Down the local

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It is a tale of two distinct halves. Over the last 12 months the project finance market in Asia has been increasingly dominated by local currency, local bank financings. Meanwhile, Asia's debt capital markets, with one notable exception, have played almost no role in the project market. Less flexible financing terms, higher costs, and not least of all, the plentiful supply of bank debt have stymied the Asian project bond business.

The return of local Asian banks to the project finance market is no surprise. Local banks have been keen to rebuild loan books in the wake of the crisis and good quality projects, like the recent $1.1 billion Ratchaburi power station financing in Thailand, represent relatively low risk, high return lending opportunities.

However, consensus among international banks is that, current levels of local bank participation may be at a high water mark for the next few years. And the local project bond market is best described as a potential new funding source (Malaysia being the only exception) ? although fixed income departments predict that several project bonds will be seen in Asia in the next 12 to 18 months.

Across the region the pace of local financial sector restructuring and the health of domestic banking systems and economies have all played their part in determining how active Asian banks have been in the project finance industry. The link between the soundness of the local bank market and involvement in project lending is not, however, a simple one ? as developments in the Thai banking sector demonstrate.

Currently, as Theerapong Vachirapong, banking analyst at Merrill Lynch Phatra Securities, explains, the Thai banking sector still faces considerable financial difficulties. Operating results for local banks are, for example, expected to slide in the fourth quarter, as debt restructuring slows and economic uncertainty forces banks to raise loan provisions. But the slow pace of reform in the corporate sector has discouraged banks from booking corporate loans, resulting, says Vachirapong, ?in excessive liquidity and higher funding costs.? Banks have therefore looked favourably on the project finance market as a source of lending opportunities not directly tied to Thai corporate names.

Although seemingly counter-intuitive, foreign observers say the Thai banking sector's appetite for project risk can be expected to diminish if the new Thai government adopts more aggressive corporate restructuring measures, or if the economic growth rate quickens. It is worth noting, that as in 2000, the corporate lending market is expected to be difficult for local banks next year, since growth in the Thai economy is expected to remain weak.

The banking market in mainland China is also currently enjoying ample liquidity ? and as evidenced by the eagerness of banks to participate in the asset driven aircraft finance market ? domestic institutions are actively looking for good quality lending opportunities. Although this is little different from elsewhere in Asia, there is one noticeable difference; a tolerance amongst Chinese banks for high exposure levels to a single project. A good example, earlier this year, was Bank of China's (BOC) decision to provide Rmb960 million ($120 million) of renminbi loans to the PuQi power plant in Hubei. BOC syndicated the loan but only to other branches of the BOC Group.

One trend which could affect the volume of domestic lending to project finance transactions, says Barry Mok at Bank of China International in Hong Kong, is a shift away from purely policy driven lending to more commercially driven lending. ?The shift away from pure policy loans is partly indicated by the fact that project deals these days do not revolve around approvals from local and provincial authorities,? Mok explains.

The increasing emphasis on commercial lending practices, spearheaded by BOC, is part and parcel of the general restructuring of the banking sector on the mainland, adds a second Hong Kong source. It was partly with this new thinking in mind that BOC opted to provide limited recourse funds in the PuQi power plant financing.

Since policy driven lending has tended to involve a far less stringent assessment of project risks, it is arguable that total lending volumes by Chinese banks will be reduced. That doesn't imply, however, that the share of the PRC project finance debt market attributable to domestic banks will be less. It is more likely, says another source in Hong Kong, that the proportion of potential projects that go unfunded will increase instead.

The Korean banking market is at a different stage of recovery to its Chinese or Thai counterparts. Korean government officials say government led restructuring initiatives will be largely complete by year-end, paving the way for the rehabilitation of merchant banks with the injection of public money. Indeed, the government recently decided to inject Won6 trillion ($5.3 billion) in public funds into the banking sector by the end of November.

Although Korean banks have been much more active in local project deals than other Asian banks, concerns about the ability to raise capital are still widespread in the Korean market. These concerns have been exacerbated, says one local analyst, by a government stipulation that banks must raise capital adequacy ratios to 10% by the end of the year, while bringing down bad loans to under 5% by next year.

According to Frank Lee at Hana Bank, there is a clear demarcation in the Korean financial sector market between those banks with liquidity (Lee includes Hana, Shinhan, Kookmin and Housing & Commerce Bank in this category) and those without. Arguably it is due to these liquidity concerns that Hana Bank looked specifically to the domestic life insurance sector for Won-denominated debt when it arranged the recent PolyMirae financing.

An injection of government capital does not imply that Korean banks' involvement in the project finance market will increase next year. That's because an Asia wide phenomenon ? financial sector consolidation ? is likely to disrupt lending activities. Mergers amongst banks in Europe and North America temporarily reduced the amount of bank debt available to the project finance market and a similar impact is expected across Asia.

According to Raymond Lee, head of regional financial institutions research at Salomon Smith Barney (SSB) in Hong Kong, neither overbanked Hong Kong, which has an incredible 265 authorized banking organizations, nor even Singapore which has only five domestic banking institutions, are immune from the mergers and acquisitions phenomenon.

