A LatinFinance Special Projects Supplement • July/August 1993

Project Finance in Latin America

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Global Power

Fundamentals of Project Finance in Latin America

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The international market for power projects has been in vogue lately. Everywhere you go, everything you read and whomever you talk to in the industry will remind you somehow that "international" is the way to go and that if you do not act fast, you may miss the boat. And if you do, you would be missing out on an estimated market of approximately 800,000 MW, or US$ 800 billion between now and the end of the century (800,000 MW x $1,000/Kw).

If the above is true for the power industry all around the world, it is even more true for Latin America. In the wake of the "lost decade," most Latin American countries have restructured their power industries and allowed for a more direct participation of domestic and foreign private capital. As a result, from the southern core of South America to the north of Mexico, power opportunities have attracted a number of interested parties — and many more are yet to come.

Despite all the euphoria, only one truly private sector transaction has gone all the way to financial closing so far — the Mamonal Power Project, in Cartagena, Colombia, in which Chase acted as financial advisor and subsequently underwrote the full financing package. This project, along with Chase's overall global experience in Project Finance, has given the bank an unparalleled perspective on international power projects.

In contrast to what is happening currently in the power industry in Latin America, the U.S. power market is not that attractive. As a consequence, it is no surprise that U.S. players have been trying to reallocate their resources, financial and otherwise, from U.S. to foreign projects. What some of these players have failed to recognize, however, is that the U.S. market is neither the most efficient nor the most competitive. Those who thought they could move swiftly abroad learned the hard way that they were risking serious injuries. One factor in particular differentiates the successful ventures abroad from the failures: CAUTION! And caution at this stage translates into doing one's homework and addressing at least two very important points: namely, where to go and how to finance a project.

Investment Fundamentals

Many investors do not really have a clear idea of where they want to go. It is fundamental in any foreign venture that the investor be familiar with the place, customs and people of the target country. Although fluency in the local language is not a must, familiarity with it is an immense asset. Overall knowledge of the culture of the country, its legal structure, the government's attitude toward foreign investment in general, the country's economic situation and, last but not least, whether the investor will be able to attain the expected return on investment, are only a few elements that should guide an investor to an informed selection of a target country. The mere reason that others are investing in a specific geographical region is not in itself a reason to do the same. Specific individual competitive advantages will play an important role in the choice of a country. One should not be deluded into believing that easy money can be made in an unknown country simply because a competitor across the street did it. One investor may be as competent as the competitor, but the competitor may have personal relationships in the target country that will make it easier to get a job done. This happens all over the world, and Latin America is no exception to the rule.

In summary, going international does not mean going just anywhere internationally. Once an investor has selected the target country, the next decision is how to finance the project. This is a crucial issue for those going abroad without the backing of a healthy balance sheet, whether its own or a parent's. Even with a solid balance sheet, the sheer size of some of the foreign projects makes it difficult for a single investor to finance a project.

Financing: Then and Now

Financing a power plant today is quite different from the same exercise a few years ago. Many industry-related problems prompted a contraction of the commercial bank lending for power projects. No power industry problem, however, had the same impact on the willingness of commercial banks to lend as the oil crisis of the '70s and the LDC debt and real estate problems of the '80s did. However, commercial banks have adjusted to the new situation. They developed new financing techniques relying heavily on external sources of hard currency for debt repayment. Despite all of this, money is still in short supply.

Due to the nature of the business itself, the financing of a power plant is never simple. The challenge today is to find investors willing to commit capital to finance an infrastructure project such as a power plant to be used locally in the host country and with revenues in local currency. The task becomes more complicated when the government of the host country cannot or — for political reasons — will not participate in the financing of the project. The question remains: Given the limited availability of debt capital in the world and the attractive opportunities in other areas, how can a specific project attract the attention of international bankers and scarce debt money from the world markets?

There are at least two factors that, when combined, may yield a positive result. The first is the possibility of a joint venture with local partners. Such partners will be more knowledgeable about the local conditions, including legal and regulatory issues plus cultural considerations. The joint venture may also bring important political connections and a mutuality of interest in success at the local level. Investors in projects in developing countries should be especially aware of the advantages of a friendly local political environment in the success of any project — thus the advantage of good local partners.

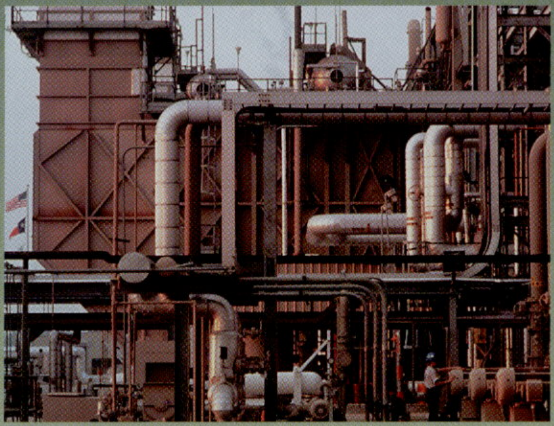
The second element is effective Project Finance. This financing technique is based on two fundamentals: Responsibilities for specific tasks should be allocated to those project participants who are either in a better position to resolve the matter at hand, or who will benefit most from the matter to be resolved. Because assuming responsibilities involves the assessment of the underlying commercial risk, these assessments are made best by the commercial and business sector, not by a banker.

