Snapshot of a growing market

Ernesto Bournigal Read and Ingrid María Jesús Rodríguez of OMG describe a project finance market where debt and equity opportunities are ripe for the picking

The Dominican Republic (DR) has always been one of the region's most attractive targets for foreign investment. Those investors should take a closer look at the country's project potential: project finance has become increasingly common, with both debt and equity opportunities. Here is a snapshot of the market, and how to navigate its hurdles and rewards.

IFLR: How has the DR's project finance industry performed over the past 12 months, and which sectors have been the most active?

The project finance industry as a whole has been somewhat less active than most years in the DR. Much of that is attributable to 2012 being an election year, with the months leading up to the elections providing uncertainty as to the outcome. With the exiting of one government, and an incoming government becoming familiar with pending authorisations and permits, the timing of some projects was most probably affected. Additionally, important restructuring efforts for various projects in the country have continued from 2011, and have certainly made financing for projects of a similar nature as those in restructuring (primarily real estate developments) difficult as well.

However, during the first semester of 2012 the DR government was very active in procuring financing for local contractors in order to finalise a nationwide initiative seeking construction, remodelling and paving of highways, streets and roads along the country. Additionally, the project finance market also witnessed key deals in sectors relating to steel, renewable energy projects, as well as more than one leveraged acquisition of fuel distribution companies, to name a few.

The second semester of 2012 has already provided at least two important refinancings of highly structured infrastructure projects, one of which was successfully able to place a 144A bond issuance of over $500 million. Furthermore, we have also witnessed large syndicated financings that are being placed for the purpose of toll roads in different sections of the country.

> **"The project finance industry as a whole has been somewhat less active than most years"**

IFLR: The DR has huge renewable energy reserves. What are the challenges to converting this into power?

The DR has passed legislation in order to permit sponsors to venture into new energy sources. The Renewable Energy Incentives and Special Regimes Law promotes private investment developed from renewable energy sources, and aims to promote social investment in renewable energy community projects. Such projects are obviously beneficial to the country, on the grounds that the installation of new renewable energy power plants will help generate local jobs, encourage agriculture and forestation and produce funds for social development.

Currently there is one operating renewable energy park in the DR, the Los Cocos – Quilvio Cabrera Park, located in the community of Juancho, Pedernales, a wind park with a capacity of 33MW, and designed to increase in the next years to 88MW. Likewise, there are two wind energy projects approved by the Inter-American Development Bank, and one solar energy project in the process of being structured. Of the wind energy projects, one is to be established in Bani and projected to start with a capacity of 30MW, and another in Montecristi, with a projected capacity of 55MW. The solar energy project will be located in Monte Plata and Yamasa with a capacity of 54MW. According to estimates offered by the National Energy Commission, by 2013, 5.4% of the total output of power generation shall be provided by wind facilities, bearing compliance with scheduling of the different projects.

Nevertheless, there are several barriers in the DR which threaten the sustainable growth of investment in renewable energy in any of its forms, such as the several government permits for the implementation of renewable energy projects imposing a significant waiting time and suspension of negotiations. Another huge barrier is the connection to the national electricity transmission or distribution grid, which requires the developers to add connectivity, so adding further complications in both logistical and operational costs of the project.

At a community level, micro-scale exploitation of renewable energy also presents difficulties with resource information, and a lack of local technical capabilities in design, operation, maintenance and resource assessment. Another significant challenge is the high cost of investment in technologies for the exploitation of resources and consultancy in the development stage and maintenance of renewable power plants.

The Renewable Energy Incentives Law had granted a 75% exemption of income tax applicable to the investment on renewable energy for three years; nevertheless, with the entry of the new tax reform this exemption has been reduced to 40% as of 2013.

IFLR: Over the past year have you seen changes to the mix of project financiers, and if so, what has prompted this?

We have not seen much of a shift in the mix of project financiers generally active in the DR. The usual financiers are a mix of multilateral institutions and governmental agencies such as AFD (French Development Agency), DEG, European Investment Bank, IDB, IFC, and Proparco, coupled with many commercial banks for large deals. Most local banks in the DR are somewhat

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constrained in their ability to lend large amounts to a single borrower or economic group due to regulatory restrictions affecting solvency ratios.

