

ACT – A case study of overcoming market risks

The project finance scene in the Asia Pacific region has witnessed a strong, albeit patchy, recovery in sentiment in the last year. One deal in particular illustrates this turnaround – the recent HK\$3,400m financing for Asia Container Terminals Limited (ACT) in connection with the proposed Container Terminal 9 (CT9) project in Hong Kong. Richard Michael and Andrew Kinloch of WestLB, technical & Insurance Bank and joint bookrunner in the deal, examines the nuts and bolts of the project.

The deal was brought to the project finance banks for consideration by the financial adviser, Schroders (as it was known then), in early 1999 when few banks had the confidence to bid aggressively. Almost a year later in April 2000 the general syndication was closed with an oversubscription of 2.2x. Not a bad result for a deal that represented a number of firsts – first project finance deal in Hong Kong to be signed since the onset of the Asian debt crisis; first major port in the region to be financed on a limited recourse basis; and the maximum tenor of 12 years was the longest seen in Hong Kong since the crisis.

This marked shift in sentiment can of course be ascribed in large part to the overall improvement in liquidity in Hong Kong, which has seen margins for the better names being driven down to pre-crisis levels. However, the success of the financing cannot be explained solely by the relative abundance of Hong Kong dollars chasing too few deals. A major factor was the quality of the project itself in terms of sponsors, credit structure and market prospects. ACT had a good story to tell, but this was perhaps not so evident if the newspaper headlines appearing at the time commitments were being solicited were taken at face value. An example from the Far Eastern Economic Review of 2 September 1999: "Terminal Decline: If Hong Kong is to shape up its economy, it may need to consider shipping out of the container business". Needless to say, such headlines would give any credit committee pause for thought.

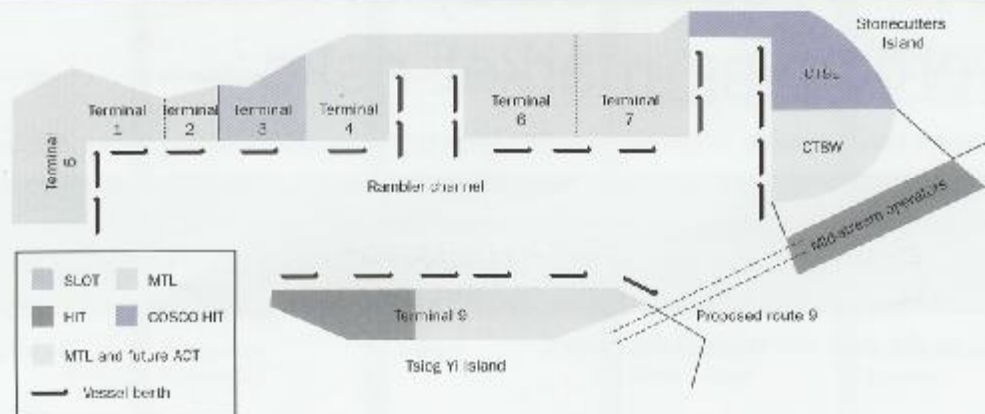
The main concern behind the headlines was at first glance a valid one: What was the point of adding new capacity in Hong Kong when ports on the mainland could handle China's exports more cheaply and almost as efficiently? The three existing container terminals in Shenzhen – Yantian, Shekou and Chiwan – were already growing rapidly and had room for further expansion. ACT would be operating in a

highly competitive environment where shipping lines could transfer business to other locations at will. No long-term throughput contracts would be available to lenders, who would be taking almost full market risk. The proper assessment of the overall prospects for Hong Kong as a port and of the competitive position of ACT was therefore crucial if a convincing case was to be made to counter any knee-jerk responses to negative press clippings.

