



Funding options

Alternative financing for infrastructure development
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Introduction

As policy makers continue to sort through the wreckage caused by the financial tsunami that engulfed the world in 2008, the infrastructure sector has not been immune

In fact, it could be argued that infrastructure is uniquely disadvantaged in the current climate. At this point only one thing is certain: the landscape for infrastructure funding and finance has been dramatically altered and could remain so for at least the near term.

Three trends are emerging. First, governments are attempting to use increased infrastructure spending as a tactic for economic stimulus. Second, tightened credit markets are posing an obstacle to raising debt finance for infrastructure delivery models – public or private – that depend on high levels of up-front capital repaid over the long term through user fees or general taxation. Thirdly, government balance sheets are constrained, making it more difficult to fund infrastructure projects.

This paper discusses these trends and the impact of each on infrastructure funding/finance, particularly with respect to the prospects for public-private partnerships (PPPs).

Leading up to the GFC in 2008, bank funding was freely available, with significant competition between funders on projects driving pricing to historic lows, and also increasing gearing and hence debt volumes. However, since the GFC funding sources have become more limited for the following reasons:

- Less funding available to banks as profitability has reduced, short term wholesale funding markets are less liquid and interbank lending has fallen
- Banks are going through a process of repairing balance sheets to reduce unsustainable debt levels, thereby restricting the level of new loans they are making and also focussing on more profitable sectors. In addition, banks that have been bailed out or supported by government may be encouraged to focus on their home market, withdrawing from making loans in other jurisdictions
- The Basel III and Solvency II rules currently being introduced will require banks to hold higher levels of capital against long term loans, making long term project finance more expensive and less attractive for banks.

Figure 1 portrays the emerging contours of the new infrastructure funding/finance landscape, outlining conditions on both sides of the market: the 'demand' for infrastructure funding/finance and the 'supply' of funding/finance on the part of the public and private sectors.

Figure 1. How the infrastructure landscape has changed in the wake of the GFC

Pre-GFC trends	Emerging trends
<p><i>Demand</i></p> <ul style="list-style-type: none">• Limited public money for infrastructure• Construction costs increasing• Fiscal dynamics encouraging governments to explore alternative delivery models. <p><i>Supply</i></p> <ul style="list-style-type: none">• Functioning debt capital and international project finance loan markets• Highly geared capital structures and attractive equity returns• Dominance of active equity investors and emergence of infrastructure funds.	<p><i>Demand</i></p> <ul style="list-style-type: none">• Infusion of public money for infrastructure• Construction costs remain high, driven by the mining boom• Government fiscal distress solidifying interest in alternative delivery models. <p><i>Supply</i></p> <ul style="list-style-type: none">• Challenged debt capital markets aided by new borrowing instruments• Price and tenor constraints in international project finance loan market• Variability in equity returns• Impairment of some active equity players balanced by continued growth in infrastructure funds.

Demand trends

Infusion of public money for infrastructure

Around the world, infrastructure investment has become a significant component of a number of economic stimulus packages developed to respond to the GFC. The European Union, for example has committed upward of \$200 billion to infrastructure.

Further east, India is investing around \$30 billion in upgrading the country's infrastructure, while China has announced that half of its \$585 billion stimulus package will go to infrastructure. In Australia, the \$42 billion Nation Building Economic Stimulus Plan provided significant support to the economy, particularly the Building the Education Revolution (BER) funding that provided additional facilities in schools. While the sizable influx of government stimulus dollars has not come anywhere close to eliminating the 'infrastructure deficit', stimulus funds should certainly help improve the condition of infrastructure badly neglected over the past few decades.

However, as the initial stimulus packages have progressed, and growth in developed economies has not recovered strongly, governments have struggled to maintain the level of investment as financial markets have placed a higher level of scrutiny over the level of government debt in many jurisdictions.

