Isthmus time

01/02/2007

The world's largest construction firms and banks are lining up to win lucrative contracts for a $5.25 billion project to double the Panama Canal's capacity. The widening of the Canal, through the construction of a third set of locks, is needed to allow the waterway to handle a new generation of ships that is too large to use the existing locks, which were built by the US government in 1914.

Since Panama voted to back the expansion plan in October last year, the world's diplomatic corps have moved into overdrive. French, US, Japanese, Singaporean and Chinese diplomats have bestowed honours on the Panama Canal Authority's (ACP) administrator and chief executive, Alberto Aleman, delivered generous donations to the country's universities and institutions and have proposed free trade agreements in the hope that their efforts will help their respective bidders gain favour with the Panamanian government.

The first important contract will be the appointment of the ACP's financial advisers. The Authority says that an independent adviser with an established international reputation will help the state-owned operator raise its first ever debt financing. According to the Authority's studies it will need to borrow between $1.5 billion and $2.27 billion, almost half of the total cost of the project. A request for proposals was sent out in December and a decision will be taken at the beginning of February. The adviser, the ACP has told the banking community, should not expect the appointment to lead to an arranging mandate, which could give an advantage to pure advisory firms.

Ricaurte Vasquez, Panama's former finance minister, was appointed last year as minister for canal affairs and president of the ACP board of directors. He will oversee the largest capital investment project in the country's history, and says the ACP will be looking for "a financial institution that has some of the expertise on all the markets, credit rating, project finance, structured and maritime industry and credit rating and sovereign financing."

What is the ACP?

An important element of the financing lies in distancing the credit of the ACP, a wholly state-owned institution, from the government's own balance sheet, since it is the biggest issuer of sovereign debt in central America. The ACP and the Panamanian government have maintained that there will be no guarantees provided by the state to lenders and the project will be self-financed, with debt backed by existing and future ACP revenues.

"The expansion program", the ACP says in its expansion proposal, "will not burden the country because its financing will not be part of the State's sovereign debt. Funds for building the third set of locks will be obtained through tolls increases. Tolls are the source of all funds to be used for the payment of all investments related to the third set of locks and for the repayment of all financing related thereto."

The ACP believes it will be able to obtain favourable financing terms, "given that the Canal's income is external, and its financing capability and conditions are dictated by the quality of the Canal users, the route utilisation levels, the fact that Canal services are paid in advance or handled through first class bank guarantees with a 48-hour collection cycle and that it is a going concern with a proven market. These facts allow for financing costs and conditions more favourable than those offered for public debt generally. For this reason, the Panama Canal Authority intends to enhance its financial independence by obtaining a risk classification better than the State's," says the ACP's Aleman. On the model that it will pursue, the ACP has still not made up its mind, despite spending $43 million on more than 140 different studies. "I don't have a unique view – that is why we are bringing in an adviser to basically say what are the best ways to go. What will produce the best benefits to the Canal and to the country in that sense," says Aleman.

"That is why we are bringing [the financial advisor] on board to start looking at this as a whole package. The financial advisor will have to look at what risks we are taking, and how much cash flow the Canal will have. We are basically looking for more expertise than that we have in house to look at all of these things together and to look at other alternatives than those we have already thought about."

Most bankers agree that the canal can produce a 12% rate of return in the next 20 years, based on net income forecasts of $1.5 billion in 2015 and $4.3 billion in 2025, compared to $484 million in 2005 and costs of $5.25 billion. The ACP should, therefore, have little problem securing the funds required, whether it be through a corporate-style financing on ACP's balance sheet, a bond issue or through project finance.

"Let's face it," says Vasquez, "there is plenty of liquidity in the market and the Panama Canal is an icon. More than 40 financial institutions have walked through the door, trying to find out what the terms and conditions will be for the financial adviser, so things are very much in place."

Structured and stressed

One banker more interested in the lead arranger mandate than the advisory role has identified the internal debate between the government and the ACP as the determining factor in its choice of adviser. Which model the ACP decides to pursue will depend on who wins the debate. Project finance might be more attractive to the government as it seeks to increase the amount it is able to borrow and push up capital expenditure. "The ACP views project finance as the government's way of over-spending and over-leveraging," he said. "The ACP doesn't want to over-borrow, and is being very fiscally responsible. Project finance could be a good solution more for the government."

Vasquez admits that the ACP would rather move ahead with balance sheet financing and repay the debt in as short a time period as possible, but accepts that it is still open to the input from its financial advisers. "Creating a special purpose vehicle will be difficult," he says, "[finance] will be on ACP's balance sheet. The element that is critical is the separation of the central government and ACP, which remains a government agency even though it has special constitutional titles. This is something that we would like to discuss with our financial adviser when we hire it, which means that we have to hire somebody relatively soon to acquire an update."

