

FINANCING AND IMPORTANCE OF BANKING IN INVESTMENT OPERATIONS OF HEP Plc

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Summary

Owing to the importance of business activities related to electric-power supply and distribution system, ownership structure, the size of assets, influence on the supporting industry and development of the Croatian economy, the Croatian Electricity Company (HEP) has always been the subject of interest of its owners, the public, financial institutions – primarily domestic ones – but increasingly so in the international business scene. The development of financial industry and appearance of competition in banking business made it possible for HEP to have an impact on cost reduction related to capital investment financing, so it is possible to choose among different products on the money and capital market. By adjusting the source of financing to the needs of a particular project, HEP actively manages its debt portfolio, respecting decisions of owners and applicable laws in the process (Company Act, Foreign Exchange Law, Public Procurement Act, etc).

Keywords: Capital investments, Capital structure, Sources of finance, Banks, Investment funds, HEP Plc.

1. INTRODUCTION

Owing to the importance of business activities related to electric-power supply and distribution system, ownership structure, the size of assets, influence on the supporting industry and development of the Croatian economy, the Croatian Electricity Company (HEP) has always been the subject of interest of its owners, the public, financial institutions – primarily domestic ones – but increasingly so in the international business scene.

The development of financial industry and appearance of competition in banking business made it possible for HEP to have an impact on cost reduction related to capital investment financing, so it is possible to choose among different products on the money and capital market. By adjusting the source of financing to the needs of a

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particular project, HEP actively manages its debt portfolio, respecting decisions of owners and applicable laws in the process (Company Act, Foreign Exchange Law, Public Procurement Act, etc).

The values of capital investments also determine the choice of a financial product. Namely, business banks in Croatia are not able to support HEP's investments independently, since they have to consider capital adequacy indicators, exposure to one client, and investment profitability, so HEP sometimes turns to often «the only and more favorable» foreign financial market. However, on foreign financial markets HEP needs to take care of more transparent business practices, more restrictive conciliations of borrowing and risks arising from foreign currency financing, since 90% of HEP's income is in kunas.

It can be said that financing of capital investments in itself, i.e. making contracts with creditors/investors and withdrawal of funds, is the focal point in the process of capital investments. Other phases will be analyzed in more detail further in this paper.

2. CAPITAL INVESTMENTS OF HEP

The main document for defining energy policy and planning the development of electric power system in Croatia is the Energy Sector Development Strategy for the next 10 years, adopted by the Croatian Parliament at the proposal of the Government of Croatia. Based on the Energy Sector Development Strategy, the Government of Croatia adopts the Implementation Program for the Energy Sector Development Strategy. HEP no longer has the monopoly in conducting activities related to the field of electric power generation and distribution, and any legal entity that obtains the license to conduct these activities can also conduct activities in this field. Therefore the long-term planning of development of Croatian electric power system is no longer the obligation and responsibility of HEP only.

However, according to the Electric Energy Market Act, HEP is a service provider in electricity supply business in Croatia, with approximately 2.2 million of tariff customers and 106 eligible customers. HEP satisfies their needs mostly from own production capacities (about 83%), and from import (17%). In the last few years there was a 4% increase in consumption at the annual level, which indicates the need for continuous capital investments.

Investment activities of HEP are complex business processes, considering the numerousness of facilities, complex procedures related to obtaining site and construction permits, development of environmental studies, long-term construction implementation, and high values of investments.

The HEP management, in compliance with the Statute, manages activities of the company, and its duty and authority is to undertake all actions and make decisions that are considered important for their successful implementation, taking into account the interests of HEP owners, i.e. the Republic of Croatia.

At the end of the year the company management adopts an *Investment plan* for the next year for companies that are part of the HEP Group, and this represents the main operational document for realization of goals adopted in the Work plan of the management.

The investment plan, along with the list of planned investments by companies of the HEP Group stating absolute and percentage amounts and planned sources of financing, has to be approved by the Company's supervisory board. It is only after the supervisory board approval that the plan becomes a binding document, based on which experts of the Corporate Finances Sector will be charged with the task of finding the most favorable source of financing, in accordance with the needs and specific qualities of capital projects.

The following sources are available to HEP for financing capital investments:

- available amortization from the current year
- estimated available amortization brought forward from the previous year
- connection fees paid by new customers in the current year
- estimated connection fees brought forward from the previous year
- loans in use
- new loans
- profits of the current year.

