A slow recovery

Zoltán Varga and Tamás Pásztor of Nagy és Trócsányi Ügyvédi Iroda predict an uncertain future for project financing in Hungary

In late 2008, the authors expressed their – somewhat optimistic – expectations about increasing recourse to project finance techniques used in Hungary, including the popularity of public-private partnership facilities due to the appreciation of such financing tool by the market (see *Building momentum* in IFLR October 2008). Regrettably, time did not justify such expectations; contrariwise, the economic decline in recent years has had a serious negative impact upon project financing within the Hungarian market. Since 2008, recourse to this special form of financing has significantly relapsed and, while on the international scene a modest activity has lately been experienced, recovery in Hungary cannot be expected as far as the near future is concerned.

Pre-crisis project financing

Project financing grew in popularity in Hungary in the 1990s after the change of regime, in parallel with the improvement of money and capital markets and after the necessary legal background had been put in place. Favorable macroeconomic indicators at that time contributed to the uptake of this financial tool. The first transactions to be financed through project financing schemes were implemented at the beginning of the 90s mostly in relation to motorway constructions as part of the overall improvements made in the country's infrastructure.

Later, in the second half of the decade, project finance was typically used for investments aimed at the expansion and modernisation of fixed-line telephony and mobile phone networks as well as alternative telecommunication and data transmission systems. Up to the breakout of the financial crisis highest-volume transactions were realised by way of project financing structures within the energy industry in relation to the development of power plants, mostly those using renewable resources and in connection with oil and natural gas investments. Apart from in these areas, project finance played an important role in the real estate industry, particularly with regard to the construction of hotels, shopping malls and industrial parks.

As from the beginning of the new century, furthermore, Hungary became the CEE region leader in the use of PPP financing structure, as a specific form of project financing schemes. The government increasingly favoured this type of financing for its development projects, implemented mostly within the framework of public procurement. In 2010 there were approximately 100 PPP projects operating in Hungary. Although those included several smaller projects, such as enlargement of student dormitories and investments related to the development of gyms, swimming pools and sport halls, prisons, and cultural establishments, the investment value of a few (including highway projects) exceeded €200 million ($281.7 million). In 2010, furthermore, ambitious projects were scheduled for the future to be implemented in the framework of PPP structure, such as the FEREX (airport railway system) project and the establishment of an electronic payment system for highway use.

> **"PPP as a financing structure turned out to be an expensive and disadvantageous tool"**

Post-crisis fallback

Contrary to prognostications, in the last two years recourse to project finance schemes has gradually disappeared in Hungary due to the lack of investment willingness on the investors' side as well as to the reluctance of financial institutions to undertake significant risk incidental to the use of such financing tool. Current activities of financiers in this respect are merely limited to the financing of operating projects or, as far as real estate projects are concerned, to the actual management of operating projects, if the financial institution acquired title to the project as a result of enforcing securities attached to the financing structure. On the other hand, financing new projects is exceptional, and is limited to existing clients, merely on significantly different terms compared to those before the economic decline. These trends are clearly the results of the continuous abuse by investors of the high credit-low sponsor support ratio that was typical in case of earlier financing structures. Such abuse materialised mainly in that, after the investment of investors was cleared, they became uninterested in operating projects and thus to pay back financial credits.

Furthermore, PPP as a financing structure turned out to be an expensive and disadvantageous tool. This was mainly because while high risk was taken by the government, the private sector realised multiple profits without taking any risk. Existing PPP projects, in addition, are now subject to governmental supervision conducted by the State Audit Office in order to examine whether terms and conditions of PPP agreements are fulfilled, and whether public monies spent in the framework of such schemes were efficient and profitable or not. Projects that may qualify as unacceptable during such supervisions, will foreseeably be subject to significant restructuring.

(Un)willingness to invest

As far as the reasons of the fall-back of project financing structures since 2008 are concerned, one can refer to the lack of actual projects to be financed. While up to the breakout of the financial crisis investments with the highest volume were implemented by project companies registered in Hungary with the ownership of foreign investors or by foreign project companies (nearly 50% of the Hungarian investments, 60% of the biggest investments) and thus Hungary had the highest concentration of foreign direct-investment capital of all the countries in the CEE region, investors, especially foreigners, have basically disappeared from the market, which can be attributed to many circumstances.

