

# Ready for the rebound?

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After a slump in activity from the end of 1997 to 1999, the Asian project finance market is showing clear signs of a rebound. Bankers predict particularly strong demand for limited recourse deals in China, the Philippines, South Korea and India. "Activity isn't yet back to 1996 levels but its getting there," says Mohsin Nathani, head of structured finance Asia Pacific at ABN Amro.

The Asian financial crisis and subsequent economic downturn not only affected the amount of developments in the market but also the banking community's willingness to participate in true project financings. Lenders shied away from deals without substantial sponsor guarantees and a number of banks reduced their project finance teams.

Institutions like Chase Manhattan, CS First Boston and Deutsche Bank shifted personnel from project finance into private equity, hoping to participate in the only two areas of significant growth, mergers and acquisitions (M&A), and privatization. Project finance experts, especially those in Hong Kong and Singapore (in Australia and New Zealand the market has been more resilient) were increasingly involved in development deals financed on a corporate rather than a project basis.

Certain characteristics of this reshaped project finance business will continue to exist, despite the steady regional recovery. ABN Amro, for example, reorganized its project finance business in the downturn giving its personnel a specific industry focus. Nathani says this organizational change, which has allowed the bank's project finance team to focus on advisory work as well as financing, will be kept intact as the recovery continues.

But there are also important differences in the new project finance market. In a wide range of industries bankers expect less emphasis on greenfield developments and more emphasis on brownfield extensions of existing projects, as well as greater privatization and M&A volumes.

A major source of brownfield deals in 2000 and 2001 will be the continuing roll out of telecoms networks, like the Lucent/ One Tel development in Australia and Hutchison's network expansion in Hong Kong. Within the telecoms industry more opportunities, say financiers, will be in fiber optic and broadband developments, rather than in the traditional fixed line and mobile communications businesses. To capitalize on the trend, banks are beefing up their telecoms industry expertise in the region. Citibank is looking either to hire bankers with telecoms expertise or to bring in qualified staff from New York or London, says an official at the bank.

In the power industry the Asian crisis set back regional electricity demand by two to three years. At the same time, power projects that started pre-crisis have now come on stream. "The supply demand imbalance for power isn't what it once was and this will mean fewer new power generation developments in the near term," says Stephen Edwards, Deutsche Bank's new head of project finance in Hong Kong. A second Hong Kong banker adds that multinationals in the power industry, particularly the US operators, are reassessing their business in the region. The reassessment has been partly provoked by the Asia crisis, "but it's also an acknowledgement that the strategy of single asset purchases in the region, hasn't really done a lot for these companies," says the source.

Declining share price is an industry-wide concern for the US power sector as stock market attentions have increasingly shifted to internet and high-tech stocks. Power operators are therefore looking at selling off-shore assets, even in Australia's developed market, to realize short term gains. In the Philippines US conglomerate, Ogden Corporation recently acquired a small 63MW diesel fuel power generation plant from another US operator. An increasing trend to vertical integration in the power business is also boosting mergers and acquisitions. In the last six months Unocal has bought stakes in gas fields off the coast of Thailand while Enron and CMS are known to be scouring for opportunities in Asia outside of their normal power generation operations.

Since the onset of the Asian crisis, the last two years have also seen a dramatic increase in the number of hybrid financings, the Electricity Trust of South Australia (ETSA) deal in Australia being a good recent example. "One might almost call the ETSA deal a corporate financing although the analysis of assets and security structures were done on a project finance basis," says Alister McConnell, head of Australian project and structured finance at National Australia Bank (NAB).

Behind the shift to corporate style funding has been an important underlying trend in the pricing of different types of transactions. As Nathani points out, during the last two years, banks have been paid very handsomely for Asian corporate finance transactions. "Banks have been getting something like three percent on a one year sovereign corporate deal in developing Asian economies, compared to just 40 basis points pre crisis." This jump in pricing comes despite the fact that corporate deals can be closed in six weeks. Pricing on project deals, where the commitments are more like 12 years and closing takes closer to 12 months, has not been much higher. In the recent past, therefore, there has been a clear incentive to put true project finance business aside, in favour of corporate style deals.

This pricing convergence has been one of the most significant trends to have affected the project finance market in Asia. Crucially, Nathani notes that a pricing differential between corporate and project deals is emerging again. "We are seeing pricing on corporate deals slipping back down to about one percent," the ABN Amro official says.

At the same time, Saadia Khairi at Citibank also believes that corporates, encouraged by financial and economic recovery are trying to push more risk on to the banking sector and to reduce the level of corporate guarantees. The question therefore is "will the banking community bite?" Most major players are pretty keen to do project finance," says a source at Chase Manhattan. Yet, over the last two years, Chase and several other key project banks have withdrawn from doing project finance in Asia's emerging economies while continuing to participate in developments in the region's developed economies. It is not clear whether the return of a pricing incentive will entice those banks who have focused on relationship business rather than the project finance market as whole, back into developing economy projects, particularly into those projects where their corporate clients are not involved.

