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SmartLessons

real experiences, real development

Teaming Up to Support Subnational Water Utility in Brazil's Frontier Region

IFC's first subnational loan in Brazil is an example of how joint work and complementarities between IFC and the World Bank, as well as a combination of investment and advisory services, can deliver comprehensive support for a client. The World Bank and IFC together were able to help a client in a frontier region¹ gain efficiencies by IFC's financing of quick payback investments of Companhia de Saneamento de Sergipe-DESO, the water company owned by the state government of Sergipe, and the World Bank's provision of critical policy-setting assistance, regulatory advice, and funding for long payback investments in sewerage expansion. Until IFC stepped in, the company could only access shorter-term loans. Further, the Public-Private Infrastructure Advisory Facility's Subnational Technical Assistance Program (PPIAF-SNTA) played a key role in helping the client become ready to borrow on commercial terms. More is expected in the near future, with IFC Advisory Services providing support on cleaner production and an additional IFC investment to help the client refinance its short-term debt. This SmartLesson shares what we learned in helping our frontier client gain efficiencies by reducing water losses and energy consumption, including tapping into World Bank-IFC complementarities, leveraging the World Bank's relationship with governments, helping inexperienced borrowers articulate their story, and identifying hidden structuring opportunities.

Background

Early in FY 2010, a World Bank senior water and sanitation specialist in the Sustainable Development Department was engaged in discussions with the state of Sergipe on a US\$70 million loan to (i) strengthen water regulation, (ii) improve irrigation systems, and (iii) enhance water quality. This third component, the largest, would be implemented by DESO, which had gone through several years of mismanagement until early 2007, when the state of Sergipe government hired professional managers to run the company. In its contacts with the water and sanitation specialist, the company asked for help to accelerate its turnaround plans and strengthen its ability to implement measures that were complementary to the World Bank project.

¹ Frontier regions are identified based primarily on per capita income, with adjustments by IFC staff to reflect prevailing business risk issues in the country.

Although the results of the management change were starting to show, the company still did not have access to long-term commercial loans or to local development finance institutions (e.g., BNDES and Caixa, the main financiers of the sector). Therefore, DESO was unable to raise funds to implement investments that would clearly have a quick payback and lead to a lasting improvement in the company's finances. These investments included purchasing water meters, standardizing water connections, and updating customer databases. As an example, Picture A depicts connections with the water meter placed on the sidewalk, which often leads to leakages, meter damage, and difficulties in meter reading. Through standardization, a box will be installed close to the sidewalk, where the new meter and the connection will be better protected from damage.



Connections to be standardized.

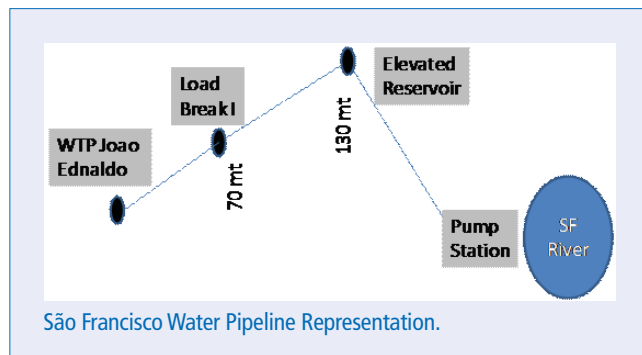


The \$13 million project will reduce water losses, which were approaching 50 percent, and make customers more accountable for their water usage. This accountability is critical in a water-scarce state, where water for the metropolitan area is brought from the São Francisco River, 100 kilometers away. As illustrated in Picture B, the water is pumped up 130 meters in the first 22 kilometers, with high energy costs, and descends by gravity after that. In addition to saving part of these costs by reducing water losses, the volume saved will increase the availability of water to the population, which recently has faced rationing periods.

Lessons Learned

1) Tap into complementarity between the World Bank and IFC.

Seeing a potential role for IFC, the World Bank specialist called in colleagues from IFC's Subnational Finance Department to jointly evaluate the possibility of an IFC subnational loan to DESO. The IFC loan would be disbursed well in advance of the World Bank's disbursements, due to IFC's shorter project cycle. IFC's loan would help the company improve its cash flow and generate resources to make investments that would improve client service. The World Bank loan would finance complex and broad water sector institutional reform at the state level and investments in water supply, sewerage expansion, irrigation improvements, and other initiatives with more than 25 years of tenor and at a spread over LIBOR of less than one-tenth that of IFC.



In addition, using the same engineer in both the World Bank and IFC projects allowed the client to benefit more from his expertise, better incorporate his suggestions in the projects, ensure consistency between these two initiatives, and increase confidence about a quick payback. These two transactions were clearly complementary.

2) Leverage the World Bank's relationship with federal governments to approve subnational deals.

