

MEES Agenda

Pushing The Envelope On Covenants: A Project Advisor's Warning

The GCC project boom promises to bring value-added industries to the region and boost employment, but in addition to these benefits, there can be negative consequences of such rapid development. The trend towards looser structures on deals could become a problem in a down cycle, warns Terry Newendorp, Chairman and CEO of Taylor-DeJongh. A year on from his last exclusive interview with MEES, he suggests that the escalating cost of projects is still the biggest challenge faced by sponsors and reiterates that they should not be tempted to overbuild or overpay for expansions.

While sponsors in the GCC are eager to push through new projects and capacity increases as a result of the sustained high oil prices, constraints on engineering, procurement, and construction (EPC) capacity are acting as a bottleneck on the numbers of financings coming to market. As a result, the considerable bank liquidity available for these deals is not being mopped up and lending has become extremely competitive. Growing risk appetite, fueled by high oil prices, has not only put downwards pressure on margins (the profits banks make) but is also pushing lenders to accept looser structures on deals. This is a troubling development and can provide "good employment for the lawyers and work-out bankers when the downturn comes," warned Mr Newendorp, echoing concerns raised in the *State of the Union* session at the Projects International conference hosted by ICBI earlier this year (see *Increased Leverage, Loosening Covenants Concern Project Finance Lenders, MEES*, 30 April).

Starting his career as a work-out banker renegotiating financing deals for troubled projects, Mr Newendorp saw clearly how mistakes made in an earlier part of a market cycle can be played out in a down turn. In the aftermath of the US power sector crash, which followed the 2001 Enron crisis, experienced bankers were searching for an explanation, and some even questioned whether the loan agreements were scrutinized properly, given the lack of covenants. "Everyone read them and they sounded perfectly fine in a boom market," Mr Newendorp said, but added that they were not viewed with perspective. He believes that during the global downturn in the power sector in 2002-04, deals that Taylor DeJongh advised on "stayed above water, met their debt servicing requirements and mostly continued to pay dividends on schedule to the sponsors," because they were not too aggressive on capital structure or covenants. To prevent problems in a down cycle, sponsors must be convinced that "pushing the envelope too far is not in their long-term interest," he cautioned.

Many projects have recently been financed without completion guarantees or long-term supply contracts, often with increased leverage and over long tenors. In some cases sponsors are strong companies, enjoying government support, and advantageous raw material costs that put them amongst the lowest cost producers in the world. But for some private sector projects, paying top dollar for expansion while striking deals with looser covenants could prove to be a bad combination. Project risk is best mitigated by keeping capital, operating, feedstock and transport costs in check, Mr Newendorp said.

Reassessing Project Economics

Rising EPC costs remain a challenge for all projects and sponsors must re-assess their project economics and reevaluate their competitive positions as a result, said Mr Newendorp. Concerns he raised a year ago that sponsors could be overbuilding and overpaying for expansions (See, *Overpaying For Industry Expansion: A Project Advisor's Warning, MEES* 24 April 2006) remain applicable today because the tight EPC market is not easing. The price hike has already led to the cancellation of high profile projects, including ExxonMobil/Qatar Petroleum's proposed GTL plant in Qatar, and delayed the construction of Kuwait's new refinery, while also impacting many smaller projects.

Prices have increased as a result of the jump in raw material costs, such as steel, and shortage of human resources at the project manager and construction manager level. While the price increases are in many cases shocking, the extension of delivery times is even more troubling, he said (See, *EPC Contractor Sees Raw Material Lead Times/Price Hikes Continuing, MEES*, 21 May). The huge slate of projects in the Gulf makes it more expensive to locate a 400,000 b/d refinery, for example, in the region than the Texas Gulf or in Trinidad, said Mr Newendorp. "There is a shortage of skilled labor, and everything is congested – ships availability, docking

facilities, etc," he added. The arrival of new entrants to the EPC market, such as China, could help to ease the bottleneck, but this is being met with resistance, in part from lenders, and also some national oil companies. In Africa, for example, there has been strong opposition to refineries or gas processing facilities being built by Chinese contractors. "If the West is unable to provide capacity we have to expect that new entrants, most likely from China and India, will enter the market," he said, noting that new companies must first prove their skill on relatively small projects and power plants, and not on a complex \$6bn-plus refinery. "We've seen Chinese contractors in Dubai building office blocks, but that's not the same as a complex processing plant," he added.

If projects are delayed by raw material sourcing or cost concerns, this could have a domino effect on the prices for many commodities – they could be sustained at high levels because new output will fail to hit the market, he warned. Some economists are hoping that this will soften the down cycle for some commodities, although the extent to which this will happen is difficult to gauge. While the EPC situation may force some rethinking and rescheduling, a wholesale cancellation of projects is unlikely, Mr Newendorp predicted. Under currently buoyant market conditions in the Middle East, sponsors are keen to reinvest cash in new capacity and exploit access to inexpensive feedstock, so will continue to push through new projects despite the glitches in securing contractors' services