In Practice

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Restructuring natural resources projects in the emerging markets: features and challenges, Part 1

KEY POINTS

- Falling commodity prices pose serious challenges for many natural resources projects as they struggle to meet debt payment obligations. Restructurings in this sector can give rise to a number of issues and these require unique solutions.
- The tried and tested approach of restructuring businesses in developed economies must be adapted for emerging markets, reflecting different legal, political and economic landscapes.
- Consideration must be given to funding sources – limited commercial bank funding for natural resources projects in emerging markets means many projects have turned to alternative lenders, who introduce different dynamics to a restructuring process.

The period since the start of the financial crisis in 2007/2008 has seen a great number of high profile restructurings in the UK, US and elsewhere. In the case of regulated industries such as banking and insurance, these have often seen intensive regulatory intervention. In other sectors intervention may be less frequent, but even in the corporate restructuring of Hibu, the Yellow Pages publisher, the Bank of England saw fit to discretely intervene with creditors.

However, restructuring professionals are now starting to see a different species of emerging market project finance restructurings land on their desks, which generally stay off the radar of regulators. During the post-2008 financial crisis, natural resources projects in the emerging markets generally delivered strong, counter-cyclical, financial performance on the back of high commodity prices. With significant downturns in pretty much all commodity prices (at the time of writing, in the last year Brent crude down approximately 42%, copper down 10%, gold down 7%, coal down 27%, iron ore down 45% and titanium down 10%), projects that previously presented robust debt cover to the project finance market may now be struggling to meet debt payment obligations while maintaining operations and meeting contractual supply commitments. Even a project with strong and effective management and sound operations may struggle in the face of a severe downturn in the price of its key product.

When these projects are in developing economies, the reasonably tried and tested approach to restructuring for a business in a developed economy is unlikely to work without significant adaptation to suit the unique features and circumstances of businesses of this kind. As will be explained in this two-part article, which will conclude in the next edition of CRI, getting to an agreed restructuring arrangement ahead of insolvency by way of a pre-pack may not be possible in many emerging market countries. Insolvency laws there are likely to be insufficiently developed and may well be an impediment to a long term restructuring of a project. Given that so many projects are dependent on concession agreements and similar key licenses, a change of ownership implemented through a debt to equity swap may also mean that governmental and/or ministerial consents are required to facilitate a fundamental financial restructuring that results in a transition of ownership away from the existing sponsors. Governments may potentially seek a degree of protection for local creditors and local labour and empowerment laws may also make a restructuring difficult to accomplish, especially where empowerment laws have created a diversified shareholder structure and shareholder consent is required in order to execute all of the terms of the restructuring.

A key initial factor to consider here will be whether the company involved has multiple assets/projects across different jurisdictions (the 'corporate' model) or is a single asset borrower with limited recourse project finance debt (the 'project' model). In the case of the latter, the next issue to consider will be whether the project has achieved 'financial completion' (has been built, become operational and passed various other tests permitting release of the sponsor's/developer's completion guarantee) and has therefore become non-recourse to the project sponsors/developers. If not, in the event of an unremedied default lenders will have recourse to the sponsors for repayment of the debt under their completion guarantees. However, this may be of limited value if the sponsor is a mining or oil and gas 'junior' with a limited balance sheet (beyond the asset being developed), or if the ultimate shareholders, including institutional shareholders, are unwilling to commit further equity to protect the asset in a severe commodity price downturn.

In terms of restructuring solutions, an oil and gas or mining project may have a 'major' sponsor (many of whom have come out of recent years with robust balance sheets) willing and able to deleverage projects to maintain debt cover. Similarly, a project may attract the attention of one of the new specialist commodity funds that have been established to invest in the distressed commodities space. In our representation of such funds we have seen that for high quality projects substantial capital may be invested. Equally, institutional shareholders or strategic investors holding impaired project or high yield bonds in an emerging market commodity company or project may be willing to commit substantial new money to a project in order to maintain their economic

Biog box

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interest. In light of the prolonged decline in commodity prices, such investments are not always easy to execute. The growing concern is that absent these capital solutions, lenders may find themselves confronted by a non-supportive or impecunious sponsor in unfamiliar and difficult terrain as they attempt to deal with a restructuring in a very different legal, political and economic environment to those applicable to a corporate with a generally OECD-based business.

