Solid bond?

01/12/2000

Malaysia's outspoken prime minister, Dr Mahatir Mohamad, is well known as a champion of Asian autonomy. The president will therefore be pleased to learn that his dream of creating a Malaysia independent of western influence has become at least partially true in the project finance market.

Malaysian project finance is unique in Asia for being dominated by domestic bond finance rather than local bank lending or international funds. Not only is domestic project finance dependent on the Malaysian bond market but the bond market itself is heavily reliant on local projects for a large stream of new issues. According to bankers in Kuala Lumpur, some fifty percent all domestic bonds issued in 2000 have been project-related bonds.

Unfortunately, the vibrant Malaysian market may be on the verge of becoming a victim of its own success. Such is the volume of project developments either in the bond market right now, or due for debt capital markets financing next year, that bankers fear a bout of investor indigestion, particularly in the water, toll road and power sectors.

Growing pains

Financiers note that there is significant depth to the Malaysian bond market. This year (see table), investors absorbed about $4.7 billion of new bond issues (both government and corporate). Last year total new issues placed in the debt capital market amounted to approximately $3.9 billion.

However a long line of domestic projects are now queuing up to be financed through the debt capital markets. Most bankers believe that the local bond market won't be able to absorb all the projects due to enter the market in the first half of 2001, in addition to those developments seeking financing right now.

In the power sector alone, half a dozen projects are expected to come to market next year. Planned power developments, say financiers, range from Sepang Power's Rm2 billion power station project in Kuala Langat, Selangor, to a 65MW plant for Malakoff Berhad. The 710MW combined cycle gas turbine power station for Sepang, which will ultimately be owned by Sepang's parent company, Malaysia Resources Bhd and by Kumpulan Darul Ehsan Bhd, the investment arm of the Selangor State Economic Development Corporation, is due to commence operations in mid-2002 and will be extended to a combined cycle plant in 2003. The smaller development for Malakoff Berhad, Malaysia's largest independent electricity producer, is envisaged as a combined heat and power station (Alsthom is understood to have clinched the contract to supply the turbines) and is destined to be built in Lumut.

What is at issue, say bankers, is not just the question of whether the indigenous bond market has the depth to buy up all the upcoming project bonds, but overly high exposure to key Malaysian names and sectors. Malaysian investors already have substantial levels of exposure to the power and water industries through the swathe of power sector and water industry projects which have been financed over the last two years.

Exacerbating the exposure problem, most projects in the power sector have been structured in near identical fashion, says Jerry Yeoh at HSBC in Kuala Lumpur. ?Tenaga Nasional is usually the offtaker and paymaster and investors rightly view the deal primarily as TNB risk,? he adds. The standard template for power station financings was set in 1994 with YTL Power Generation's $570 million local currency bond to finance the country's first two independent power projects, Pasir Gudang and Paka. Ironically, what made the transaction acceptable at the time to Malaysia's leading institutional investor, EPF, was the 21-year, take-or-pay offtake contract with Tenaga. EPF is unlikely to be so enthusiastic about a Tenaga offtake agreement in today's market.

Exposure to Tenaga's credit has been a fact of life for investors involved in a whole range of projects connected with the power sector, not just straightforward IPP deals. Lekit Bulk Terminal's recent port development project which involves the building of a new jetty terminal to facilitate the supply of coal to Manjung's new 2100MW power plant, also hinges on sponsorship from Tenaga. The project was eventually financed via a Rm445 million bond, rated AA3 by Rating Agency Malaysia and arranged by HSBC. Admittedly, according to the bookrunners, the bond did receive a very favourable response, with both the short- and medium-tenor tranches substantially oversubscribed, but arrangers are bracing themselves for less enthusiastic receptions when other power deals come to market in 2001.

One other reason power sector bonds are starting to looks less appetizing is the ongoing restructuring of industry in Malaysia. Previously, says a Singapore financier, power purchase agreements in Malaysia have been relatively concession friendly. Going forward, the restructuring process and privatization will make it more difficult for Tenaga to agree to generous PPAs for future power plants. ?Future PPAs are not going to be able to provide as much certainty to investors as far as cashflows are concerned as previous agreements,? thinks a financier based in Kuala Lumpur.

Similar concerns about financing have been voiced about projects in other industries. Financing new toll road projects is proving difficult in the current bond market, says another Malaysian banker, as recent toll road projects have not performed to expectations. ?The volume of traffic on the new highway linking Kuala Lumpur International Airport to the capital has, for example, been well below what was original forecast,? adds the banker. Arrangers say bond investors have had a hard time differentiating good toll road projects from bad ones in Malaysia and are therefore reluctant to participate in any. A lack of investor confidence is understood to be behind the difficulties Deutsche Bank has experienced placing a bond for the SILK road project. ?Deutsche were preparing the issue about six months ago but little has been heard of the deal since,? says the Singapore-based banker.

