SET SUPPORTING ECONOMIC TRANSFORMATION

FINANCING THE DEVELOPMENT OF SPECIAL ECONOMIC ZONES IN TANZANIA

Event report

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Tanzania has registered relatively little progress to date in establishing industrial parks and special economic zones (SEZs), with many zones failing to move beyond preliminary preparatory work. None of the SEZ projects included in the country's Second Five-Year Development Plan 2016/17–2020/21 (FYDP II) have yet been realised. SEZs and industrial parks were not mentioned in the Minister of Finance and Planning's latest speech to present the estimates of government revenue and expenditure for 2018/19, and the government appears to be prioritising spending on other infrastructure development over zones.

Instead, the private sector is increasingly expected to step in to develop new zones. Securing the necessary finance to develop these zones still appears to be challenging, although negotiations to attract investment into certain zones, such as the Bagamoyo Port project (where the terms of a financing deal with Chinese and Omani investors have ostensibly been agreed) and related SEZ, are more advanced.

Against this backdrop, the Overseas Development Institute's (ODI's) Supporting Economic Transformation (SET) programme held a two-day workshop in Dar es Salaam on 5–6 June 2018 to discuss options for financing the development of SEZs and related infrastructure (including energy infrastructure) in Tanzania.

The workshop agenda and focus were designed in collaboration with Tanzania's Export Processing Zones Authority (EPZA). It was attended by a range of different stakeholders, including representatives of Tanzanian development finance institutions (DFIs) (the National Development Corporation (NDC) and TIB Development Bank), Tanzania's Ministry of Industry, Trade and Investment (through the ministry's Textile Development Unit (TDU)) and a range of external experts with knowledge of, or interest in, financing and other elements of developing industrial parks and SEZs in Tanzania and elsewhere in the East African region. The latter included representatives from ODI, Lion's Head Global Partners, Africa Practice, Songas and TradeMark East Africa (TMEA).

KEY MESSAGES

- Tanzania can learn from countries like Ethiopia that have successfully attracted export-oriented manufacturing investment into industrial parks.
- Attention needs to be paid to the benefits for host countries from SEZs, and the importance of attracting the right type of investors/firms into these zones (particularly those committed to supporting the development of domestic productive capacity).
- There are many different issues to consider in the early stages of conceptualising, financing and developing SEZs and industrial parks.
- The divergent objectives and competing considerations (including economic, financial and risk metrics) of different stakeholders need to be considered when selecting financing options and operating models for zones.
- A range of different types of investors (governments, DFIs, commercial investors, public–private partnerships (PPPs)), each using different instruments and with varied risk profiles and return expectations, can potentially finance zone development in Tanzania.
- In PPPs, the capital structure needs to be carefully assessed.
- A range of different options are generally available at the implementing stage of zone development, including serviced lease, developer special purpose vehicle (SPV) or joint venture (JV) models.
- Few zone development projects in Tanzania have reached the stage of financial closure.
- National DFIs, including TIB Development Bank, could be used more effectively to finance SEZ development in Tanzania.
- Co-financing SEZs with pension funds is an option for Tanzania.
- Songas has executed a major PPP deal in Tanzania with a gas-powered electricity plant; these types of deals can support zone development (e.g. by reducing the cost and improving the reliability of zone-related infrastructure and utility services).
- The political context in the region is important – partnerships across countries can yield significant gains.

ACTION POINTS

- Consider options for early stage financing of SEZ projects (e.g. using public finance and then refinancing when projects mature and are operational).
- Identify and alleviate capacity challenges affecting the preparation of bankable SEZ projects.
- Examine ways to alleviate difficulties in obtaining no-objection permits at financial closure of SEZ projects.
- Identify alternatives to SEZ financing that do not raise public debt levels (e.g. equity, bonds, co-financing with pension funds).
- Examine the control structure of PPPs in Tanzania (including shareholdings, board control).