Changing shape of the demand for PPPs

It is too early to tell for certain whether the infusion of public money will dampen or stimulate governments' demand for PPPs or other creative financing solutions. During the first wave of stimulus spending in Australia (with the BER which was directly financed by government), the emphasis was on fast delivery and job creation. In later waves, attention will likely turn back toward achieving the goals that various PPP models were intended to satisfy: more infrastructure, delivered better, faster, and at lower cost. In addition, difficulties in raising further government debt may encourage the use of PPP models to accelerate infrastructure programs.

More public subsidy does not have to mean less

private capital. In fact, it could actually foster the reverse: better project economics, better credit and more private capital put to work. If the hundreds of billions in planned infrastructure spending in the stimulus packages can be leveraged with private funds, then stimulus dollars can generate an even more profound impact on nations' economies.

Indeed, there are many viable options for integrating stimulus funds into PPP project structures. In many countries, PPPs have been successfully executed for projects that required public subsidy to be viable. In these cases, government funding was used to 'write down' particular project costs (capital and/or operating) or risk elements either up front or over the entire project life cycle. Such an approach could be used to leverage the stimulus funding.

In addition to writing down particular project costs, jurisdictions are increasingly looking for innovative ways to make projects viable by involving multiple public sector entities, both within and across jurisdictions. Public-public-private-partnerships, or 'P4s,' are starting to emerge as a way to get projects off the ground by combining multiple levels of public support. For instance, a new energy-from-waste project being developed in Staffordshire in the United Kingdom is a collaborative effort of a number of local governments that are banding together to achieve economies of scale that will make the project viable. Meanwhile, the United States has for decades employed public-public partnerships to develop and finance infrastructure through the creation of joint powers agencies, multistate authorities, regional development agencies and other vehicles.

US Case Study – American Recovery and Reinvestment Act of 2009 and PPPs

The ARRA impacted the infrastructure sector in the United States in two ways: the act increases federal spending on projects; and it expands the instruments available in the US municipal bond market to help ease recent tight credit conditions.

We review each of these developments in turn.

Changes in municipal bonds

The ARRA includes a number of provisions designed to broaden the base of investors in municipal bonds, thereby increasing private investment in infrastructure. While many of the newly created instruments are expansions or refinements of previous programs, one, Build America Bonds (BABs), represents a significant shift in the way municipal debt is structured. Historically, interest earned on municipal bonds issued for most governmental purposes has been exempt from federal income taxation. This implicit subsidy has lowered the cost of capital for state and local governments. However, it has also limited the investor base to parties for whom exemption from federal taxation has value – US taxpayers.

BABs are federally taxable bonds offered by municipalities in which the federal government makes the subsidy 'explicit' by providing a reimbursement of 35 percent of the bond interest payable, either to the municipal bond issuer (in cash) or to the municipal bond holder (in the form of a tax credit). To date, all BABs interest reimbursements have been remitted to the municipal bond issuer. (The bond holder tax credit option is believed to be less efficient as a subsidy mechanism.) BABs, as taxable instruments widely saleable beyond the traditional confines of the US municipal bond investor base, have the potential not only to broaden the investor base but also to impact the discussion on infrastructure financing, as the federal subsidy becomes more transparent.

While BABs are unlikely to be used for PPPs because of the non-governmental nature of the use of proceeds in PPP structures, there are two other ARRA municipal bond provisions that could prove directly beneficial to PPPs.

Private Activity Bonds (PABs) have been exempted from the Alternative Minimum Tax (AMT), making such bonds fully tax free

This exemption applies to PABs issued in 2009 and 2010, as well as to new PABs issued to refund bonds issued between 2004 and 2009. Use of PABs in PPP capital structures has been impeded by the application of AMT. The exemption will both lower the cost and broaden the investor base for PABs, making the US debt capital markets a more attractive source of financing alongside the traditional project finance loan market.

The Secretary of Transportation has been given a \$1.5 billion allocation for Transportation Investment Generating Economic Recovery (TIGER) discretionary grants for transportation, of which up to \$200 million can be used to support the Transportation Infrastructure Finance and Innovation Act of 1998 (TIFIA) program, for up to \$2 billion in estimated new TIFIA loans.

