Asian project finance, long a sleepy backwater, could be set for a take-off. For those bankers still in the market, clean books and savvy sponsors could be the basis for good business. By Andrew Kinloch.

Tiger feet

Time was when bank head offices in New York and Europe rather begrudged having to have a presence in Asia Pacific. They needed the pins in the map to demonstrate global coverage but, essentially, Australia was the only familiar market. Elsewhere, i.e. Asia, business was all too slow and dangerous and making any money – yet alone reasonable money – was difficult. Recently, however, there have been distinct changes to banks' results from project finance in each of Australia, Asia and back home. Asia Pacific is set to become a more significant contributor to banks' global project finance bottom lines. This article explains why.

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Australia

Australia (and New Zealand) is the closest that Asia Pacific gets to a home market (at 36% of project finance deals closed in the region, 2002 is representative). Australia is the one economy in the time zone most familiar to the Anglo Saxon players from overseas. In terms of deal flow and consequent revenues/risks, it has it all: sophisticated domestic players; legal and tax systems with well developed jurisprudence; political stability; and a liquid currency are all evident. It boasts privatisation of the power and airport sectors, a world class resources sector, a willingness to pay road tolls, a growing acceptance of the Public Private Partnership – model in schools, hospitals and other infrastructure and a reasonable spread of telecoms opportunities (about which more later). As such, Australia is open for business across all usual project finance fronts (and some less usual ones such as magnesium, methanol, mineral sands and no doubt other letters of the alphabet). There is even nascent leveraged finance appetite. Five of the regions' ten largest deals in 2002 were done here. Deals such as MacQuarie Bank/Hochtief's use of so-called FLIERS securities in their A$5.6 billion purchase of Sydney airport or Transurban's CARS notes for their A$1.5 billion Western Sydney Orbital road extended the market's tradition for innovation. A willingness to accept refinancing risk on long-dated assets and a steady stream of changes in ownership, most recently the A$1.1 billion sale by Aquila of its Australian assets to Alinta Gas/AMP Henderson, have supported a strong flow of refinancings. No wonder Australia has taken many of the headlines and most banks have project finance teams in place.

Behind the headlines, however, competition is fierce, precisely because everyone recognises all these advantages. This is particularly so for those banks able to offer little more than good old fashioned bank debt/accompanying vanilla hedging products. This competition is manifested in razor-thin pricing which, when combined with young, small portfolios, means that one bad deal can wipe out a year's earnings. Only by committing more and more capital whilst avoiding any write-offs can such foreign banks grow their business. The competition is also manifest in very long tenors to the point where, realistically, debt is unlikely to ever get repaid. The concept has arisen of a perpetual asset supporting perpetual debt. On road deals, for example, the most contentious base case variable is the rate of population growth! Refinancing is the expected exit and this has, to date, worked for the Victorian power privatisations (from the banks' perspective if not from mezzanine's or equity's) as they have been on-sold, so too for infrastructure taken out by capital markets issues. But having experienced several years of minimal loan losses, just recently the Australian project finance market – debt as well as equity – has run into trouble on telecoms: One.Tel, Australia-Japan Cable, NextGen and REACH have all required restructuring at best/deep write offs at worst. Most foreign banks had some exposure and many will have seen earnings suffer. In this respect, too, Australia has behaved like the developed markets of Europe and the US. On the other hand, though, Australia has avoided the mistakes of the UK and the US in the power sector.

In business terms, as ever the cream comes not from the

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vanilla products but from leading the IPO, the bond issue or the long dated metal price hedging. It is the domestic big four banks plus a handful of well-entrenched foreigners who chiefly have the necessary resources to hand to make these happen. Otherwise, foreign banks, faced with a thinner deal flow, must incur the costs of setting up local specialisations; ship it in as necessary; or sit back from the table.

If Australia's lustre has been tarnished this past year, it is hardly alone and it is hardly fatal. By committing the capital and/or resources and by avoiding the banana skins, reasonable if unspectacular returns can, of course, continue to be made. Like the developed markets back home, foreign banks are a little wiser as to the earnings/risk balance but will maintain their considerable presences here.

