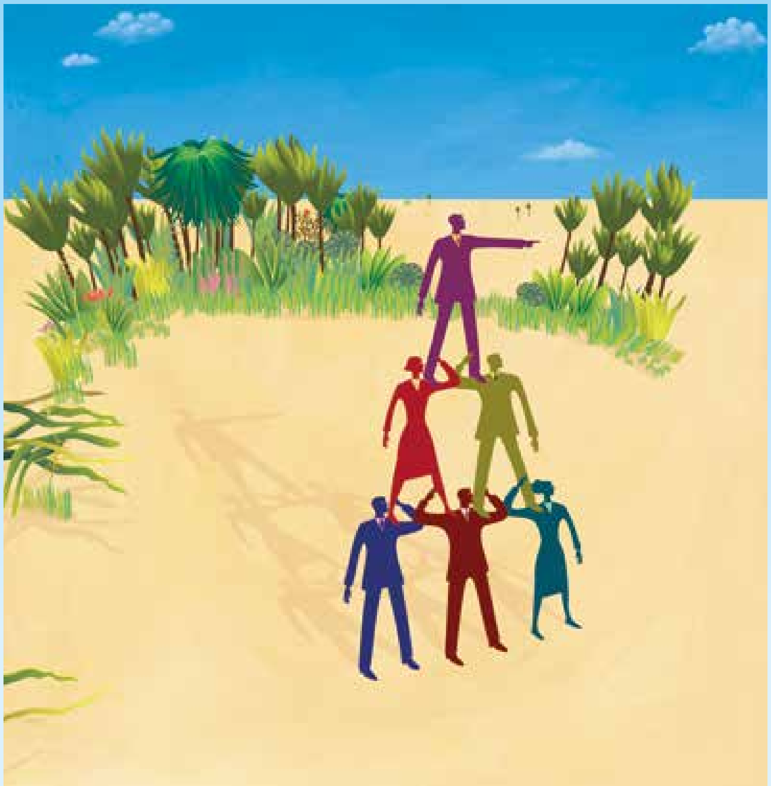
MORE THAN A MIRAGE

PROJECT FINANCE BECAME SCARCER FOLLOWING THE GLOBAL FINANCIAL CRISIS, BUT IT IS ONCE AGAIN FUNDING THE GROWTH OF THE GCC, SAYS HASSAN ALI

Project finance has traditionally played an important role in supporting the economic development of the Gulf Cooperation Council (GCC) countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).

Heavy industrial projects, mid- and downstream oil and gas projects, and the utility sectors have been the primary benefactors of an influx of overseas capital, development capability and operational expertise from international sponsors. But claims made in 2008 and 2009 that the GCC countries were immune to the global financial crisis were wide of the mark. In fact, the project finance market has witnessed a distinct downturn in volume over the past five years due to international bank liquidity becoming scarcer and being redirected to domestic purposes.

Yet diversification – one of the central strategic tenets of the GCC – enabled the continuation of national economic visions. And now the green shoots of recovery in the project finance markets appear to be shooting up. This article explores the continuing role of project finance as a means of facilitating the development of the region's critical infrastructure and industrial projects.



Capital structures

Project finance is usually wrapped in a contractual structure that allows for the importation of international expertise and it is aligned to the long-term interests of the project. Capital structures are typically made up of a combination of debt and equity. In most Middle Eastern project financing, international sponsors subscribe minority equity stakes, with the majority being contributed by the relevant awarding government. Debt servicing and returns to equity are met solely by the revenues generated by that particular project, typically termed 'limited recourse financing' because, if the project does not perform as expected, there is no corporate balance sheet to support repayment obligations. International corporate sponsors favour this form of financing because they can structure project-related debt without consolidation onto their balance sheets, whereas for the cash-rich governments of the GCC, it allows the leveraging of the infrastructure sector and the avoidance of upfront capital payments.

Globally, project financings or local derivatives thereof – such as public-private partnerships, private finance initiatives and design-build-finance-operate, to name a few – have been prevalent in delivering a wide range of state-procured capital projects. These include social infrastructure (schools, hospitals, prisons), transport infrastructure (toll roads, airport concessions, ports, metros), as well as projects in the utility sectors. Across the GCC, project financing in social infrastructure (such as Abu Dhabi's universities) has somewhat trailed off and its main application remains in heavy industrial applications: big-ticket metals projects, integrated power and water generation schemes, and mid- and downstream oil and gas projects in refining, petrochemicals, pipelines and the like.

