

## **Colombian M&A Infrastructure Deals**

### -Challenges and Opportunities-

#### 1. Introduction

Colombian infrastructure has lagged behind other Latin American countries for several years now. The World Economic Forum rates Colombia's infrastructure 84th out of 138 countries, while neighboring countries such as Panama, Chile and Ecuador are ranked 36th, 44th and 71st, respectively. This situation has become a threat to Colombia's competitiveness and sustainable growth, considering the country's areas of production are poorly connected to cities, ports and airports. As a result, over the past 8 years, the Colombian government has put considerable efforts and resources into improving Colombia's connectivity through the fourth-generation road infrastructure program ("4G Concessions Program"). The goal is to facilitate international trade, regional development and centralized government through an expansion of the country's transportation network.

#### 2. New Legal Framework and Developments

In 2011, the government created the National Infrastructure Agency (ANI), a state national agency ascribed to the Ministry of Transportation, for purposes of structuring the 4G Concessions Program as well as any other infrastructure concessions (i.e. ports, airports, and railways) and public-private partnerships ("PPP"). ANI was created with better administrative capacity, qualified personnel and technical expertise to ensure more transparency in the public procurement of the infrastructure concession program. The government also promoted a more stable legal framework by dealing with some of the issues that had been an obstacle to infrastructure development in Colombia. For example, Law 1682 of 2013 (Transport Infrastructure), was enacted to provide guidelines in terms of infrastructure requirements, dispute resolution matters, land acquisition, environmental licenses, and communities, among other things. Such law has brought some important tools to facilitate, among others: (i) the proceedings regarding environmental permits and licenses; (ii) the negotiations to acquire the land and accelerate the expropriation processes required for infrastructure projects; and (iii) the negotiations to remove and/or relocate the existing facilities (wires, pipelines, etc.). In addition, Law 1753 of 2015 amended some articles of Law 1508 of 2012, in order to enhance the PPP development. As an instance, the concept of limited liability was introduced in Law 1508 to limit the liability of the sponsors with respect to the obligations of the project company according to the rules applicable to the latter. This was a very important change as, under the rules of Law 80 of 1993, many sponsors were held directly liable for the obligations of the concessionaire. Besides, even though under the Colombian PPP model, the main risks are allocated on the private party (the investor is the responsible party for the design, construction, operation and maintenance of the productive or social infrastructure given in a concession and its related services), the Colombian government has accepted in some concessions of the 4G Concessions Program to share some important risks, such as the environmental, social and land acquisition risks, within others, in order to attract more investors<sup>1</sup>.

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<sup>1</sup> The Colombian government has accepted to share some important risks under the 4G Concession Program, not only from an economic perspective but also in terms of extending additional terms to comply with certain

In general, we have seen that with the 4G Concessions Program, Colombia is moving away from its classical model of infrastructure development, in which the concessionaire acted as the financier, promoter and constructor. The current tendency is to have different players with specific responsibilities, which is a healthy change.

These steps helped make infrastructure projects more appealing to both national and foreign investors. With 40 new road concessions representing 8,000 kilometers of roads and 3,500 kilometers of highways, the 4G Concessions Program is the largest program of its kind in Latin America.

In the context of this regulatory development, the government has structured and carried out the first round of bidding processes for the 4G Concessions Program, where investments are estimated to reach US\$17 billion for the first round, and over US\$40 billion for future rounds over the next ten years. The first 4G concession to get off the ground was the Pacifico Concession (highway that will link Antioquia department to the southern region of Colombia), Phases 1-3, which issued the first-ever foreign project bond for a Colombian toll road, and which obtained a four-tranche loan worth US\$285 million and a total raise of approximately US\$650 million according to financial media.

### 3. Main Issues and Challenges

Despite the governments' best efforts, the execution of the 4G Concessions Program has not been easy. Land management, environmental matters and prior consultations to certain communities (*consulta previa*) have been the toughest work streams, leading to considerable delays and cost overruns.

