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Panamaxed out

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The Panamanian government is set to go public on plans to expand the Panama Canal, a project that will require financing of up to $4 billion. But since Panama is a small country with a GDP of $13.5 billion and only 3 million inhabitants, it is clear that the Panamanian government is in no position to fund the construction of such a huge project in the same way that the US did during the original construction of the waterway in 1905.

A strong sense of national pride in the way the Canal has been managed by the government-owned Panama Canal Authority (ACP), since it was handed over by the US five years ago, also means that an outright privatisation is also ruled out, leaving little option other than to raise what could be the region's largest ever project financing.

Ricaurte Vasquez, minister for economy and finance and president of the executive board of the Panama Canal, has put the debt element of any expansion at around half of the total expansion cost, which is estimated at between $4 billion and $8 billion. Whatever the final size of the project, tapping the debt markets, says Vasquez, will be necessary due to the capital expenditure requirements at key stages of construction.

"You have such large contracts that you have to provide some sort of comfort and that comfort is provided by a debt facility," says Vasquez. The largest part of the project will be the construction of a new set of locks on the Pacific and Atlantic side of the Canal capable of handling vessels more than twice as large as the existing locks. "It will get to a point when you are pouring concrete that you will have capital expenditure that will be three times what we are doing now. What a debt facility does is allow you to smooth out the peaks and valleys," says Vasquez.

Poor but thrifty – the ACP

With no existing debt and annual revenues of more than $1 billion, the ACP has a balance sheet that is likely to attract investors, but with government borrowing at more than 5% of the country's gross domestic product, the government's capacity to raise money for the scheme is likely to face important challenges. As a government-owned organisation dedicated to operating the 51-mile waterway, neither the ACP nor its parent is capable of providing credit support, leaving little alternative than to take the project finance route, says Mark Gidney, managing director of Lazard's project finance division.

As any finance raised will be secured against the revenue of the Canal, which today accounts for around 4% of world trade, there are significant risks that will need to be addressed by the ACP before it can attract lenders. One of the main financial engineering challenges that the ACP will have to overcome is how to pierce the country's sovereign risk ceiling as well as the traditional risk issues associated with transport projects.

"The ACP has had a very good operational and financial track record since 1999," says Gidney. "Nevertheless for it to be able to raise the volume of debt required it will be of major benefit for it to have an investment grade rating." With Moodys rating the country at Ba1 – just below investment grade – there is a precedent, he says, in that the top-rated Panamanian corporation is rated above the country at Baa1. While this shows that it is possible to pierce the sovereign ceiling, he says, "There need to be a number of structural mechanisms to persuade the rating agencies to rate the ACP above the country."

This will largely depend on the guarantees that the ACP is prepared to offer lenders. A typical mechanism to enhance a deal's credit, according to Gidney is "to ensure that revenues are directed to a separate offshore account controlled by lenders. Funds are released in accordance with an agreed waterfall, which would include operating costs, ongoing capital expenditure and debt service."

A securitisation structure, whereby revenues are applied first to debt service and then to operating and other costs, says Gidney, is also a popular way to tap funds from the private sector. "The rating agencies and investors will take comfort from these types of structures as well as from co-financing with multilateral and bilateral institutions which will be seen to be helpful in ensuring that the government adheres to its agreements," he says.

While the Canal is keen to provide the sufficient guarantees to lenders it is also determined to protect payments from ACP to the treasury, currently around $185 million a year. "If we go to the capital markets for finance the idea will not be to eliminate payments to the government. Covenants will have to reflect that," says Vasquez. "You will honour your bondholders, you will honour your debt. If we don't have the coverage to pay the bondholders and the dividend then it may be necessary to stop payments to the government, but outright you do not just eliminate the dividend payments or any other payments to the Republic just because you have a debt," he says.

Mega-projects, mega risks

Another important consideration will be the mitigation of construction and completion risk. While the final construction cost has not yet been revealed, projects such as Eurotunnel, where original estimates of £5 billion ($9.6 billion) and ended up being £9 billion, demonstrate mega-projects' unique construction risks.

As an expansion rather than a greenfield project, however, existing revenues of $1 billion a year are likely to alleviate lenders' concerns over payment risks. In addition the authority plans to change the way the container sector, the largest user of the Canal, is charged, which will increase revenues by an additional $185 million a year from 2007 onwards, providing further comfort to lenders.