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One reason for doing so is that the project finance business – or at least a broadly defined arranging/lending business into the usual project finance industry sectors – can sometimes be the only profitable business line for a foreign bank. If margins are relatively thin in project finance, they are thinner again in many other business sectors. Accordingly, a number of foreign banks have shrunk their Australian operations to just project finance.

Asia

Everywhere else is Asia, a huge collection of countries which have little in common save a broadly drawn geographical proximity. In the late 1990s, the region had a deserved reputation for thin deal flow and poor deal quality. However, five years on, whilst many of these difficulties remain, much has changed. Further, there are several key advantages to running a business in the region. This section examines the various factors which go to make up a sustainable, profitable business.

Credit risk. For any lending business, of course, the paramount business risk is credit risk on individual deals. There has been some progress here. At the macro level, governments such as Korea and Thailand have undertaken some of the restructuring required of them by the IMF and been able to pay back bail-out loans ahead of schedule.

At the micro level, project/offtaker FX mismatch has been reduced in several ways. First, local banks have increasingly supplied domestic currency, especially in China (where they have supplied foreign currency too on the $2.9 billion BASF YPC and $4.3 billion CSPCL petrochemicals deals), Taiwan and Korea. However, from the foreign banks' viewpoint, this leaves them sitting on the sidelines. Second, there remains an undoubted need for virtually all outputs from project finance industries which local governments are rarely able to pay for themselves. This has led to the infamous Indonesian IPPs, such as the $2.7 billion Paiton Energy, finally being renegotiated with less pain for the banks than they might originally have expected. Sponsors were loyal to projects and host governments needed the output. Indeed, Sumitomo Corp has just signed up a $1.6 billion buyers credit for Tanjung Jati B from JBIC/NEXI, the first of the pre-crisis IPPs to be revived. Third, banks and sponsors have focussed more on hard currency projects such as BP's $2.1 billion Tangguh LNG development in offshore Indonesia or CNOOC's two LNG receiving plants in Guangdong ($850 million) and Fujian ($2.5 billion). Fourth, there has been expansion of cover from private insurers such as Edison Mission's $450 million CBK power project in the Philippines back in 2000.

The general lack of sophistication in industry markets can actually enhance credit risk by, for example, setting up local monopolists: contrast what too much competition has done in markets like UK power generation. Further, particular industries can represent safer risks in other ways. In mobile telecoms, 3G technical development risk is being sorted out elsewhere first; there are no huge license fees; and, with existing penetration rates so low in countries like Thailand, India or the Philippines, a more conservative base case can be financed. Thus it was that in 2001, Malaysia's Maxis was able to launch a successful IPO alongside the project financing, something no developed country telco would have dared contemplate at the time. Likewise, cable TV deals are rare of the size of Japan's ¥140 billion Jupiter Telecommunications which closed in January. On the other hand, Fraport's ill-fated NAIA 3 airport terminal in the Philippines, where it wrote off Eu293 million (the loan never met conditions precedent), remind us that the old risks do remain.

Permitting, regulatory and legal risk. All remain problematic and all require caution with drafting, for instance, conditions precedent. Note that these are not exactly easy or quick back home either: witness Californian unsustainable power price caps, the introduction of taxes specific to an industry as in the UK's power sector or specific instances of aggressive price reviews such as the A$2.4 billion Dampier – Bunbury pipeline in Australia. Occasionally, the regulatory environment can enhance risk profile to an extent not seen in western economies. For example, under Korea's Private Participation in Infrastructure (PPI) initiative, the government will top up revenues to the extent that they fall below typically 90% of base case. This is good news for lenders, less so for equity for there is a corollary that revenues in excess of 110% of base case should get clawed back. This was so significant on the $1.2 billion Pusan New Port transaction signed in May that both sides of the measure were dropped and banks took full revenue (and, incidentally, full political) risk. The state of the local legal framework – what is it, does it work and is it enforced? – likewise remains a significant issue, one which the banks

look to the sponsors to manage in the first instance.

Political risk. Instances of the traditional political risks, restricted to expropriation, currency blockage and war/civil insurrection have in fact been rare: political cover has been required more to manage banks' booking limits!