TIFIA credit support has become an increasingly important component of US PPP financing strategies, partly in response to credit market conditions. In many recent deals, the advantageous price of a TIFIA credit facility has been a key driver of a successful bid. But renewed interest in TIFIA has led to a situation where loan authority is being rapidly depleted, and so this increased capacity should be well received and rapidly utilised.

Supply trends

Tightened credit markets

Financing markets are improving, but they may remain less attractive than usual for the near term. In this context, financing markets include both debt capital markets (where infrastructure bond finance is traditionally raised), and the international project finance loan markets that provide capital for many PPPs.

While many market participants view infrastructure as an attractive defensive asset class during these volatile times, the dynamics of the credit markets, particularly with respect to the tenor of debt, have moved in the opposite direction. As a result, deal volume is down. Transactions that are being executed are taking more time, incurring higher costs and relying more heavily on official funding from institutions like the European Investment Bank and TIFIA.

While several sizable, precedent-setting transactions (the UK's M25 and Florida's I-595) have closed recently, several others (including Florida's Alligator Alley) have not proceeded in part because of conditions in the financing markets.

The table below highlights the range of capital structures executed recently for major infrastructure projects in the United States.

A number of governments are proactively trying to ensure that the credit crisis does not stall needed infrastructure projects. The UK government has decided it is better to provide additional Government-backed debt finance than to delay projects or restructure scores of scheduled PPP transactions. Toward this end, the UK Treasury announced in February 2009 that it will lend directly to those Private Finance Initiative (PFI) projects that cannot on their own raise sufficient debt finance on acceptable terms. Across the EU, the European Investment Bank has increased lending to ensure that significant deals are executed. Similarly, the US Department of Transportation will expand its TIFIA credit program for infrastructure.

Table 1. Capital structure of recent US PPP deals

Transaction	Date	Value (\$m)	Debt (\$m)	Debt/equity Ratio
Texas State Highway 130	Mar 2008	\$1,360	\$1,190	87:13
Virginia Capital Beltway	Jun 2008	\$1,930	\$1,180	61:39
Florida Interstate 595	Mar 2009	\$1,670	\$1,460	87:13

Variability in equity returns

In principal, the great variety of PPP structures makes it difficult to generalise about equity returns in the infrastructure market. For example, in some PPP structures, reduced gearing can lead to lower equity returns. In others, it can have the opposite effect. The difference lies in the nature of the revenue supporting the structure. For example, in availability payment-style structures where debt costs are passed through to the government, equity returns are stable or rising; in availability payment-style structures where revenues are fixed, equity returns are stable or declining. That said, growing competition in the sector should put pressure on returns over time, which could prove problematic for some market participants who achieved early dominance.

On the plus side of the equity equation, there is likely to be an eventual 'flight to quality,' with investors seeking sound prospects in the infrastructure sector, particularly if other asset classes remain severely impaired. This is particularly relevant for pension funds, since long-term infrastructure projects are a good fit for pension fund liabilities.

Table 2. Infrastructure investors

Investor Class	Description	Market Players
Strategic buyers/concessionaires	<ul style="list-style-type: none"> • Traditionally, operators, developers or contractors in the infrastructure sector • Often benefit from sector operational expertise, which can enhance the value of their bids • Varied investment strategy - ranging from long term investors to shorter term 'build and sell'. 	<ul style="list-style-type: none"> • Abertis • ACS • Acciona • Balfour Beatty and Sodexo • Bombardier • Bouygues • Brisa • Cintra/Ferrovial • FCC • Global Via • Hochtief • Kiewitt • Leightons • Thiess • John Holland • John Laing • Bilfinger Berger • Lend Lease • OHL • Sacyr • Siemens • Skanska • Transurban • Veolia • Vinci • Zachry.

