INFRASTRUCTURE & HOUSING FINANCE DEPARTMENT

Review of Project Financing

Five-Year Analysis
FY04-08

Foreword

This review is meant to analyze the project financing in infrastructure during the last five years i.e. FY04 to FY08. Data from five major banks is used to analyze the project financing in Pakistan. These banks are MCB, HBL, UBL, NBP, and ABL selected as the five largest banks in terms of their exposure to project financing. This review focuses on the disbursements by five major banks in infrastructure projects, financing structure, modes of finance used by these leading banks and sectors where major financing has been directed. It also analyses the emerging trends in infrastructure financing.

Team Members:

Rizwan Pesnani	*Director*
Dr. Muhammad Saleem	*Joint Director*
Usman Shaukat	*Regulating Officer*

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Overview:-

Infrastructure remains the pivotal element in a country's social and economic development. Since ancient times it is revealed that those civilizations who spent vigorously in infrastructure of their respective regions lived longer than others and provided better opportunities for prosperity to their following generations who build on later through infrastructure provided by their ancestors. We can quote here Roman Empire who lived through antiquity and managed the vast lands under its ambit by creating marvelous long roads, better fortification and advanced shipping techniques which paved the way for European naval supremacy and entrepreneurial revolution just after the Renaissance. The importance of infrastructure has grown to higher proportions during these times as it actually provides a significant social and economic indicator of stability and figures greatly in foreign investors' reckoning. India and China are investing significantly for their infrastructure and their rising stature as emerging economic giants stems from their better infrastructure.

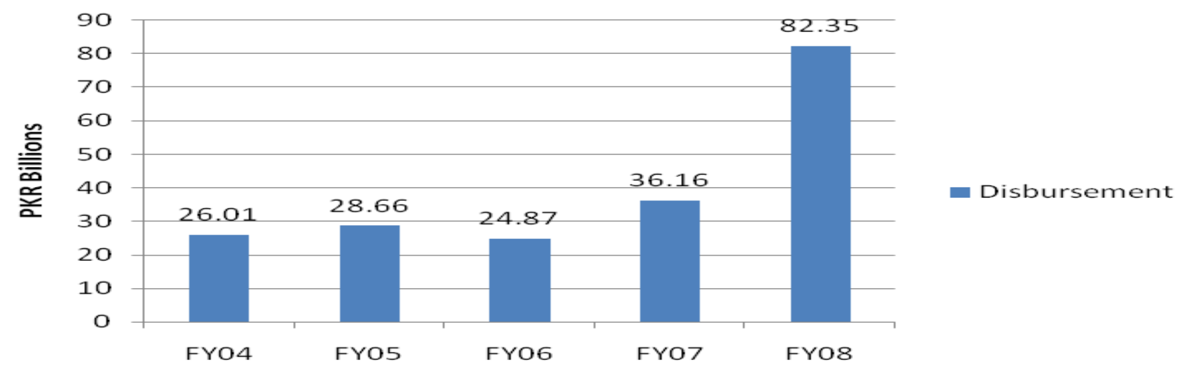
Pakistan is an emerging economy and the growth rate of its GDP since last five years is competitive in the region. The growth trend can become even better if infrastructure of the country is improved. Sound infrastructure also improves climate for FDI. There is a severe mismatching between the infrastructure needs and its resources in Pakistan. [1]A study shows inefficient infrastructure costs Pakistan about 4% to 6%of its GDP and the cost of production of indigenous goods is increased by 30%. We cannot rest on our GDP laurels as our competitors like China and India are producing cheaper goods due to their investment in infrastructure. According to a World Bank report (2007) India was spending 5% of GDP, decided to increase to 8% of GDP over the Eleventh Plan Period (2007-2012). China and other East Asian Economies have been investing over 10% of their GDP in Infrastructure Development while Pakistan's share is below 2% whereas it should be at least equal to its GDP growth rate.

[1] SBP's Infrastructure Task Force Report

Disbursements by Top Five Banks:-

Disbursements in FY04 were Rs. 26 billion (Fig 1) which rose to Rs. 36.16 billion in FY07.