Land management has been one of the toughest work streams, leading to major delays in the estimated schedules of 4G projects and cost overruns. As an instance, despite clear rules governing the expropriation law process, the land acquisition is an issue for infrastructure projects in Colombia since the property rights of the landowners are difficult to establish in certain regions (the real estate registry is decentralized, incomplete, not standard and outdated). Besides, the price is equally problematic to set since there is usually an opportunistic behavior from sellers. Finally, there is an additional issue when the land belongs to an indigenous community, as they may not be subject to expropriation process.

Environmental licenses are delayed considering the environmental authorities usually take longer to analyse the information filed by the concessionaire, and in some cases the authorization depends on the finalization of other processes, such as the prior consultation process with ethnic minorities or the subtraction of forest reserves or lifting of a ban on protected flora species. Prior consultation processes represent a significant challenge as the consultation is considered as a fundamental right of these communities; however, Colombia does not have a specific law regulating the timing and special conditions of this process. Therefore, the timing for these processes is usually longer than six months. Even if the ethnic communities do not have the right to veto a project, the government has the duty

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landmarks. As an instance, in the event there are cost overruns as a result of land acquisition, such risks are partially shared with ANI if they exceed 120%, and they will be totally assumed by ANI if they exceed 200%.

to guarantee that the communities are properly consulted, even if there is no agreement with the communities. Another significant challenge related to communities is their identification by the Ministry of Interior. In some cases, the information on the presence of these communities is scarce, leading to litigations initiated by these communities and to suspension of the execution of the projects until the communities are properly consulted.

In addition, the fact that concessionaires must deal with communities that oppose to these infrastructure projects has led to uncertainty and concerns from financiers. These issues are handled under the concession purchase agreements in the representations and warranties, as well as in the special indemnities that sellers give to buyer(s). Generally, these risks are covered by the seller up to a reasonable extent, after which the buyer bears the allocation of risk and the financial consequences it may imply.

The importance of these three issues (land acquisition, environmental licences and prior consultations to communities (*consulta previa*)), is not only limited to their consequences under the concession agreement, but also under the financing documents, as they are the main milestones to reach financial closing (i.e. disbursement of funds) under the 4G projects in Colombia.

Other risks relate more to the current dynamic of the market of 4G projects in Colombia, where projects are concentrated in few actors, which may imply a high systemic risk. In this sense, the market was particularly attuned to the outcome of the recent Odebrecht corruption scandals (which affected directly the Concession *Ruta del Sol 2*), since there was a concern that the termination of such concession could lead to termination consequences in other 4G Concessions, particularly if a forfeiture power (*caducidad*) was applied by the government. Fortunately, the market seems to have overcome these concerns, particularly as a result of the mutual agreement between ANI and Episol (concessionaire owned 70% by Odebrecht and 30% by Corficolombiana) to terminate such concession agreement. Besides, the 4G Concessions Program is structured in such a way that the Government honors the payment of the works already performed by the concessionaire (once a “functional unit” has been completed), through a trust set up for each 4G project, which ultimately secures the payment to the banks of their financial obligations, as it happened in the case of Concession *Ruta del Sol 2*.

Finally, another difficulty on 4G projects is related to their financing. Local banks have not been able to cope with the financing needs of 4G concessions due to sector-concentration risks in the banking system and its corresponding regulatory constraints. As a result, financial closings for ongoing 4G projects have been delayed. Large portfolios of projects are becoming available but they require financing to complete development or continue operations.

