Cleaning up

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Japan's PFI market has gained considerable momentum over the last 12 months. In terms of coverage, the market continues to expand beyond its initial focus on public building projects and, as a result, several PFI market firsts have been realised this year.

The long-delayed Odate Waste Incineration Plant project, which was the first waste incineration plant to be mandated under the private finance initiative law, reached financial close in March. The development, involving a 15-year concession, is expected to cost ¥4 billion ($40 million). Development Bank of Japan (DBJ) and UFJ lead the financing, which includes ¥3 billion of bank debt. To be precise, Odate, while the first to be mandated, saw construction and financing delayed several years due to strong environmental opposition. Several waste incineration PFI projects then reached financial close before Odate.

New levels of PFI

According to Koichiro Oshima, senior vice president in UFJ Bank's project and asset-based finance department, the Odate project involves a level of operational risk not seen in typically Japanese PFI schemes. "Most PFI transactions we have seen to date involve some form of government buy-out clause whereby the government agrees to buy the facility in question at a pre-specified price, thereby providing some protection for the creditors," says Oshima. He adds, "But in the Odate project, the government is not obliged to buy out the project if the sponsors go bankrupt, although they do have an option to do so." In order to get comfortable with the heightened risk, Oshima says the banks involved initiated a much more intensive due diligence process.

The importance of proper risk assessment and mitigation routines has been recently underlined by the first case of bankruptcy involving a sponsor of a PFI venture. The PFI project in question is the Fukuoka Taraso waste energy heat utilisation deal, which was one of the very first PFI projects ever awarded, whose sponsor, Oki Construction, went bankrupt in March. The project has been described as a swimming pool project which uses heat from a waste incineration plant. Although market sources did not reveal if the PFI project itself led to the bankruptcy, one source says the original revenue projections for the swimming pool usage were too optimistic and the project was small, costing between ¥10 and ¥20 billion.

Fukuoka PFI test case

According to the project contract, the Fukuoka municipal government has to buy the plant, thus protecting the lenders. Two non-bank leasing companies financed the venture. However, one financier comments: "It is not yet clear whether the government will honour its commitment. If it seeks instead to contest the original contract and wins any subsequent legal battle, that would have major consequences for the PFI market."

UFJ has been mandated to arrange another larger waste incineration plant project, worth ¥20 billion. The plant, which will be located in Nagoya to handle household waste, will be built and operated by Nippon Steel.

Just one week after the Odate financing, another PFI transaction closed for a waste treatment project in Kurashiki, Okayama prefecture. Masato Kaizaki, assistant director of the PFI department at DBJ says the development involves the construction of a facility to treat industrial waste and household waste. "Although there is an offtake agreement with the

Kurashiki government for the household waste, offtake agreements will only cover a portion of the industrial waste revenues so the project company is exposed to demand risk. We believe this is one of the first, if not the first PFI scheme where the project company has had to take demand risk."

The lead arrangers, DBJ and Mizuho closed the financing for the ¥23 billion project in March. The funding package included ¥5 billion in central government subsidies, a ¥10 billion, 16-year senior loan, and a ¥4 billion subordinated loan provided by the leads. BTM, Sumitomo Trust, Chugoku Bank, Sanin Godo Bank, Yamaguchi Bank and Tomato Bank participated in the senior loan. Kaizaki says the subordinated loan can be extended to 20 years to provide additional funding flexibility.

Kaizaki anticipates that one of the most significant, upcoming PFI projects, the construction of a new international terminal at Haneda Airport, will also feature significant demand risk. It is expected that most of Japan's major construction companies will be involved in the bidding. Market observers anticipate mandates for the project, which could be worth $2 billion to the private sector, in 2006. Japan Research Institute, a project consultancy firm affiliated to the Sumitomo Mitsui Banking Group, is advising the government on the project.

