

INFRASTRUCTURE: Road to nowhere

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By Sid Verma

Asia's infrastructure needs are vast at a time when global banks have less financial firepower. Now, private infrastructure finance in Asia is hitting a wall as foreign lenders retreat from regional project finance business

In the good years before the credit crisis, Asian governments and local banks were busy stepping up their infrastructure spending as foreign banks and investors plunged into the sector. Authorities across the region crafted a rash of new regulatory frameworks while launching concessions for monopoly assets, ranging from toll roads to power projects.

This flurry of activity raised hopes that deal volumes would gradually recover from the years of lacklustre infrastructure investment that followed the 1997 Asian crisis.

But fast forward to 2010: the higher cost of bank capital – the primary financing source for Asian projects – and risk aversion from foreign lenders is derailing the private-sector infrastructure investment drive.

Despite the thaw in the project finance market, borrowers and sponsors across the region are facing higher project financing costs. Says Conor McCooole, head of Asian project finance at Standard Chartered: "Bank appetite is returning, and competition between lenders has kicked in – but we are not anywhere back to pre-crisis levels."

Western fund managers, who had been stepping up exposures to Asian infrastructure before the crisis, have since stopped. "There is no urgency among foreign investors to increase their allocations to infrastructure funds," says Anoop Seth, co-head of Asian infrastructure investments at private equity firm AMP Capital, citing the lower country risk and attractive margins in home markets.

Higher liquidity premiums and the greater bargaining power of lenders over developers and public clients have conspired to increase costs. Seth says borrowing costs for benchmark term loans for project finance deals have jumped by around 1.5–3% on average.

Even India – where domestic bank finance overwhelmingly funds infrastructure projects – borrowing costs have increased by 1% to around 10.5–11% for nine- to 15-year term loans for greenfield power projects, says S Nanda Kumar, global infrastructure and project finance analyst at Fitch Ratings in Chennai.

There is no single Asian project finance market in a diverse region of 44 countries with varying levels of infrastructure investment and different levels of importance of local versus global bank participation in project financing.

HUGE ASIAN NEED

Asia's infrastructure needs are vast at a time when global commercial banks have less financial firepower. In a landmark study last year, the Asian Development Bank estimated the region would need to spend \$7.9 trillion up to 2020 on projects including installing or upgrading transport networks, energy networks and communications systems. It also called for another \$287 billion to be spent on "specific regional projects", with the combined investment to add \$1.6 trillion or 10% to developing Asia's GDP by 2020.

The post-credit crunch landscape has led to a flight to quality in most markets and forced public banks and multilaterals to ramp up spending. Projects with high up-front construction costs and lower margins are being snubbed as competition between global banks dwindles.

The global crisis led to a collapse in the western project finance market, given the high degree of leverage and slack covenants, says Andrew Yee, joint CEO of Standard Chartered's Asia Infrastructure Growth Fund (SCI Asia). By contrast, Asian project deals have, in general, demonstrated sufficient financial flexibility: a long concession life and surplus cashflow after debt service. As a result, projects – with the notable exceptions of Indian airports and ports in emerging south-east Asia – have managed to weather the weaker economic cycle.

Michael Barrow, director in the private-sector operations department at the ADB, says "Asian projects have withstood the crisis relatively well as they had simple structures because the region has underdeveloped capital markets." As a result, western banks are generally not buckling under the weight of impaired project finance loans.

But a tug-of-war has broken out between bankers at the global firms who want to ramp up project lending, and home regulators calling for balance sheet restraint. "Increased regulation, higher reserve requirements and higher capital costs will make project financing less attractive as the business ties up loans for a long period of time," says Ryan Orr, a leading project finance expert and executive director of Collaboratory for Research on Global Projects at Stanford University.

"For many other global banks, long-term lending in emerging markets has been relegated to the second division. This is a structural consequence of the global crisis," says McCooole. The head of project finance at a Japanese commercial bank says: "Before the crisis, banks funded themselves largely from short-term money markets and used that capital to lend long term. But that link is fundamentally broken now – and hit project finance heavily."

The basic tenet of lending billions of dollars of long-term debt at a low margin may have worked in the boom years, but banks are waking up to the new reality of higher capital requirements. What's more, "the ability to turn over capital is increasingly important for banks now," making banks more wary of long-term lending, says Yee.