However, we have noted that most commercial banks in the DR are currently flush with deposits. This is backed up by very recent declarations issued by IMF representatives, where they have praised the capitalisation of the DR banking system.

It is expected that we will see a climb in local finance interest rates, as well as possibly a downgrade on the many loan portfolios of banks as a result of how the middle and lower economic classes end up being affected by the looming fiscal measures that are being implemented in the DR. As a result, it is reasonable to believe that many of the deposits that banks are currently holding are more likely to be allocated in pursuing larger project finance deals, where they place larger amounts of credit at reasonable returns on investments in an effort to subsidise the diminishing local loans.

IFLR: Are project bonds being explored as a possible alternative to bank finance?

Over the past 12 months we have seen a few bond projects that have been either explored or placed for important infrastructure related projects. Most notably, Aeropuertos Dominicanos Siglo XXI (AERODOM) just placed a $500 million issuance used to cancel existing financing principally relating to the acquisition of the company five years ago. In most cases however the bond placements have been analysed as mechanisms to free up corporate restrictions that bank finances generally impose. As to local issuances, the securities market still has not obtained the necessary maturity to compel enough local corporations to pursue this type of financing. However, the DR government has been quite active in local bond placements for specific financing of infrastructure projects, making it the largest issuer in the country.

Yet we have noted that due to country risk considerations as well as recent precedents of issuances that have gone into default, pricing on bond placements is a difficult issue for many potential issuers. Once some of the defaulted issuances are resolved we expect the market to permit some of the more prominent corporations to consider bond issuances as alternatives to local financing, especially as a result of probable increases in interest rates.

IFLR: How successful has the government been in encouraging an IPP industry?

Power production is currently one of the most difficult industries for financing in the DR, due to the government currently being indebted by over $600million (as of October 2012) with power producers. This debt certainly affects revenues for all power generation facilities that are connected to the national power grid, which supplies the currently state-owned electric distribution companies.

Although the DR does not have any legislation regarding guarantees by the government (aside from constitutional considerations), nor a programme designed to secure debt service in any particular industry, we have seen and participated in past negotiations with the Dominican government where it has been willing to guarantee a certain indebtedness of public concessionaires as necessary for the financing of such projects. In addition it is very typical in contracts relating to public utilities, as well as many take or pay type contracts, to include covenants for insuring economic equilibrium throughout a project.

IFLR: Can you describe the risk allocations typically seen in projects today?

The structuring of project finance type deals in the DR does not differ greatly from other jurisdictions. The main objective is to correctly allocate the risks amongst the parties with adequate credit capacity involved in the project and that will assume liability, provided that those parties have enough prevention strategies, control and influence over the risk or its outcome. The challenge in project financing is to convert risks into usable, separable and transferable risks, so neutralising their impact on the participant's liability and especially on the project development. Typically, in the DR, as in most jurisdictions, the risks are shifted in various phases of the project. These risks can be grouped into structuring risks, construction and completion risks, start-up risks and operating risks.

- During the structuring phase, risks are allocated to the project sponsor and the development lenders, where the most common contingencies are highly sensitive issues such as governmental approvals and community and third party oppositions to the project.
- Once all approvals are in place (from project sponsors and construction lenders) the construction risks are dealt with by taking the necessary precautions to mitigate against events such as those affecting the construction costs (which if not properly addressed may cause significant losses): price changes caused by currency exchange inflation or fluctuation, interest rates, delays, environmental risks, legislative applicable modifications, social risks,

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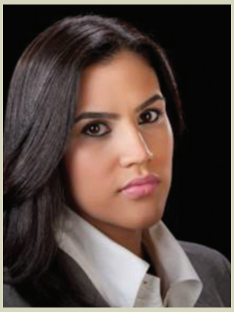

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energy, reduction of material and fuel, strikes, costs escalation and others. The outcome of these factors may mark the project as a failure, as a result of a lack of assets or credit to repay the loan.

- The overlap between the construction phase and the start up phase is a key issue; taking into consideration that if the construction does not comply with the specifications required for efficient and timely operation of the project, the cost of operation may increase in a manner that would affect the viability of the project, including estimated debt service requirements.
- Finally, the project company is responsible for the operating risks associated with the project's self-sufficiency: it must be able to return the equity invested and produce enough funds to cover operating costs and debt service. If the project company fails to meet the expected performance of the project, it shall face liabilities, penalties and the risk of termination for default, which in turn is a risk that the permanent lenders also undertake.

