Land of the declining sum

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Japan's project finance banks have a lot of explaining to do. Dramatic swings in project finance lending volumes and the overall restructuring of the financial sector have left corporate clients wondering about the commitment of Japanese institutions to a market in which they were previously such important players. ?Whenever we go and see a client these days, the merger is the first question on clients' lips,? says Naomi Yasuda Fisher, head of infrastructure finance at Fuji Bank's Tokyo project finance division.

Between 1997 and 1998 the so-called Japanese premium (over 100bp for the most troubled banks), banking industry reform, and the Asian crisis combined to severely limit all forms of Japanese bank lending, project finance or otherwise. Since 1999, the benefits of restructuring efforts, plus government-led recapitalization and a patchy recovery in Asia have helped non-recourse lending volumes to bounce back. However, although lending volumes are up, the Japanese banking sector's contribution to the project finance market is unlikely to ever be the same again.

Volumes and premiums

All of Japan's top project finance lenders say their project finance loans have risen over the last two years. Fuji's global project finance lending grew, for example, from $525 million in the financial year to the end of March 1999, to $766 million in the financial year to the end of March 2000, to $1.01 billion for the current financial year to date. For one of Fuji's merger partners, IBJ (DKB is the second), project finance exposure jumped 24% in the financial year to March 2000 and rose again, albeit more modestly, in the six months after.

Both institutions will soon be part of the new Japanese banking colossus, the Mizuho Financial Group. The new group's combined financing strength (see table 1) is already proving a boon to its constituent banks. As Fuji's Yasuda explains, the merger process has given the three institutions involved the confidence to underwrite again. ?And that in turn is helping us to secure more lead arranger mandates,? she says.

At the other end of the spectrum, Bank of Tokyo Mitsubishi (BTM), which will not enter into a full-scale merger with any other bank, has also experienced a strong bounce back in project finance business. Akira Tomioka, general manager of the structured finance division at BTM says the bank drop from being the 14th most active arranger of project finance deals in 1997 to a lowly 65th place for the financial year to the end of March 1999. In the following financial year, BTM bounced back, arranging a total of $1.27 billion in project finance loans ? the second highest amount in the bank's project finance history.

Of course, the project finance market as a whole has also grown and Japanese banks' share of the global project finance business has therefore improved less dramatically than simple lending volumes would suggest. In addition, Japan's major banks are a long way from being totally free of financial troubles . At the time of writing, Standard & Poor's has just announced a downgrade of Japan's sovereign rating, from its highest AAA rating to AA+. Moreover, general market confidence in Japanese banks is falling due to the anemic Tokyo stock market and the slow pace of restructuring.

Moody's banking analyst, Mutsuo Suzuki, doesn't think the possible financial benefits from bank mergers will be realized in the short run. In his opinion, Japanese banks' financial fundamentals will remain very weak in 2001, as indicated by the E+ average financial strength rating given by his agency. ?Their ability to generate capital internally will likely remain poor,? adds Suzuki, who does not rule out the possibility of severe capital shortages in extreme circumstances.

Now seems an appropriate time therefore to speculate on the possible impact on project finance activities of a return of the Japanese premium. It should be stressed that none of the banks interviewed by Project Finance have witnessed a rising cost of funding just yet.

Takuma Kanai, head of infrastructure projects at Dai-Ichi Kangyo's project finance division points out that project finance lending is partially insulated from rising funding costs because of the larger pricing margin non-recourse deals can attract ? this is one reason why all four of the major bank groups forming in Japan (see table 2) are so keen to stay in the business.

Commentators usually talk of the Japanese premium in general terms as if its influence in 1998 was spread evenly throughout the Japanese banking sector. Of course this was not the case. With solid and sizeable commitment lines from the international banking community, BTM was previously one of the least affected by the premium, certainly in US dollar financing capability, says Tomioka. Analysts believe BTM would again be more resistant to a re-occurrence of the premium problem.

Nevertheless, even the threat of a premium is enough to send shivers down the spines of bankers in Tokyo. Concerns about a return of the premium would certainly encourage a more conservative attitude to international lending, adds an equity analyst in Tokyo. Supporting that view, one project financier admits that the volume of project lending is likely to be indirectly affected if the threat of a substantial premium does become credible as credit department would become far more conservative about new lending.

Regional and industry appetite

As Japanese banks' project lending increases it is hard to discern any market favourites (either countries or industries) ? unsurprising given that existing exposure patterns differ widely from bank to bank.

