

MARC ANALYTICAL INSIGHTS

THE ROLE OF GOVERNMENT SUPPORT IN CORPORATE AND PROJECT FINANCE: COMMONLY ASKED QUESTIONS



INTRODUCTION

The global financial crisis of 2008-2009 raised some very pertinent questions concerning government support for many issuers and projects. As the crisis deepened, it became increasingly commonplace for global rating agencies to review their expectations of government support and the rating 'lift' provided by the support to rated entities and projects in national economies where the spillover effects of the financial crisis were most pronounced. In certain instances, changes in the government's perceived willingness to support the government-related entities were the key driver of rating actions.

Rating downgrades of government-related entities (GREs) in Dubai, United Arab Emirates and Abu Dhabi by global agencies between December 2009 and March 2010 were the consequence of not only reduced fundamental creditworthiness on the part of issuers and the challenging operating environment, but also noteworthy changes in the analytical approach to the assessment of government support. Global rating agencies made similar attempts to increase the distinction between i) explicit and implicit support, and ii) public policy institutions and GREs without explicit public mandates. The credit ratings of Dubai GREs were also lowered to levels reflective of standalone credit profiles following a November 2009 announcement by state-owned Dubai World that it was seeking a six-month debt standstill.

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Bank ratings which have traditionally benefited from significant rating uplift due to systemic support also came under downward pressure in countries where rating agencies became increasingly concerned over the declining capacity of the respective governments to provide support with the deepening of crisis. Attempts have also been made on the part of rating agencies to introduce distinctions between systemically and non-systemically important financial institutions in support assessments. This report does not address support assessments in the context of MARC's financial institution ratings which will be taken up in a separate report at a later date.

On our own shores, similar questions were raised pertaining to the Port Klang Free Zone (PKFZ) related bond issuances by four special purpose vehicles and more recently, Malaysian International Tuna Port Sdn Bhd's (MITP) Islamic debt, all of which had obtained letters of support from federal government ministries. MARC considers it appropriate to address these questions and others which have consistently emerged during the course of our contact with market participants in this report in order to provide greater clarity on our rating approach with respect to government support.

When is it appropriate to incorporate ratings 'lift' in the final credit rating?

MARC's issue ratings address the full and timely payment of obligations on a rated instrument. Any delay, for whatever reason, is considered a default. The government's commitment to support the ongoing operations of a rated entity or project does not necessarily guarantee timely payment of obligations on a rated instrument. Accordingly, an entity or issue can only benefit from a rating uplift above its standalone rating level where timely and sufficient external support is expected to translate to lower credit risk and reduced risk of default.

The rating development of MITP's debt rating provides a good example of application of the outlined rating approach. In May 2007, MARC had assigned MITP's RM240.0 million Islamic debt issuance a long-term rating of *A+ID* premised on the strong perceived government support for the tuna port privatisation project on the basis of a letter of support issued by the Ministry of Agriculture and Agro-Based Industry (MOA) to back the rated obligations and the 40% shareholding in MITP held by the government agency Lembaga Kemajuan Ikan Malaysia (Fisheries Development Authority of Malaysia or LKIM). LKIM possesses step-in rights that enable the former to assume the operations of the port in the event of a default under the concession by MITP, although these rights were not exercised subsequently.

MITP suffered a setback in the construction of its fisheries port which eventually resulted in delay in the commencement of certain operations which were expected to generate the cash flow to service the rated debt. Meanwhile, its finance service reserve account, which was designed to prefund profit payment during the construction period, had been fully utilised. MITP was unable to secure alternative sources of funds to help meet forthcoming obligations and failed to meet its RM10 million sinking fund payment due in October 2009. MARC proceeded to downgrade the debt in October 2009 to reflect increased vulnerability of MITP to non-payment of the rated debt obligations in the absence of full and timely financial support from the government. MITP missed its profit payment due on November 17, 2009 and was downgraded to *DID*.

Under what circumstances does MARC give significant weight to letters of support from the government?

In addition to the PKFZ-related issuances, MARC has also rated Kuching Port Authority's RM180.0 million Al-Bai' Bithaman Ajil Islamic Debt Securities (BalDS) at AAA_{ID} the same level as the implied rating of the state government which had issued the support letter. Although MARC regards letters of support as non-binding moral obligations, it did not distinguish between letters of support and guarantees in evaluating support for these issuances on the basis of its belief that the federal government and state government possess strong incentives to provide timely support to the supported entities. At the same time, it is important to appreciate that unlike guarantees which are generally perceived and drafted to be legally enforceable, letters of support are often not drafted to be legally enforceable and denote implicit support of the government to cover shortfalls in payments due under the supported debt and are more susceptible than guarantees to a change in willingness to support.