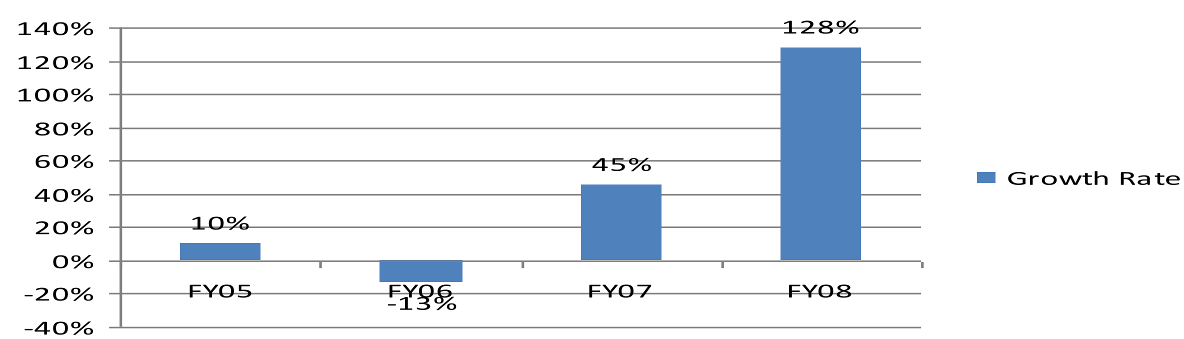
Fig. 1: Disbursment by 5 Banks FY04-FY08



In FY08 the volume of disbursements reached Rs. 82.35 billion which signifies that banking sector has snapped out consumer finance obsessions and felt the project financing also viable option for business purposes. Since 2006 there is a sharp decline in disbursement in consumer financing as in FY07 there is 78% fall in consumer financing which has gone further downward by 364% in FY08. Upward interest rates have triggered the number of defaults on auto loans and this risk may be attributed to lowering share of consumer finance.

Fig 2 shows that the growth of disbursement in FY05 was 10% which hit a low point in FY06 as

Fig. 2: Growth Rates in Banks' YoY Disbursements to Infrastructure Sectors

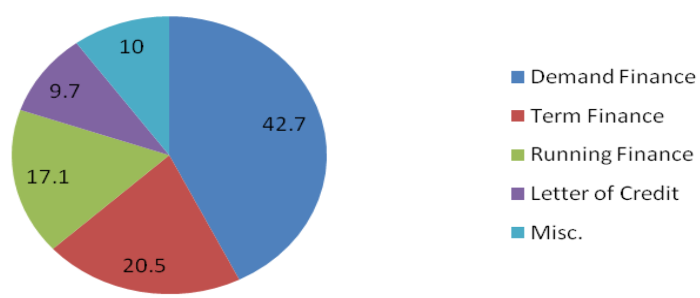


it declined by 13%. Subsequently to this transitory fall in 2006, the trend changed and disbursements rose by 45% in 2007 and by a substantial 128% in 2008. Analysis revealed that this significant growth in project financing was due to investment in Telecommunication and Power Generation sectors during the period and both sectors also attracted FDI during FY07 and FY08.

Financing Structure:-

Banks provide credit to projects under different modes viz. Demand Finance (DF), Term Finance (TF), Running Finance (RF), Letter of Credit (L/C), Bank Guarantee (B/G) etc. Demand Finance and Term Finance are modes used for launching greenfield projects or enhancing capacities of current projects. Running Finance is used for meeting the working capital requirements of existing as well as new projects. L/Cs are primarily used as credit line for importing machinery / equipments. Fig 3 shows that banks financed projects using different modes. Demand Finance is widely used mode of project financing as it has the highest share of 42.7%. Term Finance comes

Fig. 3: Share of Various Modes of Finance in Disbursement to Infrastructure Sectors FY04-FY08



second with 20.5%. Share of Running Finance is 17.1% and 10% went to L/Cs (Letter of Credit). Share of Islamic mode of financing and other modes like bonds are extremely marginal in infrastructure sectors.

