extensively throughout the world to finance infrastructure projects.

India alone has over 100 infrastructure funds serving the Indian domestic market.

### The benefits for investors:

- **Stable and predictable long-term performance:** Cash flows come from 25-30 year operating concessions backed by government covenants. Long term investments are very attractive to institutional investors like life companies and pension funds that need to match their long-term liabilities.

- **Returns with a low market correlation:** Given the nature of the underlying investments, the financial position of a well-structured infrastructure project is typically less volatile than a purely commercial investment fund.

- **Recession resistance:** A large portion of cash flows to infrastructure service providers are predicated on the availability of the service provided (especially in Africa where demand outstrips supply in the provision of ‘public’ goods). In many instances, the returns are uncorrelated with changes in economic activity, as has been evidenced in the recent global recession.

- **Inflation protection:** Off-take agreements are typically negotiated with an inflation-indexed escalation.

### The benefits for government:

- **New sources of funding:** Governments do not have to carry the burden of financing all infrastructure needs, partial or full financing can be sourced from private investors and institutions.

- **Punctual delivery of project:** As the private sector project promoters and construction companies have agreements in place with private investors there is a need to meet expectations of the agreement, so punctual delivery of the project as well as being within the budget is imperative.

- **Shifting the risk to private sector:** As implementers of the project are from the private sector the Government does not carry all the risks associated with these projects.

- **Cost savings:** It has been observed in past partnership projects globally that between 15% - 30% of costs can be saved over the life cycle of the project. 75% of these are saved during the design-build phase and the remaining 25% during the operations phase.

- **Focus on pertinent issues:** The implementation and monitoring of these projects allows Government to shift their focus to solving other national issues rather than micromanaging infrastructure projects.

### Concern for government:

- **Giving up an equity stake:** Infrastructure Funds typically invest in an equity stake in infrastructure projects, and seek equity returns on the projects that they invest in. Infrastructure funds may also trade these equity stakes, selling the investments between themselves. A private equity stake in social infrastructure projects in South Africa is a sensitive political issue that will need to be settled within Government to release this substantial source of new finance and new pool of investors.
### Senior Debt

In brief: A term loan facility, typically borrowed from a bank (either a commercial bank or a development finance institution such as the Development Bank of Southern Africa, the African Development Bank or the European Investment Bank), or other institutional investor (e.g. Pension Fund). Interest is levied based on a base rate plus a project risk margin.

**How it works:** Senior debt is the money borrowed that the project must repay first. This applies to a successful project, i.e. repayment of debt is on an agreed schedule, and, if the project defaults, then the termination amount is first used to repay the senior debt, before any other funder or equity investor.

In Government project financing structures, senior debt is typically secured by collateral or some form of government guarantee, which is used to repay the lenders in the event of default. As such, senior debt is considered lower risk and carries a relatively low interest rate, as compared to other loan instruments. Even though senior debt holders are the first in line to be repaid, they will not necessarily receive the full amount they are owed in a worst-case scenario.

**The benefits for lenders:**

- **Stable and predictable long-term performance:** The Project risk dictates the margin and hence the final interest rate, and pre-agreed repayment schedules form part of the lending documents. There is also often some form of underwriting in the case of government infrastructure projects.

**The benefits for government:**

- **Traditional source of funding:** Governments do not have to carry the burden of financing all infrastructure needs, partial or full financing can be sourced from institutional financiers.

- **Punctual delivery of project:** The lenders have a set drawdown schedule which must be met before payment is made to the contractor and this can help to keep the project on track.

**Concerns for government:**

- **Pricing of the debt:** It is difficult for government to evaluate the price of the debt. As each project has its own risks and performance hurdles, the government may end up paying a higher margin that the project should carry.
Project Finance

In brief: The finance is raised on the security of the cash-flows to be generated by a single asset. The finance required for the project is paid back with revenue generated by that project only, so the investors' risk is specifically tied to the asset being funded and not to the balance-sheet of the project promoter or developer.

How it works: With project finance it is important that the cash flows of the project are clearly identified and separated from the sponsor’s main business and balance-sheet. The asset is housed in a separate legal entity, special purpose vehicle (SPV) so that it is insolvency remote and properly proofed against any risk of insolvency of the sponsor or any other form of attack on the sponsor.

The financial model developed to forecast the likely cost of the asset and the performance of the asset once operational is vital to give investors comfort that the cash flows will be adequate to repay the finance.

