Asia Pacific Projects Update

FINANCING PETROCHEMICAL PROJECTS IN CHINA – A SPONSORS' PERSPECTIVE

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Although the nature and function of petrochemical processes and products is often a very unfamiliar subject to the average person working outside the chemicals industry, petrochemicals and the end–products that they make possible are an integral part of modern life. Petrochemicals (which are quite simply chemicals derived from petroleum or natural gas) are critical components of the plastics we use in our home and office, the advanced fibers in the clothes that we wear, and the pharmaceuticals that treat our ailments.

China, due in no small part to heavy demand from its massive manufacturing and textiles sectors, is home to the world's largest and fastest–growing petrochemicals market[1]. In the last decade, China's demand for basic petrochemicals and the most commonly used plastics have tripled. The Chinese government has also been paying attention, liberalizing rules and policies to encourage the high level of participation from multinational energy and chemicals companies to continue.

The industry is highly capital–intensive as petrochemical facilities often cost hundreds of millions or even billions of US dollars to build and operate. Thus, financing from domestic and international financial institutions are commonplace. Depending on the nature of the project, creditworthiness of the project sponsors and perceived risks to the lenders, such financing may be as simple as a bilateral working capital facility used as a cash flow contingency or as complex as a full scale syndicated project financing involving nearly all of the major domestic Chinese banks and several international lenders. Regardless of the type of financing used, ensuring that a given project is bankable and that the objectives and concerns of major lenders are adequately addressed is

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[1] "Research and Markets: Analyzing the Petrochemical Industry in China 2013" (January 11, 2013) BusinessWire Report. http://www.businesswire.com/news/home/20130111005409/en/Research-Markets-Analyzing-Petrochemical-Industry-China-2013

often an inescapable characteristic of petrochemical projects in China.

China's lending market has been constantly evolving from the early years where project finance was a completely foreign concept and often international lenders played the most important roles (such as lead arranger and facility agent) in syndicates. In recent years, domestic Chinese banks have grown to be increasingly more sophisticated and commercially driven and have become the primary source of funding for most large–scale petrochemical projects. China's ongoing bank reforms also provide increasing flexibility to the petrochemical project finance arena. On July 19, 2013, the People's Bank of China ("PBOC") announced a few measures to further liberalize China's lending interest rates effective from July 20, 2013. The removal of lending interest rate "floor" which was previously 30% below the PBOC benchmark rates opens the door for banks to further reduce interest rates in fierce competition for deals. However, such a drastic reduction in borrowing costs is not expected in the short term due to a general lack of liquidity recently amongst domestic banks.

This article discusses some of the key steps to be taken and key issues faced by sponsors in financing petrochemical projects in China. We have endeavoured to provide a very condensed introduction to a highly complex and voluminous subject matter.

THE PROJECT SPONSORS

Joint ventures between Chinese and foreign parties

Although small–scale projects (often for the production of highly specialized chemical components and additives) may sometimes be entirely built and funded by a single project sponsor, most production facilities that process basic petrochemicals (such as ethylene, propylene and benzene) are structured as Sino–foreign equity joint ventures between major Chinese state–owned energy majors and international energy or chemical companies. This collaborative approach allows the Chinese party access to world–leading technologies and processes, ensuring the construction of an efficient, high–yield facility. At the same time, foreign parties have the support of an experienced local partner that can assist with what could otherwise become time–consuming impasses, such as sourcing skilled employees to operate the facility, obtaining necessary infrastructure allocation, applying for necessary approvals and liaising with local and central level regulatory authorities. Moreover, since financing from domestic Chinese banks usually make up a substantial portion (if not all) of the loan proceeds that fund project construction, Chinese sponsors are often able to leverage existing bank relationships to achieve preferential financing terms for the project company.

Characteristics of Chinese SOE partners

The largest and most experienced Chinese SOEs in the petrochemicals sector are led by China Petrochemical Corporation (commonly referred to as "Sinopec Group") and on a slightly smaller scale China National Offshore Oil Corporation (commonly referred to as "CNOOC Group"), although several other SOEs are also very active.

As equity interests in joint ventures in the petrochemicals sector are often held approximately 50/50 between the Chinese and foreign partners, effective governance is naturally a key concern for all sponsors involved. Domestic Chinese energy and chemicals companies have gained considerable experience in building and operating world class petrochemical facilities over the past two decades and foreign sponsors are now finding their Chinese counterparts to be increasingly sophisticated, making it easier to establish trusted working relationships that are essential to the success of such projects.

Due to the symbiotic nature of petrochemical joint ventures, Chinese SOEs will often conduct substantial technical, financial and market due diligence on their potential foreign partners, above all ensuring that they are working with the most well–positioned player for the specific type of facility being built.

KEY APPROVALS AND THE REGULATORY FRAMEWORK

The Foreign Investment Catalogue

The foreign investment approvals regime in China essentially revolves around the Foreign Investment Industrial Guidance Catalogue (the "**Catalogue**"), a policy document periodically released by China's central government (and last updated in 2011). The Catalogue classifies foreign investments into the following categories according to the industry sector in which the investment is proposed to be made:

- "encouraged";
- "permitted";
- "restricted"; or
- "prohibited".

