US BASED FUNDING SOUGHT FOR PROJECTS

AS PROJECT SPONSORS BEGIN TO ANALYSE THEIR FINANCING OPTIONS FOR 2012, MANY IN THE FINANCING MARKETPLACE WILL BE LOOKING BACK ON 2011 AND ASKING WHERE FUNDING WILL COME FROM IN THE NEW YEAR. BY ERIC F SILVERMAN AND ALEXANDER K BORISOFF, MILBANK TWEED HADLEY & MCCLOY LLP.

While European banks have in recent years dominated project finance lending with a significant, and in some sectors dominant, market share, the ongoing European debt crisis has withered confidence in the ability of these institutions to act in their historical role as providers of stable funding for projects across the globe.

Similarly, while Japanese, Chinese and South Korean outbound investments have in recent memory played a crucial role in keeping the projects market supplied with fresh capital, signs of weakening demand for Chinese manufactured goods and the latent effects from the March 2011 tsunami and the related Fukushima disaster could mean that, even in a best-case scenario, new money from this region will not be enough to shore-up the European funding gap.

And while a handful of developing countries – most notably in Latin America and the MENA region – have made significant inroads in their ability to source their own financing without the need to rely on European banks, such independence often requires mobilising the participation of numerous other financing participants, which can have complexities of its own. With these circumstances in mind, many are asking what role US-based funding can have to deal with some of these potential funding shortfalls and to maintain (and perhaps grow) activity levels as we step into 2012.

2007–08 debt crisis revisited

The big issue for many of the traditional European players in the project finance market can be reduced to one fundamental problem: increased funding costs. The confluence of sovereign debt exposure, higher capital and dollar funding costs, and new regulations stemming from Basel III have created a toxic cocktail that is forcing these institutions to de-lever and shrink their balance sheets quickly.

In a way, it's as if the European banks are going through much of the same trauma that US banks went through following the 2008 Lehman crisis, resulting in a push to reduce their loan books and increase their internal capital ratios. As they do so, banks that are not as affected by dollar funding problems and that are not required to focus on short-term fixes to their balance sheets will have the opportunity to emerge as significant participants in markets where they may be seeking to increase their market share.

Having gone through many of the same problems during the 2007–08 financial crisis, as a whole US banks have already been through the de-leveraging process that their European counterparts are now facing, the result being that many of these US institutions are sitting on abundant liquidity that resulted from the difficult restructurings they experienced just a few years ago.

As criticism has built that these institutions are holding too high a volume of underperforming cash reserves, some of them have started to take action. Both JP Morgan Chase and Citigroup have led a push by US banks to increase their share of loan underwriting in Europe, a trend that is likely to continue during the next 12–18 month period as the Europeans continue to focus on stabilising their balance sheets and altering their funding mix, all while continuing to deal with the ongoing crisis that at least as of today has no end in sight.

The effect has been quick: in just the last year, BNP Paribas has fallen behind JP Morgan Chase in dollar-denominated lending, a small but significant shift given the dominance of French lenders in recent years.

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There's no place like home

In the US domestic markets, where project financing is heavily weighted towards power, energy and infrastructure projects, US-based banks and other financing entities are well poised with their significant liquidity to pick up much of the slack from the US branches and affiliates of European banks that in recent times have been, along with the US branches and affiliates of the Japanese banks, the predominant market participants.

On the non-bank side, private equity, hedge funds and infrastructure funds, which have been acting as catalysts for M&A activity in the domestic energy sector, are expected to use much of the cash from their investment monetisation activities over the past few years to continue seeking strategic investments and hunting for assets, with a focus on gas-fired generating assets.

On the renewables side, while the development growth rate will likely be below recent trends with the ramping down of the 1705 US DOE Loan Guaranty Program and the phasing out of the US Treasury's 1603 cash grant programme by year-end (unless extended by Congress), there continues to be sufficient liquidity in commercial bank and capital markets to fund well structured wind and solar PV projects up to US$1bn, though tenors in bank markets of seven to 10 years may be a constraint to large-scale, high capital cost technologies such as solar thermal or offshore wind.

Similarly, the tax equity market remains capacity-constrained, with a limited number of players, dominated by financial institutions, pushing up return targets and increasing the cost of capital for renewable projects. Nonetheless, the limited participation of foreign-owned banks should not have too dramatic an impact on the US domestic projects market as US-based banks, industrial finance companies, and funds are able to step-up for well-structured projects.

Going abroad

On the international side, while the expectation is that demand from borrowers in the projects market will increase over the next 12 months, as has been the case over the past few years, much of the response will come from export credit agencies, particularly on the largest and most capital-intensive projects.

Perhaps one of the most anticipated questions of 2012 is whether the Export-Import Bank of the United States (US Ex-Im) will be positioned to maintain its growing position and leadership role in the global projects market. For the past few years, US Ex-Im has steadily increased (in absolute dollar terms) its total authorisations and in the process has become one of the most active ECAs supporting the efforts of large-scale project developers on a global basis.

While US Ex-Im loans are subject to US-content requirements and various country-related limitations, their ability to finance very large investments without restrictions based on project size, general flexibility as to target country investment, and favourable loan terms resulted in a record number of financing requests in 2011, and the expectation is that this trend will continue into 2012 as more questions are raised regarding the reliability of other traditional funding sources.

This situation bodes particularly well for project developers and investors in some of US Ex-Im's key focus countries – Mexico, India, Australia and Colombia – where authorisations in 2011 hit record numbers and where US Ex-Im seems ready to continue its current focus for the foreseeable future.

Outlook 2012

Few expect 2012 to bring a monumental change from the uncertainty – and, at times, outright cynicism – that has battered the European banks and left the markets reeling in the face of political indecision and reliance on short-term solutions.

Here in the US too, political bickering over existing subsidy and loan programmes has placed significant pressure on those who had hoped to see 2012 as the year in which a government supported Green or Infrastructure Bank would become a reality. While the politics of history continues to hamper decisive action by the Europeans, and the politics of the 24-hour news cycle continues to destroy any sense of bi-partisanship in the US, it will be difficult to see how underlying economic health can be restored in a way that will settle markets and bring a sense of stability to the providers of financing to the global projects market.

With that said, the global projects market continues to grow, and US-based institutions, with their relatively strong liquidity positions and relative lack of exposure to the sovereign debt mess affecting their European counterparts, are well-positioned to step in to cover some of the shortfalls created by the scaling back of the European banks. Look in 2012 for a possible uptick in the volume of project bonds issued into the US capital markets as creditworthy sponsors take advantage of low interest rates for long-term post-construction debt.

Other mechanisms for recycling dollar liquidity into projects may also emerge that could be structured to capture higher lending margins expected due to bank liquidity constraints, including new dedicated project debt funds to finance diversified portfolios of project deals in the US and abroad.

On the banking side, while the smaller number of active players may mean some credit scarcity in the bank markets over the next 12 months, smaller syndicates and continuing risk-aversion will mean that there will be a premium on well-structured deals that meet the pricing and tenor needs of those institutions remaining active in the market. For the US-based commercial banks, 2012 may be the year in which they decide to shed their credit shyness and re-assert their dominance in the global projects market, unless they decide instead simply to keep the seat warm while the Europeans clean house. ■