Asia Report: Chinese Whispers

01/12/2001

The Chinese project finance market, in hibernation since the Chengdu water deal in 1999, has been prodded into life by a series of upcoming petrochemical deals, two of which are in the banking market now, the other earmarked for financing in the next 12 months. The three projects expected to come to market first are Royal Dutch Shell's Nanhai joint venture in Huizhou, Guangdong Province, in conjunction with China National Offshore Oil Corporation (CNOOC) and Guangdong Investment and Development, China Petroleum & Chemical Co (Sinopec) and BASF Corp's $2.65 billion Nanjing ethylene refinery, and BP Amoco's plans for a $2.7 billion ethylene plant with Shanghai Petrochemical and China Petroleum.

Market response to the BP/ Sinopec scheme, which will be the first to close, is reported to be very strong, partly due to the competitiveness of the project and partly because of the project's first mover advantage.

?We were originally scheduled to be the last of the three petrochemical deals to close now we're are firmly number one ? the financing for the transaction will close before the end of the year,? predicts Ashley Wilkins, head of project finance at Societe General in Hong Kong (SG is acting as adviser to the project sponsors). As Project Finance goes to press, arrangers are about to be appointed for the deal. ?Loans worth $1.8 billion in US Dollars and Renminbi are needed for the transaction. That amount has already been fully underwritten and oversubscribed a number of times,? says Wilkins.

The speed with which SG has been able to move the project forward is largely due to the financing strategy chosen by the sponsors. Most of the financing is guaranteed by BP and Sinopec. There are three tranches: a US dollar term tranche, a local currency term tranche and a Renminbi working capital term tranche worth, in US Dollar equivalent, about $120 million. It is only this last limited recourse tranche which is not guaranteed but will be arranged and financed by Chinese banks. Sources close to BP Amoco and Sinopec say that the petrochemical giants will consider a limited recourse refinancing of the current deal at a later stage.

Another banker says that 12 banks were originally invited to bid for the arranger roles. All but two banks responded to the invitations and several institutions have now been shortlisted. The shortlist is rumoured to include ABN Amro, HSBC, Sumitomo Mitsui and the Mizuho Group. At the same time, five PRC banks are reported to have been shortlisted to put together the two Renminbi tranches, but one banker speculates that all the nine Chinese banks that were invited to bid will be retained for the deal.

It is understood that the local currency, guaranteed, tranche will have a size equivalent to approximately $800 million and will be 50% guaranteed by BP and 50% by Sinopec. Although Sinopec has never secured a loan with a term of more than ten years, one financier says that it is hoping to get a 20 year term loan from domestic banks. ?What we hear,? says the financier, ?is that local banks might stretch to 18 years but they are more likely to do 16 years and definitely won't do 20.?

The US Dollar tranche is also supported by Sinopec and BP on a fifty:fifty basis and is expected to have a term of 12 years. Equity worth $900 million, or 33% of the project cost, as required by PRC regulations, has been put forward by the sponsors.

The BP project is said to have by far the lowest production costs of the ethylene crackers due to be financed. According to the sponsors, the BP/Sinopec cracker will have a capacity of 900,000 tones of ethylene a year compared to the projected 800,000 tones of annual output for Shell and CNOOC's Nanhai plant. And yet Shell's project is forecast to cost over $1 billion more than the BP venture. Even taking into account the additional facilities that the Shell project will feature, an official involved in the BP bid says the project will deliver have a better capital cost to production volume profile. Neither Shell, nor its advisors were available for comment.

Naturally enough, the strengths of the BP deal are reflected in the loan pricing. One Hong Kong-based banker says that pricing on the US Dollar tranche will be under one percent all in. The bank, which had previously bid for the advisory mandate, priced the foreign currency tranche much higher when it bid for the deal.

In contrast to BP's guaranteed financing, the BASF and Shell Chemical deals have more limited sponsor commitments. As a result, more detailed project analysis and documentation has been necessary, slowing both transactions' progress to the bank market. Shell and CNOOC have also been unlucky with their advisors. The sponsors originally mandated Chase Manhattan as financial advisers, but the bank subsequently pulled out of the project finance market in Asia. Shell and CNOOC then mandated Bank of America but they too pulled out of the business soon after they were awarded the role. IntesaBCI, the newly merged Italian bank, is now reported to be advising the sponsors.

How will the next two petrochemical deals fare when they do get to market? ?Banks are going to get more wary about these petrochemical deals as exposure builds up to the sector, but the deals will get done? says one Hong Kong banker also advising on a petrochemical project in the PRC.

