Less is more

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With some $50 billion in investment over the past three years, Saudi Arabia has come to dominate the Middle East project finance market. Last year alone, the kingdom attracted over $20 billion – some 55% of the total Middle East and Africa market – in commercial funding from international and GCC funders as well as ECAs.

The government's decision to focus on the petrochemical sector – as part of a GCC (Gulf Co-operation Council) policy to reduce dependency on oil economies – is starting to pay off. This year non-crude oil based exports are expected to hit the $20-billion mark. And it is expected that ten of thousands of jobs in downstream manufacturing will be created by securing the involvement of the private sector.

Although the petrochemicals industry as a whole is expected to take a dip in the next two years as a host of new capacity enters the market, there are no signs that the Saudi boom, which made a slow start in 2004 and took off a year later, is beginning to slow.

A number of mega projects – including Saudi Kayan Petrochemical Company and Saudi Aramco/Dow Chemical's $15 billion Ras Tanura petrochemical plant – are in the financing pipeline. Moreover, a $4 billion integrated refinery cum petrochemical plant will hit the market this year.

Attention is also turning to the downstream integration of existing or already approved projects with local firms like Sahara Petrochemical Company, Dammam 7 and Tasnee Petrochemicals integrating their value chains in an effort to maximise cost efficiencies and secure feedstock supplies.

By providing feedstock for local downstream projects, the major upstream producers benefit from savings on export costs and local long-term offtake agreements for their products. Saudi Ethylene & Polyethylene Company (SEPC), for example, will supply ethylene and propylene feedstock from its cracker to the acrylic and ethylene dichloride projects planned by Sahara. Pyrolysis gasoline from the SEPC cracker will also be supplied to the Gulf Farabi Petrochemical Company benzene recovery plant.

However, the government's drive to turn Saudi Arabia into one of the largest petrochemical production centres in the world is exerting pressure on the kingdom's existing gas capacity. The kingdom's power plants – which had been slated to run on natural gas – have been de-prioritised and will run on more expensive liquid fuel. Natural gas, which adds value to the kingdom's economy, will be channelled to the petrochemical sector.

Given the importance of this sector to the economy, the government has sought to make it easy for investors through offering feedstock at competitive rates as well as providing soft loans through the Saudi Industrial Development Fund (SIDF). Nevertheless, in order to free up new capacity to deal with burgeoning electricity and more petrochemicals demand, additional gas reserves will need to be freed up: For example Saudi Aramco is looking to develop the $10 billion offshore Karan gas field project, which could produce some 1 billion cubic feet per day of gas by 2011.

According to Dominic Harvey, international managing partner, Norton Rose, Bahrain, "The big driver for all potential projects at the moment is certainty of gas supply. Before lending on these deals, banks will need to know where the supply is coming from. If they don't get a satisfactory answer, they're not interested."

Kayan

In addition to feedstock issues, upcoming project financings may be complicated by size, margin pressure on banks and rising EPC costs.

The largest single private sector petrochemical project – and the first in the Middle East to produce polycarbonates – looks set to eclipse the Rabigh Refining & Petrochemical Company's $5.8 billion financing of last year. Estimated to come in at $9 billion, of which $6 billion will be debt financed, the Saudi Kayan Petrochemical Company mega petrochemical project is slated to reach financial close this year, although a 2008 closure appears more likely. And given rising EPC costs in the region, the $9 billion price tag may well see an increase.

At the beginning of 2006, Saudi Kayan Petrochemical Company awarded the financial advisory mandate to a consortium of banks, consisting of Arab Banking Corporation (ABC), BNP Paribas and Samba Financial Group. In February ABN Amro and HSBC joined the consortium of financial advisers to form an arranging group backing the project.

Located at Al Jubail, the complex will produce 1.35 million tonnes per year (tpy) of ethylene and 2.6 million tpy of finished products (including polyethylene, polypropylene, ethylene glycol, polycarbonates and amines), from feedstock of ethane and mixed butanes.

It is expected that the split between commercial and governmental debt will be approximately 50:50. Public Investment Fund (PIF) is expected to come in with a $1 billion loan, while Saudi Industrial Development Fund (SIDF) is also expected to take up a sizeable debt tranche.

The project has been a long time in the making: in 2003, feedstock from Saudi Aramco was allocated; two years later Kayan, a joint stock company was incorporated with equity of SR3.2 billion ($853 million). Early last year, Kayan signed a memorandum of understanding with Saudi Basic Industries Corporation (Sabic), which now holds 35% of the company's capital of SR15 billion and Kayan Petrochemical Company holds 20%. The remaining 45% will be offered for public subscription.

Given the size of the deal, the arrangers will have their work cut work out. Apart from commercial debt finance, other funding products will need to be looked at, including a sizeable Islamic tranche. "There's enough in this deal to keep the international lenders as well as local players happy. On a deal of this size you would expect the export credit agencies (ECAs) to take up $1 billion or so," says a GCC expert.