MARC's rating on Kuching Port Authority's RM180.0 million Al-Bai' Bithaman Ajil Islamic Debt Securities (BalDS) AAA_{ID} mirrors the rating agency's public information rating on the state of Sarawak. The rating considers Kuching Port Authority's status as a state-run port and a letter from the Sarawak State Government (SSG) which expresses its intent to support the BalDS and structural arrangements under the BalDS to ensure timely payment. A debt service account (DSA) was created to provide coverage of debt service on the outstanding BalDS. In addition, committed RM27 million bank credit facilities are in place to provide liquidity in the event of any shortfall in the DSA. In the event of a prospective deficiency in the DSA, the port must initiate a drawdown of funds under the credit facilities and/or notify the State Financial Secretary to transfer sufficient funds to the DSA ahead of debt service payment dates. MARC believes that the mechanics for drawing on state support and contingency liquidity arrangements will make payment interruptions unlikely.

In MARC's view, the port's net cash flow from operations is insufficient to cover annual debt maturities and capital expenditure. The port's rising annual debt maturities will increase the likelihood that the financial support from the SSG will be required to cover prospective cash shortfalls. Despite the port's relatively weak standalone creditworthiness, Kuching Port Authority has yet to make a request for the replenishment of the DSA. The rating on the BalDS would be affected by a change in the credit quality of the state of Sarawak and/or a weakening of SSG's support. The timeliness of payment also hinges on the timely notification by the port of any deficiency in the DSA.

Have there been instances in the past or present where the same support mechanism has been used for an issue but a different rating approach is taken?

Both the MITP and PKFZ-related issues received a letter of support from federal government ministries. There are, however, notable differences in the surrounding circumstances, starting with the supported entity. In the case of the PKFZ debt issuances, the supported entity is government agency Port

Klang Authority (PKA). (The Ministry of Transport (MOT) had provided a letter of support for the deferred payment receivables from PKA in respect of the land purchase and development costs of the PKFZ.) MITP, unlike PKA, is majority-owned by a private entity. The political consequences of failing to provide support for the PKFZ-related issuances were also assessed to be greater than that of MITP's rated debt. The foregoing considerations are reflected in MARC's decision to rate the PKFZ-related issuances at the same level as the implied rating of the Government of Malaysia ie: AAA. For MITP's case, however, the approach taken in assigning the final rating of the 'supported' debt was to notch up from the intrinsic or standalone rating level of MITP. The different rating approaches simply reflected a differing level of uncertainty regarding the incentive of the federal government to provide timely financial support as well as reservations about the strength of the support letter.

The PKFZ-related debt issuances, despite increasing event risk, have been serviced in a timely manner to date, and have benefited from strong statements of support from the federal government on more than one occasion. MARC's continued alignment of the ratings on PKFZ-related issues with the fundamental creditworthiness of the federal government of Malaysia considers the latter's demonstrated willingness and capacity to abide by the support letters notwithstanding alleged irregularities surrounding the issuance of the four letters and earlier anti-corruption and fraud probes involving turnkey developer and originator of the deferred payment receivables, Kuala Dimensi Sdn Bhd. MARC's negative outlook on the ratings of all the PKFZ-related issues, meanwhile, incorporates increased uncertainty as to the timeliness of payment transfers from PKA, as witnessed with earlier incidences of non-compliance with the required build-up of debt reserves ahead of payment dates. MARC had recently cautioned bondholders about a potential credit cliff situation in which the debt rating(s) of one or more of the four issuers could be lowered to 'D' upon the occurrence of missed payment.

What other forms of government support mechanisms has MARC evaluated apart from support letters?

MARC has also rated debt issuances which have benefited from more explicit forms of support. A rating example in this category is Sarawak Specialist Hospital & Medical Centre Sdn Bhd's (SSHMC) RM425 million Istisna' Serial Bonds. The bonds are rated AAA_(D), at the same level as MARC's AAA rating on Sarawak state to reflect underlying redeemable preference share (RPS) subscription agreements between State Financial Secretary Inc (SFS) and SSHMC Management and Holdings Sdn Bhd (SSHMC Holdings - SSHMC's parent company) as well as SSHMC Holdings and SSHMC. The RPS subscription payments made by the SFS to fund SSHMC Holdings' subscription of RPS in SSHMC mirror the scheduled payments under the bond issuance in terms of amount and timing, providing certainty of timely principal and profit payments on the bond issue. Each installment payment is credited into a finance service reserve account one month before the semi-annual scheduled payment date of the bonds. MARC considers the RPS subscription agreements as a form of explicit support. As of September 30, 2009, SSHMC had redeemed a total of RM142 million of the bonds, leaving RM283 million outstanding of the initial issuance.