Background

The background to ACT should be explained first. The company was established by a strong group of sponsors – New World Infrastructure, Hongkong Land, Sun Hung Kai and Sea-Land Orient Terminals (SLOT – ultimately owned by CSX Corporation of the US). SLOT, which owns and operates CT3 in Kwai Chung, would also take on the role of operator. ACT was one of three co-developers of CT9 alongside Hongkong International Terminals (HIT) and Modern Terminals Limited (MTL), both well-established players in Kwai Chung. The Joint Development Agreement (JDA) signed on 7 December 1998 set out the responsibilities of each developer – ACT would contribute just over 41% of the total shared costs of CT9. The principle underlying the JDA was that the cost of constructing the terminal itself would be shared (mainly dredging and filling the 140 hectares of reclaimed land at Tsing Yi opposite Kwai Chung, of which 68 hectares would be for the terminal proper). However, each developer would be responsible for the fitting out works (shorecranes, rubber tyred gantries or RTGs, office buildings, etc).

ACT has the two middle berths (numbers 3 and 4 out of the total of 6 at CT9), which were due for completion in July and October 2003 respectively.

ACT - The project


MTL and HIT have the two southern and northern berths respectively. Although the developers could commence operations at their respective berths once complete, the terms of the various Land Grants from the Hong Kong Government were such that full legal title would not be passed over until completion of the whole project - in legal terms, the Partitioning of CT9. The Partitioning was expected to take place in December 2004 and the developers would then be able to continue operations until expiry of the Land Grants in 2017.

There was one crucial additional element to this arrangement. ACT has the middle berths at CT9, but then would physically occupy and operate the two existing western berths at Container Terminal 8 (CT8W) currently belonging to MTL. This arrangement, set out in a Berth Swap Agreement (BSA) signed at the same time as the JDA, would allow MTL to operate from four contiguous berths at CT9. As ACT would not have legal title to its berths at CT9 until Partitioning occurred, the BSA provided for MTL to operate under licence from ACT at CT9 and for a similar arrangement to apply at CT8W. The larger handling facilities per berth at CT8W is the rationale for ACT being responsible for more than one third of the cost of CT9.

The relative complexity of the arrangements under both the JDA and the BSA and the risk of re-entry by the Government and default by the other parties to the agreements required some finessing by the banks of the pre-completion security package. However, the legal due diligence aspects are confidential and not the focus of this article. The key question the banks had to grapple with was whether the market risk being assumed was acceptable. Although it was of course key that the security arrangements be as

watertight as possible, the banks needed to work on the basis that the deal would essentially be non-recourse to the sponsors post-completion and this meant that the technical and market analysis was of utmost importance.

ACT was able to provide market studies by both the Hong Kong Port and Maritime Board (PMB) and Ocean Shipping Consultants (OSC), but the lead arrangers required independent verification and appointed Mott Connell and Babbie BMT Harris & Sutherland (Babbie) as consultants to the lenders on technical and market aspects respectively. Although the technical study did not directly cover the issues of tariffs and throughput, it was nevertheless closely linked to the market study in that the attractiveness of CT8W to the shipping lines would be of vital importance in securing market share.

No fixed price

The brief for Mott Connell was to provide the banks with the normal assurances on the cost estimates for the project at a time when the main construction contract was still being tendered. As well as the uncertain outcome of this process, banks also had to contend with the absence of a fixed price turnkey contract. As is the tradition in Hong Kong, the seven shortlisted consortia had to provide bids to the specifications laid down by the consulting engineer, a joint venture of Scott Wilson & Maunsell (SWM), on a remeasurement basis; that is, the unit costs would be fixed, but the quantities could vary (although bidders were asked to provide lump sum quotations on part of the work as an option). The track record in Kwai Chung and elsewhere in Hong

Kong of major projects being completed within budget as well as the experience of SWM were powerful mitigants of any cost overrun risk. In addition, there were contingencies built in to the financing plan to provide for a significant level of overruns. Mott Connell also opined on the traditional risk of delays in completion with similar conclusions.