Nevertheless, lenders remain concerned that engineering, procurement and construction (EPC) contractors continue to drive up prices. Given the glut of projects in the region, the cost of steel and concrete has also increased. Moreover, the dearth of EPC contractors in the market has meant that the best have often been choosy as to which deals they take. This has had a knock-on effect of increasing pricing structures. For example on the $1 billion Al Waha polyproplene and propane dehydrogenation project – one of the largest Islamic standalone financings in the region to date – EPC costs are said to have increased by 60% to 80%.

Sourcing debt

ECA financing is being touted as a funding gap solution for the region, through either direct funding or covered facilities. The problem for many local lenders is that margins on ECA-covered facilities are so low that many regional banks are unable to participate in them. In the past year, JBIC has been lending directly and guaranteeing projects across all sectors on an unprecedented scale.

And it's not just the ECAs that have put the squeeze on local players. Tight pricing and asset/liability tenor mismatches have driven certain lenders to the sidelines. Given that local players have a cost of funding around the 40bp mark, and deals are priced at a similar rate, those competing on the larger transactions will be few and far between. Paradoxically, on the smaller $350 to $550 million deals, locals are so aggressive that international lenders have decided not to bid. But with bank appetite for Middle East project debt remaining strong, pricing is unlikely to broach 60bp; though a longer-term average may be nearer the 100bp mark. "The view among lenders is that pricing has hit the bottom, and the only way for it to go is up," says an industry expert.

If local banks are to compete with international funders in the medium term, there needs to be consolidation in the market in order to turn these local lenders into regional players. However, given the strong jurisdictional ties and family-owned structures, consolidation looks to be some way off.

Although local banks are feeling the margin pressure and five- to 10-year Islamic tenors do not lend themselves to the larger and longer-term petrochemical projects, Islamic debt (now almost indistinguishable from commercial bank debt) is on the increase. "A number of shareholders are putting pressure on management boards to use Islamic financing. One of the main reasons being that if these companies choose to look to the equity market for an IPO, they will be keen to demonstrate that they are an Islamically compliant company, so they can tap into a larger investor pool. This has also encouraged many international banking players to develop multi-sourcing capabilities to support their conventional lending," says Harvey.

Following on from last year's successful $5 billion Yanbu National Petrochemical Company (Yansab) petrochemicals project, Kayan is planning to initiate an initial public offering (IPO) prior to financial close. Yansab was the first petrochemical company to close an IPO at the inception stage and had to overcome restrictions that a public shareholding places on any sponsor recourse.

Saudi Aramco's joint venture agreement for the $15 billion Ras Tanura petrochemical project with Dow Chemicals is another clear indication of the market's buoyancy. Aramco expects to raise up to $10 billion in debt for the project and to float 30% in equity via an IPO. The FEED contract will also be awarded in the coming months and construction will start in 2009. The project is expected to start up in 2012. The project combines an ethane/naphtha-based cracker, a high olefin fluid catalytic cracking complex, an aromatics complex and a chlor-alkali complex. It is expected that 30 downstream process units will produce more than 300 different products.

Sipchem

Another deal that had funders champing at the bit reached financial close in December. The three affiliates of Saudi International Petrochemical Company (Sipchem) – the Acetyls Complex, International Acetyl Company (IAC), International Vinyl Acetate Monomer Company (IVAC), and United Industrial Gases Company (UIGC) – signed a combined project finance loan facility of $560 million with nine regional banks. The 12-year project debt was lead arranged by ABC, Arab National Bank, Banque Saudi Fransi, GIB, National Commercial Bank, Riyad Bank, SABB, Samba Financial Group and Saudi Hollandi Bank. HSBC and SABB acted as the independent financial advisers for the complex.

The loan will be scaled down once a PIF loan is signed in the future. In addition, Sipchem has started the process of converting the loans to Islamic (Ijara lease) structures in line with the company's long-term goals. Over the coming years, Sipchem expects to be one of the largest private, fully integrated petrochemical complexes in the Middle East.

Sipchem is also putting out to tender for its planned $7 billion olefins complex in Jubail. The complex will consist of a cracker unit that will produce 1.3 million tons a year (mtpa) of ethylene and propylene, four processing plants and additional downstream units. Sipchem has asked for expressions of interest for the construction of the cracker. The total production of the complex will amount to 3 million mtpa of 18 different products. HSBC is financial adviser to Sipchem and Worley Parsons is the appointed project manager.

Sipchem, together with Mitsui, DuPont and Lucite, have been working on the final agreements for the complex. The deal is likely to be financed in tranches and will tap ECAs as well as incorporate Islamic facilities. Given Mitsui's involvement and JBIC's project appetite, negotiations with Japanese partners can be expected. It is estimated that the debt/equity split will be 70:30. Half of the capital in the newly formed company, that will own the complex, will be floated. The project is expected to commence in 2011.

Although Saudi Arabia is also promoting smaller downstream industries, mega projects remain the priority. "There are no signs that the market is slowing down yet: we can expect a healthy order book for the next two to three years at least," adds Harvey. The main challenge, however, will be how to bridge the funding gap. Lenders will have to look at more innovative ways of structuring transactions, which could mean more corporate and project/corporate hybrid transactions coming to market.