How is the amount of rating 'lift' decided for an issue or issuer rating?

MARC views support as a continuum, ranging from high to low. MARC generally equates outright guarantees, government control and/or ownership with high likelihood of timely government support. The issue or issuer would be able to achieve a rating equal or close to the rating of the government or sovereign itself in these circumstances. At the other end of the continuum would be situations in which there is no expectation of any form of timely support. Support could be forthcoming but there is no certainty of its timeliness and sufficiency to justify a rating uplift. Between the two extremes lie situations in which support would be designated as medium or moderate. This would include situations where the government may have a non-controlling interest in the rated project or entity, or no ownership stake. Nonetheless, explicit and/or implicit government policies and a history of predictable government intervention warrants notching up from the standalone rating.

MARC's long-term AA+ rating on Malaysia's largest electricity utility company, Tenaga Nasional Berhad (TNB), for instance, reflects the government's indirect significant ownership stake in the utility (above 80% through various government-related entities) and mostly tangible non-financial support in the form of price subsidies and development grants in addition to its own strong intrinsic financial strength.

If the rated entity or project belongs to a sector that is the process of deregulation and/or industry restructuring, MARC considers the uncertainties that the above developments may introduce and the risk that timely support may be impeded. Likewise, governments are likely to gradually distance themselves from former wholly-owned or majority-owned entities which are in the midst of being privatized. This poses an analytical challenge given that the relationship between the government and the entity or project becomes more difficult to assess and support becomes harder to predict. Over time, the ratings of such entities could diverge from those of the government and would increasingly reflect standalone business and financial fundamentals.

What should be the threshold of importance for a project or entity to be regarded as economically and/or politically important?

In assessing economic and political importance, MARC considers the project or entity's ability to generate employment, foreign-exchange and the significance of the products or services provided by the entity. MARC holds the view that governments have a greater incentive in maintaining the financial health of a project or entity which contributes meaningfully to economic and social development of the country. An economically important entity would typically account for a significant portion of its industry sector's overall assets, earnings and employment. A key determinant of the economic value and importance of an industry and its participants to a country is the economic structure of the country.

The US auto industry provides an example of an economically important sector. A key component of the US economy, the auto industry contributes

a reported 3.6%, or USD500 billion to total US annual GDP output. A 30% decline in auto sales translates directly to a 1% decrease in economic output. The auto industry also employs 850,000 workers in manufacturing and 1.8 million workers in auto dealerships. Because of its size and spillover effects on other related industries, a collapse in the auto industry will lead to significant job losses and hurt the economy. Economic importance was the key argument supporting the Obama administration's bailout of the US auto industry. Notwithstanding the administration's effort to aid automakers, bondholders of the automakers still had to take haircuts. The foregoing example demonstrates that even in instances where the industry is assessed to be economically important, there is no guarantee that affected entities will receive sufficient and timely financial support to avoid defaulting on their debt obligations.

Do government support considerations play a role in the usually high ratings of operators of critical infrastructure?

Providers of electricity and water, both private and government-owned, have historically enjoyed a perception of strong implicit government support and ratings which are close to that of the government. The following characteristics, shared by many privately owned water and power concessionaires, underpinned the perception of strong implicit support: i) they provide essential services, ii) they operate under favourable cost-recovery tariff structures and take-or-pay contracts for power or water supply with a strong offtaker, and iii) receive meaningful indirect support (for example, fuel subsidies for the power sector) and/or direct financial support. The aforementioned characteristics also enabled the concessionaires to generate highly stable and predictable cash flow to service their rated debt. Ratings of domestic private power projects invariably exhibit a high degree of credit linkage with the national utility company due to offtake arrangements.

At the same time, MARC believes that there is a need to be mindful that political and social considerations could limit governments' ability and willingness to provide indirect support through electricity and water tariff hikes. Hence, MARC's support assumptions consider the rating agency's assessment of the strategic importance of the project or entity providing the essential service, the government's track record of timely support, and political will to implement scheduled tariff increases. The support assumptions will be revisited if necessitated by developments such as the inauguration of a new administration and/or changes in political priorities in order to ensure that existing ratings remain appropriately positioned. Incentives to support may wane over time under such circumstances.