#### 4. M&A Opportunities

The high equity requirements of these 4G concession and the interest of foreign investors in developing markets with a legal and economic stable system, are the main reasons why M&A opportunities in this area have arisen, as current actors involved in such concessions do not have all the equity required, and their current credit exposure with banks is reaching the allowed limits. In that

sense, some sponsors are looking to cashing out part of their interests in some of their projects to use such resources in the remaining projects. This has become an opportunity for institutional players and bigger financial and strategic investors that are willing to enter to the local market. In fact, we have seen increasing M&A activity within previously awarded 4G concessions, which are subject to ANI approvals. Besides, projects that have closed on their financing and begun the construction phase are interested in engaging new partners. Non-traditional project finance participants, such as private equity and hedge funds looking for higher yielding investments, are increasingly active in this space. Multilateral agencies may bring development funds whereas other strategic investors, such as international construction companies, are not only interested in participating as sponsors, but also as contractors under the EPC agreements.

Some of the M&A activities that we have recently seen in the concession road projects are the following:

- InfraRed Capital Partners purchased a 50% stake in a 4G highway project east of Bogotá (*Perimetral de Oriente*) from Israeli construction company Shikun & Binui for an undisclosed amount.
- Ashmore purchased a toll road concessionaire (*Concesión Santa Marta-Paraguachón*) for US\$42 million from constructors Valorcon, Odinsa, Construcciones El Cóndor and Conccay.
- Conconcreto sold to Vinci Highways 50% of its participation interest in the Concession Bogota-Girardot (*Tercer Carril*).
- Local players Castro Therassi and Colpatria acquired a participation interest in the Concession Cartagena-Barranquilla.
- Private equity fund CFC-SK acquired a 10% stake in the Concession Pacifico Phase 1.

In our case, we are currently representing both financial and strategic investors in the potential acquisition of substantial stakes in eight (8) different concession road projects, which leads us to believe that there will be a lot of movement in M&A infrastructure deals, in the following months.

Finally, a new round of concession contracts is expected. Projects will expand into other areas of infrastructure, including river ports and the construction of buildings and facilities for different local authorities. The Colombian government is also working on concession projects and PPPs such as the re-establishment and development of the Colombian railway system, the refurbishment of the Bogotá and Barranquilla airports and the so called “social infrastructure projects,” which include hospitals, schools and prisons. Considering the above, we expect a boom in M&A infrastructure deals in the following months and years to come.

##### 5. Final Notes: Key Issues on 4G projects’ M&A deals

As a final note, it is worth mentioning that local market knowledge is essential when it comes to infrastructure M&A deals in Colombia. A thorough understanding of the Colombian legal system (in particular, the Infrastructure Law), its financial institutions and a minimum grasp of the governmental authorities’ mindset is key for foreign investor to achieve a successful deal. From our experience, any potential investor participating in infrastructure M&A deals in Colombia should consider the following challenges that have arisen in other transactions of this kind:

1. *Due diligence (land, environmental and communities' issues)*. A thorough due diligence processes, focusing on issues related to (i) land management, (ii) environmental licences and (iii) prior consultations to communities (*consulta previa*) is required. Please see section 3 of this article for a more detailed description on these issues.
2. *Authorization by the ANI*. Concession agreements establish that the 4G “leaders” of a concession are not able to assign their participation interest in the concessionaire if they don't continue to hold at least 25% of the concessionaire's stake. Some of the contracts also state that any partner that attested financial standing may not assign their participation rights. Such restrictions usually apply during the pre-operative stage and the first year of O&M, unless ANI previously approves the transfer. After the first year of O&M has gone by and until termination of the Concession Agreement, leaders and non-leader stakeholders that certified financial capacity must remain stakeholders but no restrictions concerning their participation are imposed. Please note there is currently a debate to determine whether an indirect sale of the concessionaire could occur under the 4G projects. Change of control provisions are not common in such concession agreements but we expect to see provisions of this nature in 4G agreements to come.
3. *Early Termination of the Concession Agreement*. In an event of early termination of the concession agreement, the liquidation of such contracts would include the payment of certain amounts derived from the application of the early termination formulas included in the concession agreement. The Council of State of Colombia has recognized that in addition to the events of early termination incorporated within the corresponding concession agreement, the contracting entities have the power to early terminate a public contract using the faculty stated in article 45.2 of Law 80 of 1993. As per this article, the legal representative of a contracting entity is entitled to terminate the contract whenever there are evident grounds for absolute nullity, that is, when the agreement: (i) was entered into with a contractor incurring in an inability or incompatibility event; (ii) was entered into against an express constitutional or legal prohibition (i.e. corruption), or; (iii) when the acts, that constituted the basis of the contract, have been declared null.<sup>2</sup> The event of early termination based on the occurrence of the circumstances described in article 45.2 of Law 80 was not included in the 4G concession agreements as an early termination event, therefore it is not included as one of the circumstances in which the liquidation formulas apply. As a result, the 4G concession agreements do not recognize any compensation or payment derived from the circumstances mentioned in article 45.2 of Law 80 of 1993. Future 4G concession agreements will have to address this issue. As an alternative for current projects under such scenarios, a direct agreement could be reached between the parties to apply the same formula to pay the financing of the project. Even though under the Odebrecht corruption scandal, the Superintendency of Industry and Commerce requested the termination of the Concession *Ruta del Sol 2* under the grounds of article 45.2 of Law 80, this concession was finally