Sponsors. Particularly in telecoms and power, of course, there has been a global sea change in sponsor risk. It was against many of the biggest names in the developed markets that banks wrote off the most last year. Although new names, especially funds (which come without the baggage of conflicts of interest), are emerging to replace the traditional contractors and operators, they have not done so yet. The same names dropped out of both existing and prospective financings in Asia Pacific too, hence one of the reasons to postpone various power privatisations. Doing business with the survivors only in developed countries restricts the choice of deals for banks to pursue and increases the pressure to win those that they do. In contrast, there are a number of strong, acquisitive and loyal Asian sponsors which place more emphasis on relationships. Being seen to be based in-country, getting to know counterparts and attending physical meetings are all that bit more significant when building relationships. After all, this is how the overseas Chinese diaspora compensated for the weaknesses in south east Asia's legal systems, trading with people they knew and coming to dominate commerce throughout the region. The likes of Hutchison and CLP do not just come from this culture but also have the wherewithal to back it up and an appetite to expand beyond their home markets. Local sponsors such as the Indian conglomerates bring cash and an understanding of their market: in fact pricing on telcos there has dropped to corporate levels already. On the other hand, SingTel has just cancelled a subordinated debt facility to the C2C subsea cable when banks would have expected it to support it.

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Deal flow. Deals have been slow to develop (it took ten years for Shell and CNOOC to sign the joint venture agreement for CSPCL); more prone to fall over; with less scope to. repeat a winning structure on further projects in the same industry and country (South Korea's PPI programme, a further example of which is Daewoo Construction's $1.1 billion Busan-Geoje tunnel/bridge, is perhaps the leading exception to this); and relatively small in number. As of today, the first three factors remain. In terms of volumes, too, 2003 is likely to be unexciting given the war in Iraq and SARS (even if the deals which did close were often anything but unexciting). Looking forward, however, volumes might be about to pick up. Specifically, China has in the seven months to 31 July, already placed orders for no less than 30GW (55% of the entire installed capacity in England and Wales!) of thermal power generation equipment. Whilst much will be met domestically, GE has signed $900 million of this. More generally, other banking sectors can act as leading indicators for project finance. First, Thomson Financial reports that the volume of M&A deals announced in 1H2003 involving Asia Pacific companies rose 6% (despite war in Iraq and SARS) compared to global volumes which fell 10%; that Asia Pacific represented 20% by value of deals closed compared to 5% back in 1998; and that for the first time, Asians did more acquiring than being acquired. Second, Bondware reports that Asia Pacific accounted for an astonishing 45% by volume of IPOs in the year to 29 July 2003 compared to the US 39% and Europe 16%. Looking further into the future, Airbus' current Global Market Forecast foresees $497 billion of sales for the commercial aircraft industry in Asia Pacific out to 2020 (2,100 aircraft or in excess of 100 aircraft a year) accounting for 31% of the global figure as passenger miles in the region grow by an average 6.1% per year versus 4.6% per year elsewhere. Even if actual results come in below forecast and only a small proportion is financed with export credits or structured lending, this would still make a sizeable contribution to banks' earnings.

Nonetheless, project finance deal flow remains a significant business risk. To some extent, this is an inevitable consequence of players' (and particularly governments') unfamiliarity with the various disciplines of project finance. There is also a degree of understandable caution on the part of governments in relinquishing control over key industries, such as power, given the pain suffered by many players in more developed economies. From banks' perspectives, dealflow must nonetheless be managed. This involves, amongst many considerations, focussing one of the team's scarcest resources, its time, on those prospects most likely to eventuate for that bank and not being distracted by marginal business.

Product mix. Financial markets in Asia are relatively undeveloped and product mix limited. When lending, US dollar bank loans are the main product for foreign banks, of course, with local currency generally restricted to Yen, HK$, S$ and perhaps Ringgit. Even these sometimes need care in terms of their cost of funding. Back on the asset side, financings are generally for the duration of the asset, that is long-term.