Furthermore an expanded waterway with a third and fourth set of locks capable of handling the largest vessels currently under construction will be capable of doubling existing capacity and more than doubling existing revenues, according to Manuel Benitez ACP deputy administrator.

"The studies are showing that more than 500 million Panama Canal/ Universal Measurement System tonnes is possible in the long-term. That's the demand that we would need to satisfy, which is over double what we have right now," says Benitez. Based solely on existing tolls that would imply future revenues in the region of $2.4 billion, but any expansion is likely to be accompanied by a specific surcharge for users to service any debt. By the time the largest 10,500 teu capacity vessels are passing through the Canal, it is possible they will be paying up to $1 million each to transit the waterway. The highest tolls today are around $250,000 for the largest cruise ships.

While changes to the toll structure bring with them the prospect of higher revenues, they also create their own demand risk, something that will have to be assessed by lenders. Competitors to the Canal include the Suez Canal, the US rail landbridge linking the ports of Los Angeles, Seattle and San Francisco to the US Midwest, Gulf states and the eastern seaboard and the route around the southern tip of South America. All compete for traffic to and from the US east coast, a market that accounts for 65% of traffic moving through the Canal.

According to Benitez, none of these alternatives are as price competitive or as efficient as the Panama Canal, even when incorporating the latest toll increases of $20 per container. ACP has spent more than $40 million on extensive studies into future demand and the engineering, environmental and financial aspects of the expansion. The ACP estimates that it handles 14% of all traffic to the US east coast, a figure that has grown over the last four years in response to growing congestion in ports on the US west coast. In the future, argues Benitez, the volumes will grow even further following expansion.

Bolstered by the waterway's growth in key trades, ACP is likely to become even more aggressive on pricing. Part of this is based on a desire to create the cash reserves that will be needed to raise its equity participation and also to redress what it feels are years of underpricing. "There will be a natural tendency to bring prices to their economic value and it is clear that the value added by the ACP exceeds its price," notes Vasquez.

Even with price increases linked to the expansion, Benitez is optimistic that "once the Canal is expanded we are going to see new dynamics. Customers that are not using the Canal right now that start to use the Canal in the future: Petroleum from Venezuela going to China; soya beans from Brazil. That's a lot of traffic that we would be capturing." While there is always a risk that the project may not attract the volume of usage expected or the risk that the price payable by users may be lower than expected or may decrease in real terms over time, Gidney argues that the demand risk will not be a determining factor. "The lenders will take the risks associated with fluctuation in world trade patterns through a careful analysis of the costs of alternative routes and the ACP tolling strategy relative to this," he says.

Future funds

"As ACP is ungeared and the existing cashflow will provide a significant amount of equity and at the same time provide debt service in the future. Lenders may not need to rely significantly on incremental revenue arising from the expansion."

Due to the size of the deal, multi-sourcing will be required, says Gidney: "I think it is very important that the ACP looks at all the possible sources of finance and tries to create competition as well as flexibility in case one source becomes unavailable or very expensive." By putting a securitisation structure in place and getting the commitment of one of the large development banks, it is more likely to be able to secure the investment grade rating that will unlock the capital markets. The participation of monolines alongside multilaterals and bilaterals will go some way to finding the funds required, says Gidney. Then, he adds: "If the purchase of the locks can be funded by an ECA. Then the commercial banks will be willing to participate. The volumes there could also be $1 billion, possibly more, although maturities may not exceed 15 years." While at the beginning of the project, it will be the multilaterals, the bilaterals and the banks that will give commitments to lend, and bond take-out would be considered upon completion, or after a ramp-up period.

One of the risks for the ACP, identified by Gidney is in approaching the debt markets too soon. If they are approached half way through project, he says, they may be closed or only limited volumes are available, or the price is very high. Furthermore if extra funding is needed due to cost overrun or delays, he says, "the markets may not view this favourably or the rating could be cut".

Dino Barajas, a partner at Paul Hastings, says the ACP would be advised to get its financial team in place as soon as possible to ensure success. "It will be critical to study different possible financing models and to make sure that a strong financing team is in place with international project lenders Once interested commercial lenders have been identified, a development bank such as CABEI should get involved in order to provide additional financing stability."

Smaller Panamanian banks, such as Banco Continental and Banistmo, interested in the project could be represented by an investors club, he says. "Once you have your potential lending sources in place then you come up with a feasible security structure, such as a trust structure, which would provide for a payment priority waterfall. By properly structuring the project on the front-end, you improve the chances of success for the project rather that simply putting the project out to bid for the lowest cost contractor."