

The New Key to Asian Financing Today

by

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Foreword

The new key to Asian financing today

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Asia's future looks bright...

It is a very widely held view among economists today that Asia will be the fastest growing area of the global economy over the next five years. Estimates start at a growth rate of 6.1% and range to levels much higher. As such, Asia is expected to serve as an important engine of growth for a global economic recovery.

To be certain, the potential is there – as is the demand for new investment. In the years since the 1997 financial crash, there has been a real drought of investment across many sectors of the Asian economies. But the tide has turned and investment is beginning to flow back again. It has been estimated that the levels of new investment into the Asian capital markets have equaled US\$3bn so far this year, which is roughly five times the level of cross border investment in 2003. This reflects the current economic recovery, and demonstrates some of the regulatory reforms that are taking hold.

But in the infrastructure sector the picture continues to look gloomy in many countries. By some measures, in the next 20 years Asia will require as much as US\$3.5 trillion in new infrastructure investment alone. At the same time, banking institutions across Asia are flush with liquidity. The funds available for such infrastructure investments are sitting idle.

...but there is something missing

Between the demand for investment and the supply of funds, a critical element is missing. Its absence is suffocating the needed investment activity. In a word, it is *confidence*. Without confidence, the needed equity for new infrastructure investment is not, and will not be, accessible. Hand in hand with that equity investment, of course, goes the necessary technical and managerial

expertise to actually get projects off the ground. Most of the large international companies that provided critically important leadership for infrastructure projects of all types have left the international scene. Their experiences in the region were almost universally bad, and the majority have retreated to their home countries to recover their financial health.

There are two key factors that explain the failure of so many international projects, particularly as related to the capital-intensive industries. The first is the lack of a solid and dependable regulatory framework in many sectors. Foreign firms have historically invested in the comparatively unregulated environment of emerging countries, hoping for the best. Again and again, however, they found themselves subject to the whims of host governments that failed to honour underlying contracts, or that felt free to change the regulations governing investments. After sinking into trouble one too many times, most players in the investment community have fled. They now are busy repairing the damage suffered to their corporate balance sheets. The mere mention of new international investments would be enough to send their investors rushing for the door, and their stocks into a tailspin.

The other reason major projects have suffered is that investors have been forced to invest using hard currencies in economies where there is no capital market to either provide long-term local currency loans or to allow investors to hedge foreign exchange exposures. The result has been financing mismatches that have seriously undermined, or in many cases destroyed, the economics of cross border investments. This is particularly true in the less developed countries. One of the most common characteristics of emerging economies

is that their currencies are prone to weakness and their interest rate environments are highly volatile. Thus, even if local currency financing is available, it is only available on a very short-term basis, exposing investors to the risks of refinancing and interest rate volatility.

To manage these problems, the risk premiums that companies must charge to make a potential investment financially and economically viable are quite high. As a result, the tariff or charge that they must pass along to their customers is, accordingly, very high. For this reason, the likelihood of success for such investments is that much lower. Without investment activity and proper infrastructure spending, a country faces the threat of stagnation.

In the past, governments have stepped in and funded the country's infrastructure needs themselves. But, in large measure, that day is passing. Many governments are saturated with hard currency debt and cannot take on more. Many have also learned the hard lessons of the 1997 financial crash, and have vowed not to leverage themselves as they previously might have. They have deliberately decided to limit new indebtedness and thus constrain their own spending.

The result is a vacuum that threatens the future growth predicted so confidently by economists. If the electric power needed to run the communications and computing of modern businesses (as well as the day-to-day activities of a modern economy) is not available, growth will be severely constrained. The same case can be made for water, communications and transport infrastructures. One of the most important questions asked by investors when deciding where to locate new plants and equipment is, "What is the quality of the host country's basic infrastructure?"

The new cornerstone of project finance

So where does this leave us? Fortunately, there is an alternative to this rather grim picture. In the last few years, the Asian Development Bank has devoted a good deal of its energies to the promotion of its private sector activities. In the face of the problems described above, the ADB is now uniquely positioned to provide a bridge across these problems.

At first blush, one is hard-pressed to understand how a development bank can help provide the answer. Who needs yet another funding source in the face of so much bank liquidity in the market? Indeed, one could very

legitimately ask how such an institution can provide all the financing for the immense infrastructure needs of the years ahead. The fact is that it cannot – and no one institution can. But the ADB is in a position to provide something that is, in a very real sense, far more strategic and important.