Investor Class	Description	Market Players
Infrastructure funds with PPP allocations	<ul style="list-style-type: none"> • Private or listed equity funds focused on PPP infrastructure investments • Strong liquidity awaiting investment opportunities • Typically look to take part in a consortium • Long-term investment strategy. 	<ul style="list-style-type: none"> • Amber • AMP Capital • Barclays • Brookfield • Capella • CII • Commonwealth Bank of Australia • EISER • Equitix • Hastings • HICL Infrastructure Company • InfraRed Capital Partners • Innisfree • John Laing • Macquarie • Meridiam • Plenary.

Government examining mechanisms to ensure sufficient affordable financing for projects

As a result of the constrained financing markets, governments are investigating mechanisms to stimulate market interest and make the infrastructure asset class more attractive. The benefit of this approach is that a relatively small investment by government (for example through co-funding or a guarantee) is leveraged into a much larger increase in total financing as private sector financing is increased by a multiple of the government investment. Some of the techniques used in the US, UK and Europe are described below.

Co-funding

Under this option, government provides a proportion (say 50%) of the total funding requirement as a loan at a low rate of interest reflecting the government's cheaper cost of funding. Advantages:

1. Reduces cost of funding and increases the pool of funding available
2. Bank financing retains the focus on managing cost
3. Larger/more projects can be financed
4. Involvement of a government lender encourages additional finance as the market is more confident in the project.

Example	Description
US TIFIA Loans	TIFIA loans (Transportation Infrastructure Finance and Innovation Act) are priced roughly equivalent to US Treasury bonds, and fund a maximum of 1/3 of the cost of a transport project. The program provides approximately \$500m – \$1bn per year of loans.
EIB Debt Funding	The European Investment Bank regularly provides funding up to 50% of total funding for key infrastructure projects in the European Union. This has markedly reduced the financing requirement from commercial banks, and as a result of its multilateral institution status, it is able to provide a significantly lower cost of funds.
Subordinated Debt	European Governments are looking at providing subordinated debt to projects in order to improve the credit quality of the senior debt, thus increasing supply of commercial funds and also reducing the costs. The Project Bond 2020 plan involves providing up to 15% of the total funding as subordinated debt in order to make the remaining debt more attractive to institutional investors. Private sector subordinated debt funds are also starting to appear with the same intention, for example the Hadrian's Wall Capital fund.
UK Infrastructure Finance Unit (IFU)	The UK government set up the IFU to act as a co-lender on major PPP projects where the private sector was unable to fund the entire requirement. Despite a relatively low number of projects being funded by IFU, the program increased confidence in the market, resulting in additional private finance and removing the need for the IFU to invest.

Capital contributions

Government provides a capital contribution, either through payment of a proportion of the total capital costs, or by providing an element of the works (for example enabling works) in order to reduce the funding requirement for the private sector. This has been used extensively in the UK and Europe, where capital contributions are made towards the end of the construction period to ensure that the private sector remains 'on the hook' for construction delivery. In Australia, governments have undertaken preliminary works as a way of reducing the total private funding requirement and also accelerating the delivery of the infrastructure.

Government supported funding

Another mechanism to encourage additional private sector debt funding is for government to provide credit or liquidity support to the financing. Mechanisms that have been used previously include:

- The Government Supported Debt model utilised by the Queensland Government on the South East Queensland Schools project, where the private sector provided all debt during construction, with government taking 70% of the debt after construction completion
- The Credit Guarantee Finance (CGF) mechanism trialled in the UK on two PPP projects. Under this mechanism, Government provides all the debt to the project and then receives credit guarantees from banks that mean the government is repaid in the event of a default. The government is able to provide the underlying liquidity to the project more cheaply than private sector banks
- The French Guarantee of Debt on PPP projects, where a EUR10 billion fund was set up to guarantee debt on PPP projects (up to a limit of 80% of total debt for an individual project). This has made it easier to obtain the required amount of funding for large projects, as well as reducing the cost of funding for the guaranteed portion of the debt

- The UK has recently commenced a program to guarantee debt on major infrastructure projects in order to encourage private sector finance. The program will cover up to GBP40 billion of debt. The first project announced as being covered by the guarantee is the Crossrail PPP project.

