

Project Finance: **Getting clever with credit**

Published: 13 June 2008 13:10 GMT | Author: [Bernadette Redfern](#) | [More by this Author](#)

Last Updated: 15 June 2008 15:58 | [Reader Responses](#)

Financing the petrochemicals sector's megaprojects during a liquidity squeeze is becoming difficult and bankers are increasingly turning to unconventional methods to raise capital.

A characteristic of the region's boom in petrochemicals projects is the rapid increase in the size of the schemes being considered. The latest projects under development in the Gulf are bigger and more complex than anything that has been undertaken previously.

But the surge in project risk has done little to reduce the appetite of investors and lenders to provide finance for petrochemicals schemes in the Gulf, despite the tightening of the global credit markets following the collapse of the sub-prime mortgage sector in the US.

The biggest scheme of all is the \$24bn joint venture between Saudi Aramco and the US' Dow Chemical to build an integrated petrochemicals facility at Ras Tanura in Saudi Arabia's Eastern Province, using about \$10bn of debt finance.

Megaprojects such as Ras Tanura are forcing the region's lenders to develop much more diverse ways of raising capital, using Islamic debt, bonds, finance from investment funds and loans from export credit agencies (ECAs) as well as conventional finance.

"Ras Tanura will be the first time every type of financial instrument under the sun will be used – corporate debt, ECAs, equity and Islamic and conventional bonds," says Tim Holder, director at consultant Taylor DeJongh. "It is a huge undertaking,"

Unconventional funding

The sharp escalation in the cost of borrowing over the past year, triggered by the tightening of the credit markets, is also causing project financiers to consider unconventional sources of funding.

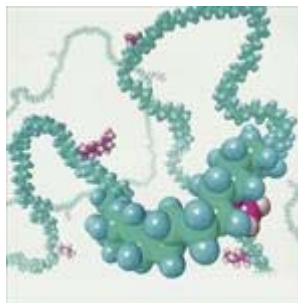
"ECAs will be more involved," says Simon Elliston, head of project finance at Citigroup. "Not because of political risks but because they have money. They are not affected by the same liquidity issues as the banks.

"Their balance sheets are as healthy as before, so it makes sense for borrowers to turn to them for liquidity."

Islamic finance tranches are gaining in popularity, tapping into the region's growing demand for sharia-compliant financial products. "Islamic financing is highly compatible with project financing," says Holder, pointing to Saudi Arabia's Al-Waha petrochemicals project as a good example. The scheme raised \$847m with sharia-compliant funding alone.

Stock market flotations are also being used to raise project equity, particularly in Saudi Arabia, where petrochemicals producers are required to list 30 per cent of their shares on the Saudi Arabia Stock Exchange (Tadawul). However a lot of analysts are opposed to this model.

"The petrochemicals sector is fundamentally incompatible with capital markets," says Terry Newendorp, chairman of Taylor DeJongh. "Capital market investors look for long-term, stable, predictable returns – not cyclical ones. Petrochemical returns are high and low over a period of years and we are expecting surplus capacity of basic chemicals in 2011/2012. There will be a



Polyethylene: Versatility gives it a range of applications

[Increase image](#)

[View all images](#)

retreat in prices and this is exactly the sort of thing that capital markets do not handle well."

Regardless of the source of finance, the cost of raising dollars has risen sharply.

In the current climate of megaprojects and tight liquidity, bankers estimate that the series of deals closed at the end of 2007 would have been forced to pay at least another 50 basis points in interest in today's market.

"Spreads are the widest they have been for five or six years," says Zahoor Khan, vice-president of the Gulf Investment Corporation (GIC). The corporation acts as an adviser on project finance deals and as an investor in private companies but it does not lend to projects.

Liquidity risk

"Margins have shot up for two reasons, higher funding costs and weaker distribution capability on the part of local banks. This means borrowers are paying the credit risk and the liquidity risk," he says.

The spread of debt, or the range of basis points above London interbank offered rate (libor) at which debt is financed, is growing for a number of reasons.

"Banks are increasing margins at the back end," says William Stevens, director in the oil and gas project and export finance department of RBS. "As banks have faced liquidity problems, they have had to become more creative in the way they pass these costs onto their clients. Whilst acknowledging upfront fees and margins in the early years have increased, banks have been offering steep pricing ratchets at the back-end.

"Asset returns can look a lot healthier and clients may generally accept this, as the transaction may ultimately get refinanced when the market improves at better terms."

Banks have tightened their own lending guidelines. Increasing returns by raising margins towards the end of a loan period makes lending more attractive to banks. The debt could be relatively cheap over 12 years only to become rather expensive towards the end. Financial models take into account the overall asset return so with this increase, credit committees at banks are more likely to approve a loan despite the fact that it will be refinanced before the end of the term.

Another issue for the lenders on mega-projects is the fact that an increasing number of lead arrangers are being used to underwrite deals. This limits the profit that the banks can make from selling on the debt to other banks. "There are a lot more club-type deals which means you can't make money on a skim," says Stevens. A skim describes the profit made when an adviser underwrites a deal for a certain percentage and then sells it on to another bank for a lower percentage.

This is another factor that can push the debt pricing up on major projects as banks seek to maximise profits in other ways. Some organisations however, are large enough to continue to demand favourable terms.

Bankers agree that the finance is still available at competitive rates for major government-backed clients such as Saudi Aramco, Sabic and Qatar Petroleum. What is more difficult is for the smaller private projects to raise finance.

With the prospects of obtaining ethane allocations becoming increasingly difficult, the secondary petrochemicals market is growing (see introduction page 38). But the economics are less obvious. Feedstock for secondary chemical plants is priced at market rates. "It used to be a slam dunk where petrochemicals were concerned but this is changing. It is not like cracking 75 cent gas for \$1,400 ethylene" says Khan.

"Manufacturing is moving over here [Middle East] for a number of reasons – security of feedstock, utility and infrastructure availability. What is missing are the markets. Specialised products are more difficult to sell but what I see is companies going and buying distributors in Europe and other markets".

With a project market worth over \$2 trillion, competition for financing from global banks, keen to hang on to their dollars, will continue to force margins up for some months to come. But in the long-term, stabilisation occurs and eventually a fall in debt pricing should follow.

Petrochemicals projects are also well placed to raise investment compared to many of the other

sectors, says Newendorp. "Pets will remain attractive. There is the weight advantage: European investors like to follow big name sponsors so it's easier to get the project past the credit committees. Pets when compared to other infrastructure are attractive as they generate hard currency in the form of export revenues. If you had the choice between investing \$7bn in a pets project or \$7bn in another type of infrastructure, these internal economics would weigh in the petrochemical project's favour."

Author: Bernadette Redfern. Features Editor
London

Story from **MEED**:

http://www.meed.com/bankingandfinance/projectfinance/specialreport/2008/06/getting_clever_with_credit.html

Visit this site regularly for further updates from the MEED team.
Go to [news alerts](#) to signup to our weekly updates and news alerts.

Copyright Emap 2008 - all rights reserved. All use is subject to our [Terms & Conditions](#) and [Privacy & Cookie Policy](#)

[Close Window](#)