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As Basel III Takes Effect, Debt Financing Evolves In The GCC

With the impact of the 2008 global financial crisis and the 2014 oil price slump still being felt in some countries from across the globe, including in the Middle East, the world of banking has gone through a challenging time. Saying that, 2019 has been a landmark year for the sector, especially in the GCC, with the completion of the Basel III implementation in March.

The focus of these new financial regulations on the improved quality and quantity of bank capital, and liquidity, coupled with forward-looking credit loss provisions has transformed bank lending. This is especially the case when it comes to infrastructure projects that traditionally relied on long-term project finance loans.

Everyone, from banks and financial institutions through to corporate borrowers and infrastructure grantors, has adjusted their financing models in response to these changes. Banks and financial institutions have replaced the traditional 18-22 year long-term project finance loans with short-term mini-perm loans, both hard and soft. This is in addition to lowering the investment levels in many cases as seen from an increasing trend of syndicated transactions.

Grantors have also accepted these market developments and added project bonds and soft mini-perm loans as acceptable forms of financing. Infrastructure companies have adapted to this market development, now relying on multiple funding sources, including mini-perm loans, ECA-backed facilities and project bonds. Almost all power and water projects awarded over the past couple of years have been financed under this structure, with soft mini-perm loans becoming the most widely-used financing structure.

Changing business models does not come without challenges, with each associated stakeholder being impacted differently by its own set of obstacles. Banks, for example, are faced with the challenge of negotiating to help projects absorb margin step-up in soft mini-perm structures. Meanwhile, infrastructure companies have also had significant hurdles to overcome, such as maintaining a profitable business model while developing multiple projects and managing leverage. And, in order to address such issues, changes have been applied to the traditional criteria of project evaluation used by these companies. Evidence of these changes can be further witnessed through the recent trend of highly competitive tariff rates in the region despite cash sweep and margin step-up of the soft mini-perm structure.

Project risk-return evaluation has evolved to take a more strategic view, considering returns from various work streams. The use of higher leverage to optimize project returns has been another key change in the funding strategy of infrastructure companies. For the project company, deferring equity injection through the use of longer tenor bridge financing facilities is aimed at minimising the risk of lower returns.

The impact of the above factors on infrastructure companies is likely to be one of higher leverage at lower returns. For infrastructure companies to be able to manage such risks, there has been a clear shift in their investment strategies. The current market dynamics have made it optimal for companies to invest in new infrastructure projects as associate companies rather than as subsidiaries. The recent trend of participating in such projects as multi-sponsor consortia is a demonstration of this new investment strategy. Perhaps an “invest to sell down” or “invest to monetise” as opposed to “invest to hold” strategy will be the most economically and commercially viable option for infrastructure companies to avoid debt overhang and low profitability.

Knowledge truly is king. The current trend of all debt financing of infrastructure projects can be viewed as risky due to flight of equity away from such projects. However, these new market developments can result in successful infrastructure development at affordable pricing if the underlying risks are well understood and managed. One preferred option for project sponsors is the reliable offtake mechanism supported by a strong underlying demand from stable demographics. This will enable the absorption of future interest rate risk of soft mini-perm loans, provision of related fuel supply and network infrastructure, and timely completion of projects at planned costs.

An increase in debt levels is a global occurrence rather than a regional phenomenon, with global debt reaching its peak in 2018, according to the IMF. GCC economies are mostly doing well though, enjoying the benefit of low debt-to-GDP ratio. A significant level of foreign participation in regional infrastructure projects is mainly because of the offtake strength of government authorities in the region. Many GCC countries have already initiated Public-Private Partnership (PPP) legislations to provide a sound framework for infrastructure development using various procurement models. These factors make regional PPP projects suitable investment options for pension funds and infrastructure funds. To tap into these investments, it is critical for the region to have a well-developed project bond and asset securitisation market.

Ultimately, a change in business models in the region can be successful if the projects can be refinanced through long-tenor bonds. Access to liquidity through a well-developed asset securitisation market is critical for private sector participation in the PPP model. Enactment of regulation within these two areas will provide a much-needed incentive for banks and corporates to be more involved. The region holds a lot of promise when it comes to infrastructure development, and with the recent changes in the debt financing models, it will be interesting to see how it plays out over the coming years.

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