New structures for new assets

Oshima says financing for the first waste water treatment PFI scheme also closed at the end of March. The scheme is in Samukawa, Kanagawa and is worth approximately ¥6 billion. The project involves private sector sponsors rebuilding part of the water treatment facility. The sponsors have also been granted a 20-year concession to operate the redeveloped section. The ¥5 billion financing for the project was arranged by UFJ (lead arranger and agent). Two regional banks, Yokohama Bank and Yamaguchi Bank participated in the financing.

Similarly, the first prison PFI project is now on the horizon in Japan and more prison PFI developments are on the drawing board, Oshima says. The government is about to launch the bidding for the first project, which is valued at about ¥20 billion. The bid winner will be responsible for designing, building and operating the prison (situated in Mine, Yamaguchi) over a 20-year period. The government is promising three to four more PFI prisons in the next two to three years. Bankers indicate that the plan has attracted the interest of foreign companies, including the UK's private sector prison operators.

Upcoming deal benchmarks

Several significant PFI ventures are due to reach financial close in the next few months. Takuma Kanai, in Mizuho's project finance division, says the Kudan No.3 Government Office Building project will close soon (Mizuho is lead arranger). The total loan amount is ¥12.6 billion. The project has a 17-year concession, including the construction period.

Kudan's forerunner, Central Government Office Building No 7, which was expected to close by the end of March, is also forecast to close soon. "We think the deal will be finalized by December," says one source. The project, with an estimated cost of ¥60 billion, is the largest mandated PFI project in Japan to date. SMBC is financial adviser. Banking sources involved in the deal would not reveal why the project has been delayed.

Still the only foreign bank involved in the Japanese PFI market, Depfa Bank expects to close its two mandates this year. The first project is for the construction and maintenance of the new Omihachiman City Hospital, which has a projected cost of ¥68 billion. The project sponsor is Obayashi Corporation. According to Fumiya Aoki, managing director of Depfa's Tokyo branch, a ¥14 billion project loan will be arranged for the development. Two other lenders, Shinga Bank and Daido Life, will participate in the non-recourse financing.

Aoki will not disclose the project to be funded via its second PFI mandate but the project has a 30-year concession period and will involve a debt financing of approximately ¥13 billion. At least one other bank is involved in the funding.

In total, according to Naoaki Eguchi, lawyer at the Tokyo Aoyama Aoki Law Office/Baker & McKenzie joint enterprise, the government has announced 36 projects are already operating, 74 projects have signed concession agreements, 13 new winners have been mandated, 30 projects are at the bidding stage and 15 new projects being preparing for bids.

Of this list, 17 projects are national government projects, 126 projects are local governments and 26 projects are quasigovernment schemes such as those for national university corporations. Eguchi notes that 24 university PFI schemes are underway. The funding arrangements for typical building projects have become standardized, adds Kanai, and therefore open to competition from new entrants.

Securitisation - low margins cure?

One of the few really noteworthy innovations in Japanese PFI financing involves a potential deal to securitise PFI debt. The project in question and the bank involved are not being revealed at this stage but it is understood that the deal is a national rather than local PFI project and for a building scheme.

Sources say securitisation is just one of the options being considered because the lender in question wants a cleaner balance sheet in order to pursue more PFI opportunities. The options being weighed up either involve the sale of the debt to an SPC, which will then lead to an issue of asset backed securities or (more likely at this stage) a straightforward loan sale. "Regional banks are included amongst the target investors. As the loan involves the government as offtaker, it would be similar to buying a government bond. But there is a private sector project company involved, so there will be a little more risk and a little more margin," one source says.

Commentators expect few, if any more, such deals in the near future as most financial institutions in Japan are trying to expand their asset base. "Saturation is not a big issue for financiers involved in the PFI market. Exposure levels are still modest," says Depfa's Aoki.

Because of the increased competition, principally from institutional investors and regional banks, bankers say that average pricing realised in PFI financings has fallen from 150bp over Libor for a project loan of 30 years to below 100bp. Some central government PFI projects have seen pricing fall to below 50bp. "Institutional investors and regional banks are partly drawn to the market because of the lack of other good investments," says Aoki, "government bonds are yielding returns below Libor and regional banks have excess cash because of the reduced funding requirement of local firms during Japan's economic downturn."

