Mega-lomania?

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Management at Compania Mega in Argentina received a rap over the knuckles from their bondholders and the credit rating agencies in January, after it transpired that the company had borrowed an additional $30 million and put itself in breach of its loan covenants.

After a series of meetings between management, lenders, bond underwriters and the rating agencies the problem was resolved by putting in place a new loan. As a result the Mega project was able to avoid the embarrassment of a bondholder meeting, or even worse a potentially damaging downgrade to below investment grade.

The Mega bond offering was one of the most high profile deals out of Latin America in 1999, and was the first oil & gas financing to get done on a project basis in the southern cone, the area which includes Argentina, Brazil, Uruguay and Chile. Credit Suisse First Boston and Citibank together led the 1999 offering of $195 million worth of ten year floating rate notes, $102 million worth of 13 year floating rates notes, and $175 million worth of senior secured fixed rate notes.

The Mega sponsors, YPF of Argentina, Petrobras of Brazil and Dow Chemical of the United States, put up the $203 million equity portion. Compania Mega was set up as a special purpose entity to build, finance and operate the various components of the project. These include a natural gas separation plant in Neuquen province, which borders the Andes, a pipeline to transport the stripped natural gas liquids eastwards to the port of Bahia Blanca, and a gas fractionation facility to extract ethane, liquefied petroleum gas (LPG) and natural gasoline from the natural gas liquids (NGL) stream at Bahia Blanca.

There have been some minor hitches during the construction period, and the project has been running slightly behind schedule from an original schedule which anticipated that it would be fully operating by late 2000. LPG is already being produced, and the first shipments to major offtaker Petrobras are soon due to arrive in Brazil. But there have been delays in the ability of the major offtaker Petroquimica Bahia Blanca (PBB) to start receiving the 5,000,000 metric tonnes of ethane that it has contracted to take on an annual basis. PBB is majority owned by Dow Chemical, with YPF and Itochu Corp as minority partners.

The problem with Mega's unauthorised loans came to light during a review of the company's finances carried out by Standard & Poor's. The Republic of Argentina was itself put on creditwatch last year, because of the poor economic climate and high borrowings in Argentina, and as a result all foreign currency ratings in that country which went above the sovereign ceiling were closely examined.

The Mega ratings were originally placed on creditwatch negative on 1 November, at the same time as the Republic of Argentina. The sovereign was indeed downgraded from BB to BB minus on 14 November, with S&P noting that heightened political uncertainty was hindering the government's efforts to reduce the country's budget deficit, promote a stronger economic recovery, and ensure reduction of the public debt burden.

At the same time S&P were reviewing Mega to see if the weakened sovereign creditworthiness and deteriorating

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economic conditions would allow Mega to retain its own investment grade rating. On December 22 Mega's creditwatch status was updated, with S&P saying that the company remained on creditwatch negative, but this time acknowledging that the company was technically in breach of its loan covenants.

It transpired that during 2000 Mega had gone to local Argentine banks and borrowed $30 million, and that the documentation gave the lenders pari passu status. These additional dollar funds from local Argentine banks were needed to finance increased construction costs due to minor changes in the scope of the project.

But the $30 million loan did not comply with Mega's covenants agreed at the time of the international bond offering. Under the terms of these covenants on the original project bonds, Mega had been given leeway to take on a small amount of additional debt, with the covenants stipulating a mix of subordinated, pari passu and guaranteed loans as well as an overall ceiling.

The action by Mega in taking on an extra $30 million worth of pari passu loans was clearly in breach of these limits, and had put the bonds in technical default.

Bankers familiar with the Mega project say that the three project sponsors were unaware of what had happened, and suggest that the way the loans were structured came down to an error or oversight ? albeit an extremely unusual one for a high profile project with international capital markets access- on the part of Mega and the bank lenders and lawyers involved.

But even though it looked like a mix up, the bankers were anxious to fix the problem as quickly as possible and avoid a downgrade from S&P. This was of most concern to the lead underwriters of the 1999 bond offering, CSFB and Citibank, who hardly wanted to see one of their most high profile Latin American bond offerings being downgraded.

The result was a flurry of correspondence between various banks and Mega management in Buenos Aires, and efforts to put a solution in place that would in the words of one banker ?put the brakes on S&P? moving towards a downgrade.

They were successful to the extent that on December 22 S&P was able to issue a press release which said that though the company remained on creditwatch because of breach of loan covenants, nonetheless ?Standard & Poor's expects Mega to be able to resolve this issue and cure this technical default in a timely fashion, probably before the second week of January.?

The company had also indicated to S&P that while considering other remedies, it might call for a bondholder meeting and ask for a waiver to avoid the effects of the breach of covenants. In the event this was not necessary, since a new loan was agreed.

?The company was allowed to have addition debt, but the debt had to be subordinated to the notes, whereas they took pari passu debt,? explains Lidia Polakovic, credit analyst at Standard & Poor's in Buenos Aires. ?But the issue has been resolved, since Mega has raised subordinated debt and with that paid off the pari passu loans,? says Polakovic, pointing to a $40 million subordinated loan which was put in place in January.

But lenders into the new $40 million financing clearly wanted some support for being in a subordinated position, and the project sponsors had to step up and provide guarantees.

The sponsors are the merged entity Repsol-YPF (38%), Petrobras (34%) and Dow Chemical (28%). These three sponsors have already put in $203 million worth of equity, under the original financing mix of 30% equity/70% debt.

There are few new projects getting signed in Argentina today, given the uncertain economic environment. But given the importance of Petrobras as an offtaker the project has at least received a boost from the rapid recovery of the Brazilian

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economy, after the 1999 devaluation of the Real ? an event which itself has caused some of the economic problems in Argentina.

Having the project company downgraded to junk bond status for a relatively small amount was obviously a situation to be avoided, and bankers were clearly happy that the matter was resolved quite quickly. Mega had its all important investment grade rating confirmed on January 12, leaving it at triple B minus. It has now been taken off creditwatch, but nonetheless the outlook remains negative.

Since the 1999 launch of the bond offering the largest sponsor, YPF, has been taken over by Spanish oil and gas company Repsol to form Repsol-YPF. In November of last year Repsol YPF itself had its credit rating reviewed, reflecting not only the Argentine sovereign downgrade but also Repsol's increasingly aggressive financial and business strategies. However the rating was affirmed at A minus.

?In a way it is all much ado about nothing,? comments one banker, though he does express amazement that such a high profile project could get itself into such a difficult situation, and that banks could put up money without a clear legal opinion on the status of the new loans versus existing loan covenants.

?It sounds like there was an oversight in Argentina, and a purely unintentional breach of covenants,? he says. ?Management got slapped over the wrists and now it has all been fixed.?

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