HEP is 100% owned by the Republic of Croatia. State ownership means that HEP has constant support in its core activities. Although HEP is not financed by funds from the state budget, until 1995 the state provided financial support in the form of loans and guarantees in order to help HEP in achieving its goals. Returns haven't been allocated to owners for the time being, but were either used for covering losses from previous periods or completely reinvested.

Since 1998, and especially after the initial financial rating was determined by Standard & Poor's (BBB), HEP has changed the policy of financing and it appears independently on domestic and foreign financial markets, without government guarantees, except in situations when projects are financed by foreign international financial institutions that always require government guarantees. These are usually long-term projects by means of which some new areas are developed, in accordance with international practice, and which wouldn't be placed on the priority list accord-

ing to profitability criteria (for example, investments in alternative energy sources, ESCO projects, development of consumption management through allocators in the heating business, etc.).

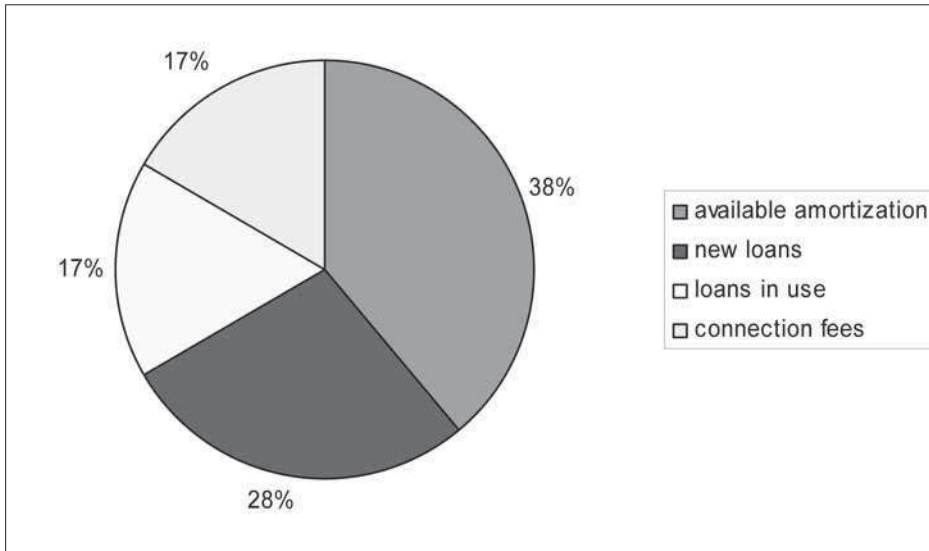
The perception of HEP in the eyes of creditors hasn't changed, that is, lack of this kind of state support hasn't significantly increased the price of capital. The capital price is still determined by the strength and stability of the company and the current situation on the market. The fact that HEP is one of the few companies in Croatia that has a credit rating of S&P's and has successfully maintained it for years makes HEP a reliable business partner with transparent business activities. Namely, the credit rating (BBB) itself gives insight to all potential investors/creditors/partners into the current situation and risks of business operations, returns related risks, but it also gives projections of long-term sustainability of the company, the industry, and the market on which the company conducts its business activities. All strengths and weaknesses in HEP's business operations, as well as conditions in the business environment are visible in the conclusion of S&P's.

«CONCLUSION: Indebtedness of HEP is moderate, debts-to-assets ratio is 21% at the end of 2004. Of the remaining debt at the end of 2004 more than half were foreign bank loans, about 15% was a rescheduled debt of the electricity company in the former Yugoslavia, and the rest were mostly domestic bank loans. Most of the debt is subject to variable interest rates. About 85% is in Euros, and almost 13% in dollars... For approximately 25% of the remaining debt there are state guarantees... In spite of the relatively low indebtedness, financial flexibility of HEP is weak due to problems with collecting payments, negative or marginal free cash flow, possibilities for maintaining the level of cash and liquidity and due to somewhat insecure approach to the capital market. The main source of flexibility is the delay of investments. Conditions on the domestic bank market have improved. Although HEP is one of the best loan users in the country, the Croatian financial market perhaps still hasn't got sufficient depth for financing large investments at attractive interest rates. At the same time, fiscal restrictions might diminish the potential for more significant capital inflow from state contributions or privatization. Therefore the company will probably rely on access to international markets in order to satisfy the needs for financing.»²

Capital structure and financial flexibility

Shares of individual sources of financing have changed over the years, but the largest part of investments has been financed from available amortization funds, new loans, loans in use and connection fees, as shown in Figure 1.