WORKSHOP OBJECTIVES, FOCUS AND CONTENT

The core objectives of the workshop were to take stock of specific challenges, progress and achievements in relation to the development of SEZs in Tanzania, to examine experiences with zone development in other countries, to interrogate different ways to prepare bankable project proposals that are attractive to financiers and to scrutinise options for solving financing challenges and appraising investment proposals.

The first day of the workshop focused on taking stock of what is already known about financing SEZs. Presentations on experiences in other countries were provided by Neil Balchin (ODI) on the factors influencing the investment decisions of private firms in industrial parks/SEZs (focusing on PVH's investment in Ethiopia) and lessons from Ethiopia's approach to developing industrial parks and SEZs; and Mark Priestley (TMEA) on TMEA's plans for different types of interventions to develop zones in East Africa. Turning to Tanzania, Chris Kandie of Lion's Head Global Partners then presented details of the company's approach to developing a project proposal and modelling financing options for the NDC's dedicated textile and apparel SEZ in Kibaha. Discussion among the workshop participants followed these presentations.

The second day, which was structured in a roundtable format, focused on Tanzania and considered different models and options for bankable SEZ development projects. Judith Tyson (ODI) provided insight into alternative models for financing zone development in Tanzania, highlighting both basic financing models and potential new financing structures. This was followed by a presentation by Nigel Whittaker (Songas) on PPPs, in which he focused on his experience of managing power PPPs in Tanzania. Thereafter, representatives from TIB Development Bank discussed their existing involvement in financing SEZs in Tanzania and potential options (and challenges) for the bank to play a greater role in this area. These expert presentations paved the way for further in-depth discussion among the workshop participants.

KEY MESSAGES FROM THE WORKSHOP PRESENTATIONS AND DISCUSSIONS

Tanzania can learn from countries like Ethiopia that have successfully attracted export-oriented manufacturing investment into industrial parks

Neil Balchin (ODI) explained how effective promotion and support to investors (led from the highest levels of government and via key investment-related institutions), generous incentives in manufacturing and export-oriented sectors, a range of investment climate reforms and consistency in following through on commitments have helped Ethiopia attract private firms, including major multinationals such as PVH, to invest in manufacturing, particularly in the country's industrial parks. The Ethiopian government has also been open to different models for zone development (government-led industrial parks and private foreign-led SEZs); it has used different financing models to develop zones (e.g. government-financed via the international capital market versus private sector foreign investment); and it has created a strong institutional environment to support zone development (with a key role for the state-owned, profit-making Industrial Parks Development Corporation to develop and operate zones).

Attention needs to be paid to the benefits for host countries from SEZs, and the importance of attracting the right type of investors/firms into these zones

This is particularly true for foreign private sector-led SEZs and export-oriented zones. Some workshop participants raised concerns about the lack of local content in the Ethiopian model for zone development. It is important to be clear what host countries are getting out of deals for zone development and to ensure backward linkages and domestic participation are encouraged.

In this context, it is important for Tanzania to attract the right type of investors/firms into SEZs and industrial parks. The focus should be on firms that invest to create a long-term base within the country and support the development of domestic productive capabilities and capacity. Stephen Ramsey (TDU) argued Tanzania already has some comparative advantages over countries like Ethiopia – including better productivity, lower staff turnover (only 3% in some firms, which is in line with international standards) and some level of vertical integration in textile and garment production – that can be harnessed to attract these types of investors into activities like textile and garment manufacturing.

SEZs and industrial parks can play a key role in addressing existing challenges in Tanzania (and elsewhere in East Africa) related to a lack of fit-for-purpose infrastructure and insufficient clustering, to produce positive agglomeration effects. In this vein, Mark Priestley indicated that TMEA saw SEZs/industrial parks as important tools to feed into its broader strategy to develop growth hubs and nodes in East Africa with a view to unlocking growth and jobs, and helping develop a trade and distribution network within the region.