Full government funding

Government provides all the funding for the project, assuming the associated risks in return for a lower cost to government. This approach is already used for the majority of infrastructure provision in Australia, including the use of Design and Construct (D&C); Design, Build and Maintain (DBM); Design, Build, Operate and Maintain (DBMO) or Alliance contracts.

Governments are also looking at new mechanisms to raise funding. Examples include:

- Expanding land value capture programs to utilise the benefits from infrastructure to residents and local companies to assist in paying for the infrastructure development. For example the UK Government has levied additional business rates on London businesses in order to assist in funding the Crossrail construction
- Raising additional funding through Tax Increment Financing (TIF), whereby loans are made against future increases in tax income resulting from infrastructure development.

Involvement of financial investors (superannuation funds/insurers)

Many governments are encouraging more financial investors such as superannuation funds and insurers to provide funding to projects. Programs have been set up in the US, UK, India and Canada to investigate mechanisms to increase the level of institutional investment. The advantage these entities bring is that their liabilities are long term in nature and so naturally match with the long term inflation indexed returns of many infrastructure projects.

The main obstacles to pension fund investment are the construction risk associated with many infrastructure assets and the sometimes extended period of zero cash returns before operations commence (which is fundamental to enable

these financial investors to service their pension and insurance liabilities). Superannuation funds are generally unwilling to take these risks and so additional structuring is necessary to overcome this (for example through bank guarantees during construction similar to those used for EIB funded transactions, or contingent equity during construction) or debt to equity synthetic transactions.

However, superannuation fund investment in social infrastructure may not be ideal, as the market is much smaller than for economic infrastructure and even a small allocation by pensions funds would quickly flood the market, reducing returns and rendering investment unattractive. In addition, the individual investments are usually smaller, and pension funds are unlikely to devote resources to these small investments.

Example	Description
AMP Capital debt fund	<p>The AMP Capital debt fund is up to its fourth close, with a total of EUR326 million committed. It has 21 Investors from Japan, US, UK, Australia and Hong Kong, including pension funds and government entities.</p> <p>It aims to invest in subordinated debt with a 6–7 year tenor. It's target sectors are regulated utilities (water, gas, electricity), transport (airports, toll roads, ports) and social infrastructure.</p>
IDBI Indian Infrastructure Debt Fund	<p>IDBI is targeting US\$5 billion in funds, with a mandate to provide long term debt to the infrastructure sector in India.</p> <p>The Indian Government/Securities and Exchange Board has set up guidelines for the establishment of infrastructure debt funds to facilitate the creation of funds such as this.</p>
UK Infrastructure Investment Platform	<p>The UK Government has signed MOUs with the National Association of Pension Funds and the Pension Protection Fund to set up an investment platform to facilitate investment in infrastructure by pension funds called the Pension Infrastructure Plan (PIP). It is hoped overcome the relative lack of experience of UK pension funds in infrastructure investment.</p> <p>The PIP is examining both equity but primarily debt investments.</p> <p>The end aim is to increase pension fund allocation to infrastructure to 2.5%.</p>
Specialist infrastructure investment funds	<p>There are specialist infrastructure fund managers that focus on PPP investment. However due to the lower level of risk taken on by equity investors in availability type PPP structures, debt levels tend to be very high and equity only represents a small proportion of overall financing. IRR returns from these financial investors range from 10% for secondary assets to mid teens for primary assets (with construction risk).</p>
Infrastructure Trusts	<p>A new development in the US, infrastructure trusts aim to facilitate identification, management and investment of major projects in a region. More detail is shown in the box overleaf.</p>

Case study – institutional investment

The City of Chicago recently set up the Chicago Infrastructure Trust (CIT). The US\$7 billion trust aims to facilitate private sector investment from institutional investors such as pension funds, insurers, endowments, sovereigns and private equity. Washington, Oregon and California are currently attempting a similar initiative called the West Coast Infrastructure Exchange (WCI) which should be available in the next six months. WCI has appointed an experienced infrastructure advisory firm to advise on potential investments.

