

Recent Trends in Energy Project Financing in Emerging Markets

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Abstract

Purpose: The purpose of this paper is to provide an overview of the recent trends and developments in project finance as a tool for funding large energy/infrastructure projects in developing countries.

Design/methodology/approach: Secondary data analysis and case studies are used to identify the major trends and developments in energy project financing for the recent years.

Findings: Thorough literature review and case studies support the main idea behind application of project finance, and defines it as a vital tool in funding large infrastructure and energy projects. Even though, the global financial crisis caused an enormous damage to the project finance market and revealed a number of issues related to organization, marketing and management of project finance loans, the ultimate benefit from utilization of project finance techniques is undeniable

Originality/value: Although there is an immense literature base on project finance and its application, this paper is unique and could be a valuable source in observing recent trends in energy and infrastructure project finance

Keywords: project finance, developing countries, energy

Paper Type: Research Paper

Introduction

The term project finance has number of definitions proposed by different authors depending on its unique features and characteristics. However one of the most distinctive definitions was given by Yescombe, who identifies project finance as means of raising long term financing for a separate project via financial engineering. And since lenders basically look into the cash flow generated by the project alone, project's success heavily depends on thorough evaluation of all of its risks, and their mitigation by the parties through contractual obligations (Yescombe, 2002).

This definition addresses the main characteristics of a basic project finance deal. First of all, it reflects the fact that project finance lenders primarily look to the future cash flows from project's operation as a main source of return on their investments. Secondly it identifies that unlikely from any other means of financing, project finance is about raising limited-resource or non-resource funds to finance an economically separate investment project. Here, economically separate project is called a project company or a special purpose vehicle (SPV) and can be defined as separate legal entity financed with limited or non-resource debt and organized around specific business or asset (Bruner *et al.*, 1995).

Although first records of project finance date back to XIII century, its modern form is believed to develop in 1970s as a response to increased extraction of natural resources. But it is still considered as a relatively new discipline, as project finance market has been growing dramatically for the 15 years. For instance, if in 2001 global project finance market was valued at \$190 billion, in 2011 it reached a record \$215.5 billion in deals (Dealogic, 2012).

Project finance market was constantly growing until the second half of 2008, when global project finance volumes decreased dramatically in light of the world financial crisis. At that point value of total project finance deals decreased to \$115 billion (Dealogic, 2012).

Project Finance in Emerging Markets

According to The World Bank estimations, developing countries need around \$1 trillion in annual infrastructure expenditures until 2020. Figure 1 describes anticipated annual infrastructure financing needs in developing regions based on industry (Report from The World Bank Group, 2013). But according to The McKinsey Global Institute, there are some practical steps that could help to reduce this cost. It is been suggested that increasing the efficiency of existing infrastructure projects while improving the project management and quality could eventually boost productivity of infrastructure sector by up to 60%, and decrease the spending by 40%. In other words, for the next 18 years, it would mean paying \$30 trillion for \$48 trillion worth of infrastructure (Richard *et al.*, 2013).

Against this background, both World Bank and regional development banks are undertaking enormous efforts to support infrastructure spending in developing countries. Given the scarcity of bank lending and weak legal system, alternative financing options of infrastructure projects are drawing more attention from the investors. Significance of international financial markets is therefore increasing, as they possess a great potential to raise necessary financing for infrastructure projects. At the same time, involvement of institutional investors into large projects is offering an additional opportunity to source long-term financing (Report from The World Bank Group, 2013).

Taking into account all the above, innovative financing sources that use financial engineering tools are gaining huge popularity in projects in developing countries. Project finance is one of these sources of financing that combines both financial engineering and innovative financing features.