The instruments used in the DR's practice to mitigate risks are long term contractual agreements regarding fixing fuel prices, electricity off-takes, material supply, concession agreements, direct agreements with the government, construction, take-or-pay and put-or-pay agreements, as well as joint ownerships structures, and political and construction risk insurances.

IFLR: What are today's biggest challenges for sponsoring projects?

The biggest challenges for sponsoring projects are largely attributable to the regulatory and governmental interventions that frequently take place in order to make projects bankable. Often, permits relating to construction, environmental issues, municipalities, tax exemptions (if applicable) will take many months to be finalised and therefore affect business models for potential sponsors. On a positive note, President Medina issued Decree 626-12 on November 10 2012, which seeks to implement a single centralised filing unit where all necessary permits and licences, relating to both local and foreign source investments may be requested jointly. Once this unit begins to operate, it is expected to help make the approval process much more efficient.

Other key elements that make sponsoring projects in the DR rather difficult are the operating costs (due to issues such as taxes as well as the continuing elimination of tax exemptions), electricity bills, and the cost of registering security in the DR, which is considerable and often a deterrent to many financing deals (currently two percent of the secured amount for mortgages).

IFLR: And the common pitfalls for financiers?

Although the DR has made serious strides in trying to update its legislation to modern business models, the largest issues for foreign lenders doing business here continues to be related to antiquated legislation in certain areas, particularly concerning security structures and enforcement. Lenders that are not accustomed to regularly doing business in the country often struggle with concepts in the local law that require extensive explanations, which in turn delay projects until the lenders feel completely comfortable.

Other pitfalls that tend to annoy both lenders and sponsors are related to the pace at which governmental entities tend to consider requests. For example, the DR issued Decree 162-11 (and its modifications) that requires any issued exemption to be first verified by the Ministry of Finance prior to the benefited party actually being able to enforce its rights (which are granted by laws). This process can take upwards of four months in many cases.

IFLR: Which recent and upcoming legislative and regulatory changes should foreign sponsors and financiers be aware of?

The most significant piece of legislation that will likely affect sponsors is the recent passing of a comprehensive fiscal reform law which amongst other modifications, will now impose a 10% tax on repatriation of funds by local branches of foreign entities. Prior to this legislation it was fairly common for sponsors to set up equity structures whereby the operating project would often be entities incorporated offshore with a local DR branch for operating purposes. Once all applicable taxes were paid in the DR, the local branch was able to remit its funds offshore free of any taxes.

On the financiers' side, the most relevant piece of legislation is the creation of the Security Agent through Law 189-11. Under this law, an applicable security agent may, in the benefit of all lenders current or future, represent and hold security for a determined transaction. Upon a foreclosure procedure, the security agent is also able to transfer any property to the lenders free of any additional taxes. This figure will surely enable syndication of larger deals in the DR because prior to Law 189-11, it was advisable for each lender to directly register security in its name in order to avoid any litigation by procurement considerations. Although Law 189-11 has been in effect for over a year, the regulator has yet to pass the applicable ruling regarding security agents, and therefore has delayed the implementation of the instrument.

"Most commercial banks in the DR are currently flush with deposits"

Two additional pieces of legislation that are currently in congress and will require constant attention are a law regarding mercantile restructurings and a concessions law.

IFLR: Is there anything else foreign project participants should be aware of when developing projects in DR?

2013 looks to mirror 2012 in many ways, particularly those relating to an economic recession highlighted by a huge fiscal deficit (expected to close at approximately 8% combining fiscal and Central Bank debt) by DR standards. As a consequence, most business are not expected to grow immensely, which will likely lead to more consolidation within certain sectors (2012 was particularly characterised by very important consolidations of the food and beverage industry, with the sale of the largest beer producer in the DR, Cervecería Nacional Dominicana to AMBEV, as well as the sale of Parmalat Dominicana to Induveca).

Although the national budget does contemplate a continuance of important civil works and new projects, government spending on infrastructure is also expected to be reduced from the levels reached in 2012. Furthermore, many of the more important projects have been consigned to entities that have tied up their financing as part of their bidding process (such as, Odebrecht).