First, Hungary has lately been rated as a high-risk country by several foreign rating organisations with reference to, among other factors, the instability of the Hungarian central budget.

Second, both national and foreign investors are reluctant to approach the Hungarian market for the long term, since they deem the Hungarian regulatory framework to be somewhat uncertain and inconsistent. Inconsistency of legal instruments as well as livelong authorisation procedures are typical examples of such inconsistencies.

Third, the continuous instability of the Hungarian currency further enhances the unwillingness of investors. Such instability results in high exchange rate risk which must be dealt with both by investors and financiers on a medium- or long-term basis. The other important impact

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of exchange risk is that while credits are merely provided in euros, cash-flow is realised in forints, which makes crediting even more expensive.

Finally, lack of actual investment is also explained by the more hurtful financing conditions applied by financial institutions, especially by higher risk taking on the investor side, increasing own resources/down payment obligations.

Even if an investor would prefer to finance its Hungarian investment in the framework of project financing, he would face difficulties raised by financial institutions due to their changed crediting policies. For the purpose of securing the loan, all financial institutions require a certain contribution of own resources, or a down payment, from the debtor. The relative size of the down payment depends upon the characteristics of the project and on the collateral system applied, but the required minimum is usually between 20% and 40%; however, such amount is now likely to be higher, depending upon the actual project and the credibility of the investor.

Furthermore, while balance sheet financing is also not uncommon, financial institutions tend to require investors to obtain assurance from the state in which it undertakes to purchase the goods and services produced or provided in the course of operating the project and thus to enhance the return of credit. In addition, financial institutions are not satisfied any more with the project itself, as security; they more often require investors to provide sponsor securities, such as suretyship or bank guarantee as securities that are independent from the project.

Reluctance to finance

As far as the financing side is concerned, banks, as a result of the financial crisis, became somewhat reluctant to apply project finance techniques; as mentioned earlier, only operating projects are typically financed on a continuous basis. Furthermore, even if financial institutions would have the opportunity to use project finance schemes and would actually choose to do so, the terms and conditions of the financing structure would differ from those which existed before the decline, basically because financial institutions would likely endeavour to reduce their own risk and shift such risks to the investors as much as they can.

According to market analysts, the main trends that will likely prevail in the future relate to the amount and

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structure of financing. Typical amounts of contribution will presumably not exceed €30 to 50 million, and only with a higher involvement of investors' funds; projects of a higher value and especially those of a value of around €200 to 300 million (if any) will be unimaginable without the involvement of EIB, EBRD or export credit agencies.

As far as the financial structure is concerned, the dispersion of hybrid financing structures can be prognosticated on a middle term, which involves both cash-flow and balance sheet financing. It is also likely that for the purpose of cost efficiency huge contractual structures will not be preferred by financiers and thus master contractors may be left out from project implementation. An example of this contractual structure was applied recently in the case of the Metro 4 project in Budapest, where different contractual packages were concluded on different levels of implementation, without the involvement of a master contractor who would have been in control of the whole project. This solution, however, inevitably increases the risk of opacity.

As to crediting conditions, there is no prescribed threshold above which a loan was regarded as a project finance loan; however, some banks, depending on the project, recommend a project financing facility above an investment value of €750,000 to €1.75 million, while other banks choose to go down the project finance route only for deals above €3.5 to 4 million.

Typically, the investment value of domestic projects earlier fell somewhere in the €7-8 million to €40 million range, though projects of between €40 million and €240 million were also not uncommon.

The term of loans usually ranges from between three and 15 years, with a grace period of between one and four years depending on the nature of the project. Earlier, the term tended to differ in case of real estate financing, where it was shorter, usually one to three years. In the near future, however, financial institutions would presumably not undertake financing for more than 10 to 15 years and therefore mini-perm structures are expected to universalise.

The currency of the loans usually corresponds to the currency in which the investment relates, or to the currency of the future revenues from the project, or else is determined based on the method of indexation. Up to the decline most loans were euro- or Swiss franc-based, but loans based in other foreign currencies could have also been taken up, and multi-currency loans were also increasingly popular. These trends are not likely to change; however, continuous instability of the euro/forint exchange rate is of a high risk considering that revenues are mostly realised in forints.