As project finance departments turn their collective attentions to the Asian M&A market, the banking industry is itself seeing extensive M&A activity. The headline grabbing tie-up between Dresdner and Deutsche Bank is currently being worked through, "but we still don't know what the implications will be for both banks' project finance businesses in Asia," says Deutsche Bank's Edwards. On the other hand, according to Saadia Khairi the more advanced merger of Schrodgers into the Saloman Smith Barney (SSMB) organization will not mean any dramatic changes. Most Schrodgers officials will simply move into SSMB's energy oil and gas and project advisory units.

Overall, project finance bankers don't expect a less competitive market as a result of industry consolidation. It is interesting to note that while the number of banks with previous project finance experience has reduced, Japanese institutions have made a limited return to the market. Fuji Bank, Sumitomo, Dai-Ichi Kangyo and Bank of Tokyo Mitsubishi, for example, have all participated in the recent First Gas Corp project deal in the Philippines to finance a 500MW power plant. But one banking analysts thinks recent Japanese interest may be a temporary phenomenon. "With the wave of mergers in the Japanese banking sector, Japanese banks are simply trying to beef up their balance sheets so that they are better placed to secure the dominant role in the new combined bank. This isn't a whole hearted return to

project finance? the analyst says.

As individual banks have grown larger and the number of banks has declined, institutions have increasingly been trying to develop a more extensive range of financial solutions. This year, in the Australian market, the upshot will be more financing proposals based on capital markets solutions. If the trend is partly driven by banking consolidation, it is also a case of market opportunism. McConnell says the biggest source of project finance opportunities in Australia in the next 12 months will be the refinancing of power assets based in Victoria. ?Since there is no government sell-off this time round, the mandates that come out of Victoria's power industry are not going to hinge on a specific deadline. That means that the banking industry has the time to work out what sort of financing is really best for these projects,? says McConnell. Capital markets solutions, suspects McConnell, will be the answer.

NAB has added a structured distribution team to its project finance department, as a response to the projected demand for bond financing. ANZ, which like NAB has traditionally been a debt provider and only a minor capital markets player, is also pushing hard to apply bond to projects in Australia. From the issuers perspective, capital markets funding often offers more efficient financing, in terms of structure, tenor and even cost. For the banks pricing, or more strictly speaking remuneration, is again an issue. ?With a capital markets deal the bonuses are often better,? says one Sydney based source.

NAB's understandable enthusiasm can, however, be contrasted to Nathani's more cautious appraisal. ?Asia is still overwhelmingly a banking market,? he says. According to Nathani, interest in bond financing will be scant outside of Australia and other developed markets. ?The increasing role for capital markets products is more a function of the sort of deals that we are expecting to see in the next 12 months particularly in Australia, rather than any long term trend,? adds Chris Tomkin at ANZ. The bond market won't be a finance vehicle for merchant risk assets, says Tomkin, as they are only applicable to very safe, existing projects with regular cashflows. Moreover, because the indigenous Australian market is paper thin for anything less than AAA rated entities, most transactions need to be credit enhanced or wrapped.

The recent ETSA transaction is again a case in point. The ETSA financing entails no construction risk and cash flows are stable and easily predictable. The successful purchasers of ETSA, Hong Kong Electric (HKE) and Cheung Kong Infrastructure (CKI) originally financed the purchase using an on balance sheet structure as a sort of bridge facility. Now, part of the A\$3.4 billion (\$2.1 billion) corporate guarantee transaction, which included participants, Citigroup, National Australia Bank, HSBC, Barclays Capital and UBS, is being refinanced through a limited recourse bond, valued at approximately A\$ 2 billion. McConnell says the capital markets financing is expected to come from the local Australian market and a Eurobond issue. The ETSA deal is therefore likely to be witness to the largest Australian project bond in the last three to four years.

There is promise of more to come, other Australian energy assets, like Power Net and Gas Net could be refinanced in similar fashion.

Australia has been home to what was easily the biggest project finance market in Asia over the last twelve months. The size of the market has naturally attracted the attentions of most of the global project finance community and therefore significant competition. Players do not expected to see as many deals in Australia over the next two years as during the last two. ?A very large proportion of our business is therefore going to depend on how many refinancings come out of existing projects,? says a local banker.

NAB, whose Asian project finance business has been overwhelmingly centered on its home market, is responding to the slow-down in activity by looking for expansion opportunities in the rest of Asia. ?Two years ago we were thinking to expand but our plans got disrupted by the Asian crisis,? says McConnell. NAB's project finance department now has clearance for between four and five new team members focused on the rest of Asia. ?We haven't yet formalized our plans but expect to make a decision in three to six months,? says McConnell. Other banks who have focused on the Australasian region, can be expected to follow suit.

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