² Standard and Poor's credit rating report 2004

Figure 1. *Financing source structure*

«While determining the structure of sources of financing for a particular year, the following limiting factors are taken into account: *indebtedness level* of the company providing regular liability servicing and maintenance of investment credit rating; *respecting contracted financial indicators* in existing credit arrangements; *monetary policy measures of the Croatian National Bank* aimed at limitation of credit expansion of banks and *measures of the Government of Croatia* aimed at reduction of foreign debt.»³

HEP is a company with large financial potential, low level of indebtedness (debt-to-assets ratio up to 25%) and good credit rating, which makes it possible for the company to find sources of financing on both domestic and foreign money and capital markets. Accordingly, in the last ten years, depending on the specific qualities of a project, HEP concluded contracts or was negotiating with the most important foreign and domestic financial institutions, such as:

- international and domestic development banks (IBRD, EBRD, EIB, KfW, HBOR)
- export credit agencies (EXIM, HERMES, NEXI, NIB, Coface)
- business and investment banks (European, American, Japanese, ...)
- investment funds, insurance and retirement companies.

³ Investment plan of HEP group for 2007

Development of financial market, strong competition and introduction of new instruments and techniques of financing make it possible for HEP to shift away from classic credit and deposit business and to choose the most favorable instrument for financing its capital investments, taking into account the cost component, investment structure, but also the risks of transactions themselves. In its financial activities so far, HEP has really used different financial products. After a conservative start, HEP was slowly entering the international market by concluding bilateral and the first syndicated loans, relying on experience of business partners, opinions of relevant ministries and advisers in the process, then making progress over contracting structured loans linked to masut price movements, interest rate and currency swaps, to issuing corporate bonds. In this way HEP has diversified its debt portfolio, expanded investor base, reduced financing costs, thus actively hedging business risks and acquiring new knowledge and reputation on the market. In order to confirm the above stated, several significant capital projects financed from different sources will be described.

Description of more significant investments

Investments plans included partially reorganization and system modernization, and partially the construction of new facilities due to the increase in electricity consumption and the need for improved stability of electric power system. Investments were financed from own capital with less than 50%, and the remaining part was financed by investment loans (28%) and connection fees (25%).

	2003	2004	2005	2006
HRK (mil.)	2.153	1.813	2.414	2.609

a) Financing by IBRD loans: ESCO Project (EUR 4.4 mil.) and Development of Heating Business in Croatia (EUR 24 mil.)

The Bank strategy supports activities that will help Croatia to join the EU and meet requirements from EU directives. ESCO Project will enable efficient management of electricity consumption, and the loan will be repaid by funds saved as a result of reduced electricity consumption. The main goal of the Project is to develop larger number of ESCO companies and to increase energy efficiency in Croatia.

The heating project will support demand management through a voluntary program implemented by HEP – Toplinarstvo (*heating business*) and policy changes based on implementation of the Heating strategy of the Government. Demand management will help in reducing electricity consumption in buildings, which will result in reduced emission of carbon dioxide in accordance with the EU directive that explicitly points to energy efficiency of the heating sector.

Both loans are long-term loans, with utilization period up to 5 years, and semi-annual repayment over 10 years. One loan is a variable spread loan (VSL) and the other has a fixed spread throughout the loan period (FSL). Both products include the option of automatic fixing of margin after withdrawal. Loans are in Euros, and they are utilized according to the Bank rules, and the Bank also has to approve every public tender for goods and services that will be financed by the loan (the so-called No objection). In general, the advantages of such loans are that they are long-term loans, the spread is significantly lower compared to business banks, and the state supports project development. The disadvantages are bank procedures, the need for documenting every cost, periodical reporting on project progress and financial condition of the Company, and restrictive financial indicators that are the same for all clients which are generally not negotiable.