Although Depfa has been the only foreign bank involved in the Japanese PFI financing business, it aims to pursue deals in other areas. "Our two deals were awarded more than a year ago when pricing levels were acceptable. But we are not happy to see the margins prevailing in the market now," comments Aoki.

Even the Japanese banks are uncomfortable with current pricing levels. "Most of the major PFI players, like ourselves, are now targeting the more specialized PFI projects, to try and get better margins," says Kanai.

One piece of good news for the banking sector lies in the recent PFI law review. Eguchi says that the committee established to review the law has recommended that PFI special purpose companies be allowed to transfer lease rights. "It is probable that the government will follow this recommendation. The necessary amendment to the law may be made next year. This would be good for lenders as mortgages could be transferred in the event that the SPC went into bankruptcy," says Eguchi.

PPP and private projects

Elsewhere in the world, the terms PFI and PPP are often used interchangeably. Not so in Japan, where public private sector partnerships refer to projects (usually brownfield and privatisation projects) which do not fall under the PFI Law. "PPP projects enjoy legal support from the government in recognition of the fact that the law governing public sector entities is quite different from the legal system for private companies, but they do not usually enjoy the same economic support as PFI projects," says Ryusuke Kuwahara, deputy director in the Planning Department for Investment Banking at DBJ. In Japan, PPP denotes developments which involve a transfer of assets or risk from the public to the private sector without having special PFI status. In Japanese law, there is no such thing as a PPP company.

DBJ, as ever a prime mover in the evolution of the market, is working on a scheme, which, if successful, will be the first water PPP project in Japan. The water sector in Japan is still almost 100% government owned and in need of a major infrastructure overhaul. The scheme is therefore highly significant.

This first project proposal centres on the sale of a concession to operate the water system in the town of Zentsuji."The private sector would be responsible for all new investment thereafter," says Kuwahara.

The local government has yet to give a green light to the PPP approach. Even if approval is given, Kuwahara estimates that it will be at least 18 months before any deal can be signed with a private sector company. However, the market could potentially be very large. The DBJ banker says there are over 3,000 municipalities in Japan owning 11,000 separate water businesses. The infrastructure for most of these businesses is 30 to 40 years old.

Infrastructure fund development

Outside of government-backed assets, Japan continues to see occasional transport deals. Hakone Turnpike Limited (HTPL), which Macquarie Bank and DBJ's 50:50 joint venture, Japan Infrastructure Group (JIG) invested in, and raised ¥1.35 billion on a non-recourse basis, to finance the acquisition of the Hakone Turnpike, a 15.8km toll road running from Hakone to Odawara in Kanagawa prefecture. BTM and Sumitomo Trust Bank were the two co-leads.

According to Takehiro Hashimoto, at Macquarie Bank (Japan), the acquisition cost is ¥1.2 billion and the volume of equity in the project is higher than typical toll road projects outside of Japan, at about 40%. "This reflects the need to have a relatively high volume of reserves to cover earthquake risk and the need to make the deal acceptable to the debt market," says Hashimoto.

HTPL sought two credit ratings for the project. The first rating was sought because HTPL originally planned to raise funds via securitisation. Once it became clear that the issue size would not be large enough to deliver good economics, the sponsor switched to a bank debt financing. But the lenders still requested a rating because they wanted a third party reference of the risk profile of the project. S&P rated the ¥550 million subdebt at BBB and the ¥800 million senior debt at single-A. DBJ provided the subdebt. BTM and STB split the senior debt equally between themselves. Both loans have a 10-year term. Hashimoto says the sponsors may still launch a securitisation, but this will only happen when traffic flows start to improve or at least stabilize from their present downturn.

The banker adds that JIG is currently reviewing a large number of other infrastructure investment opportunities. Because of Macquarie's previous experience, JIG will focus partly on toll road and possibly on airport ventures. The joint venture also expects to look at water, gas and railway projects. "The best opportunities will generally be acquisition opportunities because high project costs make it difficult to achieve good returns on greenfield projects," Hashimoto says.