Different banks interviewed by Project Finance each raised different concerns about the economics of the petrochemical projects. ?Financiers will want to try an assess how much floating rate exposure these projects can absorb and the direction of oil and gas product prices in China as the oil and gas sector is deregulated. Both are difficult questions to answer,? says Stephen Wermert, director in BNP Paribas's project finance department in Singapore. Concerns over floating interest rate costs arise because of the heavy reliance that all three projects have on local bank debt finance.

Nevertheless, the underlying economic rationale for both projects is still compelling and all the projects are expected to tap loans at attractive rates. ?Demand for ethylene is certainly one of the key questions, even more so given the global economic slowdown as a substantial chunk of the output of these projects will be exported,? says the Hong Kong financier. ?But at least forty to fifty percent of local demand for ethylene is still uncovered by local production according to our estimates and has to be imported. So even taking the global downturn into account, over capacity is not an issue,? he adds. SG's Ashley Wilkins thinks this is a conservative assessment. ?Even if all three projects were up and running today there would be a shortfall in the domestic supply of ethylene within China when compared with the demand ,? he suggests.?

The Shell Nanhai venture and the BASF Sinopec project will rely more heavily on limited recourse debt than BP. An information memorandum on BASF's project will be sent out to banks sometime in the first quarter of 2002 but no details about financing plans are yet available. Citigroup is advising the sponsors. Details about Shell's financing plan are also sketchy but substantial export credit cover is expected. Like the fundraising for BP, 50% of the debt is likely to come from the local bank market. Sources say that Shell sent out an information memorandum on its project to international banks early this year and received a strong response in return. As many as 19 institutions sent in finance proposals to the sponsors. One financier says that 9 or 10 banks have been shortlisted.

A fourth petrochemical project valued at $3.5 billion and to be located in Fujian province is also under discussions, sponsored by Exxon Mobile, Saudi Arabia's Aramco, Sinopec and the Fujian provincial government. But the project has not yet got approvals from the government. Deutsche Bank is rumoured to be acting as financial adviser for the consortium. The financing plan for the venture is being put together on, ?quasi-project finance lines? says one banker. Completion guarantees from the sponsors are expected to be in place prior to launching the deal into the banking market. However, that is not expected to happen until the end of 2002 at the earliest.

Also waiting in the wings, is the $14.5 billion East West gas pipeline which will require a very substantial funding commitment from the international banking community. ?Given how complex and difficult the project will be the sponsor's are bound to have to finance the venture on a guaranteed basis,? says one project banker. Negotiations with bidding consortia led by major global oil companies are still ongoing in order to secure a joint-venture role with PetroChina in the project.

Legal and structural issues

Although the international banking community has seen Chinese project finance transactions before, mostly in the power sector, a financing template has not yet evolved in China for large scale petrochemical projects. ?Even the power deals were financed in their own unique way,? says a source at a US bank, ?sometime they were all Renminbi, sometimes refinancings of corporate deals. But generally some level of ECA support has been used for the offshore tranches.?

Since the last round of Chinese deals back in 1999, there have been no significant changes to the legal or regulatory environment affecting project finance, says Mitchell Silk, a partner at Allen & Overy in Hong Kong. However, the financing structure for all the planned, large-scale oil and gas deals will, by necessity, be quite different from the structure of past project finance deals, he says. ?What we are seeing is that the old project financing model used to finance previous Chinese projects is having to be tailored to meet the complexity and size of the oil and gas deals,? he says.

Construction risk will have to be managed in a different way than the turnkey, all-in fixed price obligation or wrap guarantee standards of previous project deals. It is improbable that one EPC contractor will be prepared to take the turnkey contract risks involved by itself.

Silk says that the upcoming projects are likely to borrow from other large scale projects completed outside China both with respect to financing arrangements and construction method. Silk says that construction on some of the projects could take place in discrete construction phases. While this method increases co-completion and interface risk, it also reduces the likelihood of complete plant failure. Completion guarantees and more rigorous debt to equity ratio requirements are also expected to feature in the upcoming project financings to lessen the residual risks. ?But these approaches have not been used in China before,? Silk says, ?and will need to be carefully tailored in order to fit with Chinese law.?

For the sponsors Silk says that achieving revenue stability from domestic and international sales will be particularly challenging in the light of Chinese rules and regulations. ?There are a host of regulations which will impact on domestic sales, retail sales, shipping, exporting and pricing which will require sponsors to look at means to mitigate revenue risks.?

Petrochemical projects are also prone to numerous cashflow risks, such as price volatility and associated upstream and downstream risks which will similarly have to be dealt with in the context of China's developing but under-developed legal system. As Silk says, ?petrochemical and gas projects present new risks to those bankers who have become familiar with in traditional Chinese projects. Instead of there being a single offtaker the projects will all supply product to a multitude of end customers.?