Fig.4: Year-wise Disbursement by Various Modes of Finance

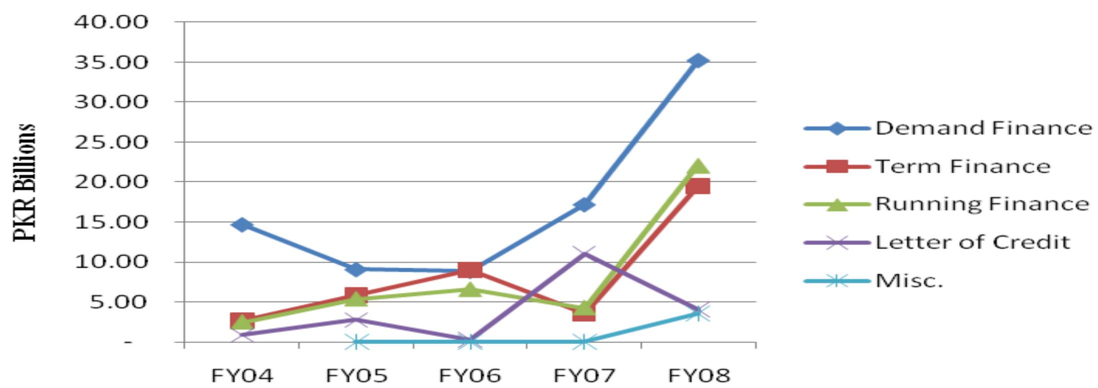
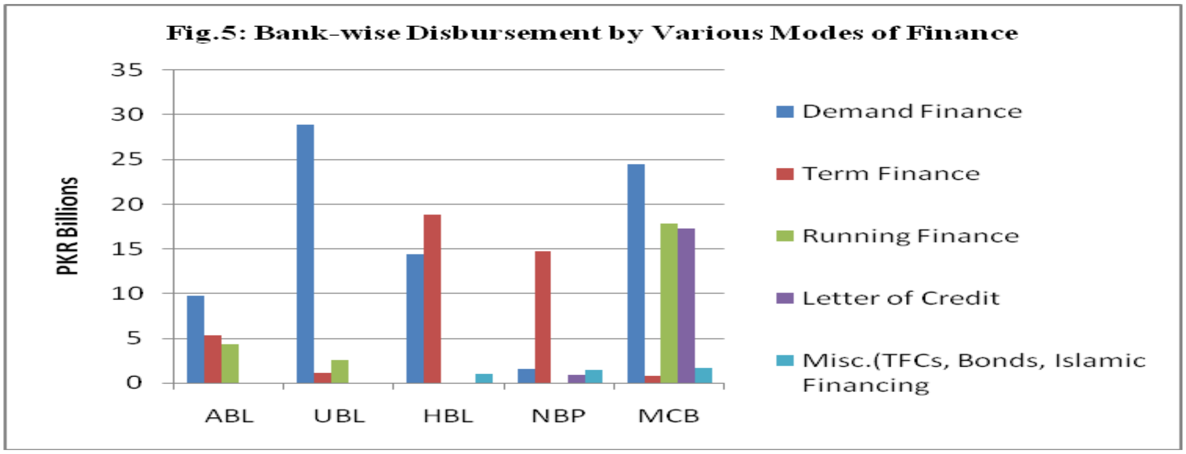


Fig 4 shows year-wise trend of modes of financing. Demand Finance, Term Finance and Running Finance demonstrated a sharp increase in FY08 primarily to finance telecommunication and power generation projects, as explained earlier. The trend shows that banks are financing infrastructure sector through conventional modes. Figure 5 also confirms that the Demand Finance and Term Finance are the most common modes of financing by banks. UBL and MCB



are the two major banks which used Demand Finance for project financing while NBP used Term Finance significantly higher than other options of project financing. HBL, on the other hand, has been financing through both Term and Demand Finance modes. With regard to financing through Letter of Credit for import of machinery/ equipments in infrastructure sector, MCB has by far a clear leader among all major banks. Figure 5 also shows that MCB is the only bank which is using all options of project financing and having diversified structure of project financing. MCB disbursed over Rs.15 billion through Running Finance to meet the working capital requirements, whereas, share of other banks is significantly low in this mode.

Syndication:-

As cost of most infrastructure projects is huge, almost all big projects are financed by syndication of banks where one bank plays lead and pool funds by forming syndicate of other banks willing to take exposure in these projects. This not only helps in risk pooling, it also provides opportunity to banks to diversify their portfolio. Projects related to Telecommunication, Power Generation, Gas Distribution are appraised to the tune of more than Rs.5 billion and in order to mitigate the risk associated with the extent of exposure, syndication is considered a viable hedge against such risk.