Regional lenders have always supported projects of national importance in their home markets – in bad times as well as good. Indeed, greater investment into intellectual capital by the local financial institutions, coupled with markedly increased liquidity, will necessarily bring greater competition into the GCC markets. But, as international lenders are selectively returning to the GCC markets with renewed appetites for lending, is there any prospect that project financings will be used as the catalyst for greater economic growth funded by tomorrow's revenues? The answer lies somewhere between 'yes' and 'no'.

In the traditional, heavily industrial sectors that have long-established contractual architecture and well-understood risk allocations, project finance will undoubtedly remain a primary delivery vehicle. An example is the successful financial closure in 2013 of the multibillion-dollar Sadara integrated chemicals complex in Saudi Arabia, a joint venture between oil company Aramco and the Dow Chemical Company. It was larger than most other deals done to date, but it was built on the tenets of sound project finance structures, so it maintained annual project finance volumes, even if the total number of deals to close in 2013 tailed off.

Equally, the signing of the loan and power-purchase agreements on Kuwait's Az Zour North integrated water and power project represents the first deal to be executed under a national strategy to deliver key infrastructure using public-private partnerships on a scale that is probably more ambitious than what has been seen before in the GCC. In the more established project finance market of Abu Dhabi, the closure of its latest power and water generation project is keenly awaited.

Alternative pools of liquidity

Besides the revival of project finance, there has been a shift towards exploring alternative pools of liquidity to support national infrastructure. While some of these are at relatively early stages of development, their popularity is likely to keep growing as governments step up their economic-diversification programmes. It is also worth noting that there are specific – yet selective – regulatory developments in the banking sector around single obligor exposures that will stimulate the development of additional sources of medium- and long-term financing.

In 2013, the GCC saw the issuance of the first project bond for several years. The $825m pricing of the Shuweihat 2 project's senior secured bonds represented something of a landmark transaction in that it was the first bond in the GCC to be backed by a power asset (a power plant). It also had the longest weighted average life since deals arranged before the global financial crisis and it was the first amortising bond in the GCC since 2009. While the bondholders are unlikely to accept development and completion risk any time soon, making the financing of greenfield projects with bonds difficult, this award-winning project does signal a clear path for the recycling of bank liquidity and the freeing-up of credit lines that will fuel the growth of other debt instruments.

ADVANCING DEVELOPMENT AIMS

While the project-finance sector underwent its period of recovery and new forms of funding emerged, infrastructure development didn't stand still. The GCC region has unusually – perhaps uniquely – shown little hesitation about tapping into less structured forms of lending to advance its development aims.

The UAE government aptly demonstrated its dexterity in approaching the debt markets to tailor debt with the funding market's capacity to deliver when it secured funding for the first phase of the UAE's $1.28bn heavy-rail project, Etihad Rail. And for cash-generative assets such as Salik, Dubai's electronic toll system, the securitisation structures that were used to monetise future revenues have also enabled the government to reinvest into areas of economic priority.

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Last year also saw the accelerated evolution of contractor-financing arrangements in the medium- to long-tenor infrastructure space. With risk equitably divided between developer and procuring government authority (supported by central departments of finance where necessary), the 'bring a bank' approach to major project procurement promises to come to the fore in jurisdictions such as Dubai, where speed of procurement is a major constraint to conventional project financings. Compared with other approaches, contractor financing involves relatively light documentation and straightforward tendering processes, so it could have the momentum to kick-start the glut of project awards needed to service Expo 2020 and all the associated development plans.

As banks feel the challenges of complying with Basel III more keenly in the run-up to full implementation, the availability of long-tenor project financing may well take a backward step. There is little evidence to support that this is currently the case, however, and project finance is one of a diverse mix of funding approaches that is available to governments. Thanks to the GCC governments' ambitious 'Vision' programmes, opportunity continues to abound in the region. The sands never stop shifting.

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The views expressed are those of the author and not necessarily those of the bank

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