

# Hard sell?

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Tightness in the syndication market and a rapid fall in the number of potential bank participants has made debt syndication an increasingly dark art. For ratings agencies, which have been pushing for several years to increase the volume of business that comes from loans, the moment is auspicious. Even the Basel II accords, with their onerous capital adequacy requirements and tacit blessing to a rating-based methodology, favour the movement.

Nevertheless the use of ratings for project finance loans may come up against similar obstacles to those that characterised the struggle to create a broad front over Basel. At the heart of this is the feeling, as prominent at commercial banks as it is at investment banks, that risk management is a proprietary discipline. In this climate, due diligence by banks, as well as their own enhancement processes, become closely-guarded secrets. The more conservative lenders often deal with credit committees with an extremely hard-headed view of project risks.

However, Standard & Poor's, which has led the way in project ratings, and has a lock on the project collateralised loan obligation rating business, is attempting to reach out to the bank market. It recently convened a meeting in London of top syndicators in the loan market to mull over the issues. The meeting took as its starting point the Oman LNG deal, a \$1.3 billion refinancing that closed at the end of 2001 and which was very well received (for details, see Project Finance Deals of the Year, February 2002).

Michael Wilkins, managing director of infrastructure finance ratings at Standard & Poor's, pointed out that the rating came in above that of the sovereign and offtaker. It also assisted in making the debt a marketable asset, and quietened worries about the absence of Citigroup, the advisor, from the arranging group.

Wilkins' further points were that the deal can be useful for clients to market themselves, can assist in Basel and credit committee certification, and can aid in a transfer to bond markets. US borrowers Kern River and Southern Power would also assent to this last point.

However, the cost of ratings does hold some borrowers back. For instance, Kim Humphreys of Mizuho was one of several to state that it depended on the cost to the client. Certainly, all projects would benefit from a rating but the cost to the client was prohibitive for all but the largest projects. It was generally thought that on smaller transactions the banks would undertake their own due diligence because there was less money available for ratings and other reports. \$1 billion plus transactions would need to attract more banks and they would be less familiar with the sector or borrower. Here a rating would help.

Cost is one of the most sensitive issues for rating agencies to address, but is not always the issue it seems. Willie Orr at HBOS, for instance, said it was 'peanuts' in relation to the overall cost of arranging LBO deals, which typically involve a myriad of externally produced reports and the payment of substantial fees to advisers. Dominic Crawley at S&P described the cost as 'crumbs on the table'. The cost was assumed to be around one basis point.

However, others disagreed. Julian Van Kan of BNP Paribas said that as one of the top five arrangers, he heard considerable discontent amongst his borrowers regarding the costs, and in particular new costs, associated with the use of an already public rating. Adding that he fully respected the fact that Standard & Poor's has a franchise that it needs to protect, he thought that for the sake of the borrowers, arrangers needed to understand more fully how and when a rating can be used in the context of loan syndication.

Still others added that the costs, for the borrower, can seem never ending. There can be so many reports that have to be commissioned ? environmental, health and safety chief among them ? that it all adds up. If any report is not a legal requirement, a common belief is that it can be easily dismissed as ?not required?.

But was the rating a decisive advantage for the Oman LNG deal? Ines Silva at Citigroup defended the benefit of the rating in the distribution process. She stated that there are LNG projects in other countries that have had or will have a similar bank list (i.e. support from regional banks) but have been or will be more difficult to syndicate because they are less likely to be rated above the sovereign. Being rated above the sovereign was the key ? especially as most banks' internal ratings would not go above the sovereign. Silva also noted that the deal did not require flexing, despite launching shortly before 9-11.

However, Gary Griffiths at ANZ stated that, in his view, the rating did not have a major impact on Oman LNG's syndication success. If the regional banks had not supported it, in his view the syndication would have been a failure. In this respect the rating had only a minor impact. Mizuho's Humphreys' added that the plant's operating history had an equally significant impact.

Ratings have, however, traditionally been seen as a useful tool for bringing in smaller investors, those without the resources to do more than kick the tyres of a deal. The overall feeling from the meeting was that this last factor was significant in widening participation, especially for marginal institutions. Moreover, headline deals, or ?story credits? in market parlance, may need a rating to reassure investors. The recent NATS and London Underground PPP deals are good examples of such a situation.