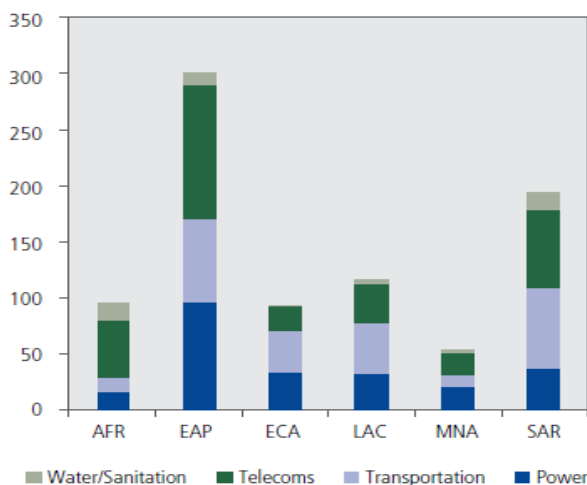


Fig. 1: Regional infrastructure needs (Source: The World Bank)

Wide application of project finance techniques in developing countries can become a substantial trigger of economic development in emerging markets (Klemeir and Versteeg, 2012). At the same time, application of project finance tools is considered more beneficial in countries with substantial levels of political risk, weak institutional and creditor rights, and ineffective legal systems (Hainz and Kleimeier, 2012; Tung and Subramanian, 2011).

One of the distinguishing features of projects located in countries with high level of political risk is that, they are more likely to facilitate the participation of development banks as project lenders. This is mainly explained by the fact, that development banks play crucial role in mitigating political risk (Hainz and Kleimeier, 2012).

Another important feature of project finance that facilitates its implementation in less developed markets is loan guarantees which play critical role in project finance risk management (Girardone and Snaith, 2011). Nonfinancial contracts are also considered as important risk management tool in risky environment, since they allow sponsors to attract funds with lower interest rates (Corielli *et al.*, 2010).

Project Finance Industry Outlook

As of June 2012, global project finance volumes reached \$172 billion in 381 deals worldwide. Regionally, Asia Pacific remains remained the main concentration area for project finance, as 49% of all deals were initiated within this region. Europe, Middle East and Africa (EMEA) countries accounted for 30% of total deals, whereas both Americas initiated 21% of global project finance deals. It is notable, that compared to previous year, figures for both Asia Pacific and Americas demonstrated positive dynamics, whereas the share of EMEA countries in global project finance arrangements has declined (Dealogic, 2012).

On a country basis, biggest project finance initiators were Australia and India with \$30.0 billion and \$24.3 billion worth projects respectively (Fig 2). Also noticeable that, 6 out of 15 top nations in Figure 2 are considered as developing, with aggregate of \$55.9 billion project finance deals.

| 1H 2012 Project Finance Volume by Top 15 Nations | | | | |
|--|----------------|----------------|-------|--------------------|
| Rank | Nationality | Value (US \$m) | Deals | % Change (1H 2011) |
| 1 | Australia | 30,002 | 31 | 114% |
| 2 | India | 24,332 | 86 | -57% |
| 3 | United States | 15,804 | 43 | -4% |
| 4 | Malaysia | 9,585 | 12 | 2484% |
| 5 | France | 9,203 | 15 | -33% |
| 6 | Brazil | 7,673 | 16 | 37% |
| 7 | Uzbekistan | 5,239 | 2 | -- |
| 8 | Saudi Arabia | 5,231 | 4 | -2% |
| 9 | United Kingdom | 5,208 | 20 | -36% |
| 10 | China | 4,931 | 8 | -33% |
| 11 | Indonesia | 4,187 | 7 | 177% |
| 12 | Singapore | 4,140 | 2 | -37% |
| 13 | Germany | 3,821 | 3 | 98% |
| 14 | South Korea | 3,687 | 8 | 109% |
| 15 | Norway | 3,436 | 2 | -- |
| Total | | 171,955 | 384 | -21% |

Fig. 2 Regional analysis (Source: Dealogic)

Recent Cases of Outstanding Deals

Curtis Islands Pacific LNG project was the biggest project finance deal ever in Australia (Fig 3). Taking into account the size and its unique and complex structure, the deal received several awards including the award for the Best project finance deal of the year from Finance Asia (Australia Pacific LNG, 2012).

The syndicated project finance deal was signed by the US EXIM bank, the China EXIM bank, and a number of local and international banks. The uniqueness of the deal came from the fact, that for many participant banks, it was the first time when they assessed LNG risk. At the same time, for US EXIM bank, it was the second-largest single project financing in its history, and the first time when export financing arms of US and China have collaborated on Australian project (Australia Pacific LNG, 2012).