Financing a project through the Project Finance technique does not mean simply finding a project and raising money for it. On the contrary, Project Finance is a separate and distinct financial technique, with its own characteristics and idiosyncrasies. These include the following:

1. Typically, the borrower is a joint venture ownership of a specific facility. It may take the form of a corporation, a partnership, or any other legal form. In Latin America, a preferred structure is the "Limitada" or Limited Liability Company, which has existed in the region and in Europe for more than a century and only now is being introduced in the United States. This entity may be located in the host country, but tax considerations may dictate that it be located abroad.
2. The borrower will be financed on a limited recourse basis; that is, the creditors will have recourse for repayment of the debt only to the extent of equity obligations of the owners, or other contractual provisions negotiated specifically for the particular project. If the project is underwritten by one sole bank, the debt obligations will be contained in a single credit agreement. If there is more than one lender or syndicate, the credit agreement will be complemented by an inter-creditor agreement or some other specific financing arrangement.
3. The project often qualifies for off-balance sheet treatment by the owners.
4. Upon its creation, the borrowing entity is not creditworthy. Its creditworthiness, and that of the project, is provided by a series of operating contracts with the construction company, the fuel supplier and the purchaser of the output, among others. If the operating structure is successful, the security package that will have been put in place will not have to be tested. Obviously, this is the situation desired. These operating contracts are part of the security package and will be assigned to the lenders as collateral to the loan. The financing banks will perform a thorough due diligence regarding the ability and incentive of each of the contracting parties to perform under these contracts. Any outstanding credit issues will be dealt with during the due diligence.

A joint venture makes the most sense because people in the industry are better positioned than bankers to understand and deal with political, economic and social issues. Long-term contracts make sense because individuals running the industrial companies are better qualified than financial executives to understand the industry and to assume the risks involved.

Basically, if the informed power purchasers and other parties to the power project are willing to enter into long-term arrangements in the context of the project, or are willing to enter into contracts which allocate to them the risks of their own industry, then a bank will feel comfortable with this informed willingness. If this is not the case, any bank would be justified in not entering into long-term loan arrangements in the context of the project.



A vast array of legal, technical and practical considerations characterize Project Finance. They must be addressed by any investor to ensure that a specific project will succeed. Like any U.S. Project Finance deal, all risks involved in a foreign project must be carefully assessed and allocated. These risks include, but are not limited to, technical (engineering and maintenance), legal, economic, political and regulatory risks.

Know the Law

The legal structure of the host country will have to be scrutinized to determine the issues and risks that must be addressed by any investor. Special attention should be paid to those rules that actually create the atmosphere in the host country conducive to such kind of foreign investment. The host country tax laws should be dear to the heart of any investor, specifically concerning withholding taxes on repayment of principal and interest, remittance of equity returns and repatriation of capital.

One of the basics of a successful Project Finance endeavor is the host country's tradition of respect for the rule of law, with a history of independent interpretation and enforcement of contractual obligations by governmental entities and the courts. Of utmost importance is the host country's enforcement of its dispute resolution rules, which enable the contracting parties to select arbitration as a form of settling their differences.

Look at Past Performance

On the technical side, an investor should, obviously, select a technology that has been proven under similar conditions. Project Finance bankers are uncomfortable with experiments — the realm of venture capital. If a technology has not been used previously in the host country, chances are that the local authorities and local companies are not acquainted with it; thus, they may have difficulty understanding the process and its implications. In addition, an investor should be supported by the best professionals available, preferably those who are familiar with the host country's geography and overall industry structure. They may be costly, but these professionals are worth every penny when the plant passes the performance tests successfully.

By definition, investors in an international project must deal with foreign currency. Depending on the host country, there may be currency risks, as many countries restrict the exchange of local currency into hard currency. In the case of a power plant, the output will, typically, be sold locally and paid for in local currency. Thus, investors should link the rates payable by the power purchasers to a readily available, convertible hard currency. This measure will take currency parity problems into account, but the possibility of inconvertibility may require a bilateral or multilateral agency's participation in the project.

Depending on the host country, no project will be considered able to be financed without the participation of multilateral or bilateral agencies such as the World Bank and the various export credit agencies (ECAs). These agencies will participate not only with their own funds, guaranteeing debt repayment and thus extending the maturities of any bank financing, but also through inconvertibility and expropriation insurance to qualifying parties.

In Chase's experience, many of the local utilities sponsoring a power project or purchasing the project's output lack the necessary creditworthiness to be a financeable party by a Project Finance bank under the specific power purchase contract. As a solution to this problem, Chase has structured transactions in such a way that industrial companies interested in purchasing energy have entered into various kinds of association agreements, either to purchase power directly from a power plant or to guarantee the local utility's purchase of the power. In these cases, the lenders to a project will create a tight security package that will allow them to rely on the credits of the individual power purchasers or the consortium.

Another concern is the overall attitude of the host country government toward private power. This attitude is reflected not only in government-sponsored laws and regulations favoring private power projects, but also in the direct participation in these projects by state entities, which, for example, may control fuel supply and transportation. Naturally, the success of a power deal abroad is directly dependent on the agreement of the host country that private power is needed and that the project contributes to the country's needs.

The above pattern repeats itself time and again. One can actually write the script for a new Project Finance deal at the outset, in the United States or in Latin America. What will be seen, however, is that transactions in Latin America will require a bit more patience, more skill and a lot more knowledge of the industry itself and of the host country. Some casualties will occur, no doubt, but the market's attractiveness will motivate developers, equipment suppliers and, last but not least, financial institutions to go south of the Rio Grande looking for business. As mentioned before, this is a task that can be accomplished — with caution!

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