In terms of other earnings, all are limited to one extent or another. The syndications market features less developed primary and secondary markets and smaller appetite for underwriting risk (absent China petrochemicals). There is little secondary market. In terms of advisory business, at the risk of generalising, Asians are not so prepared to pay for such intangibles so this works best as a lead into the ultimate financing for which one should therefore be able to provide the full range of bank debt, equity and perhaps capital markets solutions. A number of banks have built reputations/profitable businesses on this basis and there are several advisory boutiques plying their trade but the number of success stories is relatively small. There is the

occasional equity raising or tax driven deal which when they happen, can of course generate excellent earnings. There is no project bond market to speak of.

With their low capital allocation, export credits enhance returns on equity even if fees are understandably slim. (Interestingly, JBIC and NEXI provide more funding/risk cover than even the World Bank, albeit that much of it is at a government-to-government level rather than at the individual project finance level. Lately, however, its appetite at the lower level appears to have picked up appreciably).

All of which makes for a portfolio that is a lumpen one, long-dated and capital intensive; and a revenue mix which is more skewed towards margin income than fees; but, given the considerably higher margins, one which can nonetheless be nicely profitable.

Parenthetically, project finance teams stray into the occasional leveraged finance opportunity. Here, Asia splits into Japan and everywhere else. Japan may currently offer few attractive project finance opportunities but in terms of leveraged finance, the usual private equity houses are very much present with significant amounts to invest, be it on the Ripplewood/Shinsei scale back in 1999 or more conventionally aimed at the dismantling of zaibatsu and, in Korea, chaebol. In Asia ex-Japan, however, dealflow is fitful, rarely justifying a specialist in the region (although some have tried) and allowing J.P.Morgan to pioneer/dominate the fledgling debt market. Without such specialist personnel on the ground, the occasional deal, which can be lucrative, tends to be handled by the project finance team, sometimes even the vanilla corporate lending team. Either way, though, a specialist leveraged financier back at head office should be involved so as to avoid the likes of the $2.0 billion LG Phillips divestiture which breached covenants within months of being signed.

Expertise. In the wake of the Asian and other crises, most banks have tightened credit control procedures, recruited and trained more industry expertise, applied more consistent standards of evaluation and monitored limits more closely. Although banks have notoriously short memories, I would like to think that at least some lessons have been learned.

Competition. Globally, banks have come under unprecedented pressure recently to justify their presence across most markets, particularly so in project finance given its provisioning requirements last year. If this has led to several withdrawing from the market, then it is to be hoped that there is that bit less competition amongst those who remain. Note that competition manifests itself not just in winning deals but also in recruiting and retaining staff. Post 1997, the region is building a track record of successful deals but there are still comparatively few people who have actually led, i.e. made happen, sound deals across a range of sectors and countries.

Resource management. Credit and country limits need, as usual, to be internally negotiated then applied to the most promising sponsors and prospects. Personnel need to similarly stay focussed on that bank's most likely earnings opportunities. With lower completion success rates in Asia, it is that much easier to end the year well informed about what did not close rather than well remunerated from what did. Being open for business across a number of sectors – whilst retaining the necessary expertise in each – smoothes deal flow, personnel use and earnings given that many individual deal cycles inconsiderately run longer than banks' annual budgetary and reporting cycles.

Many banks have established or inherited a network of branches and rep offices around the region. When markets are so immature or risky and when closing branches gives so final a message to the local market, what to do with them? Project finance, with its greater risk mitigation, information flow, right to intervene and earnings is often the best type of business to book in such outposts.

Results. Banks clearly wrote smaller tickets in Asia Pacific post 1997 but, beyond that, the above enhancements in varying combinations had some effect for it is significant that banks wrote off debt in significant amounts last year almost everywhere *except* Asia Pacific!

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Conclusion

Whether as a participant or lead arranger, lender or advisor, the landscape in which foreign banks can make money from project finance in this half of the world has shifted.

Australia remains the easier market, at least to understand. As in other developed markets, there have been recent losses in the telecoms sector but, significantly, not in the power sector. Australia will continue to produce both the headlines and reasonable earnings which make a handy contribution to global results.

In Asia, the challenges of making a reasonable return have in the past been significantly greater but lessons have been learned and markets have evolved. Prospects have improved for a bigger as well as safer deal flow. With the right management focus, these will translate into considerably better bottom line results. ■

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