Financing with HBOR loan

In 2003, a long-term loan in the amount of EUR 123 mil. was concluded for the purpose of constructing transmission plants TS Žerjavinec and TS Ernestinovo and for works on Split and Rijeka program. Since the most favorable offer was submitted by a domestic consortium (Končar, Đ. Đaković), HBOR was selected for financing, although some international development banks had more favorable offers. Namely, these banks do not acknowledge the clause about domestic preference in the tender procedure, and they insist on international public tenders. Ernestinovo project is the most important project in the after-war period, since it provided reconnection to the Hungarian electric power line and connection to the southeastern part of transmission network.

b) 200 mil. EUR Club loan

In July 2005, a contract on club loan in amount of EUR 200 mil. was concluded for the purpose of construction of new production facilities of HE (power plant) Lešće and a new co-generational unit L in TE-TO Zagreb. The procedure of contracting the source of financing started with publication of a public tender in the Official Gazette, since HEP as a state-owned company is subject to this Law. Financing on the capital market (commercial bills, bonds, shares) is exempted from the Law, and for all other types of financing, even the short-term ones, a tender is envisaged. It is obvious that the Law lacks some logic, failing to take into account the size and the needs of HEP, because there are only few domestic banks that are able to make offers for the whole loan amount on their own, without violating the provisions of the Bank Act. In addition, no room is left for negotiation with banks in order to additionally reduce costs, but the lowest acceptable offer has to be accepted, if this is the selection criterion. However, in 2005 the Law allowed for a possibility of direct negotiation with creditors, subject to the approval of the Public Procurement Office, and HEP took the opportunity to do so.

The loan was concluded with five banks, including one domestic bank. Other banks were not able to meet the requirements of foreign banks, considering the restrictive measures of the Croatian National Bank (increased rate of required reserves), which automatically increased the price of capital for them. The achieved spread was 50 bps, which was a significant cost saving, considering the market conditions at that time (over 100 bps). Although the state guarantee was not required, HEP is obliged to obtain the Government approval for every foreign borrowing, and only then can the loan business be registered at the Croatian National Bank. The procedure for obtaining the approval begins with sending the request to the Ministry of Economy, Labor and Entrepreneurship, which forwards the request to the Ministry of Finance. Their positive opinion is sent to the Government, which makes the decision about approval of foreign borrowing on one of its sessions. The whole procedure, from the invitation to banks to submit their offers to the effective Contract lasts several months, therefore it is important to start the procedure in time in order to provide the means for financing a capital project, because very often preparation works at the construction site take place at the same time as contracts with contractors and suppliers.

c) Structured loan

A bilateral structured loan in the amount of EUR 50 mil. was concluded for the purpose of partial financing of the Investment Plan for 2004. The loan is due on the 5th anniversary of the signing, as one-off payment. A particular feature of this loan is that the spread is linked to masut price movement on the market. Namely, the contracted interest rate, a three-month EURIBOR, is enlarged, or diminished by the spread that depends on the price of masut that HEP uses in its thermo-electric power plants and on the price of dollar. The spread ranges from -0.75% to 2.70% . If masut price increases on the market, the spread goes down, and if the masut price goes down, the spread increases. Considering the situation on the oil market, in the last year HEP was paying EURIBOR -0.75% . At the moment when analysts envisaged stagnation and decrease in oil price, and referential interest rates started to go up, we decided to reschedule the loan and the contracted variable rate was changed to the fixed rate. The achieved interest rate is 3.58% and this currently represents the lowest cost of long-term financing for HEP.

d) Issuing corporate bonds

The Croatian market of debt securities consists of long-term and short-term securities. Long-term securities include state bonds, corporate and municipal bonds, while short-term securities include treasury bills of the Ministry of Finance and commercial bills of companies. The more significant expansion of the debt securities market started with the implementation of reform of the pension system, which resulted in foundation of obligatory and voluntary retirement funds, and lead to a strong development

and growth of investment funds with an appetite for investing in bonds. The most important participants in bond trading on the domestic market are *banks, retirement and investment funds, and insurance companies and housing savings bank*. At the end of 2005 and beginning of 2006, the conditions on the securities market were, compared to the costs of borrowing through loans, more in favor of issuing kuna bonds with a fixed interest rate. Namely, yields on Kuna curve were about 4.5%, which in conditions of EURIBOR growth was very acceptable. Therefore, in the first half of 2006 there were several kuna emissions: the state with the second tranche of HRK 2 billion, RBA with HRK 600 mil., Podravka with 5-year kuna bond of HRK 375 mil. and NEXE Group Plc with the amount of HRK 750 mil. HEP also strived to use the good timing for the initial issue of bonds, diversifying its debt portfolio at the same time, expanding the investor base, freeing credit lines toward domestic banks, and reducing its exposure to currency and interest rate risk. Namely, of the total long-term debt, 89% was denominated in EUR, 10% in USD and only 1% in HRK.