The financial freedom of the ACP is restricted by the 1997 law that authorised its creation, outlines its relationship with the state, and protects the annual dividend paid to the government during construction. This ensures that payments to the National Treasury during construction will continue to rise. During construction of the third set of locks the Canal's contributions to the National Treasury, the ACP says, will be on average more than $750 million per year, and when the new locks open in 2015 and debt repayments begin, it could be more than three times the payment of $489 million made to the treasury in 2005.

In 2025, according to the ACP's estimates, the total contributions by the Canal to the Treasury could be more than eight times those of 2005, when the debt has been re-paid. Debt will be required in 2009 when the capital expenditure programme reaches its peak. Most shipping lines also believe this will be the year that the Canal will reach its existing capacity adding to delays for users. The ACP's financial model sees the debt repaid in eight years.

Programmed expenditure for the project is set to increase from $120 million in 2007 to a peak of $1.56 billion in 2010, before falling to $174 million in 2014. Of the total cost of $5.25 billion, $1 billion has been allocated for unforeseen construction costs and the ACP has also included a $530 million provision for inflation during the project.

Cem Karacadag, an emerging markets analyst at Credit Suisse, believes this buffer for risks and unforeseen events will be 'adequate' to avoid any painful surprises. "In sum, we see downside risks on project costs as tolerable and the amount allocated for contingencies, at 28% of base costs, as adequate," said Karacadag. The ACP's experience in carrying out much of the work needed will be an advantage in its bid to bring the project in on budget. The ACP estimates that there is an 80% probability that the project will cost $4.7 billion.

Sovereign soundings

During the construction period, however, three different governments will have to refrain from taking any actions that adversely affect the Canal's cashflow. "Lenders will be affected by what future governments might do and that will affect the amount of money that is available," says another banker running for the advisory position.

Thus, the financing package will have an impact on the freedom of movement of the government in raising its own funds. The ACP and the government alike are aware of the impact a project of this size will have on the financial markets' appetite to lend to a country with a GDP of around $14 billion. "We don't want the project to be considered sovereign financing but we have to be aware of the limitations that it might impose," says Vasquez. "We don't want to crowd out the market with ACP coming to the market and limiting the Republic of Panama's access to their market."

In his time as finance minister between 2002 and 2005, Vasquez pushed through tax reforms, a successful refinancing of the country's debt and a programme of spending cuts in a bid to lift the country's sovereign rating in case the ACP needed to tap the bond markets. In December Fitch affirmed its BB+ sovereign rating for the country.

"The approval of the Panama Canal referendum could yield positive results for the country in terms of higher external and fiscal receipts and improved GDP growth prospects over the longer term," says Fitch analyst Theresa Paiz-Fredel. In the case that the ACP needs its own credit rating to tap the bond markets, Paiz Fredel believes it is eminently possible for the organisation to break through the country's BB+ sovereign ceiling. "The financials of ACP are much stronger than the government," she says.

Tolls and timing

In the short-term, though, the ACP's ability to push through toll increases will have a major impact on the debt required and on the country's credit rating. An outline of the increases needed to pay for the construction of the new locks is due to be announced and the first increases implemented this year. The only details available at the moment are that ACP says that a doubling of tolls in real terms over the next twenty years will pay for the project.

But the pace with which the ACP is able to push through these toll increases will be important in reducing the overall debt burden for the ACP and the country as a whole, says the agency. "Its immediate impact on the sovereign's creditworthiness is constrained as uncertainties remain about debt financing, future revenues from tolls and Panama's ongoing fiscal consolidation," says Paiz Fredel. "To the extent that they can front-load toll increases, and reduce the amount [of debt] they need, it is going to be positive."

One of the key elements of the ACP's expansion strategy will be its ability to increase tolls sharply in the next three years, the time before debt is required to cover the peak of construction costs in 2009.

Doubling of tolls in real terms would require an annual increase of 3.5% over inflation but the ACP has floated a "less conservative" tolls policy that would involve an 8% increase during the first five years of the project, which would cut the need for external bridge financing by $800 million to $1.5 billion. Toll increases in the Suez Canal and congestion on the US west coast ports and US rail network, the Panama Canal's biggest rivals, have helped the ACP push through more aggressive toll hikes in the last five years. Growth in the number of container ships using the Canal has shown no sign of slowing, despite a 67.5% increase in transit costs over the last three years. The sector now accounts for around half of the ACP's annual revenues.

Tankers have also paid more than twice their existing transit fees via an auction system introduced for one-day transit, showing the premium some ships are prepared to pay to transit the Canal during times of congestion. All this will encourage the ACP to push ahead with a more aggressive toll increase program.