While several large pension funds in the US have been actively investing in infrastructure (eg CalPERS has committed to invest up to US\$800m in California infrastructure and CalSTRS is investing US\$500m in Industry Funds Management, an Australian infrastructure fund), smaller funds find it difficult to invest directly in projects due to the specialised skill sets required and so need an investment platform that undertakes project identification and management on their behalf.

The first investment by the CIT is to be used to facilitate US\$1 billion in energy efficiency investments, with funding coming from Citibank, Macquarie, JP Morgan and Ullico.

Government examining alternative procurement mechanisms to ensure value for money

In addition to encouraging additional private financing for projects, governments are attempting to achieve 'more bang for their buck' through utilising alternative procurement mechanisms. Some of the major mechanisms are set out below.

Head contractor

Government engages design consultants to design the project, then calls for tenders on a lump sum or schedule of rates basis once design is complete. A project manager acts on government's behalf to manage the design and monitor the construction contract. Cost and time risk is passed to the contractor (subject to design being appropriate).

Design and construct

Government prepares a design brief which describes its requirements, then calls for tenders on a lump sum or schedule of rates bases to produce design and to construct the works. Cost and time risk is passed to the contractor.

Project management/construction management

Government engages design consultants to design the project, then calls for tenders for a project manager. The project manager then acts on the government's behalf to tender and supervise works packages to deliver the works. Here cost and time risk rests with the government.

Managing contractor

Government appoints a consultant to manage the project on its behalf D&C. The managing contractor has a defined cost limit but it is not a fixed time/fixed cost contract, so some risk remains with government.

Alliance contract

Government and the contractor work cooperatively to achieve agreed outcomes for the project on the basis of sharing risks and rewards. Alliances are typically used on very large and complex projects. The majority of risks associated with the project remain with the government.

PPP

- DBFO – The most widely recognised form of PPP, where the private sector is responsible for designing and building the facilities (as per a D&C contract), financing the facilities, maintenance over a medium/long term contract period, and potentially operation of the asset (for example a toll road where the contractor undertakes all operations in return for the tolls collected). The combination of these roles seeks to ensure that the lowest cost over the whole life of the project is achieved
- DBMO – Similar to a DBFO, with the funding provided by government
- DBM – Similar to DBMO, with the private sector responsible for maintenance of the facility and government for operation of the facility (for example a hospital where the buildings are built and maintained by the private sector and the medical staff are government employees).

In summary

Infrastructure funding and finance is in a period of flux. On both sides of the equation – supply and demand – there are positive and negative influences resulting from the GFC and governments’ responses to it. How those influences will settle out over time remains to be seen, but it is clear that infrastructure needs remain pressing the world over and that governments will struggle to meet them, particularly on the heels of a global economic downturn that is having damaging fiscal impacts.

Given this dynamic, there should be an ongoing role for the private sector in the development of infrastructure and the public services delivered through it. The GFC may have temporarily changed the economics of public-private partnerships as financial transactions, but it has also highlighted the need for new approaches to solving the world’s infrastructure problem.

Infrastructure Australia recently released a report into financing Australia’s future infrastructure requirements. The major findings were that:

- In many instances, government development of infrastructure provides best value for money
- Once infrastructure is developed, the private sector can play a role in owning and operating the assets
- Proceeds from post-construction sale of infrastructure assets can be used for further infrastructure development
- There are currently \$220 billion in operating infrastructure assets owned by Australian governments.

Contacts



Luke Houghton
National Leader, Transport
and infrastructure
Tel: +61 2 9322 5245
email: lhoughton@deloitte.com.au



Andrew Johnstone-Burt
National Leader, Public Sector
Tel: +61 2 9322 7525
email: ajohnstoneburt@deloitte.com.au



Michael Posener
Author
Tel: +61 2 9322 3931
email: mposener@deloitte.com.au



James Riddell
Global Leader, Infrastructure M&A
Tel: +61 2 9322 7216
email: jriddell@deloitte.com.au

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Contact us

Deloitte

225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1220 Australia

Tel: +61 2 9322 7000
Fax: +61 2 9322 7001
www.deloitte.com.au

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