Different categories of foreign investments will be subject to different levels of approval scrutiny and application requirements. Generally speaking, foreign investments in the petrochemical industry are either "encouraged" or "permitted" under the Catalogue.

Key approvals for foreign investment in petrochemical industry

Foreign investments in petrochemical projects shall be subject to the following key approvals and regulatory framework:

- **Project approval**

  The National Development and Reform Commission and its local counterparts (the "**DRC**") are responsible for approving all major fixed asset investment projects in China, regardless of whether such projects contain a foreign investment element. The DRC is a unique feature of China's still centrally–planned economy, and is one of the primary ways by which government authorities determine which fixed asset investments go ahead and when. Due to the powerful and influential nature of the DRC in China's government apparatus, DRC project approval is by far the most important approval to be obtained, and is a key condition to the remaining investment review process. Furthermore, since DRC approval is largely discretionary in nature, domestic Chinese banks view this as a crucial step that indicates whether a project is financeable.

  The key application document to be submitted to the DRC is a feasibility study report, which is a highly detailed study that defines the scale of the project construction, the technologies being used, the amount of total investment and registered capital needed, the details of any proposed debt financing, and, much like a business plan, the commercial "business case" for the project demonstrating how and why the project will become a profitable venture.

- **Other key approvals**

  Prior to and sometimes concurrently with seeking formal project approval from the DRC, the project sponsors will prepare and submit various other key application documents to relevant government authorities, such as the Ministry of Environmental Protection and the Ministry of Land and Resources (Planning Department).

- **Establishment of the joint venture**

  Once the DRC grants a formal project approval for the petrochemical facility, the sponsors are then able to apply to the Ministry of Commerce or its local counterparts ("**MOFCOM**") for establishing the joint venture project company. Where the proposed project will be built by an existing joint venture, such as in the case of a project expansion, MOFCOM approval must be obtained for increasing the existing joint venture's registered capital and total investment amounts, as well as to amend the joint venture contract and articles of the company.

- **Registration with the State Administration of Industry and Commerce ("AIC"):**

  After obtaining the approval certificate for the establishment of the joint venture, it is necessary to apply for registration with the AIC or its local counterparts and the issuance date of the business license is the date the joint venture is formally established.

It is worth noting that the above approvals and licenses are the key documents that will be reviewed by lenders for the purposes of their internal credit approvals and conditions precedent. As project approval by the DRC is the most significant approval and often determines how the other applications will fare, it is a common approach for the substantial financing negotiations to begin only after DRC approval is obtained, so as to fully leverage the lenders' interest in the project to quickly negotiate the financing terms and reach financial close.

TYPES OF FINANCING STRUCTURES AND DEBT LIMITS

Debt limits of the project company

Under PRC law, a joint venture's registered capital represents the equity that the investors hold in the joint venture. Registered capital and debt together make up a joint venture's total investment amount (which effectively corresponds to the planned scale of its business operations).

Appropriate amounts of total investment and registered capital must be determined before applying to establish a foreign invested enterprise ("FIE") such as a joint venture project company between domestic and foreign sponsors. A minimum ratio of registered capital to total investment is required under PRC regulations. The ratios are as follows:

Total Investment	Registered Capital (As percentage of total investment)
Up to US$3 million	At least 70%
Over US$3 million up to US$10 million	At least 50% (minimum of US$2.1 million)
Over US$10 million up to US$30 million	At least 40% (minimum of US$5 million)
Over US$30 million	At least one–third (minimum of US$12 million)

FIEs are not required to submit information to government authorities about loans borrowed from domestic financial institutions and therefore will not be subject to the above restrictions on the debt–equity ratio. On the other hand, the amount of debt borrowed from foreign financial institutions and lenders is actively monitored in accordance with the above requirements and must not exceed the difference between the FIE's total investment and registered capital.

Types of security arrangements

While unsecured facilities are sometimes available to petrochemical borrowers, lenders would generally require that the project company be fully operational and generating healthy revenues and cash flow before considering offering such a facility. Thus, the vast majority of financing in the petrochemical sector in China involve some combination of the following types of security arrangements:

- **Parent company guarantees**

  Due to the high level of risk present during the construction period, lenders involved in financing greenfield petrochemical projects will often ask for some level of parent company support, either in the form of a guarantee for the entire debt of the borrower, or in the form a completion guarantee that secures the loan until the project becomes operational.

- **Security in project accounts**

  Also omnipresent in financings of greenfield projects is security in the bank accounts of joint venture borrower in the form of a project accounts agreement. Through the facility agent and various account banks, the borrower's day to day transactions are closely monitored and regulated to ensure compliance with the borrower's covenants in the finance documents and that, upon a default situation, the borrower's funds can be quickly directed towards repayment of the facility.

