Fasten seat belts – Japan infra to take off

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On April 1 2016, the Japanese government handed over the keys to Kansai and Osaka international airports to a consortium comprising French and Japanese sponsors, marking the first ever major airport privatisation in Japan and the country's biggest public private partnership to-date. By Rémi Maumon de Longevialle of Vinci Airports, Lionel Epely of Vinci Concessions, and Ross Howard, Yusuke Abeand Amelia Hanscombe of Clifford Chance.

The ¥2.2trn (approximately US$18bn) privatisation is the first of potentially 30 airport privatisations in Japan[1], and represents a critical policy shift for the Japanese government, which has long been protective of its ownership of public infrastructure.

Labouring under the weight of significant public debt, the Japanese government has come under pressure to cut spending and find ways to generate revenue from major assets in order to support its ageing population.

The Kansai airport in particular has been a huge source of public debt (estimated to be around ¥1.2trn, US$14.7bn), incurred as a result of the high costs of construction on reclaimed land in Osaka Bay and the subsequent implementation of measures to counteract the effects of differential ground settlement.

Former airport operator New Kansai International Airport Company (NKIAC, wholly owned by the Government of Japan) has been unable to tap into much of the potential for growth at the airport, but the sheer volume of passenger numbers and importance of the region – both commercially and for tourism – led the government to handpick the Kansai and Osaka international airports for its first major infrastructure privatisation. Together, the airports welcomed 37.7m passengers in 2015, making them the second busiest airport group in Japan.

Following an intensive tender process in mid-2015 and the negotiation of a 44-year project agreement conferring the operating right, newly formed SPV Kansai Airports took over operations on April 1 this year. France's Vinci Airports and Japan's Orix Corporation each own 40% of Kansai Airports, with a group of 30 minority shareholders owning the remaining 20%.

Among these minority shareholders are a number of well-known corporates from the Kansai region, including Osaka Gas Co Ltd, Obayashi Corporation, Kansai Electric Power Company Inc,Keihan Electric Railway Co Ltd, Panasonic Corporation and Nippon Telegraph & Telephone West Corporation (NTT West). Notably, almost all of the minority shareholders are from Kansai except for Project Finance Initiative Promotion Corporation of Japan (PFIPCJ) – a strong indication of the support for this project from the Kansai business community. Both PFIPCJ and a number of regional banks are shareholders as well as lenders.

Orix Corporation is a long-established Japanese financial services group, with expertise in lending, investment, life insurance, banking, asset management, automobiles, real estate and energy-related businesses. It operates over 15 hotels in Japan and manages the second largest fleet of rental cars in the industry. It was originally formed in Kansai, and has retained a strong presence in the Kansai region for many years.

France’s Vinci Airports is a leading international player in the airport sector, currently developing or operating 34 airports worldwide: 12 in France, 10 in Portugal, three in Cambodia, one in Chile, two in Japan and six in the Dominican Republic. Together, these airports handle more than 100m passengers a year. Its core business is developing, financing, building and operating airports, leveraging its investment capability, international network and know-how to optimise the management of existing airport infrastructure, facility extensions and new construction.

Concessionaire Kansai Airports has committed to the region for the long haul, with the project period being scheduled to run for 44 years until March 31 2060. During this time, Kansai Airports will operate Kansai International Airport and Osaka International Airport under an operating right granted from NKIAC pursuant to Japan’s Act on Promotion of Private Finance Initiative, taking over both the aeronautical (eg, operation, maintenance and management of runways) and non-aeronautical businesses (eg, operation, maintenance and management of terminal buildings).

Air traffic control, customs, immigration control and quarantine functions will continue to be conducted by the government, while NKIAC and Kansai International Airport Land Company will continue to own the airport site and facilities.

The consortium has big plans for the two airports, aiming to generate sales of ¥250.9bn from airport operation and attract 57.51m passengers in the contract’s final fiscal year in 2059 – both representing a 70% increase from the figures of fiscal 2014. An important part of this expansion programme will be to bring new Western and Asian carriers to the Kansai region and expand the airport’s flight network, especially by adding a number of long-haul flights between Europe and Japan and increasing the number of low-cost carriers utilising the airport.

