Extending the Orient Express

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For Hong Kong's project finance community the next big Asian infrastructure project is a stone's throw away. In the New Territories, Hong Kong Island's backyard, construction has begun on the West Rail project, a 30km extension to Hong Kong state rail operator, Kowloon-Canton Railway Corporation's passenger and freight network.

According to Samuel Lai, finance director at Kowloon Canton Rail Corporation (KCRC), the so called West Rail project phase II, had an estimated cost of HK$64 billion ($8.25 billion) in 1997, including land acquisition cost and the HK$51 billion cost of construction and systems procurement. ?Its a hugely significant for us. We are moving from being a relatively static rail operator to being a planner and builder of new rail networks,? says a company spokesman.

Prequalification for West Rail's civil construction projects commenced in July 19??, and two construction tenders have already been mandated. Notably the HK$1.79 billion contract for the design and construction of the Tai Lam tunnel was awarded to a joint-venture of Japanese engineering firm Nishimatsu and French civil constructor, Dragages. KCRC aims to award five pure construction contracts in the first quarter this year. Systems contracts will be awarded from the end of the first quarter on. According to the company, all 12 of the major contracts up for grabs should have been awarded by mid 1999 with full scale construction set to begin in the second half of the year.

KCRC has now spent over HK$1 billion on the undertaking, including consultancy and technical studies. For these and the other costs that will be incurred, a large-scale financing plan has been drawn up.

Despite the scale of the project and the onset of the Asian financial crisis, KCRC's financial executives are relaxed about the fundraising plan. The company already has a considerable financial cushion, namely HK$29 billion, more than 45% of the total financial requirement, committed by the Hong Kong government. A further HK$10 billion more was to come from internal funds (although the figures have changed because of the onset of the Asian downturn). KCRC plans to raise the remaining capital from external funds.

Lai says KCRC won't use pure project finance for the required external funding. Advised by Hong Kong and Shanghai Bank, Lai's finance team is using KCRC's own corporate strength to tap the cheapest financing rates, a move that makes sense according to project finance specialists. ?Hong Kong's current financial and economic outlook may be negative but KCRC is still one of the strongest transport companies in Asia,? says one. A point reinforced by Lai: ?We have diversified income, a track record of sustained profitability and being wholly-owned by the Hong Kong government we have a good sovereign credit rating.?

In fact, the fundraising assignment looks surprisingly easy. KCRC has had to obtain credit ratings from Standard & Poor's and Moody's to access global capital markets in the future, but to date, no external finance has been needed. ?Kowloon Canton Rail is lucky enough to have a very lucrative franchise, so it hasn't had to raise significant debts or resort to adventurous financing tactics,? says a transport analyst in Hong Kong. Historically, almost all of KCRC's capital investment programs, like the hefty HK$1.27 billion refurbishment of East Rail trains which is due to complete this year, have been met through internal cash reserves. At the end of last year, KCRC had no debt, while the 1997 financial year closed with KCRC enjoying a net cash balance of HK$275 million, after, that is, a dividend payout to the Hong Kong government of HK$300 million and profits tax of HK$683 million.

The HK$29 billion in government money gives KCRC the luxury of time. As Hong Kong authorities are providing half the funding now and half in June next year, KCRC will not need to draw down external funding until the year 2001.

KCRC's financial plan is to have committed finance facilities to meet the external funding needs arranged 18 to 24 months ahead of when they are needed. That implies the rail operator will go to market next year or the year 2000 at latest, says Lai. ?We still have some room to consider all options for the external financing,? says Lai. And to wait for the historically high spreads for Asian corporates to reduce to more normal levels. Pricing for Hong Kong corporates, even reputable names like Cathay Pacific, have risen by 20% or more during the course of the Asian crisis, says a Hong Kong banker.

?We'll look at everything from syndicated loans to export credit finance, equipment leasing and the bond markets,? Lai adds. KCRC does have specific requirements. For example, as all future income will be in HK$ the company is aiming to have 70% of funds raised in local currency. ?We will also be wanting at least half the funding in fixed rate instruments but that can be achieved in any number of ways,? Lai continues.

Lastly KCRC is looking for a blend of short term and long term financing. The blend will allow the rail operator to refinance in stages rather than all at once. KCRC already maintains a mix of long-term committed revolving credit facilities (of HK$2,500 million), short-term money market lines (HK$1,558 million) and an overdraft facility of HK$25 million, to meet sporadic requirements flexibly and at low cost, says Lai.