The revenue cash flows that the asset generates once operating are used to repay the finance. The cash flow waterfall (who has access to the revenues and in what order) needs to be clearly identified and sequenced in the funding documents.

Project finance is often used to fund infrastructure assets procured through Public Private Partnerships.

The benefits for investors:

- **Stable and predictable long-term performance**: Cash flows for debt repayment come from concessions or projects supported by government covenants.

- **Returns with a low market correlation**: Given the nature of the underlying assets financed, the financial position of a well-structured infrastructure project is typically more stable than exposure to a purely commercial entity.

- **Recession Resistance**: The debt pricing is often hedged, so the returns are stable. In many instances, the returns are uncorrelated with changes in economic activity.

The benefits for government:

- **New sources of funding**: Governments do not have to carry the burden of financing all infrastructure needs, partial or full financing can be sourced from private investors and institutions.

- **Punctual delivery of project**: The lenders conduct an independent and comprehensive due-diligence of the project over and above that of Government or the private sector investor. This helps to ensure that the project fundamentals are correct. They also have a vested interest in ensuring the project is delivered on time and on budget.

- **Shifting risk to the private sector**: As implementers of the project are generally from the private sector the Government does not carry all risks associated with these projects.

- **Cost savings**: the cost of the Government capital contributed far exceeds the cost of commercial debt. Often people focus on the cost of government debt compared to private sector debt, however, one needs to add in all the other costs that government’s carry in a traditionally financed project. These include operational and maintenance costs, design cost and cost overruns. If these are translated into a cost of government capital and then compared with the cost of capital from the private sector a different picture of relative cost will often emerge.

Concerns for government:

- **Pricing of the debt**: Project finance carries a significant premium (typically 200 - 400 basis points) to senior debt funding given the isolation of the project owner’s balance sheet, i.e. lenders only have recourse to the asset and its cash flows and if the asset does not perform as modelled then the lender will be left exposed. For this reason, South African Government institutions have not to date made extensive use of this form of funding and have instead generally followed a traditional central treasury approach (even for large projects such as the new Kusile and Madupu power plants), using on-balance sheet senior debt raised through the bond markets. One way of addressing the risk premium, while still opening up a new pool of project finance investors, is for Government to provide some form of underwriting or guarantee on the performance of the asset (e.g. by guaranteeing a minimum number of daily commuters on the Gautrain, or a minimum number of trucks using a toll-road).
Concerns for government:

• **Pricing of the debt:** As above for project finance. In addition, project bonds typically have to be rated, typically by two or more international credit rating agencies, which can add additional cost, risk and delay.
5. Partnering for growth and development

As shown above, there are a variety of financing instruments and structures that can enable Government to realise infrastructure projects in excess of the number that the fiscus can support off of the SA Inc. balance-sheet. By partnering with private sector developers and private sector investors and funders, more can be achieved in a shorter space of time. Successful project identification and analysis are the first steps in reviewing a potential project in order to define the optimal funding mix between government resources and the variety of private financing instruments available in the market.

Just as Government has the opportunity to move beyond on-balance sheet finance, the private sector also needs to be creative in how it partners with government. This creativity needs to extend beyond traditional senior debt products into the range of new and innovative financial products available, some of which have been highlighted above. While projects and financing instruments need to fairly priced, the private sector must focus on reviewing their structuring and pricing of government infrastructure projects to ensure that the cost of private financing will not exclude these options from being applied. A range of potential credit risk mitigants to achieve this have also been touched on above. With careful consideration, and an honest and transparent process from both sides, a fair allocation of risk and return can be achieved for both parties, and to the benefit of South African society at large.
Why Deloitte?

Deloitte has a significant range of public sector specific strategic business solutions. We have a dedicated team specifically focused in the area of Debt Advisory, PPPs and Infrastructure and Capital Projects Advisory. This team advises governments on capital structuring for projects and can assist with creating and managing the procurement process for the appointment of service providers. The team also advises consortia tendering for PPPs or other capital projects on funding structures and assists with scoping studies, bankable feasibility studies, financial modelling and fundraising to support their tender submissions for large public sector infrastructure initiatives throughout Sub-Saharan Africa.

Our solutions are designed in conjunction with our clients and government officials, to ensure that they are relevant and can better serve and uplift South Africa. Deloitte assists governments and private entities with new capital financing, refinancing maturing debt and re-structuring existing debt. We also provide advice on the funding strategy, alternative funding structures and the funding plans specific to the entity or a particular project, and provide a detailed analysis of all structures considered, with advantages and disadvantages of each and recommendations on the optimum model and structure.

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