Vinci Airports has achieved significant traffic and route growth at all of its major airports since taking over operations, and is a close collaborator with many airlines and cargo outfits. It hopes to leverage this track record in order to attract new routes, while ORIX will cement the consortium’s presence in the region and develop relationships with local business.

Orix will lead the effort to develop new commercial space in and around the airport, which – having opened in 1994 – is well overdue for a make-over. Plans describe extensive new shopping and commuter rest areas, as well as more affordable lodgings for layover passengers. The consortium intends to improve passenger flow inside the airport and revamp passenger amenities, as well as give local businesses better opportunities for commercial enterprises and shops to showcase culture and industry within the Kansai region.

Engagement with local business is a strong focal point of the consortium’s project strategy, as the Kansai region has huge untapped potential for aviation demand – the region has the country’s second largest economy and population, after the Tokyo metropolitan area, as well as a plethora of tourist landmarks – being home to both Kyoto and Osaka cities.

The number of foreign tourists visiting Japan is expected to grow steadily in the medium to long term, and tie-ups with local enterprises and nearby tourist facilities are intended to differentiate Kansai and Osaka from international “business” airports Narita and Haneda in Tokyo. The 2020

Olympics, to be hosted in Tokyo, are expected to bring enormous tourist traffic and exposure of Japan as a tourist destination, with the Japanese government planning to double the number of visitors to Japan to 40m by 2020.

The two airports are the Vinci group's first major investment in Japan, and its first time partnering with Orix. The deal is also the largest infrastructure investment in Japan from a non-Japanese company, a significant accomplishment in itself for a market that is traditionally perceived to have high barriers to entry for significant inbound investment.

That said, international appetite for acquiring the operating right to the Kansai and Osaka airports was strong – shortly after the Japanese government released the initial RFP, 11 foreign enterprises passed the initial bid screening and were rumoured to be eager to place a bid – including Australia's Macquarie Capital Group, Spain's Ferrovial SA, Singapore's Changi Airports International and Global Infrastructure Management, which operates London's Gatwick Airport.

Despite their apparent keen interest, these heavyweights were thwarted by an inability to find a Japanese partner and meet the RFP requirement that the lead member of any consortium be a domestic company. Potential domestic investors were reportedly ambivalent to take on a project of this size for more than four decades in an area that was not their traditional business.

Another factor for both foreign and domestic suitors alike was the concession fee – regarded by some as very high. Many interpreted the fee as being structured to match the repayment profile of the public debt incurred to build the Kansai airport, and not calculated on the actual value of the airport itself.

On this basis, media speculation suggested that international operators would regard the return as too low, and that only Japanese sponsors would be willing to take a low return asset because of the lack of country risk. In reality, notwithstanding the high fee overall, the small upfront payment proposed by NKIAC was attractive to international investors, especially given that the deal was to be financed on a non-recourse basis.

Ultimately, the Franco-Japanese alliance of Vinci Airports and Orix was the only team that entered a compliant bid – though the project agreement and associated documents were no less fiercely negotiated by NKIAC. Clifford Chance advised Vinci Airports on all aspects of the transaction, which involved several months of due diligence and intensive negotiations.

The bidding and tender process provided insight into how the Japanese government is likely to manage future brownfield deals with significant overseas appeal, with NKIAC appointing both international and local counsel. NKIAC and the Japanese authorities were also willing to prepare the first set of documents in both English and Japanese, and to accommodate the consortium – to a large extent – in running documentation in both English and Japanese in parallel, although the final binding documents are in Japanese and are governed by Japanese law.

Mizuho Bank Ltd, Sumitomo Mitsui Banking Corporation, Development Bank of Japan Inc, Bank of Tokyo Mitsubishi UFJ Ltd, and Crédit Agricole Corporate & Investment Bank arranged a syndicated project financing for approximately ¥190bn (including ¥30bn of ancillary facilities), with Mizuho and Sumitomo also acting as bookrunners. A total of 13 financial institutions participated in the syndicate, which was dominated by regional banks – Crédit Agricole being the only foreign lender to commit funds. PFIPCJ also provided a ¥20bn mezzanine loan, signing up as both a lender and a shareholder in the deal.