In the water sector deal arrangers also detect investor hesitance. ?I wouldn't call what we are witnessing, market indigestion,? says HSBC's Yeoh, ?but investors are looking for water deals with stronger counterparties and better credits.? Several water industry deals have closed in the last nine months including the Rm300 million Islamic debt securities package to finance SAJ Holding's Johor Water concession and the Rm1.2 billion serial bond and Rm435 million FRN issued by SPLASH to pay for the Selangor Water Concession. Unlike power industry deals, financings for recent water projects, including SPLASH and Johor, have been skewed more to the concessionaires rather than the offtaker, says Yeoh.

One other sector, the telecoms industry, is likely to generate several large scale project financings over the next year with the expected announcement of third generation telecoms licenses. Financiers are predicting that the bond market will also find these telecoms deals as difficult to stomach as toll roads. ?Investors seem to doubt predictions made by the telecoms industry regarding the growth of local demand for mobile services over the next few years,? thinks the banker in Kuala Lumpur. ?Investors will probably prefer the devil they know ? Tenaga and power, for example ? to telecoms deals.?

Greater equity, shorter maturity

What is likely to happen, when, as is expected, a large volume of projects hit the bond market in the first half of 2001? Murray Ashdown at HSBC in Singapore thinks projects in the power sector are likely to be financed on a first come first serve basis, with those that arrive late facing the toughest test. ?Appetite is generally ratings driven and the market won't distinguish much between, for example, two AA deals,? he adds. If bond investors do make any great distinction between rival power projects it is likely to be to secure higher yields. Bond specialists therefore expect investors to favour higher risk IPP projects over pure Tenaga credit.

Ashdown notes that the bank market in Malaysia is currently awash with liquidity. ?Domestic banks are exhibiting plenty of appetite for domestic projects,? he says. It is unlikely, however, says another Singapore financier, that domestic banks will step into a deal that the bond market is reluctant to take on. ?Many Malaysian pension funds and banks share the same parent company,? the Singapore source says. ?The credit committees of the pension funds and the banking affiliates can therefore be the very same people. Its illogical to think these credit committees will reject a deal in the bond market and accept the same deal in the bank market.?

Moreover, Malaysian banking institutions are still wary of lending over the sort of terms typically requested by project sponsors. Local banks typically keep loan maturities below 7 years and although foreign observers detect a growing acceptance of the need for longer, loans with long maturities are still far from the norm.

Another alternative, offshore financing, is possible if a project is of sufficient quality and its sponsors are willing pay a considerable premium in funding costs. Giving an indication of where the current premium is at, Yeoh says that benchmark sovereign Malaysian bonds (rated BAA) are being priced at between 250 and 300 basis points above Libor ? very unfavourable compared to the 100 basis points over Libor paid out in the AA-rated Splash deal and the 120bps over Libor paid for by single A rated SAJ Holdings during the Johor water deal. Bank Negara Malaysia also has strict guidelines regarding which sort of project can tap the international financial markets. ?The central bank will only allow projects with ample foreign currency revenues to opt for foreign funding,? Yeoh adds.

In conclusion, with offshore funding only available for a small percentage of Malaysian projects and Malaysian banks still reluctant to lend on a long term basis, most Malaysian sponsors who plan to secure capital over the next six months are likely to have to accept one of two things: bond programmes with shorter maturities or an increase in the amount of equity put into their respective financings.

A template for Asia?

A range of factors have helped to make the Malaysian bond market one of the region's most successful. On the one hand, the country's developing pensions business has led to demand from pensions funds for long term, bond type yields. ?Previously, before the bond market really took off,? says Mark Yeo, in ABN Amro's Singapore power and infrastructure group, ?fund managers had to look for those sorts of yields in specially structured bank loans.? ?The bank loan solution was not particularly satisfactory and a more suitable alternative had to be found,? adds another foreign financier, ?as it created plenty of mismatched deals along the way.?

The local bond market has also developed in response to Malaysian corporates' craving for long term fixed rate financing through which they could take advantage of the country's historically low interest rates. ?Malaysia currently lacks an interest rate swap market of depth and the easiest way to lock into this low interest rate environment, since the debt capital markets took off, has been via a bond issue,? says a banker in Kuala Lumpur.

Along side free market dynamics, the Malaysian government has pushed hard to develop its indigenous capital markets ? particularly hard since the start of the Asian crisis. As the table below indicates, government bond issues soared from 1998 on, and annual government bond issuance is now about four times what it was before the Asian crisis. At the same time, says Yeo, the government has been largely successful in a parallel ambition: to turn Malaysia into an Islamic banking sector. Much of the activity in the project bond market this year has followed Islamic finance principles.

Although Islamic finance in Asia is likely to be limited to Malaysia and Indonesia, other Asian nations have been encouraged by the success of the Malaysia government's capital markets program and are also attempting to encourage indigenous bond industries. ?Neighbouring Thailand,? says Murray Ashdown at HSBC in Singapore, ?has demonstrated that it is likely to follow in the footsteps of Malaysia through the bond financing to pay for the acquisition of the Ratchapuri power plant.? HSBC and other foreign institutions have already put bond professionals in place in Bangkok confident that the Thai market will evolve as rapidly as Malaysia's.