El Cajon: the unwilling pioneer

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The Mexican project bond market has been non-existent since the Monterrey Power deal in 1998. The country's steady progress back to investment grade - it now stands at BBB - has not been accompanied by any capital markets issues beyond structured Pemex paper. The $742.4 million financing for the El Cajon hydroelectric project ends this dry spell.

El Cajon is the largest pidiregas awarded under the administration of Vincente Fox, the largest power project financing ever in the sector, and the first bond deal to gain an investment grade rating at issue. Nevertheless, behind this achievement lie some awkward truths about bank appetite for Mexican risk - future financings will need to be both more inventive and more tightly structured.

El Cajon is a 750MW hydroelectric dam located on the Rio Santiago in Nayarit, the central west of the country. It has been built as part of the Proyectos de Impacto en el Registro del Gasto (pidiregas) programme. It is a priority project, one which the state-owned electricity monopoly, the Comision Federal de Electricidad (CFE) will buy at completion.

But construction is in the hands of the private sector, in this case a consortium of Promotora e Inversora Adisa (40%), Ingenieros Civiles Asociados (25%), Energomachexport Power Machines (20%) and Peninsulra Compania de Constructora (15%). The first two are subsidiaries of Empresas ICA, a large Mexican construction concern, the second is a Russian supplier of turbine equipment, and the third another domestic contractor. The consortium - Constructora International de Infraestructura S.A. (CIISA) - won the contract in early 2003, on the back of bidding documents issued in August 2002.

ICA, which had already built a dam on the same length of river ten years previously - the last hydroelectric project to go forward before El Cajon - was the clear favourite. What worked slightly to its disadvantage was its corporate rating, which at CCC was low by international standards. It required a contract, and financing, that was structured to take advantage of the rating of, and lay off risk onto, the CFE.

According to Jose Luis Guerrero, ICA's CFO "the specifications in the contract were very detailed, and a single unitary payment covered 90% of the work. The remainder of the work is related to geological and hydrological risk, and payments will be increased accordingly." The prospect of any problems with the site, or of there being insufficient rainfall to test the turbines, is now covered by the CFE. The plant is 10% complete.

The sponsors mandated WestLB, with which ICA had worked previously, as a potential debt provider before it had completed its bid. The bank, an infrequent participant in the country's power market, had scooped a large deal with the potential to become a template in the sector. But appetite for CFE credits in the bank market is a source of endless speculation - several IPP and transmission deals have had a slow progress through the market.

The bank market, however, is an attractive route, partly because a borrower can customise its drawings and repayments, and also because two payments at provisional and final acceptance constitute the bulk of the deal's revenue streams. As such the bond route, with its negative cash carry, and straightforward repayment profile, held less allure. According to ICA's Guerrero "we obviously attempted to maximise the available proceeds from the banks."

The proceeds from the debt are needed to complete construction and repay a bridge loan provided by WestLB in 2003. This is believed to be for around $100 million. The bank debt has been structured so that CIISA draws down the funds as and when they are required for a given piece of work. The debt will largely amortize at the end of the deal's life. Completion and delivery are scheduled for August 2007, while the debt matures on 31 August 2007.

Market rumour in the middle of 2003 suggested that WestLB, with a strong franchise in private placements, would look at some kind of bond for the project. Certainly, finding $742.4 million would have been a challenge in the current bank environment. WestLB raised the highly respectable sum of $452.4 million, and banks that have seen the info memo were impressed with the structure and, particularly, the pricing, which was 300bp over Libor. This is understood to have compared well to that on the IFC B loan that SG syndicated for EdF's Rio Bravo deal.

However, the bulk of the remaining funds came in through a $230 million Rule 144A issue. This was co-led by Citigroup, had the same maturity as the bank piece, and priced at launch slightly higher - 6.5%, the equivalent of 349bp over. However, the bank debt has a Libor cap of 3%, so as not to leave the project open to much-anticipated rises in US interest rates. Moreover, the fees offered to co-arrangers are believed to be very lucrative. DEPFA, Santander, HSBC, BBVA, Nord/LB, GE and Interacciones came in to support the deal. Nevertheless, market rumour has it that WestLB may have been left with a hold substantially similar to its bridge financing.

The bond piece achieved a substantial oversubscription despite its short maturity, and could well set a precedent for other borrowers looking to raise money overseas. Indeed, given the challenges of structuring a deal around the ICA credit, it should be possible to tweak the deal. For CIISA, the capital structure also includes $40 million in letters of credit to cover potential overruns. These LCs also function as quasi-equity, since the sponsors are not putting up any equity upfront. Providers of the LCs are Banco Santander, Bank of New York, UBS and WestLB.

The deal did nonetheless gain an investment grade rating of BBB-/Baa3, only one notch below that of the sovereign. This is the first ever achieved for a Mexican project, as Guerrero points out. Structuring out performance risk, and persuading the CFE to accept a more friendly termination regime bore out clear rewards. Future pidiregas will be fortunate to snare such generous terms.

Constructora International

de Infraestructura S.A.

Status: Closed 5 March 2004

Size: $742.4 million

Location: on the Rio Santiago in Nayarit, Mexico

Description: 750MW hydroelectric financing under the pidiregas programme

Sponsors: Promotora e Inversora Adisa (40%), Ingenieros Civiles Asociados (25%), Energomachexport Power Machines (20%) and Peninsulra Compania de Constructora (15%)

Debt: $452.4 million in bank debt, $230 million in 144A bonds, $60 million in letters of credit

Maturity: 2007

Lawyers to the banks: Vinson & Elkins

Lawyers to the underwriters: Milbank Tweed Hadley & McCloy

Lawyers to the sponsors: White & Case (international), Suayfeta (local)

Technical adviser: Sargent & Lundy