The make-up of the lending syndicate – and the fact that the sponsors were able to successfully procure 30-year senior debt and 35-year mezzanine debt – suggests that Japan continues to be a particularly liquid market, with a strong appetite among local lenders to lend to home-grown projects. Most Japanese banks usually have to seek out overseas project finance transactions, due to a dearth of projects domestically. This was a novel project for most of the 13 banks, however, as it was the first project financing for a concession-based project in Japan as well as the largest project financing to-date in Japan.

Concession business and privatisation of major assets are key areas of focus for the Abenomics growth strategy. Past privatisation in Japan mostly occurred in the 1980s – including NTT, Japan Tobacco and Japan Rail – but slowed again throughout ensuing decades. This was partly due to the financial crisis and the Great East Japan Earthquake, the latter being a major diversion for the Government of Japan’s resources and energy.

The Japanese government updated its laws on private financing in 2011 to allow private investor control of airports and other public facilities, and Prime Minister Abe has continued to drive the push for private finance initiatives (PFI) since being re-elected in December 2012. In 2013, the Cabinet Office announced a major action plan for the reform of PFI and PPP projects, setting a target that aims to triple private-sector investment in Japan’s infrastructure to ¥12trn over the next decade.

Airports are at the forefront of infrastructure assets earmarked for PFI concessions in Japan, with the bid process soon to commence for the Shizuoka Airport privatisation and for the Kobe Airport privatisation. The Shizuoka Airport is a regional airport located between Tokyo and Nagoya and is close to Mount Fuji – making it popular among tourists and Chinese airlines. Due to subsidies from Shizuoka Prefecture, the airport has steadily expanded its operating hours and passenger numbers reached around 700,000 last year.

The “Basic Scheme Plan” released for the Shizuoka Airport invites potential investors to comment on the plan by mid-June, and welcomes both domestic and foreign players – although foreign investors will be requested to present a plan regarding how they will cooperate with local business in Shizuoka. The bid for the 20-year concession, with extension options for another 20 years, is expected to take place from April 2017.

Similarly, Kobe City aims to start its bid process for the Kobe Airport in February 2017, with privatisation slated to occur in spring 2018. Kobe Airport offers domestic flights by multiple airlines off the coast of central Kobe, and like Kansai International Airport, is built on reclaimed land.

The sales of the concession rights for three other domestic airports – Hiroshima, Takamatsu and Fukuoka – are also in the early stages, while there are ongoing talks at government level about the privatisation of a bundle of airports in Hokkaido. Outside the airport sector, there is also the ongoing Aichi Tollway privatisation project, while numerous waste and waste-water concessions are expected to come to market in the next few years.

Regionally speaking, numerous airports throughout Asia are coming up for privatisation – particularly those in developing nations. These airports are typically owned and operated by central or local governments or by state-owned companies, but like Kansai and Osaka, lack the funding or expertise to drive successful expansion.

Governments throughout Asia (including the Philippines, Mongolia and Nepal) are announcing plans to sell off long-term management rights to both foreign and domestic players, in order to pay off hefty sovereign debt and gain know-how and increased passenger traffic. Some reports estimate a market of over US$80bn for airport management in Asia.

The Kansai and Osaka airports privatisation will undoubtedly set an important benchmark for brownfield, concession-style PPPs in Japan for both domestic and foreign future sponsors. The successful financial close in March 2016 should boost confidence in the market and pave the way for more opportunities for international sponsors, as well as local and international banks. Contrary to perceptions that it is difficult for overseas investors to close onshore deals in Japan due to different languages, business culture and systems, this privatisation proves that Japan is indeed open for business.

Clifford Chance acted as legal counsel for Vinci Airports, with Nishimura & Asahi as legal counsel for Orix. Nagashima Ono and Tsunematsu acted as legal counsel for the lenders, and Anderson Mori & Tomotsune and Freshfields Bruckhaus Deringer acted as legal counsel for NKIAC.

Footnote

1 — In 2011, Japan's Ministry of Land, Infrastructure, Transport and Tourism (MLIT) announced plans to privatise all national airports by 2020, with the first privatisation process to begin with Kansai and Osaka international airports. While some passenger terminals or small domestic airports have been privatised in Japan, this is the first time that private investors will manage a major airport.

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