LENDER DYNAMICS

Country limits and political risk issues have generally resulted in limited or constrained access to commercial bank 'uncovered' funding for natural resources projects in the emerging markets (although admittedly this varies and projects in more established Latin American, Middle Eastern and CIS markets may well have access to significant uncovered bank debt). Also, recently the bond/high yield market has generally been closed or highly constrained for projects of this kind, save in a few examples where the project has reached financial completion and high yield notes have been issued as part of a refinancing. However, for newer markets in Africa and elsewhere projects have most commonly been funded by some combination of:

- political risk absorbing Export Credit Agencies (ECAs), such as United States Ex-Im, COFACE of France, Hermes-Euler of Germany, SACE of Italy, ECGD of the UK and others, either as direct lenders or as insurers of commercial bank debt;
- Development Financial Institutions (DFIs), such as IFC/World Bank, European Investment Bank, European Bank for Reconstruction and Development, and African Development Bank;
- specialist funds such as Emerging Africa Infrastructure Fund, Africa Finance Corporation and others;
- commercial banks, either with or without ECA guarantees/insurance.

Dealing with a lender group comprising some or all of these lenders will introduce a dynamic to a restructuring which is very different to that in a commercial bank/ bondholder process. Factors to consider include:

Loan transfer restrictions

Recognising sponsor sensitivity to the relationship issues inherent in working with an ECA/DFI focused lender group, lenders may have agreed to terms that restrict loan transfers without borrower consent. Even if this is not the case, taking into account the next issue mentioned below, ECA and DFI lenders may be more reluctant than commercial banks to sell debt to specialist funds and 'loan-to-own' investors. This reflects the potential reputational and political fall-out that might arise should transferees of this kind prove to be obstructive 'hold-out' creditors, whose position can be traced back to those original holders who, by their own lending policies, are obliged to fulfil social and development objectives.

Development mandates and policies

Certain of these lenders may have policy objectives that go beyond the obvious lender aspiration to get repaid with interest and earn fee income. For example, the African Development Bank's Private Sector Development Policy and the environmental and social policies of practically all DFI and ECA lenders impose policy based constraints on lending terms. Allowing transfers to lenders who do not hold the same standards and objectives may be problematic for these lenders. In addition, for these lenders to embark on a hostile restructuring strategy or to withdraw funding support or enforce security/ sell the project to a new owner may be problematic given potential concerns about the approach that a successor owner may take to environmental and social issues. These policy concerns may make these lenders substantially more 'gun shy' than commercial banks and bondholders in respect of a conventional OECD business.

Decision-making processes

Not all lenders of this type will have specialist restructuring teams and, indeed, many may have very limited experience of the loan restructuring process. In addition to making them more dependent on their external advisers (legal, financial and technical – and the choice of these may prove to be a key factor in the prospects for success of the process), it also means that the decision making process may be much more deliberate and slower than might otherwise be the case (and these lenders may be resistant to the idea of operating a more agile creditors' steering committee or similar, insisting that they all want a 'seat at the table'). This will all be in the context of a project finance covenant package which, in varying degrees, will constrain the borrower from full commercial flexibility, for example in how it deals with its contractual counterparties and offtakers, prioritises payments and so forth without lender consents and waivers.

Intercreditor issues

Procuring collective lender alignment on the overall approach and restructuring strategy may also be difficult: for example, commercial banks, ECAs and government supported DFIs with differing agendas will find it much more challenging to approve a scheme of arrangement or similar cram down. These difficulties are likely to be compounded where the project lenders are obliged to meet the exacting requirements of risk-absorbing insurers and ECAs as a condition of their continued underwriting of the project debt. Against this back drop, face-to-face meetings, thoughtful sponsor presentations and overall relationship management by the sponsor are likely to be key to the success of the process. Generally, a project finance borrower is likely to have built up a strong working relationship with each key lender over the course of a project finance process, and continuing to nurture these relationships through the restructuring process will be vital to the project as it enters a more challenging economic environment.

PART TWO

In the concluding instalment of this article, the authors consider country specific issues, the engagement of CROs and director issues, and the opportunities for potential buyers, new equity and strategic investors. ■