Sector-wise Disbursement:-

Project financing in Pakistan remained vibrant due to performance of Telecommunication and Power sectors.

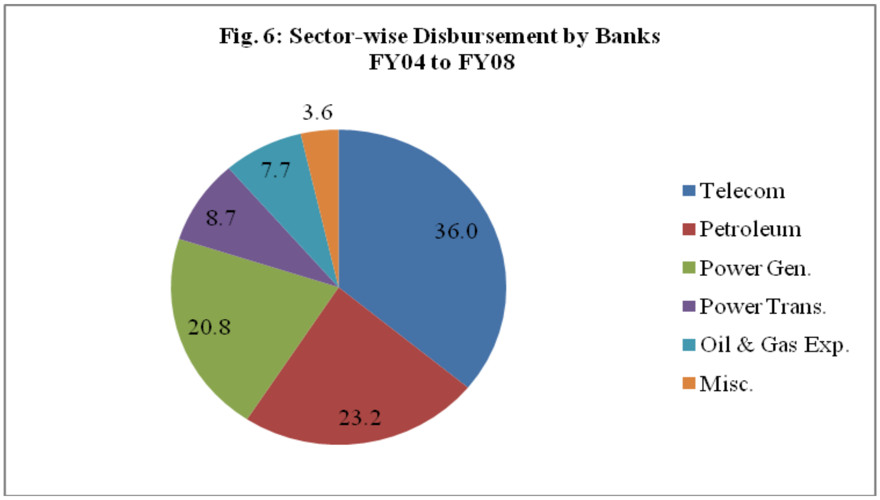


Fig 6 shows that since last five years telecommunication sector has the highest share (36%). Petroleum sector is at second with 23.2% share followed by Power Generation and Power Transmission with 20.8% and 8.7% respectively. Oil and gas is fifth largest sector financed by banks. However, its share is declined in FY08.