There are many different issues to consider in the early stages of conceptualising, financing and developing SEZs and industrial parks

Mark Priestley explained that TMEA was in the early stages of conceptualising a programme to include zones and industrial parks. He indicated this had mostly involved work to define core concepts and undertake pre-feasibility studies. The key issues TMEA is considering in these early stages include:

- How to obtain buy-in and stakeholder ownership (including government champions) for industrial parks
- Whether to focus on clustering or piecemeal parks concentrated on specific sectors
- What complementary measures are necessary to support the success of industrial parks (e.g. trade facilitation, others)
- How to create partnerships to ensure a more coherent approach to the development and operationalisation of zones/parks
- How to ensure parks/zones have a stronger local content footprint
- How to avoid a race to the bottom where all East African countries focus on developing the same types of zones/industrial parks focusing on similar sectors

There is a need for more discussion on the potential to develop regional value chains and prospects for product differentiation across East African Community countries. This is especially important given that differences in national and regional agendas are hampering progress towards industrialisation.

Early stage financing for projects can also be difficult and needs to be considered carefully. One option is to use public finance for project development and then to refinance projects once they are mature and operational. To date, this has been the focus of TIB Development Bank.

There have been some administrative barriers to financing and execution in SEZs. For example, financing that uses public debt needs high-level approvals because of its impact on national debt levels. TIB Development Bank has examined other alternatives, including financing exclusively with equity, raising bonds (such as for Bagamoyo) and co-financing with pension funds (see below).

The divergent objectives and competing considerations (including economic, financial and risk metrics) of different stakeholders need to be considered when selecting financing options and operating models for zones

The considerations and objectives of different stakeholders – including governments, investors and tenants – involved in the development, operation and use of SEZs and industrial parks can be varied. Chris Kandie of Lion's Head Global Partners explained how governments were focused on economic development, budget constraints, land ownership, investment promotion and attraction,

and the ease of implementation of particular models for zone development. In turn, investors need to consider the ability of the zone to deliver the required returns as well as their level of risk exposure (be it legal and regulatory, financing, development or operating risks). Finally, prospective tenants looking to locate within zones are primarily concerned with the operating costs (rent, electricity, labour), the quality of import and export logistics services and infrastructure, labour availability and productivity, SEZ policies and associated fiscal incentives, and the extent of access on offer to key markets.

Meeting these divergent objectives and balancing competing considerations needs to be factored in when deciding which financing options and operating models are most appropriate. Chris Kandie explained that, in the case of the NDC's dedicated textile zone in Kibaha, for example, it had been necessary when narrowing down financing options to ensure rent costs were competitive regionally (in order to attract firms to locate in the zone), while, at the same time, producing a return on investment for investors that was comparable with commercial projects (currently at about 17% in comparable commercial real estate projects) and generating an income for the NDC (e.g. in the form of rental income, dividends).

A range of different types of investors, each using different instruments and with varied risk profiles and return expectations, can potentially finance zone development in Tanzania

The presentation on the NDC's textile zone in Kibaha showed how investors could generally be grouped into three broad categories: government, DFIs and commercial investors. PPPs are an important fourth category.

(i) *Governments* can provide budgetary allocations, infrastructure bonds or grants to relevant line ministries or implementing parastatals. In the case of the zone in Kibaha, for instance, the Government of Tanzania (GoT) is set to fund the provision of infrastructure up to the fence, and some government funding has also been earmarked for internal infrastructure. Government expectations are generally more focused on economic returns (jobs, infrastructure, sector development, growth) than on monetary returns, meaning they tend to be less risk-averse and typically have low or no return requirements (ranging from 0% to 5%). Government funding has the advantage of giving full control to host economies and is typically cheaper than private finance. However, it can increase public debt levels, and this needs to be given careful consideration.

(ii) *DFIs* (e.g. the African Development Bank, World Bank and CDC), some of which already invest in East Africa (e.g. in Ethiopia and Kenya), and impact investors can provide financing support for zone development via sector funding lines or specialised funds. This could take the form of either concessional debt or equity investment in a project SPV. DFIs' return expectations are more commercially oriented than those of government (e.g. concessional debt returns in the region of 3% to 10%; similar equity returns to commercial investors), although they do also emphasise developmental returns. As well as finance, DFIs can bring expertise in commercial development and have been crucial in SEZ financing and development elsewhere.

