

# Deal Monitor

PUBLISHED BY IFLR ISSUE 4  
JANUARY 28 2011

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THE AUTHORITY ON HIGH YIELD, PROJECT FINANCE AND M&A STRUCTURES

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The return of multilateral and export credit agency-based lending has brought new considerations for commercial banks and sponsors. Political risk has been absorbed by the ECAs, but refinancing must be addressed earlier.

Local liquidity has helped here; local banks are able to advise on a subsequent local securities offering. Sponsors are accepting more construction risk, and lenders have responded with a more lenient approach to sponsor-liability caps.

#### COMPANIES FEATURED

Carlyle, Credit Suisse, Dafu Media, Deutsche Bank, EFG Eurobank, EIB, Emporiki Bank, Enron, Fubon Financial, GDF Suez, GEK Terna, Kbro, Labco, Nitixis, Piraeus Bank, Stefanini, Taiwan Mobile, TechTeam Global, UBS

#### LAW FIRMS FEATURED

Bredin Prat, Chadbourne & Parke, Chen & Lin, Cravath Swaine & Moore, DLA Piper, KGDI, Lee and Li, Norton Rose, Paul Weiss Rifkind Wharton & Garrison, PotamitisVekris, Ropes & Gray, Shearman & Sterling

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## 1 Greece: Merchant power returns in hybrid financing

A novel hybrid financing has been used to address the demand risk arising from a rare merchant power deal.

The sponsors of Greece's Heron II power project, GEK Terna and GDF Suez secured a €200 million senior loan from a consortium of Greek banks and European Investment Bank (EIB). But with no obvious off-taker and forecasts of dwindling electricity consumption following the country's financial crisis, the banks demanded a high level of comfort.

This was achieved by organising the facility as a corporate loan with the ability to convert to non-recourse at the banks' election.

"The revenue projections were adversely affected by the economic crisis," said Euripides Ioannou, a partner with PotamitisVekris which acted for the sponsors. "To address this risk, last year we decided on the current structure which had some elements of sponsor guarantees but would switch to a pure project finance transaction once certain conditions were met."

This compromise was reached three and a half years after negotiations began. All parties originally anticipated a merchant power non-recourse loan. But adjustments were needed when Greece's economic problems began to materialise.

Poor power price forecasts made lenders reluctant to fund a project that had neither a tolling agreement nor prices and demand locked in under a long-term power purchase agreement (PPA), but instead intended to sell into the competitive wholesale market.

"It was structured as a merchant deal of which there are very few over the last ten years," said Simon Currie, a Norton Rose partner that acted for the banks.

Financing for these projects relies heavily on macroeconomic projections relating to electricity prices and alternative generation sources, plus regulatory reform. Not surprisingly the structure fell out of favour after the Enron collapse, followed by the wave of project developer bankruptcies in the US and then the crash of power prices during the recession.

These events tarnished the concept of merchant power, Currie said. But Heron II's developers were adamant that notwithstanding the low demand at present, the project is viable long term without a PPA.

The hybrid structure addressed the banks' concerns over project revenues, and is expected to be replicated in the right circumstances.

"It's a solution when the projections are not that attractive but still the sponsor believes the project has the future potential to be financed on a non-recourse basis," said Ioannou.

Like most of the country's large scale projects, the transaction is governed by English law but takes account of peculiarities of Greek law. For example, the funds are provided under a bond-loan structure to achieve breaks relating to withholding tax, stamp duties and registering the securities.

It is documented as a subscription agreement and issued through a

### TEAR SHEET

#### DECEMBER 2010

The Heron II power project (a 435 MW combined cycle gas turbine) in Thiva, Greece reached financial close. The project is sponsored by GEK Terna and GDF Suez and financed by EFG Eurobank, Piraeus Bank, Emporiki Bank and EIB. The facilities consist of a 13.5 year €200 million corporate loan which switches to non-recourse upon satisfaction of certain conditions, plus a VAT bridge loan.

**International counsel to banks:** Norton Rose

**Greek counsel to banks:** KGDI

**International counsel to sponsors:** Chadbourne & Parke

**Greek counsel to sponsors:** PotamitisVekris

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bond programme but contains typical loan covenants. As the issuer is Greek, mandatory local law provisions relating to the bondholders' representation (including in relation to the collateral agent), rights and calling of meetings had to be excluded from the governing law provision.