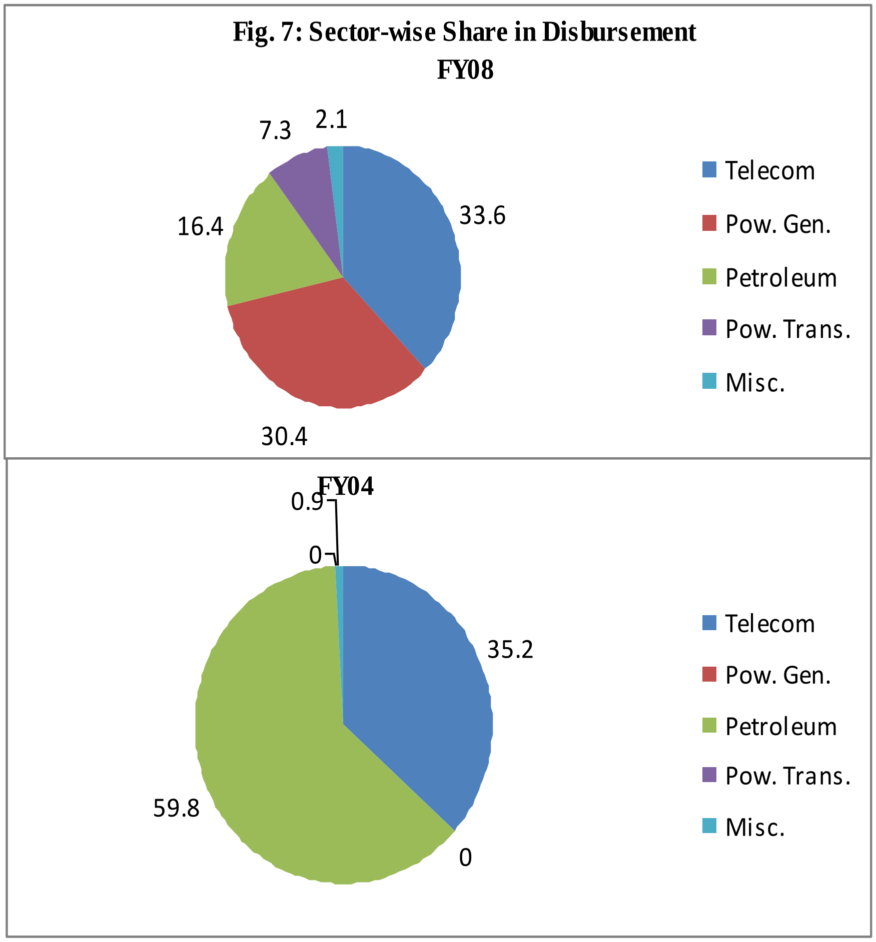


Fig 7 shows the shift in share of major sectors since FY04. As can be seen that there were only two major sectors namely Telecommunication and Petroleum where financing was made by the banks in FY04. As a result of GoP policies and acute shortage of power supply, financing for Power Generation consequently intensified and share of Power Generation is more than 30% in FY08, which is marginally less than the Telecommunication sector.

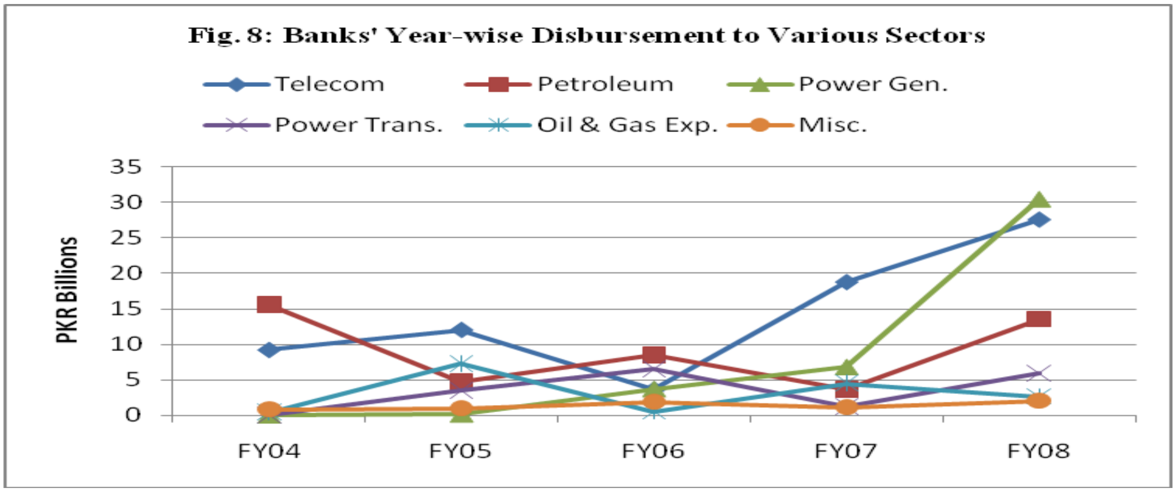


Fig 8 shows yearly financing by banks in different sectors. Power generation started off in FY04 being at the lowest with but since FY07 financing in power generation took a steep upward trend and reached Rs. 30 billion. This is due to energy crisis in Pakistan which appeared during FY07 and more aggravated in FY08 leading to fast tracking of proposals for IPPs. Financing in petroleum follows a zigzag trajectory with more than Rs. 15 billion in FY04. In FY05 it received less financing as only Rs. 4.5 billion were disbursed in petroleum related projects. In FY06 the trend followed upward movement which again diminished in FY07 and rose in FY08. Telecommunication sector since FY06 is on the rise as the trend is mostly positive in FY07 and FY08 which is marked by arrival of China's largest mobile company in Pakistan. Oil and gas exploration sector is following a downward path since FY07which is disappointing considering the dire need of indigenous fuel for power generation.

