To big to loose

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The Korea Development Bank (KDB) is the dominant force in the domestic South Korean project finance and private participation in infrastructure (PPI) businesses. But KDB also has ambitions to be a major player in Asia's international project finance market and has already secured its first cross-border advisory mandate.

While its sights are set on expansion internationally, the PPI sector continued to account for the majority of Korean project deals in 2004, both for KDB and the Korean bank sector as a whole. Using its own balance sheet, KDB provided about $1.6 billion equivalent of debt to PPI projects in 2004, easily outstripping the $962 million it lent in 2003 and $661 million lent in 2002.

In terms of both debt participation and arranger volumes, KDB remains the most active bank in the PPI market. Since 1994, when the government first enacted a law to attract private investment into infrastructure projects (the Promotion of Private Capital into Social Overhead Capital Investment Act of 1994), KDB has won 81 financial advisory contracts. Mun-Hyon Hwang, senior manager in KDB's Project Finance Team I, says KDB was responsible for arranging KRW3.68 of PPI debt in 2004. In 2003 and 2002, KDB arranged PPI financings worth $2.09 billion and $1.95 million respectively.

Highlighting the overall size of the Korean PPI market, Hwang says that Korean banks as whole arranged financing worth approximately KRW7 trillion for PPI developments last year. "But 2004 was an exceptional year," says the banker. He explains: "the total market volume was greatly increased by the Incheon railroad project for which we were financial adviser and lead arranger. The debt amount for the Incheon Railroad project alone was KRW2.31 trillion." In 2005, Hwang expects financing activity to fall back to the sort of level seen in 2002 and 2003.

"We have the highest exposure to PPI projects of any Korean bank," observes Hwang. In order to keep its exposure in check, the banker adds that KDB attempts to syndicate its mandated financings as widely as possible. But despite the sharp increase in PPI loans in 2004, KDB's bankers do not express any great concern about PPI exposure. "We can still take a lot of comfort from government support for the PPI scheme, even if direct economic support in the form of the Minimum Revenue Guarantee is falling." The Minimum Revenue Guarantee (MRG) is provided by the state to support project cashflows up to a certain percentage of original patronage projections. Rather than scaling back PPI lending, other Korean banks suggest senior management at KDB are pressing the bank to be more, not less, involved in lending to PPI schemes.

When asked whether KDB should be leaving more of the market to Korea's commercial banking sector, which is now well versed in PPI and project finance techniques, KDB would only say that it is trying to encourage greater participation from its private-sector counterparts.

KDB clearly has the balance sheet strength to maintain its leading position in the PPI sector. Last year, the Korean government strengthened KDB's financial position by injecting additional capital worth KRW1 trillion. This contribution increased the bank's paid-in capital to KRW8.2 trillion. In fact, since the financial crisis from 1997 to 1998, the government has contributed KRW10.4 trillion in capital to the bank, leaving it with a capital adequacy ratio well above the international standard.

Bank loans to PPI projects may have increased sharply in 2004, but investment equity has also become an increasingly important source of finance for Korean PPI ventures in the last three to four years. For non specialist funds and other local financial equity investors, road projects have been a favourite target. Such funds have invested in projects ranging from Machang Bridge, to the Daegu-Busan Expressway and Seoul-Chunchon Expressway. "Life insurance companies have been naturally interested in PPI opportunities as these projects provide a good match against the long-term liabilities of the insurers. Moreover, the government has also actively promoted PPI-related equity investments," says Hwang.

Life without the MRG

However, he agrees with other commentators that the government's plans for reducing or even scrapping the MRG scheme may reverse that trend and increase sponsors' reliance on bank debt.

The government has already reduced both the period and scale of level of the MRG by 10% for every 5 years of operation over a maximum period of 15 years. Previously the guarantee was provided at 90% over the life of the concession, for solicited projects, and at 80% for unsolicited projects. Other changes in the last two years include the length of the guarantee being reduced from the previous range of 20-50 years, the range of duration for PPI ventures to a 15-year maximum. Hwang says the Seoul Metropolitan Government has already abolished the MRG system in its area of responsibility.

To cope with this changing environment, KDB will put even more stress on due diligence and detailed market, technical and financial studies. "We are likely to need more outside help from specialist consultancies, but we don't expect any major staff changes internally," Hwang says.
He believes that financing structures will become more complex and will included more extensive risk mitigation mechanisms. "It may also be necessary to increase the size of the Infrastructure Credit Guarantee Fund (ICGF) to ensure that adequate financial support is available," says the banker. ICGF resources are managed and operated by the Korea Credit Guarantee Fund, and includes finance from both central and local government.

