Won flew over the chaebol nest

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It all sounds very impressive. Over the next five years, Won 110 trillion ($98 billion) is needed, according to a South Korean government study, to fund social overhead capital projects around the country. Of the total capital expenditure requirement, over Won 20 trillion is required, the report says, for infrastructure projects this year alone. Earmarked infrastructure developments range from water schemes, to new roads, rail systems, subways and ports. Outside the infrastructure arena, power sector reform provides a second major source of project finance opportunities.

Banking observers believe that the volume of projects that actually move off the drawing board and into the financing stage is likely to fall significantly short of what the Korean authorities are predicting. ?If other Asian countries are anything to go by, only a portion of the role call of mooted projects will get off the ground, at least within the time frame earmarked by the government,? says one Asian banker.

More importantly for foreign project bankers, a number of different factors are going to limit the number of developments that international banks will be involved in, particularly in terms of lending. These include; the tendency for South Korean projects to be financed in Korean Won, the improved financial position of the domestic banking sector, uncertainties about the creditworthiness of the institutions providing safeguards against revenue and foreign exchange fluctuations, and Chaebol efforts to restrict opportunities for foreign and non-Chaebol Korean corporates. ? Opportunities do exist,? says one banker, ?but not on the scale that the government report might indicate.?

Naturally, with Korean project revenues and costs predominantly denominated in Won, greenfield, brownfield or M&A activity in South Korea is most likely to be financed in local currency. ?In contrast to the Philippine market where there are a lot of US dollar financings, in Korea, the banking community, whether domestic or international, is looking to maximize the Korean Won element,? says John Mulcahy, managing director of project finance at Bank of America in Hong Kong. The real question, particularly in the aftermath of the Asian financial crisis, is the domestic financial industry's ability to match the funding requirement.

?The Won debt market is proving to be quite deep,? says Jason Fisher, vice-president at CS First Boston in Singapore, ? both Korean insurance companies and banks are involved in providing finance.? But some source do doubt the ability of the Korean institutions to provide enough long term, fixed rate funds to finance projects in their own back yard. Life insurance companies have been brought in to provide the necessary long term finance for recent projects, including Vivendi's purchase of an industrial water treatment plant from Hyundai Petrochemical ? a deal arranged by Korea's Hana Bank. However, the capacity and willingness of life insurers to provide the volume of long term project finance now required is unclear.

In the past, the Korean bond market has been the source of a small number of project finance bonds; project bond issues up to $100 million dollars been done, says Mulcahy. However, bonds with long tenor are rare. In the Korean corporate bond market the longest tenor is currently three years, says a fund manager based in Seoul. Also, the market is only now recovering from the collapse of the Daewoo Group. Two of the largest Korean investment trust companies (ITCs), Korea ITC and Taehan, had recently to turn to the government for capital injections, largely because of their heavy exposure to the Daewoo Group. As the largest purchasers of domestic bonds and with a total of about Won 250 trillion of assets under management, ITCs are vital to the bond market. Until the bond market is more stable, financiers say that project bonds are an unlikely option.

Foreign institutions also have the ability to lend in Won to supplement local supply, but the cost of lending in the Korean currency is such that it is only marginally attractive, says a Singapore-based financier. For that reason, combined with the inability of the local market to fully meet the funding needs of all the planned projects, offshore debt financing will be at least a feature, if not the mainstay, of the Korean project finance market.

Some financiers argue that the most logical supply of offshore funds will be the Japanese banks. ?Yen debt is possibly a better alternative to US dollar funding because the Yen and the Won are more closely linked than the US dollar and the Won,? says the Singapore source. ?Korean project sponsors could therefore go to Japanese financial institutions to take advantage of the very low interest rates available there,? the banker adds.

Remembering the extreme volatility that the Won suffered during the Asian crisis, a substantial foreign exchange hedging mechanism would still be required for any off-shore debt tranche, says Christophe Rousseau, at BNP Paribas project finance team in Singapore.

Ostensibly, a partial safeguard does exist to foreign exchange fluctuations. For designated public-private partnership infrastructure projects, government authorities are obliged to provide appropriate financial support if foreign exchange movements are 20% above or below a certain, pre-agreed benchmark, says Rousseau.

A similar support mechanism exists to iron out major revenue fluctuations. ?If revenues fall below a floor level (10% below the pre-agreed revenue target), for example because of lower than expected traffic volumes, government organizations are required to step in and make up the revenue difference,? Rousseau explains. By the same token, if revenues rise 10% above the target, the project's sponsors are required to pass surplus earnings back to the state.

What worries international bankers is the credit standing of the government bodies that are obliged to support project financings through these schemes. ?These organizations won't necessarily be central government level institutions but rather province or metropolitan authorities,? a second Singapore banker says. The problem is that second and third tier government institutions in Korea generally don't have bankable accounts detailing the level of surplus tax revenues available to support project finance commitments.

Some authorities, at the provincial level, do at least have credit ratings assessments from Japanese ratings agencies. However, as one banker puts it, ?Japanese ratings tend to be more bullish about Korea than other international ratings agencies and they apply less stringent tests. These ratings are, better than nothing, but are likely to provide more comfort to Japanese institutions, than other international banks.?