### RISK ALLOCATION

The deal's lawyers said the concept of a hybrid loan was based on the traditional IFC and EBRD structure whereby a corporate loan switches to non-recourse once the project reaches the operational phase.

In this case the switch is triggered by the satisfaction of conditions relating to the market's stabilisation and the project maintaining specified financial ratios. Upon satisfaction of these conditions, the switch is still at the banks' discretion.

"With a merchant deal you are exposed to the good and the bad of how the market moves," said Currie. "The sponsors need to take that risk until such time as the project can show it can stand on its own two feet...[and] that the prices in Greece are sufficient for the banks to take the risk of going merchant."

Conversely, there was no completion risk. The sponsors had taken out bridge loans due 2011 from EFG Eurobank and Piraeus Bank (both of which are in the syndicate of senior lenders) to commence construction.

But negotiations took so long that the project became operational just weeks after the financing closed. The senior loans will be used to refinance these bridges.

### LENDERS' SECURITY

Until the banks are satisfied that the switch-conditions have been met, the sponsors fully guarantee the borrower's obligations. Once the switch occurs those guarantees drop away leaving a typical project finance security structure.

## HIGH YIELD

## 2 High yield benchmark for French corporates

French diagnostics company Labco opened the year's European high-yield market with its €500 million debut bond. Compared to the private equity-driven offerings that dominate the French market, the issuer's complicated ownership structure introduced extra considerations under the country's regulations.

For the country's high-yield lawyers, a corporate choosing to refinance this way is relatively uncommon. "It was interesting to see a widely-held French corporate seeing the benefit of issuing high yield," said Ward McKimm from Shearman & Sterling who acted for the issuer.

Its collection of subsidiaries presented issues under French regulations. Despite appearing on its consolidated balance sheet, Labco lacked majority voting power in many of the group's entities. Extra steps were needed to bind these subsidiaries to the terms of the indenture.

"We needed to make sure that each subsidiary where Labco had this

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minority voting position would sign a covenant agreement, and that took some explaining," said McKimm.

This added to the explanations needed for the many individual shareholders unfamiliar with high yield.

The issuer's growth strategy is to acquire independent laboratories, with their owners becoming shareholders of Labco while continuing to manage their business. These account for more than half of Labco's capital (according to its website) creating a relatively unusual situation where the decision to launch a French high-yield issue spanned beyond sophisticated investors.

"I hope it's the beginning of a trend where the appetite for high yield instruments in France is shared by corporate issuers as well as more sophisticated consumers of debt products such as private-equity houses," said McKimm.

### COVENANT PACKAGE

The issuer needed the flexibility to continue to grow through laboratory acquisitions but also minority investments in other jurisdictions; plans for the latter required consideration when negotiating the restricted payment basket.

### SECURITY

The package is relatively light, consisting of first-ranking liens over the majority of the group's shares and certain inter-company loans. No tangible assets were secured.

"In order to give the bondholders security interest or guarantees you had to go through a fair amount of corporate hoops," said Olivier Saba from Bredin Prat who acted for the banks.

This is due to Labco's structure as essentially a large group of operating laboratories and the fact Labco had concurrently entered into a senior €125 million revolving credit facility (RCF).

France's strong corporate benefit rules state that a subsidiary must receive something in return for granting a guarantee or security. This meant the guarantees and security able to be offered by Labco's subsidiaries was dictated by the distribution of Labco's proceeds from the RCF and its bond issue.

This was overcome through the intercreditor arrangements.

### INTERCREDITOR TERMS

The RCF and bonds were intended to be secured on the same assets. "[So] the security package and intercreditor principles were constructed to provide a consistent package to both the RCF and bond investors," said McKimm.

Notwithstanding the corporate benefit rules, the intercreditor obliges each party to share its security subject to the agreed waterfall.

### COUNTRY LAW

The transaction was a New York-law governed 144a/Reg S offering.

## TEAR SHEET

### JANUARY 2011

Labco completed its debut bond offering: €500 million senior secured 8.5% high-yield notes due 2018. The notes have a three-year non-call period and, together with a €125 million super senior revolving credit facility, the funds will be used primarily for refinancing. The bookrunners were Credit Suisse, Deutsche Bank, Natixis and UBS.