The interest and premium conditions vary depending on the risk of the project. In the riskier periods of an investment, these tend to be higher than in the payback period when the project usually generates income and hopefully turns a profit. For a single bank, the rate of the interest premium – which, despite the risks of such projects, made participating in them an attractive proposition for the banks – varies from between 0.7% and 2% which has recently been supplemented by additional charges levied by financial institutions in consideration of the risk of the project.

Due to the high risk of investments and the large value of the loans involved, syndicated lending – where several banks participate in the financing and share the associated risks, with one bank as lead manager – also became popular in Hungary. In fact, due to the strict lending limits on individual banks and to prudential requirements prescribed by law, syndicated loans were often the only option. Where the value of the project was between €8 million and €40 million, there were usually between one and three financial institutions involved. If the value exceeded €40 million, the number of banks was usually anywhere from four to 20.

There is also a particular form of multiparty financing where the participating lenders do not contribute to the financing at the same time but chip in at different stages of the project. This was typically the case in real estate investments. First the real estate company developed the property using the cash provided by a bank and, once the construction phase was over, during the operation period, a leasing company financed the project. Thus the construction and the operation phases were clearly separated in terms of both the form of financing and the financiers.

As far as financiers are concerned, in the last years not much change has been experienced. High-value investments are usually implemented with the help of loans provided by financial institutions. Hungarian commercial banks have added project financing to their roster of lending products which are mostly very similar due to the intensity and transparency of competition. In addition there are also some private equity funds operating in Hungary, though their role in project finance is not significant.

By contrast, the national development bank (the Hungarian Investment and Development Bank) plays an important role especially with regard to the implementation of domestic regional investments. Its involvement, however, occurs only on a case-by-case basis, in accordance with its in-house policies applied in connection with project financing. Apart from this it was also typical for loans to be taken up from foreign banks or from development financial institutes operating in other countries.

Energy industry: a typical example

A recent typical example of the reasons and circumstances of fallback in terms of the use of project finance tools appeared in the energy industry. Earlier highest volume investments in Hungary were implemented within the energy sector, especially with regard to the establishment of power plants using renewable resources. Power plants producing electricity from such renewable resources are supported by a so-called mandatory transmission system which implies that electricity produced from renewable resources (including electricity produced jointly using natural gas resources) must mandatorily be taken over by the transmission system operator and other participants within the transmission system.

According to a recent proposal by the government, however, as from July 1 2011 such mandatory transmission system will be terminated and changed. This will definitely have a serious impact upon electricity prices, among other things. After the government announced its plans to the market, the financing of one biogas project was cancelled by a commercial bank, since financing such projects is

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of a high risk before the actual change of the mandatory transmission system. Thus, pursuant to regulatory uncertainties in the energy sector, both investors and financiers are waiting and projects are stagnating, at least until the relevant new laws come into force.

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Expectations

According to market analysts, recovery in the project financing sector cannot yet be prognosticated. While some projects have recently been announced by the government (such as the Nabucco gas pipeline project which aims to establish a high capacity gas pipeline between Turkey and Austria, through Hungary, or the overall development of the Hungarian railway system announced to be carried out by Chinese investors), their financing structure is not likely to involve project financing methods by banks, but rather financing facilities by the EBRD and significant risk taking by the government.

Furthermore, the general approach within the government is that small and middle-size projects should be promoted first, in order to facilitate general economic recovery within the country. For the purpose of promoting such recovery, the government recently introduced the so-called New Széchenyi Plan, which is a specialised tender system for the purpose of allocating governmental subsidies.

Some government measures announced lately also do not enhance the spread of project financing. A typical example is a plan popularly referred to as the mall-stop plan, according to which investments aiming to establish shopping centres above a certain size would not be authorised.

On the other hand, some positive legislative measures have also been taken in the last year which may facilitate higher value projects.

First, the government prepared and submitted to parliament a proposal for a new public procurement act which would significantly change the current public procurement system, aiming to make it simpler and more effective. In some respects the proposal received negative attacks, because it does not seem to treat step-in rights of financial institutions in the framework of public procurement investments properly, for example.

Second, last year the government amended the legislation on facilitating building projects qualifying as important in terms of the national economy, which makes it possible to obtain all necessary permits related to building projects in one and the same proceeding.