Another noticeable project finance deal was secured in Uzbekistan. Construction project of Ustyurt Gas Chemical Complex (GCC) on Surgil field was the largest project finance deal in a developing country in 2012 and named the International deal of the year by Thompson Reuters. Ustyurt project became the first international project financing deal in oil and gas chemical complex in Uzbekistan. The deal is also considered as the major project finance in Central Asia and major in gas chemistry industry in the CIS (Uzbekistan National News Agency, Feb 2013). The deal was labeled as unique due to its complex structure and large network of agreements. It featured almost all available sources of financing, insurance and guarantees such as regional development banks, export credit agencies, local banks, and international bank syndicates. Debt financing was provided by Korea EXIM bank, China State Development Bank, Asian Development Bank and other foreign banks, whereas insurance coverage was secured by Korea Trade Insurance Corporation, Swedish EKN and German Hermes.

Project of Ustyurt GCC was carried out with a \$2.5 billion loan that had no sovereign guarantee of the Government of Uzbekistan. Taking into account the high levels political risk and extremely high uncertainty in financial markets, this decision was labeled as an indicator of the readiness of foreign investors to be involved in large projects in emerging markets (Uzbekistan National News Agency, Feb 2013).

| Project Name | Country | Value (\$m) |
|---|--------------|-------------|
| Curtis Island Australia Pacific LNG Project | Australia | 12,893 |
| APRR Motorway Acquisition Refinancing | France | 4,580 |
| Sydney Water Kurnell Desalination Plant PPP Project | Australia | 4,211 |
| Marina Bay Integrated Resort Refinancing | Singapore | 4,030 |
| Surgil Ustyurt Gas Chemical Complex | Uzbekistan | 3,964 |
| Open Grid Europe Acquisition | Germany | 3,582 |
| Solveig Gas Transportation Facility Acquisition | Norway | 2,976 |
| Jubail Acrylates Complex Long Term Financing | Saudi Arabia | 2,838 |
| Krakatau POSCO Integrated Steel Mill | Indonesia | 2,659 |
| Klang Valley MY Rapid Transit Railway | Malaysia | 2,577 |

Fig. 3: Top 10 Global project finance deals 2012 (Source: Dealogic)

Project Finance and Financial Crisis

Steady growth of project finance volumes for the past couple of decades was primarily driven by the increase of liquidity in developed markets. International banks started practicing “originate/distribute” strategy in project lending. Banks started to book loans in high volumes and then distribute them in the market using such techniques as syndication or securitization. This resulted in emergence of a secondary market for project loans, which in turn facilitated the application of credit rating for loans. The availability of ratings for project loans made it easier for investors to deal with them, although they had quite little information about the underlying projects (Leigland and Rusell, 2009).

Increase in liquidity resulted in extraordinary competition among lenders, which in turn facilitated the price decrease for project loans. Excess liquidity started to dry up when the market for interbank borrowings started to shrink. The interbank borrowing markets were the primary approach for banks in rising project finance funds. Accordingly in light of the progressing subprime mortgage crisis, banks were questioned on their ability to serve their own debts, and the origination of project finance loans started to decline (Leigland and Rusell, 2009).

Effect from the crisis was apparent in developing countries, as projects in many developing regions started to face a delay in financing and execution, or even cancellation of deals (Izaguirre, 2009). Most projects in EMEA countries were put on hold. The Global project finance market shrunk to \$115 billion in 2009, compared to \$193 billion year earlier.

Currently the project finance remains on its recovery phase, demonstrating steady growth. Governments are taking enormous efforts on dealing with the consequences of recent financial crisis on project finance markets, specifically by improving risk management process, identifying the most optimal proportion of public and private financing and encouraging prudent and in depth due diligence analyses.

Summary

This paper aims to provide a brief overview of the recent developments in project finance market, with emphasize on developing countries. As a financing tool, project finance provides plenty of opportunity for further development especially in emerging markets like South America, Africa, Eastern Europe, Southeast and Central Asia. In light of the continuous growth of the industry and increasing demand for funds, there is no doubt that new funding structures and innovative financing instruments will continue to evolve. Taking into account theoretical and practical experience gathered from examining project finance phenomenon, there is no doubt that project finance is one of the most effective practices in risky environments. Research studies and practical experience show that project finance could be an efficient risk mitigation tool and directly impact the development of a whole economy.

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