Hwang also expects the government to continue to have a strong hand in managing the PPI environment. "Without some measure of control there would be too many competing projects and the whole market outlook would be weaker. But we expect the government to continue to actively manage the overall PPI arena, especially on the transport side," he comments.

Even though changes to the MRG make PPI projects more risky investments, KDB has signaled its intention to become more active as an equity investor in PPI projects with the Pyungtaek port project. "This was the first PPI project in which the bank participated as a developer and equity investor. In doing so, we got much more control over how the project as a whole was structured," says Hwang. "We will continue to look at equity investment opportunities if the projects meet our criteria," he adds.

Power and perception

Outside the PPI market, Woong-Chan Park, deputy general manager, Project Finance Team I at KDB, expects the project finance market to grow strongly in 2005 (although he counts shipping and aircraft financings as being within the project finance arena).

In simple monetary terms, the non-PPI project finance market jumped in size last year, as highlighted by KDB's own arranger volumes, although the 2003 figure was well down on the 2002 peak. "We arranged about KRW950 billion of project finance loans in 2002, KRW164 billion in 2003 and KRW659 billion in 2004," says Park. In terms of project lending, KDB's participation rose to KRW461 billion in 2004, compared with KRW84 billion in 2003 and KRW377 billion in 2002.

The banker notes that much of the 2004 total is the result of KDB's central position in the K-Power financing (the country's first merchant power financing). Korea Development Bank was sole arranger and underwriter for the deal, which will finance a 1,074MW combined-cycle plant in Kwangyang, South Korea. The project's sponsors are SK Corporation (65%) and BP (35%). The financing comprised a KRW440.5 billion term loan tranche plus an annually renewable US Dollar denominated $20 million standby letter of credit facility.

Park expects that market to continue to grow strongly, and for the focus of activity to expand beyond the power industry. "Major corporates in all industry verticals are looking to diversify their sources of funding and that includes into project financing," comments Park. The power sector, however, will remain one of the most important sources of new mandates.

Underscoring this, Park says the bank has two more mandates to arrange financing for new merchant power schemes. "The two deals are about half the size of the K-Power financing," says Park, although he adds that the transactions may not close until 2006.

To ease the strain on the local bank market (and presumably its own balance sheet) KDB has been working to attract more capital markets funds into domestic developments. "Where a project is worth over KRW500 billion, or the financing is over KRW2 billion to KRW3 billion in size we generally aim to include a debt capital markets component, with half the money coming from bonds, and half from bank debt," says Park.

To this end, KDB established a debt and equity investment vehicle, with the English title of "Korea Infrastructure Fund" (KIF). KIF is run by Korea Infrastructure Investments Management, and is established as both a domestic and an offshore fund. When *Project Finance* reviewed developments in the Korean market in March last year, commercial banks suggested that the fund had not been particularly active. Park refutes this, and says that KIF has participated in five projects so far, including the Pyungtaek Waste Water Treatment project, which signed in August 2003, and the KRW2.12 trillion Busan-Geoje Fixed Link project, which signed in December 2003.

He also adds that the bank will increase the size of the fund, but he would not be drawn on how substantial the increase will be.

International ambitions

It is hard to imagine KDB carving out a more dominant position in the domestic project finance market that the one it enjoys now. Given that there are limits to how much of the local market the bank can grab, it is not surprising that KDB is eager to increase its presence in international project finance and PPP deals.

According to Seil Kong, the overall head of the Project Finance Department, last year the bank started looking for opportunities to participate in international projects, either as a financial adviser or an arranger. A specific international project finance team within the Project Finance department was established in 2004 for this purpose, with the chief geographic focus being China and South East Asia. "Our international finance department has long participated in international deals, but the target of the Project Finance department in the international market is advisory work," Kong comments.

Kong admits that the international arena has proved to be difficult to crack. "Obviously we still need to build up experience and expertise in specific country markets and that takes time," says the banker.

To date, KDB has managed to win one international advisory mandate, for a toll road project in Vietnam, on which one of the chief sponsors is a Korean construction company. Kong hastens to add, however, that KDB will pursue advisory opportunities even where they do not involve any other Korean interest.

Vietnam may be a particularly active market for KDB because of the Korean government's increasingly strong ties with Hanoi. In an interesting parallel to the toll road project, state-level assistance to Vietnam has been especially strong in the transport and roads arena. In recent years, South Korea has, for instance, offered government loans to help fund a million project to upgrade roads in eight northern Vietnam provinces, and a similar scheme in the country's central provinces. South Korean entities have been involved in other major infrastructure projects, including the construction of the Thanh Tri Bridge and Da Nang's port.