**Counsel to issuer:** Shearman & Sterling

**International counsel to underwriters:** Cravath Swaine & Moore

**French counsel to bookrunners:** Bredin Prat

### 3 Two-step mergers grow with Brazil deal

Brazil's first mid-market investment into the US has used the increasingly popular top-up option to close the two-step merger.

IT service company Stefanini's acquisition of TechTeam Global for \$93.4 million illustrates the recent preference of cashed-up strategic buyers to minimise competitive bids by using the revitalised takeover structure.

"Tender offers achieve faster closing," said Diane Frankle, a DLA Piper partner who acted for the buyer. "If you're doing a cash transaction this really is the structure of choice as it's the fastest way to get from a signed agreement to a closing."

The Brazilian buyer achieved the quickest outcome possible, completing the deal 20 business days after its launch. The merger agreement was signed on November 1, tender commenced November 12, and closed midnight December 10 after being open for the mandatory minimum period.

Under the governing Delaware law, the buyer can close the tender if it is offered the majority of outstanding shares on a fully-diluted basis, but it must hold 90% before it can pursue a short form merger.

At the offer's close Stefanini owned 89.4%. But the top-up option meant it was entitled to buy newly issued shares to bring its holding up to the statutory threshold, paid for with a promissory note and cash.

"If you are able to do a short-form merger immediately thereafter you can literally close the entire transaction in the same day, which is what we were able to do here," said Franklin. The deal closed the next business day, December 13.

Buyers have recently fought for these merger agreements to include a top-up clause as it enables them to close without either a shareholders' meeting or filing further disclosure materials with the US Securities and Exchange Commission (SEC).

The majority of the shares have already been acquired by the tender's close. "And this process enables both buyer and seller to consummate the deal without going through a lengthy proxy process when you already have the majority vote locked in," said Jesse Yeo from Ropes & Gray which represented the target.

Lawyers have witnessed a recent surge in cash tenders followed by second step mergers. The structure was expected to return four years ago after the SEC confirmed a buyer's financial arrangements with a target's executives and key employees did not violate the best-price rule.

But this clarification was shortly followed by the dominance of private equity and then the recession, meaning only now with the upswing in M&A activity have two-step mergers gained traction again, and with the added feature of top-up clauses.

#### DEAL PROTECTIONS

The buyer benefits from a material adverse change clause typical of a US public company and a 3% (of deal value) break fee.

#### TEAR SHEET

##### DECEMBER 2010

Through wholly-owned subsidiary Platinum Merger Sub, Stefanini acquired TechTeam Global through a cash tender offer and follow-on merger for \$93.4 million.

**Counsel for seller:** Ropes & Gray

**Counsel for buyer:** DLA Piper

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The target benefits from a no-shop covenant subject to a fiduciary out, and a right of specific performance that is guaranteed by Stefanini's UK holding company.

## CONDITIONS

Discussions regarding the parties' collaboration started in 2009, but extra authorisations were needed because of TechTeam's government solutions business would have impeded a speedy closing. Once this unit was sold, Stefanini was invited back into the discussions.

Both the Department of Justice and Federal Trade Commission terminated the 15-day waiting period which enabled the deal to close the same day the tender results were announced.

The deal was not conditioned on receipt of financing.

## M&A

# 4 Taiwan sale suffers from heavy conditions

Carlyle's sale of a majority interest in Kbro, a Taiwanese cable television operator, has featured a number of onerous buyer conditions – an ominous sign for future private equity deals in the country.

The buyer is Dafu Media, a new vehicle set up for the acquisition by the Tsai family after a failed bid by their media company, Taiwan Mobile.

Despite Dafu being a private domestic company owned by the Tsai family, the country's regulator imposed restrictions commonly seen with foreign bidders.

"A few of the conditions were really quite surprising. It's the first time we have noticed so many," said Jeanette Chan, partner at Paul Weiss which advised Carlyle.

The deal was initially structured as a 100% sale to Taiwan Mobile in exchange for certain shares of the company.

But Taiwan Mobile intended to issue treasury shares to Carlyle, which cannot be sold. They would have to be contributed to a separate entity and then transferred to Carlyle.