Indeed, if one looks at the ADB merely as a source of funds, one is missing the true picture. We in the private sector arm of the ADB strongly believe that *money is not our core product*. Money is, of course, always important. The ADB is fortunate in that it has the full toolkit of financial products, i.e. debt, equity, mezzanine finance, political risk insurance, as well as partial credit guarantees. But if we were forced to compete purely on the basis of cash, we would be struggling in today's markets. Money is an over-abundant commodity. To compete solely on this basis is to ask for trouble and failure.

The real question is not what the ADB's private sector department can provide, but what the ADB can help *enable*. In a very real sense, the ADB is addressing a larger strategic issue – namely, promoting the idea that the best governmental action is *not* the provision of societal goods and services. The private sector has shown time and again that it is far more efficient at this task. On the whole, those governments that function best are those that seek to create a proper enabling environment for the private sector. In this area in particular, the ADB is uniquely situated to make a difference.

Instead of cash as our mainstay, we view ADB's Private Sector Department as providing a critically important element – what the bank refers to as *private sector development*. Because the ADB enjoys the support of virtually every country in the region (indeed, they own the bank), and because we have a 40-year track record of working with the region's governments on developmental issues, we have long been viewed as an honest broker and a partner in development. To a much greater degree than any private interest or company, we can go to our member countries and provide advice on existing regulatory frameworks and the need for reform. Coming from us, such a message will generally be well received. The identical message delivered by a private party will usually be treated as an attempt by the private sector to line its own pockets. In this manner, we can help work to improve the regulatory regimes of the projects at hand, as well as future projects in the same sector. This same honest broker role goes a very long way to helping facilitate the privatisation of government services or

assets. Taken together, we can help facilitate a greater inflow of direct foreign investment.

It almost goes without saying that knowledge transfer is a related core 'product' of our activities as well as that of all of our sister organisations. Concepts such as cash flow analysis, risk management, credit assessment, etc., which we regard as workaday tools of finance are virtually unheard of in many countries. We can help, in very large part by introducing such concepts and by helping identify the 'right questions to ask', always 90% of any task.

Another aspect of private sector development is *risk mitigation*. With regard to risk mitigation, there is a great deal of evidence demonstrating that ADB's entrance into a transaction changes the dynamics of that transaction. For a variety of reasons, the ADB's mere presence can go a long way towards staving off capricious government intervention. Governments in emerging markets far too often do not have a well-conceptualised or articulated set of regulatory frameworks. Thus, projects are subject to new priorities, policies and government pronouncements. The ADB's presence can help protect projects from volatile government intervention. The ADB's involvement in a project acts as a stamp of approval, indicating the international community's imprimatur and support. To interfere with the project is to invite the disfavour of the 63 nations that make up the membership of the ADB.

In other cases, the ADB has succeeded because of the values it, as an institution, espouses. For example, the ADB is known to be very strict on environmental issues. One might think that this acts as a hindrance to our private sector activities. Quite to the contrary; we have seen numerous instances in which our presence is heralded as a public certification that the project at hand is as environmentally friendly as current technology will allow. This serves to free up private sector funds to come in and public concerns to be allayed. This is yet another facet of risk mitigation.

Are these ironclad guarantees of success? Hardly, but they add another dimension that is far, far better than going it alone.

Local currency financing

As noted earlier, one of the most pressing problems facing cross-border investors has been currency risk. Where there are local bond markets, investors have available a mechanism to obtain long-term, fixed-rate local currency financing. But in smaller countries, there

are usually no such options. They then face a no-win situation. They can accept the risk of converting hard currencies into local currency for domestic needs, and hope they don't run into trouble when they seek to repatriate those funds.

Alternatively, they can accept the short-term local currency financing available in the local financial market and absorb the refinancing risk and interest volatility associated with such funds. Either way, they are taking on a significant financial risk, which will be factored into the risk premium needed to safeguard the cash flows of the project, and to cover the economics of the full transaction in order to make it viable.