- **Security in project assets**

  Whether security is envisioned in project assets that have yet to be created (such as in a greenfield project) or in existing project assets (such as for the financing of a project expansion), security in project assets is the most common type of security arrangement taken by lenders in petrochemical financings. However, the notion of security in "project assets" can refer to a wide variety of security interests. Common security components include: security in buildings and land use rights, security in accounts receivable, security in equipment and other movable property, and security in inventory. As an indication of growing sophistication of sponsors and domestic lenders in China, non–recourse off balance sheet project financing has become increasingly common approach for financing new projects. In such structures, security in project assets is often required in conjunction with a project accounts agreement.

Currency of the facilities

Project companies commonly borrow funds in both Renminbi and US dollars, depending largely on how their expected capital costs are allocated. In practice, the currency of the loan is likely to depend on the project needs and are taken into consideration along with the project documents. For example, if the joint venture enters into an equipment purchase agreement or a technology licensing agreement with foreign companies and needs to make US dollar payments under such agreements, it would be appropriate for the joint venture to ensure that such amounts are taken into consideration when designing their US dollar facility.

Domestic debt and foreign debt

As mentioned above, a joint venture can borrow funds from both domestic and foreign lenders as long as foreign debt amounts comply with regulatory requirements for minimum debt–equity ratios.

However, while only the foreign debt of the joint venture is actively monitored and restricted, financing from domestic banks will also be subject to similar limits due to restrictions imposed upon lenders by China's banking authority the China Banking Regulatory Commission ("**CBRC**"). The CBRC also requires banks to closely monitor how loan proceeds are utilized by the borrower, particularly where the relevant loan drawdown is more than RMB5 million.

Term facilities and working capital facilities

Due in part to the fact that the feasibility study report submitted for DRC approval (as mentioned above) often indicates not only the total capital costs of a project but also the initial working capital funding required to bring the project into operation, many financings of greenfield projects will include both a term facility and working capital facility. Less experienced lenders may take issue with committing to a facility that won't be drawn down until after the construction period, but such working capital facilities are nonetheless a commonly agreed feature of greenfield projects.

It is important that the sponsors ensure that the amount of the term loan facility, combined with the proposed registered capital of the joint venture, is adequate to fund the entire capital costs of the project (including any potential project cost overruns). This is because even though working capital facilities may be committed and available to the project company, according to stringent CBRC regulations, working capital loan proceeds cannot be used towards fixed asset investment.

MANDATING AND NEGOTIATIONS

China's major domestic banks

With the development of the current lending market in China, domestic banks have become the main source of funding for projects in China. The Chinese domestic banks have gained more experience and market influence as a result of their significant experience in funding projects.

The main domestic banks in China include: (1) Industrial and Commercial Bank of China, which is China's largest bank and often a mandated lead arranger in domestic project financings; (2) Bank of China, which is often seen as China's most sophisticated lender with a strong international presence; (3) China Construction Bank, which focuses on financing real estate and infrastructure projects; (4) Agricultural Bank of China, which traditionally has been concentrated on financing in the agricultural sector but has lately been expanding toward a full range of commercial lending capabilities; (5) China Development Bank, which is a large policy bank in China charged with providing development–oriented financing for government projects of national priority.

Timing the negotiation of the finance documents

As can be expected from a rapidly advancing banking industry as large as China's, the level of a lender's experience and expertise that sponsors encounter will vary greatly depending on factors such as the bank that has been chosen, whether the specific branch of that bank has had significant exposure to complex financings, as well as the role and competence of lender's counsel.

In most cases, domestic banks are only willing to seek internal credit approvals once they have received and reviewed the project's formal DRC approval. However, lenders are occasionally open to engage in negotiations on the finance documents when DRC approval is still pending. Such an approach would shorten the timeline required to reach financial close, though it may still be an open question whether lenders can be held to their pre–negotiated positions once the DRC approval documents are obtained. Regardless of the approach, sponsors would find it difficult to have any execution of finance documents take place until DRC approval is issued. Theoretically, sponsors could push the process forward by proposing that DRC approval documents be a condition precedent to the first drawdown, but in our experience, it would present a challenge to convince most domestic Chinese banks to formally enter into any finance documents at such an early stage in the approval process.

CPS AND FINANCIAL CLOSE

Generally speaking, the number and complexity of conditions precedent as required by lenders depends on the bargaining power of the sponsors and the strength of the project (taking into account current lending conditions). If the sponsors are in an advantageous position, the conditions precedent may be simple and it may not be difficult for the borrower to satisfy such conditions. However, if the financing market is not in favor of sponsors or the sponsors do not have a strong market position, the conditions precedent may be burdensome for the borrower to satisfy and it may be difficult to convince the banks to agree to waive such conditions.

Despite being the world's largest and fastest growing market for petrochemicals, financing petrochemical projects in China still presents many challenges that arise from an ever–changing regulatory landscape and a still–maturing lending market. However, as with all large scale projects, the involvement of numerous stakeholders from local to central governments, domestic to international banks, and feedstock suppliers to customers and end users, means that each project carries a unique set of obstacles to be overcome.