Then in June last year, Taiwan regulators held up the deal because it breached rules on government ownership of media companies.

Taiwanese law states that political parties cannot own shares in media companies. The Taipei City government has an indirect stake in Taiwan Mobile via its ownership of shares in Fubon Financial, Taiwan Mobile's parent. Fubon's Tsai family is Taiwan Mobile's largest shareholder.

Because of this, lawyers had to restructure the deal so the Tsai family raised the financing and then purchased 80% - not 100% - for a cash deal, at \$2.4 billion.

The deal took over a year to structure.

## TEAR SHEET

### NOVEMBER 2010

NCC approves Dafu Media's acquisition of an 80% stake in Kbro from Carlyle for \$2.4 billion.

### JUNE 2010

Taiwan regulators held up the deal because it breached rules on government ownership of media companies.

### 2006

Carlyle bought Eastern Multimedia, from which Kbro was spun out, for \$1.5 billion.

### **Seller's international**

**counsel:** Paul Weiss Rifkind Wharton & Garrison

### **Seller's domestic counsel:**

Lee and Li

### **Buyer's local counsel:**

Chen & Lin

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## CONDITIONS/APPROVALS

The National Communications Commission (NCC) imposed 14 conditions before approving the 80% stake, according to Sophia Yeh, partner at Lee and Li.

The NCC required the buyer to agree to reduce the tariffs for some of the system operators. It also required that any additional purchasers of system operators would have to be reapplied.

Lawyers spent a lot of time negotiating with the regulators on conditions. "Carlyle was trying to sell and make the Taiwanese party the majority owner. We felt like saying: 'isn't it wonderful? Why are you making it so difficult?'" said Chan.

The regulators were using that opportunity to exert their influence in this industry. "It was quite astonishing," she added.

Dafu Media is also prohibited from holding shares in any other cable provider or in Taiwan Mobile. And the Tsai family cannot supply more than one third of households or one quarter of channels.

## CABLE THRESHOLD

Although rules preventing government or politically-involved parties owning cable companies are common, Taiwanese legislation allows for no maximum threshold for ownership. "It's gone too far. You can't even own one share, which doesn't make sense," said one lawyer close to the deal.

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IFLR Deal Monitor analyses documentation, structures and trends from around the world, giving special attention to those in the emerging markets. It helps you stay ahead of the competition within M&A, project finance and high yield by analysing individual deals and through deal trends. It explains:

How the terms are changing

How deals are structured

Who is winning the mandates

Off-the-record commentary from the lawyers involved in the deals

Deal Monitor explains the variables that really matter within high yield, project finance and M&A:

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Termination rights  
Financing  
Conditions / approvals  
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### PROJECT FINANCE

Risk allocation  
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### HIGH YIELD BONDS

Covenant package  
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## Latin American project finance

### Multilateral agencies and ECAs' affect on infrastructure finance structures revealed

The past two years have seen a resurgence of multilateral and export credit agency (ECA) activity in Latin American infrastructure financings. A combination of market and regulatory developments has created conditions ripe for these - plus local - sources of funding. The most obvious are of course the Basel III and Dodd-Frank reforms which, when combined with the fallout from the financial crisis, has stifled international commercial banks' appetite to invest in the region's long term projects.

But there are important changes at a regional level too. Projects are increasingly bigger and need more lenders, local markets are flush with liquidity, and there's been a flurry of ECAs granted direct lending approval. Chile, Peru and Brazil also benefit from 10 to 15 year build-out plans based on their governments' economic projections.

"That changes the whole dynamic of doing projects in Latin America," says Carlos Albarracín, a Chadbourne & Parke partner based in New York. "Unquestionably, the infrastructure needs in Latin America are more pressing than before as the region now has a more sustainable development model with mature financial markets." Although agencies can be less interested in more developed countries, they are reactive rather than dealmakers and many have participated in these schemes.

With all these developments set to continue into 2011 the new lender-mix is expected to thrive - in the immediate future at least. Senior

partners recall the 1980s when an influx of investment promotion agencies filled gaps left by the banks that had withdrawn from the region. Some similarities are financing negotiations being made tougher by multilaterals trying to maneuver within their policies, government relations being of prime importance, refinancing options needing to be addressed at an

**"THE DAYS WHEN CONSTRUCTION RESPONSIBILITY WAS ATTRIBUTABLE TO A SINGLE ENTITY SEEMS TO BE DISAPPEARING"**

early stage, broader due diligence investigations and renewed emphasis on the consultation-based approach to intercreditor arrangements.