This was the first subnational transaction in Brazil, so it was critical to persuade the country's federal government of the benefits of a transaction that would be financed under commercial terms. Given that Brazilian states and municipalities are highly indebted, federal government approval is required for each foreign loan taken by these governments and companies owned by them. This type of approval requirement, in one form or another, is common for subnational investments in emerging-market countries. Because IFC normally does private-sector investments, it usually does not have contacts with the authorities that grant these approvals, while the World Bank often has a close relationship. Leveraging this relationship is critical for subnational investments to quickly signal consistency with country strategy and to facilitate the dialogue. In the case of the loan to DESO, the World Bank explicitly supported the initiative by putting its credibility behind it and calling a meeting with the Brazilian authorities, DESO, and IFC.

3) Count on PPIAF-SNTA to help inexperienced borrowers better articulate their story.

From the first meeting, it was clear that DESO could not adequately demonstrate to potential financiers the positive impact of the financial and operational turnaround the company was implementing. DESO did not have sufficient sophistication or experience to prepare the forward-looking view that financiers would normally request. To fill that gap, the team contacted PPIAF-SNTA,² which quickly brought in a financial consultant to assist DESO in preparing financial projections and a credit memorandum on the company. By

² PPIAF-SNTA, a donor-funded program administered by the World Bank, was established more than 10 years ago to facilitate creditworthy subnational governments and entities in accessing commercial banks and capital markets.

delivering this forward-looking analysis to the company and going through the process of discussing the impact of the key turnaround initiatives in future financials, the PPIAF-SNTA-sponsored work helped DESO substantially improve its ability to interact with financiers, including IFC. Following such work, the company has attracted more interest from commercial banks, with which IFC plans to work to refinance DESO's US\$23 million short- and medium-term debt.

4) Carefully look at structuring possibilities: Inexperienced borrowers may have hidden opportunities.

The appraisal revealed a company without a clean auditor's opinion in the financial statements and low operating cash flow, but improving at a fast pace. In addition, the IFC team identified high-quality collateral available to be pledged, which substantially reduced the credit risk for IFC.

The team mitigated the credit risk with a pledge of receivables from water supply to one of the largest oil companies in the world (Petrobras) and receivables from sales to a diversified pool of customers. Each of these components was expected to exceed debt service. DESO also committed not to increase indebtedness, and it undertook to implement a plan to address all noncompliance items identified by the auditors. As a result, IFC was able to provide a \$11 million local currency-linked loan with seven years tenor, including two years' grace period. To further the company's improved credit profile, IFC agreed to jointly approach local banks to form a syndicate to refinance DESO's short-term debt.

5) Look to cleaner production advisory services for valued support to turnaround companies.

During the appraisal, DESO emphasized its frustration with the difficulty in addressing its energy costs, the second largest cost item after personnel. The company was convinced of a high potential for energy savings related to the transportation of water from the São Francisco River to the capital, Aracaju.

Savings could be achieved either by optimization of energy consumption—mainly in the pumps, transformers, and related equipment—or by self-generating hydroelectricity, taking advantage of local topographical variances. Preliminary calculations carried out by the Cleaner Production Advisory Team in the Latin America and Caribbean region indicate water

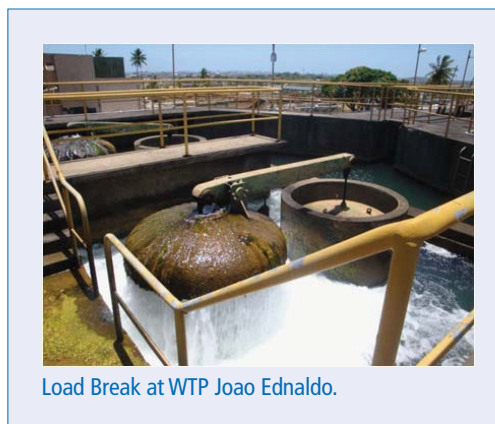
flows of 7,000 cubic meters per hour at Load Break 1 and 5,000 cubic meters per hour at the Joao Ednaldo water treatment plant. These volumes will increase with DESO's pumping capacity expansion plan to reach 10,000 cubic meters per hour. Picture C is a photo of the second deceleration station, where pressure is neutralized without recovering part of the energy consumed during pumping.

In previous attempts, DESO was unable to attract interest from specialized consultants to implement energy efficiency initiatives due to its inability to prepare a preliminary diagnostic and terms of reference. The company is extremely pleased that IFC's Cleaner Production Advisory Services Team has visited them and will help them draft terms of reference and pay for half of the costs of the consulting services. DESO is confident that IFC's involvement will attract interest from Brazilian experts that will lead to the desired optimization and savings.

Conclusion

Working together and delivering to a client investment and advisory products, IFC and the World Bank are able to improve client service significantly and achieve a higher level of development impact than would be possible without such joint efforts. This impact is particularly relevant when working in difficult sectors like state-owned water utilities from frontier states like Sergipe.

In terms of processing time, it took IFC five months from mandate to commitment, and 12 months if counted from initial contact. The International Bank for Reconstruction and Development (IBRD) project cycle is expected to last one and a half years because it is a Category A project, involves multiple parties in the Sergipe government, and, as with all World Bank Projects, will require sovereign guarantee.



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