(iii) *Commercial investors* (e.g. industrial real estate developers, real estate funds, pension funds and other collective investment schemes), some of which have already invested in SEZs in East Africa, may utilise concessional debt or commercial debt instruments or take equity investments in a project SPV. Financial returns are central to their investment decision-making and their return on equity requirements are typically in the range of 12% to 18%. They can also bring expertise including business acumen. Private finance also has an important advantage of transferring risk to the private sector. Some SEZs (mainly in Asia) have been fully financed by private investors but they tend to be small relative to publicly financed SEZs.

(iv) *PPPs* have been important in the financing of SEZs (e.g. for the Panama Pacifico Project) and can deliver both finance and expertise.[1] They have been particularly useful in enabling private firms to locate into SEZs. However, contract terms need to be carefully considered because disputes have led to problems for host governments.

Importantly, investor engagement, and the potential for involving different types of investors in SEZ financing, evolves over the project lifespan as de-risking occurs. This means that, while it is generally necessary to rely on government and grant providers in the very early stages of zone development (e.g. feasibility studies), owing to the high level of risk at these stages, other types of investors can be attracted as the zone development advances and risk declines.

In PPPs, the capital structure needs to be carefully assessed

Tanzania has completed a number of different types of PPPs, from majority to minority ownership by the public sector. There needs to be a critical examination of the control structure of PPPs, including shareholdings and board control, reflecting risk being taken and assets and financing being put in, as well as other matters such as dividend policy. In balancing these issues, there needs to be realism that greater control and reward is reflective of greater investment and risk-taking. The government has in a number of deals opted to provide land as part of its input into JVs, including using it as collateral and granting long leases to private investors. This has been a cost-effective way of taking a public stake in SEZs.

A range of different options are generally available at the implementing stage of zone development, including serviced lease, developer SPV or joint venture models

In the case of the zone in Kibaha, for instance, the NDC considered three different options for implementation: a serviced lease, developer SPV and JV. As Chris Kandie explained:

- The *serviced lease* option would involve the NDC developing the base infrastructure for the zone (funded through grants and government budgetary allocations) and renting the serviced land to private investors or tenants via a zone operator. Private investors would develop the factory sheds either to rent to tenants (seeking commercial returns) or for their own use (self-financed).
- The *developer SPV* model would require the NDC to take the lead in forming an SPV to develop the zone and inviting investors as shareholders. The NDC's equity contribution would encompass land and GoT investments in the zone. In this model, base infrastructure is financed by grants and government allocations and/or by DFIs providing 'patient capital'. In turn, private investors would provide the balance of finance in the form of equity and/or debt for base infrastructure and factory sheds.
- In the *JV* model, the NDC would be a minority equity partner, taking equity in the JV vehicle alongside a private investor (majority equity partner), with the latter given the task of managing the JV company. The NDC and/or GoT would be responsible for contributing land and cash investments, with the private investor supplying the balance of finance (via equity and debt) for base infrastructure, factory sheds and management of the JV company. However, this JV model has proven unattractive to the NDC as it has been unable to secure a steady return stream in past projects.

After discussion with GoT, the serviced lease option was selected as the preferred model (see Figure 1 on modelled investor returns). Calculations indicated investors could achieve a return of 17% under the serviced lease model at the lowest annual rent (approximately $45 per square metre), while also enabling the NDC to make a steady rental return. However, further work needs to be done to test the serviced lease model with potential funders and tenants. In addition, a

[1] For further details see Tyson, J.E. (2018) 'Financing special economic zones: different models of financing and public policy support', SET report. London: Overseas Development Institute.

number of outstanding legal, fundraising and marketing, and construction and planning tasks will need to be completed to realise the development of the zone.