But this time around there are also new considerations. Agencies are playing in packs, are accompanied by the rise of Asia and its development banks and ECAs, local banks are investing in their neighbours, and parties must contend with new perceptions of risk in the region. A new model of infrastructure financings has emerged.

#### RISK ALLOCATION

For two reasons, risk allocation takes an altered significance in the new lender-mix. Firstly, agencies are particularly lending on projects that require longer tenors and are viewed as riskier or non investment grade credits, says Eric Silverman, a New York-based partner with Milbank Tweed Hadley & McCloy.

**FIRMS:** Chadbourne & Parke; Milbank Tweed Hadley & McCloy; Rubio Leguía Normand & Asociados

"The basket that most of the large scale development projects and greenfield projects fall into." Secondly, the varied lender-group gives more options to allocate those higher risks to the party most able to manage it.

This model is comparable to the A loan/B loan structure. The agencies never work alone, but in groups numbering into double digits for the bigger projects. They provide an umbrella that permits more active participation by commercial lenders, effectively allowing them to treat their loan as a higher-quality investment and avoid the longer tenor.

Commercial lenders have benefited from the involvement of more ECAs and their ability to absorb political risks, and local banks simply being less concerned by it. In any event, some lawyers witness commercial lenders taking a slightly different approach to these risks, especially inconvertibility risk. Experience has shown that a country's exchange problems can be linked to more basic credit issues which make it difficult to generate the local currency. This can prevent

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inconvertibility insurance claims to which the lender may have otherwise been entitled. For this reason, some lenders are becoming more comfortable taking the risk.

While multilaterals can be more understanding in deals involving host governments, disputes coverage continues to be used by commercial lenders under concession schemes. "That's been a huge benefit in Latin America and elsewhere," says Peter Fitzgerald, from Chadbourne & Parke in New York.

Insurance for governments' failure to pay any arbitral award, typically relating to a termination payment or project guarantee, has paid off for investors. "Political risk insurers can backstop that payment and if you get an arbitral award against the government and it doesn't pay then the political risk insurer will pay you," Fitzgerald adds.

Refinancing risk also takes on a new dimension. Agencies' ability to refinance is typically constrained by their development goals; the need to push money into new areas. This means agency-financed projects that are developed in two phases need to find alternative sources for the second phase. An added difficulty is that a phase two financing with different lenders might have to be accounted for in the phase-one project documents.

The involvement of local banks has helped mitigate refinancing risk. In addition to political risk issues – and their efficient decision-making process – these banks have proved useful to borrowers in refinancings. They have the advantage of being able to lend in the first phase and advise on a local securities offering for the second phase. "They can arrange local issuances in the midterm to refinance existing obligations of a direct loan through corporate bonds or securitisation once the construction phase has fin-

ished," says Juan García Montúfar from Rubio Leguía Normand & Asociados in Peru. "[This] gives more flexibility to the borrower or project entity when they do have incoming flows from the operation of the project."

The risks that can't be absorbed by the agencies or local banks are being dealt with in other ways. An increasing number of lenders are asking project developers to use swap providers to mitigate interest rate risks. But a new perception of the principal risk – construction – has caused lenders to take a different approach.

"As projects get bigger, more complicated and with more parties I'm seeing contractors doing things less than on a fixed-price, fully-wrapped basis and lenders trying to get comfortable with that," says Fitzgerald. The days when construction responsibility was attributable to a single entity seems to be disappearing. This is especially so with the emergence of new types of projects such as renewable energy where new services are coming together and there is no standard way to wrap them.

The risk premium has become so high for getting a fixed price and an EPC package wrapped that it becomes more of a financial decision, says Albarracín. "There are only so many places you can go with construction risk. But at some point the cost to the sponsor of coming up with a totally risk-free construction contract might just be too high," Fitzgerald adds.

Sponsors are willing to absorb a little more of this risk, sometimes backstopping this throughout completion with a letter of credit. Lenders are also generally a little more relaxed on limitations to sponsor support caps.

Risks not yet accounted for are also beginning to receive attention.