The ADB has recently devised an elegant way of cutting through these risks. For the first time, we are now in a position to provide long-term, fixed-rate local currency financing in those countries that do not, as of yet, have a functioning capital market through which to do a bond issue. The full details of this methodology are provided in a paper entitled, "*The Local Currency Financing Revolution*," which is available on the Private Sector Department's section of the ADB's website. (http://adb.org/documents/others/local_currency_financing.pdf)

The ADB has stepped up to the challenge of the market and provided a service that fits very well with our risk mitigation and private sector development products. With this instrument, we are both eliminating a major component of the risk of a project in an emerging country, and also helping the development of a capital market by stimulating the use and acceptance of longer-term monies.

The effective use of this instrument, however, is only possible through a very close partnership with the host government.

Public-private partnership is the key

This local currency financing model works because of one very important factor – the ADB has forged a strong internal public-private partnership (PPP) tie within the ADB, with the governments of the countries in which we operate, with our sister bilateral and multilateral institutions, and with the business community. If we did not have those partnerships, we would be struggling to find a role with money as our only product, and seeking to compete with the private sector banks in an already overcrowded commodity market. We reject that model,

as it violates our core precept of not crowding out or competing with the private sector.

Indeed, public-private partnership is an important remedy to the fundamental problem of confidence in today's Asia. Only the private sector can provide the trillions of investment dollars needed in the foreseeable future. But the current rules of the game do not inspire confidence. To address this confidence problem, we intend to use the weight of the ADB and our member countries' **public sectors to enable** a change in the environment. That in turn will help clear the road for the **private sector to provide** financing, as well as goods and services.

The critical missing piece in the markets today is public-private partnership. This term has been overused to the point of becoming a cliché. We are now in a position to turn it into an effective and forceful reality. This formula is undoubtedly of equal value in other regions of the globe.

The natural extension to the above discussion is to ask where the ADB's Private Sector Department should be working to maximise its natural advantages. With limited resources we need to prioritise. From our perspective, the answer is clear. Our core competence and greatest market advantage occurs where there is an overlap between the public and private sectors. Stated another way, we should be seeking to work where there is a large regulatory component to the industry. This is certainly true and most easily seen in industries such as the power sector, the water sector, transportation, the banking sector, etc. Financings at point A in Figure 1 have, in some cases, the potential of crowding out the private sector.

We often quote the phrase we hear from the private sector, "If the ADB is in we are in. If the ADB is out, we

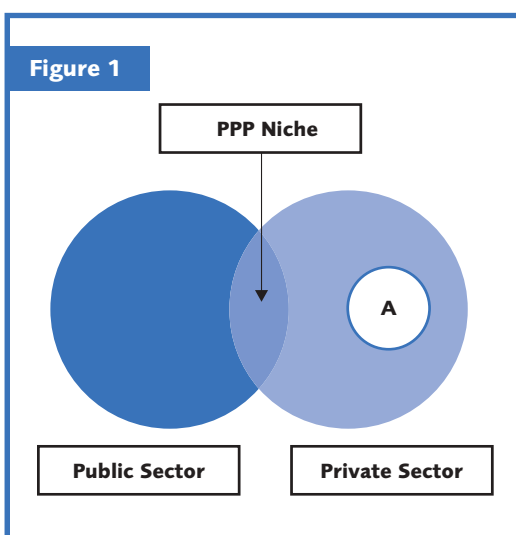
are out." Is this universally the case? Absolutely not. But it is certainly true and we hear it most often when we are operating in the core market niche shown in Figure 1.

One of the chief characteristics of Asia is, of course, the diversity of the region. Our market niche – where we can act as risk mitigators for the private markets or enter into regulatory dialogue with governments – is very large in some Asian countries, and very small in others. In between the extremes of Afghanistan and the wealthier countries of Asia lies a wide spectrum. With a territory that spans from Azerbaijan in Central Asia to Vanuatu in the Pacific and beyond, the ADB must deal with each country's own issues and needs.

The ADB is at a unique time and place in its history. Public-private partnership alone can fill in the current confidence gap that is suffocating the free flow of capital investment into the emerging countries of Asia. In Asia, the ADB is uniquely situated to provide that link. The public sector sees us as the bridge to the private sector; the private sector views us as a bridge to the public sector. No other institution in Asia is as well positioned as the ADB to offer this critical service of facilitating public-private partnership, both now and in the future. The ADB fully intends to play just such a role on Asia's stage.

Note

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