<u>Bank-wise Distribution of Project Financing:-</u>

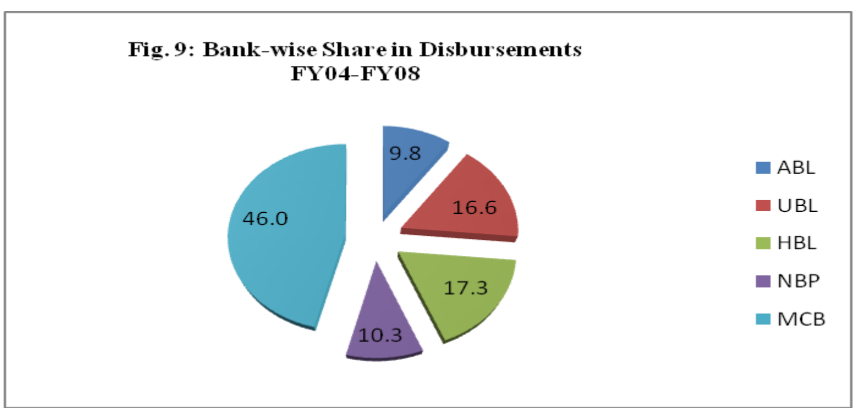


Fig 9 shows project financing-wise five large banks. MCB is the clear leader with 46% share in project financing since last five years followed by HBL and UBL with 17.3% and 16.6% respectively. NBP and ABL are among the lowest with 10.3% and 9.8%.

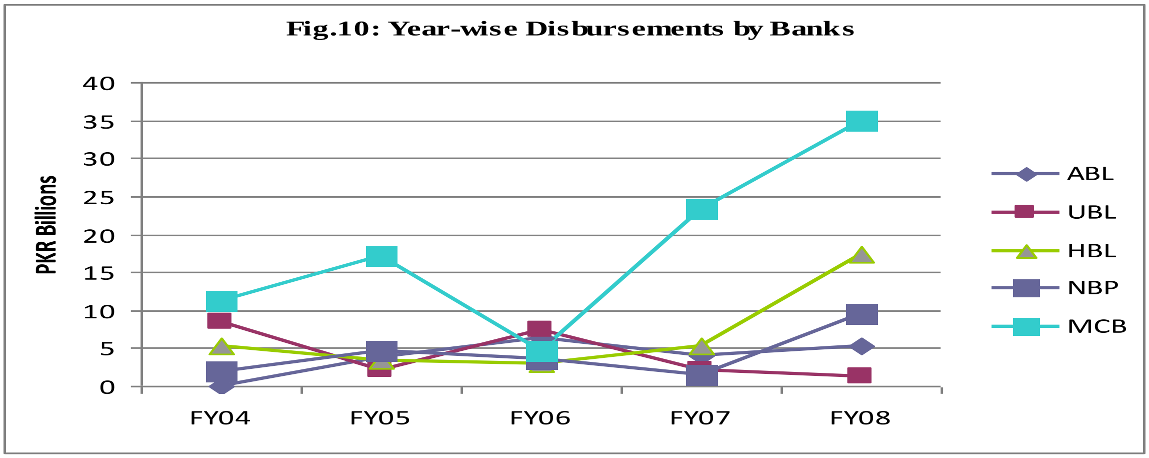


Fig 10 shows yearly disbursement of banks in various infrastructure projects. Apart from FY06, MCB has been the clear front runner. Its disbursement reached Rs 23 billion in FY07 which further rose in FY08 to Rs. 35 billion. In FY08 HBL grew tremendously with Rs. 17.5 billion disbursements which were 229% higher than the previous year.NBP also faced an upward trend in FY08 as was the UBL. UBL's disbursement in infrastructure projects abated in FY05, then escalated in FY06, again lowered in FY07 and increased in FY08 thus more consistency is desired.

Major Borrowers of Project Financing:-

As telecommunication sector is the largest sector in terms of finances received so telecommunication companies are at top when it comes to financing.