KCRC and Asian financial turmoil

KCRC has received no guarantees to support the external financing effort. Hong Kong may own KCRC lock, stock and barrel, but the company is independent of the government in almost every operational regard. Lai explains: ?we get no subsidies, no special treatment for being a state entity and the KCRC board is free to set fares as the market dictates.?

Lacking the crutch of state support many a transport company would balk at large scale fundraising in today's financial conditions. But observers are more likely to detect a sanguine attitude at KCRC's headquarters rather than one of concern. Doubtless this is due to the surprising fact that the Asian downturn has had a net positive impact for KCRC. Large scale infrastructure projects are often afflicted by rising costs. However, the downward pressure on land prices, inflation and other factors means that the total financing cost of the West Rail project is actually diminishing.

The cost of land acquisition has been dragged down by the property market in Hong Kong. Property prices have been falling since the recession first began in the Special Administrative Region. Added to that, procurement prices in general are lower than the finance department's original estimates. Firstly because slowing economic growth has smothered inflation and secondly because global contractors are now competing for fewer projects in the developing world as many projects stall in the face of economic and financial turmoil. With less demand and constant supply prices inevitably come under pressure. Lai provides an example. The two tunnel construction contracts that were recently awarded ? were mandated at between 10% and 15% below original cost estimates. ?It's difficult to say though whether this trend will continue for pricing on other contracts, so we have not assumed so in our budget ? there is the potential therefore, for a further reduction in total costs, compared to our estimates,? says Lai.

Another key source of upside in the crisis lies in the Hong Kong government's monetary policy. Interest rates have been pushed up to defend the local currency. Therefore KCRC is now earning more interest than expected on its stored credit, those government funds that have already been handed over for West Rail construction as well as KCRC's own cash reserves.

What are the negatives? Most obviously, KCRC's credit rating has been downgraded. Standard & Poor's reassigned a single ?A'-plus rating to the company's long term credit and a ?AA-' to its local currency rating. Short term ratings were assigned at ?A-1'-plus. The cost of going to the financial markets has naturally risen as a result of its credit downgrade.

As a state entity the downgrade was inevitable after Hong Kong's own sovereign rating was downgraded in September last year. However, ratings agency Standard & Poor's was at pains to explain that KCRC's own financial position has not deteriorated. In fact, according to the agency, the medium term traffic volume and earnings derived from KCRC's core railway operations are growing steadily: the company's transport revenue increased by 11.6% in 1997. At the same time, KCRC has managed to sustain a high return on assets despite gradual expansion of operations. Return on average net fixed assets reached 29% in 1997. The ratings agency also sees little danger as a result of KCRC's West Rail Phase I program. ?The corresponding risks are mitigated by the government's strong ownership and regulatory support,? says S&P's Hong Kong transport analyst, Paul Coughlin.

KCRC ratings were downgraded together with the ratings of other reputable local names like Mass Rapid Transit Corp, Swire Pacific and even GE Capital Finance's Hong Kong business.

KCRC's financial program has also been adversely affected. It can also no longer count on significant profits from property development because of the slump in property demand in Hong Kong. A sizeable proportion of KCRC's revenues have come from property and property development in the past. Recurrent revenues on the company's property assets reached HK$473 million in 1997. HK$2,308 million in property development profit was realized in the same year. These figures compare to total operations revenue of HK$3,718 million the same year. KCRC sets its financial planning horizon several years ahead, currently up to the year 2003. The finance team is naturally reluctant to estimate property gains that it might have set against the cost of the railway projects in a volatile market. ?But we don't now need to,? says Lai. The net result of the financial crisis, according to KCRC estimates, is still positive. KCRC forecast a significant reduction in the external financing requirement, of HK$5 billion. The company is now looking to raise a total of HK$20 billion in external finance. Samuel Lai is one of the few who can smile at the impact of the Asian financial crisis. ?It's a useful reduction,? he says.

KCRC Selected Financials - Five Year Statistics (HK$million)

	Revenue from Operations	Profit on Property Development	Net Profit*	Capex	Debt/ Equity ratio
1997	3,718	2,308	3,263	3,582	-
1996	3,294	2,468	3,077	2,538	-
1995	2,973	24	901	2,065	1:13.6
1994	2,668	705	1,323	1,118	1:14.8
1993	2,417	963	1,311	800	1:11.3

after property development