## BRAZIL

Brazil's sophisticated projects market puts it in a slightly separate situation to the rest of the region. Not only are its projects bigger, longer and more complex, but different sources of finance are becoming available.

- Since Q4 2010 project bonds have been issued by investment-grade developers. But they must grapple with investors' strong aversion to construction risk and seem possible only for projects nearing completion that are backed by strong EPC contracts.
- Pension funds, including state-owned funds, are cash rich and need to invest. But they must do so according to strict regulations – something which multilaterals and commercial banks in pension-funded deals are having to adapt.

"Political risk insurers would like to be writing more coverage, and they are looking at the risks that lenders and investors are having these days and seeing if they need to come up with new products to cover the new risks that are emerging," says Fitzgerald. Some products being looked at are arbitral awards coverage for host governments' expropriation claims under bilateral investment treaties, and coverage for changes of law post-investment that adversely impact the lender.

This latter risk has emerged only recently. Previously project relations with host governments were governed by contracts, breach of which may have given rise to an

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insurance claim. But as the region has developed, regulatory regimes have developed in their place. The difficulty for lenders is that these regimes may be changed to their detriment without the government having done anything wrong. Fitzgerald says that while investors in the region are finding this risk hard to accept, this is outside the scope of political risk insurance and little movement is expected in this area in the short-term.

### INTERCREDITOR ARRANGEMENTS

Bigger projects and more lenders mean tougher intercreditor negotiations, highlighting lenders' different approaches to decision-making. For international banks, credit is the overriding concern and majority-rules is the favoured approach. Multilaterals still prefer to consult (sometimes for up to 90 to 120 days) before reaching a unanimous decision, and to proceed independently if they can't agree.

This clash isn't new, but the sheer number of multilaterals, each with their own programmatic restrictions and governmental policies has increased this tension and made it harder and longer to decide on a hybrid approach. Borrowers are bearing the brunt of this. For example, three multilaterals consulting before making a decision takes less time (and gives more certainty) than six or seven agencies. The added risk is them not agreeing and proceeding differently, which makes the group less cohesive.

ECAs' intercreditor preferences have changed over successive returns to Latin America, but this time they seem to sit somewhere

between the multilaterals and commercial banks. "The export credit agencies in general are a little more aligned with commercial banks' approach and a little more open to agreeing to the majority-rules decision making approach. But they also have policy commitments, so it's more of a hybrid," says Fitzgerald.

The local lending market's emergence adds another dimension. The region's liquidity has seen local banks become more active project lenders, and it's not just on a national basis. "We now have companies and developers from within the region that are going into other countries to develop projects - and they are taking their local commercial and development banks with them," says Albarracín. "It's a new world in some ways for projects in Latin America."

Local commercial banks have also brought a more forthright perspective to intercreditor arrangements. Quick enforcement through a promissory note or other instrument is often preferred over consultation or votes. The final intercreditor agreement still comes down to the financier-balance in any deal, but the different needs of more diverse lenders is a concern.

Lawyers see more borrowers becoming party to intercreditor agreements. And swap providers brought onto the deal by sponsors also get folded into these discussions. Swap providers' role in keeping interest rates down, without actually participating any more in the project, begs the question of where they fit into the decision-mak-

ing model, says Fitzgerald.

"In the old days swap providers took a backseat role when it came to intercreditor decisions," says Albarracín. "[But] because banks are now more concerned with risks and their exposure under swaps, they are taking a more active role in negotiating and demanding intercreditor terms."

This has caused some multilaterals to reassess their hardline principles and try to incorporate more sophisticated credit dynamics into their approach.

### INDUSTRY PRIMER

The Build Operate Transfer (BOT) concession has been in use for sometime in the project-finance-established jurisdictions of Brazil, Peru, Chile and now Columbia. But a number have been recently improved through the introduction of risk mitigation features favouring lenders.

"Concession arrangements in some countries in the region are now guaranteeing the lenders a certain percentage of the value of the assets if the concession is terminated before the debt is paid off," says Albarracín. "I think this is a significant change that allows not only agencies but also commercial banks and export credit agencies to rely more on the terms of the concession agreement and the rights granted to them in the agreement."

This compensation payment is not subject to any continuing government rights, something which not long ago was unheard of in the region.

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