Both the Singapore and Hong Kong local bank market are, says Lee, ?awash with liquidity.? Indeed Singapore's banks on average have a capital base which is double the domestic monetary authority's already conservative requirements. A questions therefore arises ? why haven't Hong Kong and Singapore banks been more active participants in project financings in the region, outside their own jurisdictions? During the past year the explanation has partly been a caution attitude during the initial stages of Asian recovery says, a source at one local bank. But if Singapore and Hong Kong banks have not returned in greater numbers a year from now, the reason for their hesitance is more likely to be that their attentions are elsewhere and focused in particular on M&A activity.

Robert Kong, also a banking analyst at SSB, says that a merger between Singapore's OCBC and OUB is a distinct possibility. Meanwhile DBS could be up for sale to a foreign buyer. At the same time, Singapore banks have been scouring Asia for buying opportunities in other financial markets.

At its roots, industry consolidation is driven by fears about global competitiveness. The same concerns about competitiveness have prompted Singapore banks to reorganize their project finance businesses. DBS has already completed its reorganization. As a result, according to a senior executive at the bank, both corporate and project finance capabilities have been placed around specific industry sectors. ?The primary focus for both corporate and project financing will be Singapore and to a more limited extent, the Asia Pacific region. But our reach will not extend beyond the Asia Pacific,? the official says.

In Thailand seven banks have already been closed or restructured and sold to foreigners over the last year. But Thai banks have traditionally been reluctant to merge operations, owing to differences in shareholder and corporate mentalities, plus relatively restrictive labour and bank regulations. Most Thai finance sector analysts say this reluctance has merely served to draw out the consolidation timetable and almost all predict further mergers and acquisitions.

In Korea, Kookmin Bank is rumoured to be targeting Cho Hung or Korea Exchange Bank for a merger. Housing and Commercial Bank, one of the healthiest of the domestic banks, is also widely speculated to be seeking a merger deal with either KorAm or Hana Bank.

Several sources in the international project finance community have speculated about a major return by the Korean Banks to the international project market. Pre-crisis Korean banks were quite active in international project financings but between 1997 and the end of 1998 there was a dramatic retrenchment of project finance activity and even, in isolated cases, defaults on lending obligations. Lee at Hana Bank believes that in six to 12 months Korean banks will start to display appetite for international deals. ?Those banks with liquidity and experience, like Hana Bank and Shinhan, are the most likely international players,? Lee adds. Most international banks, however, doubt a widespread return. ?A lot of Korean banking houses are still government directed credit channeling institutions and many still have very shaky financials. We aren't likely to see Korean banks in the international market for two to three years, except in very exceptional cases,? says one skeptic. Increasing M&A activity makes the probability of a major return to the international market even less likely.

Nevertheless, Korean banks have been involved in a few financings this year, including the $470 million export credit financing for the Ilijan power deal in the Philippines. Hana Bank, Lee informs, also participated in Sithe's purchase of shares in Coco power plant in Thailand. The deal was a limited recourse bridge financing in which Hana lent $20 million. Korean banks may be tempted into greater involvement in the international market if the Korean Export Insurance Corporation (KEIC), which provides risk insurance to lenders in Korean export deals, pursues (as Lee says it plans to) a more aggressive Korean export promotion strategy.

The local banking industry will be re-treading old ground as it gradually increases its project finance exposure, but for Asia's debt capital markets, the project finance market is a new departure.

Recently bankers in Singapore have been trying to market the Singapore dollar bond market as a new source of finance for corporates and industries across Asia. But Quah Sy Yi, director of capital markets at UOB, points out that the bond market in Singapore is small. In 1999 market volume was S$9.2 billion ($5.2 billion). This year Quah says, market volume will be slightly over S$10 billion.

There has never been a project bond in the Singapore market, says Quah because the product doesn't offer the same flexibility as debt market issues. ?Project sponsors have looked at the capital markets in Singapore for financing but ultimately rejected the bond option,? she adds.

One source at ABN Amro's Singapore office says his institution is looking at capital markets financings for several upcoming developments in Asia. ?It is possible that deals will get done in Korea, Hong Kong, Taiwan, Thailand, the Philippines and even Indonesia next year. We are looking particularly hard at resource sector project bonds? says the source.

Intriguingly, one of the few country's the ABN Amro banker does not mention is the country where the market really has taken off ? Malaysia. An executive at a foreign bank in Kuala Lumpur says that the Malaysian project bonds have become the staple financing diet for domestic developments because the local banking industry has been absorbed by merger plans or the need to alleviate the problems of non performing and bad loans domestic. ?The Malaysian debt capital markets is quite deep, liquid and long term and the structures we are seeing include both conventional as well as Islamic debt securities,? says the executive. Deals include the RM800 million, 10 year bond used to finance Johor Holdings water project and the RM1.2 billion FRN for the Selangor water concession.

Large domestic investors like the state-run Employers Provident Fund have displayed substantial appetite for project bond issues. But, predicts the Kuala Lumpur source, ?the rate at which these deals are being done may cause some indigestion in the near future.?