But one common factor that independent observers think has restrained the extent of Japanese involvement in the project finance market, particularly in Asia, is the diminished presence of Japanese companies, particularly Japanese trading houses, across the region. Japanese trading houses were aggressive equity investors in international projects before the Asian crisis. Since the crisis, and having got severely burnt by the regional economic downturn, their involvement has been far more modest.

All six banks interviewed by Project Finance stated their intentions to continue nurturing relationships with non-Japanese corporate clients in order to increase the percentage of non- Japanese deals in their portfolios ? deals, that is, which do not have Japanese corporate or government agency involvement.

Although, as Kanai at Dai-Ichi Kangyo says, Japanese corporates will always be a core market for Japanese financial institutions, gone are the days when Japanese banks lent first and foremost to Japanese corporates on relationship driven terms. In Fuji Bank's case, Yasuda says that nearly 50% of its deals have no Japanese corporate or government involvement. Hiroyuki Takahashi, joint general manager of project finance at IBJ says that his bank is, ?shifting strategy as a result,? he says, ?from marketing ourselves mainly on the basis of our ability to secure Japanese ECA finance, to emphasizing our advisory experience in order to get involved in a deal at the earliest possible stage. From there we are in a good position to participate in the eventual financing as an arranger.?

Like Japanese trading companies, Japanese banks have learnt hard lessons from the Asian crisis. Noburu Kato, head of

Sumitomo Bank's Tokyo project finance team, says his bank increasingly favours hard currency-generating emerging market deals, notably in the oil and natural gas sectors, having experienced, like many other banks, unhappy results from Yen or US dollars financings for local currency generating Asian projects.

Fuji Bank's Yasuda says that the power sector has accounted for about 60% of Fuji's deal activity in the last few years. But with market risk becoming more commonplace in the power sector, more regulated markets, for example, those involving environmental-related and water industry projects, are becoming more attractive for the bank.

There is also an interesting divergence in attitudes towards the telecoms sector. Bank of Tokyo Mitsubishi tells Project Finance that it aims to cautiously build its expertise in telecoms related project finance, which is currently significantly lower than most international banks, whereas Sumitomo Bank, says Noburu Kato, is interested specifically in Asian telecoms. Fuji, in contrast, has a more conservative attitude to involvement in telecoms deals particularly to the upcoming 3G related initiatives in many developing countries.

At a general strategic level, Moody's Mutsuo Suzuki suggests that Japanese banks are gradually shifting their focus to Asia while being increasingly selective about lending in North America and Europe. No doubt this is a reflection of the fact that, as Masanori Akiba, head of global project finance at Sanwa Bank puts it, Asia is very much the home turf. But Suzuki believes the emphasis on Asia (and indeed Latin America) is also a reflection of the competitive nature of the European and North American markets and the decisions by some Japanese banks to reduce their capacity in these two markets. ? Going forward there will be more emphasis on competitive advantage. Japanese banks will focus resources where they feel they have the power to compete,? Suzuki says.

There has already been some retrenchment of operations in the developed western economies. No one suggests, however, that this is an overwhelming shift. After all, participation in North America and European syndicated loans is seen by the Japanese for what it generally is ? relatively low risk, easy money. Almost all the Japanese big banks still have a strong project finance presence in either Europe or the US, although few are strong in both. And there are obvious exceptions to the general retrenchment theme. BTM and Sumitomo, for instance, have not seen any significant cut back in its global operations.

Japanese banks have been involved in some of the largest Asian project finance deals in Asia in the last two years, deals like the Ilijan Power deal in the Philippines, the Polymirae petrochemical deal in South Korea and the Australia-Japan cable financing. If total lending volumes are not that high, Japanese bankers say that's largely a reflection of the scarcity of good quality project deals in the region. ?A landscape that is only slowly changing,? says one.

Understandably Japanese banks talk eagerly about the domestic Japanese project finance market. Although Japanese financiers aren't exactly scrambling to jump into the local market ? its not moving fast enough for that ? they are paying the market more than lip service; the major institutions have already been involved in at least one local market PFI or project finance deal. An interesting question over the next few years will be to what extent Japanese domestic project finance opportunities deflect attentions away from the international market. None of the banks interviewed say that the emergence of a Japanese project finance market will lead to a reduction in international project finance activities. But with limited manpower and lending capabilities, even at the largest merged entities, it is hard to see how international project finance business will not be affected, if the local market booms.

Growing pains

While Japanese bank mergers are designed to restore confidence in and the competitiveness of the Japanese banking system, one banker admits that the mergers are causing short term disruption to his bank's project finance business. ? The merger process is confusing both to our customers and banks outside our immediate merger group and people are wary of the fact that the merger is taking a while to complete,? says one banker.