The less traditional part of Mott Connell's scope of work was a detailed assessment of the physical attributes of CT8W after fitting out and of CT9 (as ACT would end up operating there if the berth swap with M11 failed to proceed). In particular, lenders needed to be assured that CT8W was sufficiently future proof; in other words, would the terminal be able to handle the types of vessels expected to handle Chinese exports in the next decade or so, given current trends in the shipping industry? The latest generation of vessels are capable of handling over 6,000 TEUs, but the trend is now towards in excess of 8,000 TEUs and by the time ACT begins operations the 10,000 TEU vessel may be a reality. Such vessels require a minimum quayside depth of 15 metres, whereas the current average in Kwai Chung is just 12.2 metres.

Competitive advantages

In the case of CT8W, the quayside depth is already 15 metres and it is capable of being dredged to a maintained depth of 15.5m. Additional competitive advantages over other berths at Kwai Chung include the terminal area per berth, which is a key factor in the efficient handling of containers - CT8W has 14.3 hectares per berth compared with the average for Kwai Chung of 10.9m.

The length of each berth ACT will operate is also greater than the norm: 370m versus 320m. CT9 by comparison will have the same quayside depth of 15.5m, average terminal area per berth of 11.3 hectares and average berth length of 323m (hence the lower capacity per berth than for CT8W). Although the increased capacity of container ships has tended to be reflected in the length and draught, it is likely that future expansion will also mean wider ships - up to 22 rows of boxes across against the current 17 rows. CT8W (and CT9) will have the ability to handle these wider vessels with properly specified shorecranes.

The conclusion of Mott Connell was that CT8W (and CT9) would be able to handle anticipated future developments in the container shipping business. This would only translate into revenues for ACT if it could convince shipping lines that they would receive a high quality of service - the infrastructure on its own would not be sufficient. The operational performance of ACT was therefore a key factor to be assessed and

this fell within the Babtie scope of work. As mentioned, ACT would delegate the operational responsibility to SLO. Under this arrangement SLO would provide the necessary personnel and support to ACT's operations. This was crucial for lenders, especially given SLO's impressive track record of operating efficiency at CT3. In 1998, the latest year for which figures are available, SLO managed to handle more than double the average number of boxes in relation to the berth length at CT3 - 3,482 TEUs per metre compared with the Kwai Chung average of 1,551 TEUs per metre. CT3 therefore achieved a higher market share than would be warranted by its size and it was important to the competitive position of ACT that this performance be repeated at CT8W.

The assessment of ACT's ability to carve out a place in the market in Hong Kong was the last piece of jigsaw as far as Babtie's study was concerned. The study employed a cascade approach to the analysis of the revenues to be generated at CT8W, starting with container volumes for South China overall, moving down to the share that would be captured by Hong Kong before arriving at the volumes for ACT. The study took due account of such factors as: the cost competitiveness of existing and anticipated capacity in the Shenzhen ports, the possibility of direct trade links across the Taiwan Straits, the capacity of the supporting infrastructure in the form of road, barge and rail links as well as the impact of the trend towards major shipping alliances which is expected to exert some pressure on tariffs.

Although the Hong Kong port as a whole is facing stronger competition, particularly from the 2m TEU capacity facility at Yantian, it has certain inherent strengths which allow it to compete even if a premium in terms of tariff is paid. As the largest integrated port facility in the world with a capacity of 15.8m TEUs, Kwai Chung offers the major shipping lines greater flexibility and a critical mass of feeder services and connections. In addition, Hong Kong has a distinct advantage from its status as a free port with relatively liberal customs procedures and minimal red tape.

Babtie's overall assessment of the market did lead to a discount factor being applied to the earlier PMB and OSC forecasts. However the resultant lenders' base case demonstrated very robust cash flows which could withstand quite severe downside scenarios. Thus the real story behind the superficial headlines could be conveyed in terms potential lenders would appreciate.

The ultimate success of the ACT financing in syndication owed as much to the strength of the economics and the structure of the deal as to the recovery in market appetite.