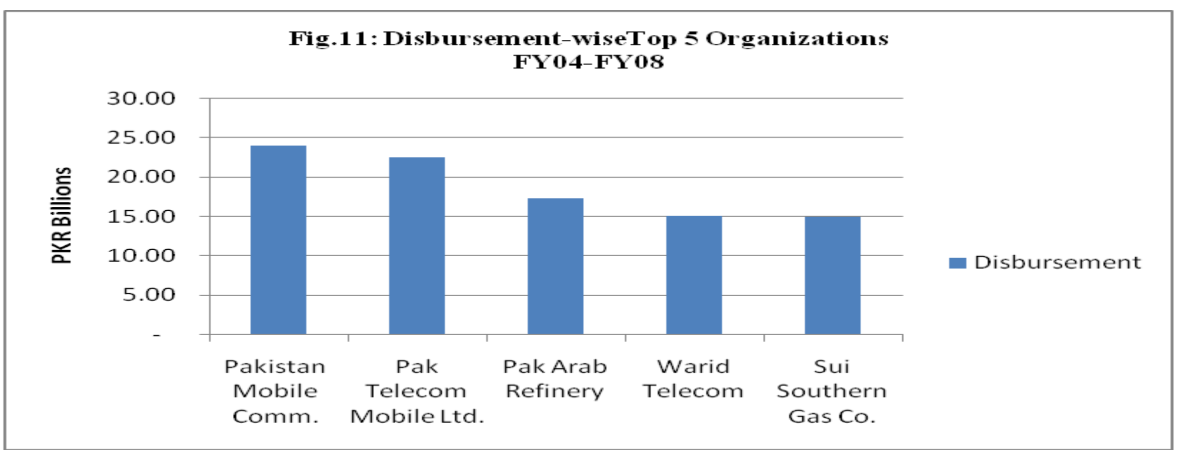


Fig 11 shows five largest organizations in terms of financing during last five years. Both Pakistan Mobile Communication and Pak Telecom Mobile Ltd. received over Rs. 20 billion for their projects followed by Pak Arab Refinery with more than Rs. 15 billion. Warid Telecom and

Sui Southern Gas Company Ltd. received Rs. 15 billion during last five years from major five banks. Total share of these five organizations is 47% in overall financing during FY04-FY08.

SBP Initiatives for Project Financing:-

State Bank of Pakistan established, in September 2006, a dedicated Infrastructure and Housing Finance Department (IHFD) to enhance the access of financial services for development of infrastructure sectors by creating enabling environment for investors & lenders and by adopting international best practices. Although IHFD is relatively new but it has taken many initiatives to identify and analyze issues which hinder growth of credit in these sectors and formulated recommendations to overcome such hindrances. A brief description about the current status of these areas will signify the work of IHFD.

(i) Infrastructure Task Force:-

Infrastructure financing is at its nascent stage in Pakistan. SBP, being conscious of the importance of infrastructure sector, established infrastructure task force, by roping in the experts from financial and infrastructure sectors viz. power, roads, and water and sanitation etc. These recommendations overarch a broad array of issues and propose measures for credit enhancing to different projects. The underlying idea is intensive public private partnership in line with international best practices adopted by developed economies to increase the availability of credit in sectors which are essential for overall improvement of infrastructure in Pakistan.

It is a foregone conclusion that involvement of private sector is vital to the improvement of infrastructure because government alone cannot efficiently shoulder the responsibility of initiating and financing new infrastructure projects due to fiscal constraints. The role of private sector is overwhelming in developed countries for prompt delivery and enhanced efficiency of infrastructure services. Participation of private sector in infrastructure development also ensures the availability of public funds for other social development projects. SBP believes that to promote public private partnership it is imperative to work out a conducive policy framework for public-private participation by enhanced coordination between local, provincial, and central governments. Undue cost and time in execution of government contract hinders the participation of private sector so a strategy is required for smooth execution of contracts on the part of government. Alternative financial mechanisms, including establishment of bond market and capital market for long term funds are also desired for long term funding of infrastructure projects.

(ii) Capacity Building:-

IHFD is also focusing on capacity building, in collaboration with World Bank, and has been planning to conduct training for developing skills and knowledge of professionals associated with infrastructure financing activities. Modalities have been finalized to start the training at the end of the current year.

Conclusion:-

Although lending in infrastructure has increased over time but it still leaves a lot to be desired. In FY08 there were only telecommunication and petroleum sectors where most of funds consumed but since FY08 financing in power generation and power transmission also figured prominently. But more diversification is required as other important sectors like roads, bridges, ports, mass transit etc. are getting very marginal financing by our banking sector. Development of secondary markets for long term funds is necessary as loan tenure in project financing is quite long while financial institutions mostly finance these projects through short term deposits. This asset liability mismatch can be overcome by issuing Bonds, Sukuks, and TFCs whose current share in project financing is very marginal. Banks should also promote their products based on Islamic mode of financing to diversify the existing financing structure and move beyond conventional modes of financing.