Mike Wilkins was keen to point out that S&P has never advocated giving up on undertaking internal analysis. He said that ?it is simply the case that a rating can add to that analysis ? a third party independent opinion. This, at least, should speed up the credit approval process. This even goes for the bond market. Institutions should not abdicate their own analytical functions.? Humphreys stressed that in a bank market banks are paid to analyse risks and must therefore do their own due diligence.

The meat of the discussion, typically for a meeting dominated by bankers, was the effect on pricing. The general consensus was that the key point with pricing was that loan market pricing is not as efficient ? especially in Europe ? and there is little price difference between B and BB rated deals. Until the market sees a difference in price between differently-rated deals, there would be little price incentive to getting a rating. More sensitivity on pricing was needed before ratings would make a big difference.

The effect is probably more marked for LBO deals, however. One participant pointed to a 100bp reduction on pricing for a rated deal. Moreover, until there is greater institutional interest, as in the US, and greater liquidity, ratings would not be a key factor. Ratings, paradoxically, could be a key factor in the creation of such a market. This is one area where the debate will become clearer in coming years, particularly if rated deals are more commonly used as pricing benchmarks, as Humphreys suggested.

Van Kan at BNP does accept that the spur created by a secondary market would help the agencies, since in this market there will always be a greater demand for rated paper. In his view Europe will follow the US route eventually, but for the time being banks have to get borrowers acceptance for a rating ? and they question the need. He considered that the fundamental difference in how ratings will be ?demanded? in Europe is the difference in the investor class. He added that

liquidity is not always the byproduct of rated loans, and there was little push from the retail side for them.

Equally sensitive, however, is the role of agencies in stimulating enhancements to deal structures. Do agencies now offer another layer of financial advisory? This is countered by the fact that banks will normally not accept a rating if it comes in below their target, although many are prepared to tweak structures if this will get 'the right' rating. This is why Standard & Poor's offers a multi-stage ratings process, but is a less compelling argument if a bank is selling a sub-investment grade deal. Moreover, news of an attempt to gain a solid rating that failed would have an adverse effect upon a syndication, and might lead to a pricing flex.

The last two areas where S&P and its peers have to be careful is in the relationships between ratings and credit committee and regulatory approval. The former hurdle is not really an area where ratings agencies will be able to gain undue influence. According to Declan McGrath at RBS, when he goes to his credit committee with a rated deal it will habitually rate it lower. Willie Orr agreed, adding that the Oman LNG deal was rated at a level that he could not have achieved internally. Some committees will look warily on an originator that looks as if they are using a rating to supplant their own due diligence.

With Basel II, the vista for the agencies is a little more pleasant. Tom Mulligan at Commerzbank considers that Basel II may have an impact. According to him, the implications of Basel are, as yet, unknown but the chances are it will change things in favour of a rating. Mike Wilkins says that S&P has a neutral stance on Basel II but that where it could help would be by bringing the ratings process into banks - helping them benchmark. However, as he has stressed before on the subject, he warned against raters becoming pseudo-regulators for the banking market.

Basel's effect will probably run alongside the other trends in the loan market, in bringing it closer to the prevalent practices in the US. Greater demand for ratings will be driven by the need to convince regulators of capital adequacy ratios. According to Wilkins' colleague Dominic Crawley, the agency has already begun to receive enquiries about the use of ratings to benchmark portfolios. Even if the expected boom in project CDOs has failed to happen, this could be important new business.

The debate over the relevance of bank ratings has yet to be settled, despite the stringent efforts of the agencies. Several US projects have had their ratings withdrawn, with the announcement that the borrower has stopped providing adequate information. This is often a useful euphemism for an obviously troubled project refusing to continue paying a maintenance fee.

Sectors as varied as mining, roads, and emerging markets power have suffered waves of default in the past. US power projects look like being the next wave, but may be better candidates for ratings. Banks looking to get out of sectors on loans as close to par as possible may look to bank rating to bolster their case. In this respect, however, Europeans may not wish to follow the US experience.

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