Figure 1: Modelled investor returns from serviced lease, developer SPV and JV options for implementation of the textile zone in Kibaha

Source: Lion's Head Global Partners

Few zone development projects in Tanzania have reached the stage of financial closure

The National Debt Management Committee in the Ministry of Finance and Planning (MoFP) determines whether government ministries, agencies and other entities can borrow funds, including to finance zone development. A no-objection permit from the MoFP is required before financial closure. Such a permit is required, for example, to obtain funding from TIB Development Bank or social security funds. The government approval process can be by-passed if equity options, rather than debt financing, are used.

But most EPZA and NDC projects have not reached the financial closure stage and, hence, have not reached the point at which a decision on the no-objection permit would need to be made. This appears to owe, at least in part, to capacity challenges related to the preparation of bankable SEZ projects.

National DFIs, including TIB Development Bank, could be used more effectively to finance SEZ development in Tanzania

TIB Development Bank representatives noted that the bank already had some involvement in Bagamoyo, Kurasini and Kigoma SEZs but had not done much to date in relation to financing SEZs. The bank could play an important role in financing infrastructure for zone development. It could also be involved in early stage investment for zones, taking on the initial risk and paving the way for other types of investors to become involved at later stages as de-risking occurs. However, indications suggest GoT is moving away from debt as an instrument to finance economic zones, which has forced TIB Development Bank to rethink its position. Some consideration is being given to pooling funds together under the bank (e.g. Rural Development Fund, Road Accident Fund).

The bank's technical assistance function could also be used more effectively. This could involve close collaboration between the NDC/EPZA and TIB Development Bank, with the NDC/EPZA

developing projects at the conceptual level and TIB Development Bank providing technical assistance up to the point of financial closure.

Neil Balchin (ODI) suggested the bank could also perform a similar role to the Development Bank of Ethiopia (DBE) at later stages when the zones are up and running, including by supporting firms located within particular zones. In Ethiopia, the DBE provides long-term loans to priority sectors at subsidised rates. This encompasses, for instance, channelling working and investment capital to firms participating in industrial parks and providing special investment loans to both domestic and foreign firms to support expansion (covering up to 60% of expansion costs). The DBE also provides preferential credit to incentivise domestic investment into zones.

Co-financing SEZs with pension funds is an option for Tanzania

Tanzania is mobilising financial resources through pension funds. These represent an option to finance SEZs and related infrastructure. Pension funds have some key advantages: they involve local currency investments and are relatively cheap and stable compared with other financing, especially foreign capital. To date, there has been some financing from pension funds in the transport sector. However, there are some concerns about the quality of the assets, and this is an issue that needs to be carefully considered. If this can be managed well, pension funds may be an attractive source of financing. The risk can also be managed through government taking the 'first loss' risk. Structuring deals as bonds would also add value through providing liquidity for pension funds.

Songas has executed a major PPP deal in Tanzania with a gas-powered electricity plant

This deal was financed by DFIs via agreements with the public supplier of gas and an off-take agreement for electricity production from the national state utility company, TANESCO. The plant now produces 21% of Tanzania's electrical output and has saved $5 billion in diesel used for electrical generation. There has been some public criticism of pricing, but the pricing structure is designed to reflect the capital costs and fixed running costs of production as well as the variable costs relating to generation. The cost and reliability of electricity is a major barrier to the development of SEZs and it is a critical area of competitive disadvantage for Tanzania relative to other countries in East Africa. Reducing the cost and improving the reliability of electricity would add to the competitiveness of Tanzania's SEZs. The Songas deal needs to be put into the context of Tanzania's overall energy strategy. The country needs to diversify its sources of electricity generation, including through gas and hydro-electrical generation, and to develop a system that is able to meet peak needs from households and firms. Songas-type deals can assist with these problems.

The political context in the region is important

Regional cooperation can be difficult and reaching agreements can take considerable time. However, there have been good examples in the region, such as the Malawi and Tanzania water projects, which included partnerships across the two countries in 13 projects for water management and hydroelectric generation. These projects have yielded significant gains for Tanzania.