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<sup>2</sup> This does not mean that the contracting entity is declaring null or void the contract since only a judge is entitled to do so, that is the arbitral tribunal under the concession agreements.

terminated under a mutual agreement between ANI and Odebrecht, therefore the risk mentioned above disappeared.

4. *Step-in Rights.* Lenders' step-in rights are not automatic and their exercise is only possible when concessionaire's rights of defense and due process have been observed. Furthermore, before Lenders' step-in rights are triggered by the concessionaire's default or major breach of the concession agreement, a remedy period is to be given to the concessionaire. If the concessionaire fails to cure its breach, then a process to impose penalties must be followed. Please note that step-in rights are foreseen for default or major breaches of the concessionaire only, therefore it will be very difficult to be exercised in the events described in article 45.2 of Law 80 of 1993 mentioned above, which lead to terminate the contract whenever there are evident grounds for absolute nullity, which means that the lenders will not be able to step-in, in the event the contract can be declared null and void by the corresponding judge.
  
5. *Package of Transaction Documents.* As sponsors are required under the concession agreement, the financing agreements and the insurance policy of the concession agreement to provide some guarantees and collaterals, the negotiation of this M&A agreements should include a complete package that covers these different aspects for the investor. In this sense, depending on the stage of the concession agreement and the financing, investors should try to guarantee in the transaction documents their active participation in the negotiation of the EPC, the O&M and the financing agreements. This can be included as a condition precedent under the stock purchase agreement. This issue is especially crucial for financial investors, as in most cases they do not participate in the EPC or O&M agreements and therefore, it has to confirm that the risks under the concession agreement are transferred to the EPC and O&M contractors as part of the back-to-back principle.

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As a member of the Banking, Finance & Capital Market practice, Natalia has focused her practice in financing transactions, advising Colombian companies and local and international financial institutions. She has ample experience drafting and negotiating financing and security documents.



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Felipe Mariño is a member of our Corporate / Mergers & Acquisitions practice and is also part of the infrastructure and real estate areas of the firm. He has more than 11 years of professional experience. Felipe has worked at Gómez-Pinzón Zuleta since 2006, and he also worked, as International Associate, at Simpson Thacher & Bartlett LLP (New York City), between 2012 and 2013 and, as general counsel, at Amarilo S.A.S. (a leading construction company in Colombia), between 2014 and 2016.

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Felipe has participated in different M&A transactions in the financial, energy, communications, infrastructure and real estate industries, among others. Felipe has worked with some of the most important economic groups and private equity funds, with presence in Colombia such as Valorem, Mercantil Colpatria, Advent International and Ashmore.

Felipe has also worked, both at Simpson Thacher & Bartlett LLP and Gómez-Pinzón Zuleta, in debt and equity operations in the securities market, including among others, the IPO of AviancaTaca Holding S.A.

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