ALL CHANGE

Over the past 10 years, the Asian project finance market has seen a retreat from such names as Deutsche Bank and US lenders, such as Citi. In recent years, European players such as Calyon, Dexia, HSBC, Société Générale and Standard Chartered and Japanese players have dominated the project finance market. Those banks with project finance experience and balance sheet strength now have a competitive edge.

Market sources say Deutsche Bank's tentative plans, pledged in 2007, to re-enter the Asian project finance business, after retreating in 2000, are in disarray. ANZ and Barclays Capital's bid to diversify its Asian project finance business outside Australia is on hold. Meanwhile, RBS and ING are struggling with the legacy of merchant bank-style lending as long-term loans to clients in aviation and shipping stay soar due to weak global exports.

Political pressure to repatriate capital to home markets is also derailing the Asian project finance business for bailed-out banks. For example, RBS inherited a profitable Asian project finance business through its 2007 acquisition of ABN Amro. However, the banking group has been forced to downgrade its project finance business as it scales back its balance sheet in the wake of its part-nationalization by the UK government.

"From some western lenders, it is more attractive to finance PFIs [private finance initiatives] and other infrastructure projects in home markets where there is less country risk, and so we have not seen global banks make a strong comeback here on the back of the stimulus plans," says Frederic Blanc-Brude, director of Infrastructure Economics, a consultancy based in Shanghai.

But Bharat Parashar, CEO of Emerging Markets Partnership's joint venture with Daiwa Capital Asia Fund, says global banks can make considerable returns from vanilla deals, such as simple one station power projects, which offer strong revenue streams due to growing economic activity.

According to Dealogic, the Asia Pacific region accounted for 41% of global volume in 2009, compared to 27% in 2008. The largest deal to close in 2009 was the \$18 billion Papua New Guinea LNG project, which comprised \$14 billion debt and \$4 billion equity.

Stephen Paine, global head of infrastructure finance at UBS, says: "Banks are reviewing all their business streams in the wake of the global financial crisis, but infrastructure as a sector is perceived to be a good sector due to strong economic demand for nationally critical, monopoly infrastructure assets."

Asian project finance deals, excluding Japan and Australia, were worth \$97.7 billion in 2009 compared with \$63 billion in 2008. But these statistics mask the fact that Chinese and Indian state-backed enterprises dominate the landscape. State Bank of India led the mandated arranger rankings with \$27.0 billion from 51 deals in 2009 and advised on 34 projects worth \$32.8 billion.

The global crisis has accelerated the rise of local – and mostly state-backed – financiers in Asian project finance as they grab higher market share as domestic financial systems deepen. Nevertheless, global banks still have a competitive advantage in renewable energy projects, in places such as China, after their experience of the business in developed markets. For example, European banks have been scrambling to arrange and finance Chinese power projects, first in hydroelectric sectors, then wind and solar projects and now in the waste management sector, says Yee at Standard Chartered.

But increasingly, heavy competition from cash-rich local banks for certain projects is threatening the push by global banks into the project finance market. For well established infrastructure projects such as thermal power plants in south-east Asia, local banks are dishing out project finance loans at competitive rates, which is "squeezing out a lot of the bigger global banks", says Yee.

Chinese state-owned banks have aggressively stepped up lending outside the country and provide concessional lending to projects that favour Chinese developers from Indonesia to Pakistan. But analysts are alarmed at the frenetic pace at which Chinese banks are disbursing loans to select projects. "If there is going to be a bubble, local banks are more likely to be the ones driving it – even though the Asia crisis of 1997 left many people burnt – because, let's face it: memories are very short," says Yee.

Blanc-Brude at Infrastructure Economics says, "This push by Chinese banks may affect project financing standards, as often the risk management and due diligence is lacking. Moreover, exchange rate risk is not absent in these projects since funding is principally provided by Chinese banks in US dollars." For example, Bank of China financed a \$535 million coal-fired steam power plant in Teluk Naga, Indonesia last May as a quid pro quo for Chinese equipment purchases.

Before the crisis, analysts cited the region's underdeveloped capital markets and weak regulatory regimes as the biggest barriers to Asia's infrastructure investment drive. These issues still weigh heavy on the market.

But the post-crisis landscape faces the new problem of reduced global bank capital – an issue that is likely to darken the project market outlook for years to come.