

An overview of strategies in multi-currency financing for International IPP Projects. By Terry A. Newendorp, chairman and CEO, and Senake Gajameragedara, associate, Taylor-DeJongh, Inc.

# Back to basics

## Introduction

IPP projects and investors have had a torrid experience in emerging markets. Adverse market conditions, financial crises, regulatory uncertainty, overly ambitious project scope, and less than optimal financial structuring, among other issues, have led to losses for both sponsors and lenders in Brazil, to India, to the Philippines. Foreign exchange (FX) risk has been a key factor in almost all troubled IPP projects. With a new round of privatizations and IPP RFPs anticipated in Central Europe and Northeast and Sub-Saharan Africa, as well as other emerging markets, investors would do well to take a step back and look at reducing project FX exposure as a first step in minimizing the potential fallout of adverse currency movements and sovereign constraints on FX convertibility and transferability. Re-embracing multi-currency financing, once a fundamental feature of international project finance, can provide clear advantages to prospective emerging market power projects in the competition for international capital.

## Burned by FX

Hard currency-financed forays by US and European sponsors – and by extension their lenders – into newly liberalized power generation sectors in Latin America and Asia involved significant FX risks that were mitigated primarily through power purchase agreements (PPAs) denominated in or indexed to hard currency. Generally, such PPAs converted FX risk into counterparty credit risk and also exposed projects to sovereign convertibility and transferability risk. Most emerging market IPPs took the credit risk of the local distribution utility, in some cases backed by revolving letters of credit and sovereign guarantees for the term of the PPA. In countries where electricity distribution remained state-owned, counterparty

credit risk was essentially sovereign credit risk. In the few cases where projects operated on a merchant basis, such as the gas-fired Brazilian IPPs that were built in response to depleted hydro reservoirs, a local entity – in this case Petrobras – was contractually required to top up revenue, again indexed to hard currency, when merchant revenue was insufficient.

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## What is multi-currency financing?

The idea behind multi-currency financing is straightforward – it seeks to combine hard currency capital with local capital, which reduces a project's net FX exposure by better matching revenues and obligations over the life of the project. This natural hedge can provide a substantial measure of relief during a period of chronic hard currency shortage or sustained depreciation or sharp devaluation of the local currency. While most emerging market financial and banking sectors are still undergoing reform of varying degrees

and capital markets are only in nascent form, many developing countries boast high levels of savings, and local sources should not be overlooked in the search for capital. There can be many challenges to incorporating local capital in international project finance transactions. When considering local bank and capital markets, sponsors and financial advisors should carefully analyze banking laws and regulations against the capital investment needs of the project and macroeconomic prospects of the country.

## Multi-sourcing

Pricing and tenor for local debt can often be uncompetitive vis-à-vis dollar debt.

### Prospects for multi-currency financing

Privatization of integrated power and water projects continue at full speed in Abu Dhabi with bids already submitted for the Taweelah B scheme. Financing requirement is expected to be around \$2 billion, which suggests that there is ample room, perhaps even demand, for a significant local financing component.

Capital and bank markets are developing rapidly in a number of emerging market countries. In Malaysia, one of the notable survivors of the Asian financial crisis, capital market development has been associated with the rise of Islamic finance. According to the Ratings Agency Malaysia (RAM), Islamic bonds accounted for approximately 40% of all corporate issues during 2001-2003, with project finance bonds commanding 77% of all Islamic bonds outstanding as of early 2004. Not surprisingly, utilities and infrastructure dominate Malaysian project finance bonds, headlined most recently by the RM3.4 billion (\$900 million) 15-year Islamic bond refinancing of the 2,420MW Kapar multi-fuel power project.

IPP projects in Asian countries with underdeveloped capital and bank markets stand to gain from a new Asian Development Bank (ADB) currency swap mechanism. Under this arrangement, ADB swaps hard currency for local currency from the government and lends the local currency to domestic and international private sector financial intermediaries for long-term domestic project lending on a commercial basis. At the end of the swap period, the ADB and the government will

exchange initial local currency and hard currency principals. As a first step, the ADB has approved a \$200 million swap up to 15 years for the Philippines.

Another round of IPPs – 223MW Mexicali II, 972MW Tamazunchale II and 411MW Agua Prieta – is expected to be sent out to bid in Mexico over the next twelve months. Though domestic banks have not been significant participants in past IPP projects and Mexican capital markets are still underdeveloped compared to Latin American countries such as Chile and Colombia, the Inter-American Development Bank (IDB) remains focused on supporting the growth of local currency infrastructure and project financing in Mexico. In particular, IDB hopes to replicate its success in Chile, where it provided a partial credit guarantee to the \$306 million equivalent peso bond issue for the Santiago-Valparaíso-Viña del Mar Toll Road project. The high cost of peso debt against dollar debt, however, is likely to be a significant obstacle for projects considering local financing in Mexico.

### Conclusion

Recent history of emerging market IPPs has been troubled at best. Experience shows that the financing structure should be utilized to include local currency where possible to minimize foreign exchange exposure over the life of the project. Local currency financing may not always be easily available and, even if available, terms may be uncompetitive. However, with a new round of IPP projects expected in Tunisia, Abu Dhabi, Tanzania, and Uganda as well as in Bulgaria, Romania, Macedonia, Poland, and the Ukraine, sponsors and lenders would be well served to fully evaluate multi-currency financing options. ■

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