MARC recently placed under formal review the ratings of all its Selangor water sector-related issuances to reflect its view that significant hurdles in the restructuring process, in particular protracted negotiations between the Selangor state and water players, did not bode favourably toward attaining a timely and orderly resolution of industry restructuring-related issues. The credit implications are currently negative given the spillover financial and liquidity constraints for the water treatment operators arising from cash flow issues at Selangor water distributor Syarikat Bekalan Air Selangor Sdn Bhd (Syabas). Syabas' water tariff hike which had been scheduled to take place in January 2009 remains unresolved. Syabas continues to be unable to meet

in full its monthly bulk water payment obligations to water treatment operators in spite of an earlier soft loan obtained from the federal government to alleviate the impact of the revenue shortfall. The foregoing example underscores the importance of receiving not only timely but sufficient financial support from the government to counter credit pressures caused by a change in the underlying project economics - in this case, the state's sole offtaker of bulk water. MARC believes that the developments in the Selangor water sector, in particular the failure to implement an much needed (scheduled) rate hike signals waning economic interest in the financial well-being of water concessionaires, particularly on the part of the state government, notwithstanding the essentiality of services provided.

Certain road networks, airports, ports and gas pipelines may be regarded as critical infrastructure on account of the role they play in the national economy. While government support for the operators of such infrastructure has historically been taken for granted, MARC believes that on the basis of its aforementioned experiences as well as others, the strategic importance factor alone may not be sufficient to support ratings at sovereign or near sovereign levels. The government may intervene to ensure that the operational obligations of a financially distressed infrastructure operator are met rather than its financial obligations as the following example from neighbouring Indonesia suggests.

Electricity demand in Indonesia had been badly hit by the 1997 financial crisis, and PT Perusahaan Listrik Negara (PLN), the sole electricity off-taker in Indonesia, refused to honour its electricity offtake commitments to PT Paiton Energy (Paiton), Indonesian's first and largest independent power producer (IPP). Paiton was in turn unable to fulfill its obligations to lenders. Negotiations led by the Indonesian government eventually resolved the situation. Even though there were no haircuts taken by Paiton's lenders, the borrowings were restructured with longer maturity dates. Most importantly, Paiton was still operating. Similarly, the bankruptcy protection filed by Japan Airlines International Co., Ltd. (JAL) will in all likelihood not result in the winding up of its operations, but the lenders may have to suffer a certain degree of capital loss. Ultimately, the business and financial fundamentals of the critical infrastructure operators remain as key drivers of their creditworthiness.

Can the economic and/or political importance of entities change over time?

The economic and/or political importance of an entity or project may decrease as the market structure changes as the experience of Proton Holdings Berhad (Proton) suggests. Proton was considered an important entity when it was established in the 1980s. Proton helped to promote government's aspiration to develop technical expertise and transform Malaysia into an industrialised country. Support industries emerged to supply parts to Proton to meet local content requirements in order to maintain its national car status. A second national car maker, Perusahaan Otomobil Kedua Sdn Bhd (Perodua) was subsequently established, creating competition. Technical engineering expertise developed from within Proton also carried over to other industries. These factors reduced Proton's strategic importance in the economy. In 2007, the Malaysian government indicated that it will not bail out Proton when the local car market was opened to outside competition despite losses sustained by the national carmaker.

However, it may also be mentioned that essential assets such as water and electricity sectors are less likely to lose critical value, but it is quite possible that other assets that are not essential (like fixed line telephony or car manufacturing) will lose their criticality over time. Changes in economic and/or political importance may result in weaker incentives to provide support on the part of the government. MARC believes that it is important to continually assess the possibility that the rated entity or project's economic and/or political importance could change and to be mindful that the government will typically have less incentive to provide support as the entity's or project's importance declines.

What affects a rating agency's expectation of timely government support?

All other things being equal, any financial support from the government will only be possible if the government has the financial capacity to provide the support. There is considerable empirical evidence to support the assertion that government-owned or controlled enterprises are more likely to receive timely support than private entities. If willingness is present but capacity is absent, no ratings 'lift' will be incorporated in the final credit rating of rated entity or project. Examples abound in the global rating scene. The primary cause of rating downgrades of government-related issuers has been, as everywhere, deterioration in macroeconomic conditions. Political will is often tested in trying economic times and changes in priorities occur. The government may be unable to garner sufficient public or political support for a bailout or the overriding consideration may be that the bailout is unlikely to work, as in the case of perennially dysfunctional entities.

The bankruptcy protection filed by JAL in 2009 may or may not have reflected the Japanese government's fiscal challenges but the fact remains that Japan's primary deficit had more than doubled from ¥5.2 trillion in the initial budget for fiscal 2008 to ¥13 trillion in fiscal 2009. The ratio of government debt outstanding to GDP also reached 114%.

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