Inward investment

Over the last 18 months, Neil Donoghue, partner at Baker & McKenzie in Hong Kong, says the Korean government has dramatically improved the environment for inward investment, particularly through the Foreign Investment Promotion Act. Along with a host of other measures, the act simplified reporting procedures for foreign investment, changed the corporate laws to make it easier to buy into Korean corporates, and augmented tax benefits.

But shortcomings in both the legal framework and documentation standards in Korea still discourage international banks from more active involvement in the local market. An insufficient security package and patchy documentation papers were rumoured to have been responsible for the delay in the signing of the PowerGen/LG power purchase agreement. Considering the credit risks in Korea and that the country's number two conglomerate [Daewoo] is bankrupt, documentation standards need to be a lot better.

Due to the Korean market's limitations, Asian bankers say that the main project finance opportunities for non Korean institutions lie in advisory work and projects outside the infrastructure arena (notably in the power market). Only a small proportion of the pipeline infrastructure developments will lead to actual financing mandates for foreign players.

The volume of likely advisory mandates is being boosted by mergers and acquisitions activity across a wide range of industry sectors. Bankers involved in the Korean market claim that Korea's main business conglomerates, the Chaebol, have attempted to prevent foreign corporates from developing a major presence in infrastructure developments. Korean observers also say the Chaebol have used the recent liberalization of the financial markets to raise money to support weak businesses and avoid sale of assets as demanded by the government. The top five Chaebol ? the Hyundai, Samsung, Daewoo, LG and SK groups now own 39 financial companies, including investment banks, insurers and asset management funds, that provide financing to affiliate companies.

Even if true, it is undeniable that the restructuring of the Chaebol has opened a door for a large number of foreign companies to access a Korean market once impossible to enter. Two recent deals illustrate the trend. Firstly, Sithe's purchase of a captive co-generation facility from Hyundai Petrochemical. The deal, valued at Won 100 billion, involved Hyundai Petrochemical entering into a long term off-take agreement with Sithe for power supply from the co-gen. Foreign financial institutions weren't involved in arranging financing (Won 70 billion of the total cost came from a limited recourse Won denominated debt financing led by Hana Bank). But one foreign bank, CS First Boston did act as sell-side adviser. Hana Bank was adviser on the buy side.

CS First Boston, Hyundai Petrochemical and Hana Bank were also involved in a second M&A deal. The landmark acquisition saw French firm, Vivendi, purchase an industrial water treatment facility from Hyundai Petrochemical, which again entered into a long term off-take agreement for the facility's services.

Total acquisition cost for Vivendi was Won 150 billion. As with the co-gen deal, Hana Bank arranged a Won limited recourse debt financing (to the tune of Won 110 billion). The deal makes Vivendi the first non-sovereign entity to own and operate a water treatment facility in Korea.

Vivendi ambitions in the Korean water industry could lead to many more project finance advisory mandates. The group aims to invest $1 billion in constructing 26 sewage treatment facilities in Korea. However, significant regulatory hurdles still exist before Vivendi can make headway in the residential water treatment business. ?There's a big difference between operating a captive asset and a water treatment plant where the general public is involved,? says Fisher. ?But the general feeling,? he adds ?is that the government is keen to see more investment in public utilities, whether it be from foreign of domestic sources.?

Pressure to restructure from both the IMF and the Korean government has led other Chaebol to sell assets to foreign companies. Samsung's petrochemicals business at Seosan sold a captive power generation plant late last year and is currently in the midst of selling a captive water treatment facility. Schroders acted as adviser to Samsung for both dispositions.

In contrast, the main (non Won) financing opportunities for foreign institutions will be in the power sector, says Francois Xavier Thomas, head of project finance at Credit Lyonnais in Hong Kong.

The power deal exciting most attention at present is the $625 million auction of two KEPCO plants at Ayang and Bouchon. Having retracted the sale first time round because of a failure to meet pricing targets, the government is now believed to have drawn up a shortlist of contenders in a second bidding process. El Paso and Singapore Power are likely to be in that shortlist, say banking sources. Sithe and AES are not. Details about the financing proposals behind the respective offers are sketchy, but a large number of foreign banks are keenly awaiting the results anticipating opportunities to team up with the appointed financiers.

Two bills on the restructuring of the power sector, due to go before the next session of the Korean parliament are expected to lead to similar auctions. The bills will provide a framework for the privatization of KEPCO and the sale of generating companies currently owned by KEPCO. The dispositions will be conducted either as trade sales, initial public offerings, or a combination of both, says Donoghue at Baker & McKenzie.

Owing to opposition from Korean unions, the privatization timetable has, however, been pushed back. ?Optimistically, I think the Korean government might get round to selling off KEPCO assets at the end of 2000 or in 2001,? Donoghue adds.

The second phase of the power sector liberalization will see the establishment of a priced based electricity pool to replace the cost based pooling mechanism. A priced-based pool, following a UK or Australian based model, is expected to be in operation by the end of 2000.