Right now Fuji, DKB and IBJ still ostensibly compete for deals (although their competitors suggest regular collusion) because government recapitalization payments are conditional on the three banks meeting individual performance targets. Only when a sponsor specifically asks for a combined proposal do they put one together.

Merging Japanese banks are obliged to maintain confidentiality agreements on all transactions booked and are not allowed to pass on information to their merger partners until the respective merger is complete. ?We can't fully ascertain each other's exposure levels to particular countries and companies although our credit departments do speak on a regular basis,? says Fuji's Yasuda. After April 2002 when the merger is concluded, the Mizuho Group may well be surprised by consolidated exposure levels to specific companies, industries and countries and have to abruptly clamp down on lending in high exposure areas.

Off record, Mizuho's competitors believe that there will be considerable rationalization of the new group's lending capacity. ?It won't be a case of one plus one plus one equals three,? says one Tokyo banker, ? as the newly merged group is going to have to reconsolidate its balance sheet and boost its capital adequacy ratio.? Yasuo Sato, senior deputy general manager in IBJ's project finance department says in response, ?our lending capacity will depend on the fund raising ability of Mizuho. We can't yet be sure that the new group will be able to preserve the three banks' current commitment amounts.?

Of all the Japanese project finance banks BTM will feel the least direct impact from the restructuring process. BTM is not entering into a fully fledged merger with Mitsubishi Trust and Banking (MTB), instead both institutions will operate individually under one holding company. In addition, MTB has not been very active in the project finance arena, only having participated in the occasional project deal. ?We will work with Mitsubishi Trust & Banking on a case by case basis the same as before,? says Tomioka, ?albeit in a more co-ordinated fashion.?

The Sumitomo/Sakura merger is also a relatively simple and quick restructuring process, says Kato. The two institutions will have wrapped up their merger in April this year with unified project finance teams in Asia, Europe and USA.

Being the biggest and most complex merger, the Mizuho case still leaves the most questions unanswered. Two key issues, reporting structure and whether or not to build industry teams, have yet to be resolved, says Hiroyuki Takahashi. Whereas Fuji's regional project finance teams report directly to the global headquarters (Tokyo) similar to European and US banks, DKB has distinct project finance departments reporting only to the top management of their respective regional offices. Similarly, whereas Fuji and IBJ Tokyo puts its project finance staff into different industry teams, DKB's project finance staff have a more generalist approach. ?I think DKB is ultimately going to follow Fuji's lead on both issues since they represent best industry practice,? comments an observer at another Japanese bank.

Fees, returns and roles

While appetites for different industry sectors vary from bank to bank, Japanese institutions are more consistent about how they aim to participate in the project finance market in future. All the institutions interviewed place greater emphasis on winning advisory and arranger mandates rather than simple debt participation. For some this is a new departure. Fuji, for instance, has only been in the advisory business for the last four years. Yasuda says ?our advisory fee income is now about 10% of total fee income and the percentage is clearly rising.? For others like Sumitomo Bank, the stress on fee income has been a feature of their strategy for at least a decade. Kato says about 30% of Sumitomo Bank's project finance revenue is earned from fees.

The renewed emphasis on arranger and advisory work is largely driven by the increasingly challenging return targets ? return on investment (ROI), return on risk assets and so forth ? set by top level bank management. Akiba says that Sanwa has set itself a target of increasing ROI by 20% in only two years. However, like Sumitomo, Akiba says Sanwa's project finance policy has been reasonably constant for the last 10 years, namely to be a conspicuous player in project deals (particularly in Asia) and not just a low key debt participant. As a result of its long commitment to advisory work about 40% of Sanwa's current income is fee income. Japanese banks' pursuit of more project finance fee income is being helped by the fact that Japanese companies, who traditionally have paid less than the international fee norms, are now paying closer to international rates.

At the same time, Japanese banks' credit assessment methods are getting nearer to international standards. Some banks, like BTM, say their lending evaluation techniques are no different from US or European banks and haven't been for some time. Its interesting to note, however, that Sanwa and IBJ have only started to use the international Risk Adjusted Return on Capital (RAROC) approach in the last few years.

In the reorganizing banks it will be important to see how the credit departments are structured: Will the new banks have separate credit departments for their investment banking arms? Will the credit departments include some project finance experts? BTM's Tomioka says his bank already has a separate credit division for the investment bank, which includes personnel with project finance experience. For the other merging investment banks the credit department structure is not yet clear.