In the structure of contracted loans, about 90% of interest rates are variable, and only 10% are fixed. In order to reduce currency and interest rate risk, HEP management made a decision about issuing bonds in the domestic currency, with fixed interest rate, in the amount of HRK 500 million.

When investing in HEP securities, investors, in accordance with own risk and return ratio preferences, knowingly take the following kinds of risk:

Industry risk - HEP generates almost all of its revenues in the field of electricity, where HEP has almost a monopolist position on the Croatian market and has no real competition. In gas supply industry there are 38 companies, among which HEP holds the second position with 13,75% share. In terms of industry development, HEP has a good position, where it can utilize its experience and the effect of the economies of scale.

Competition risk – high entrance barriers for potential new competitors, like investments in infrastructure construction, significant fixed costs, government conditions and procedures, limited location resources, and influence of the government on the price of particular production resources, guarantee long-term stability of the position of HEP Group.

Risk of change in ownership structure – the current law regulating the privatization of HEP, adopted in March 2001, states in Article 3 that the Republic of Croatia maintains ownership of 51% of HEP shares until Croatia joins the EU. After EU accession, based on a separate law, the Government of Croatia shall determine the schedule and dynamics of HEP privatization by selling its share in the company. Because of the importance and sustainability of electric power system, the state shall take utmost care regarding the timing and selection of the strategic partner.

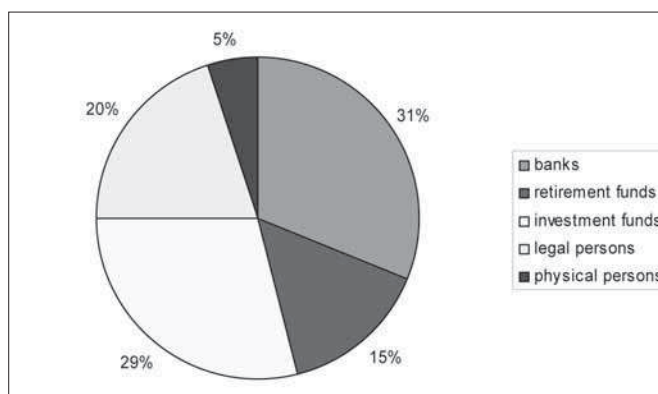
Exchange and interest rate risk – most of the long-term liabilities of HEP as well as costs of fuel and electric power purchase are linked to foreign currencies exchange rates, in the first place to the US dollar (USD) and Euro (EUR). Of the total long-term debt, 89% has been denominated in EUR, 10% in USD and only 1% in HRK. In order to protect the company against changes in exchange rates, HEP uses contracted and FORWARD transactions for fixed liabilities toward foreign banks and suppliers.

In the structure of contracted long-term loans, about 90% of interest rates are variable, and only 10% are fixed interest rates. As far as in 1998, HEP concluded a contract on interest rate swap, protecting HEP against exposure and changing the interest rate from variable to fixed.

Credit risk – this risk is related to receivables and it refers in the first place to corporate subjects, especially those that are in difficult financial situation.

The initial issue of HEP's 7-year bonds, with 5% talon, was characterized by large interest of both institutional and individual investors (legal and physical persons). The amount was exceeded several times, and the investor structure by categories is shown in Figure 2.

Figure 2.: *Structure of investors in HEP bonds*



3. FUTURE CAPITAL INVESTMENTS AND POTENTIAL FORMS OF FINANCING

Continuous growth of electricity consumption creates new obligations in electricity production for both tariff and eligible customers, which can be met *only by construction of new production facilities*. Therefore it is planned in the next 10-year period to build approximately 1.200 MW of installed power. The following production facilities should be put into operation during that period:

- two blocks (250 MWe, 50 MWt), in the existing TE Sisak and TE-TO Osijek

- reserve block on coal (500MW) on the location TE Plomin
- HE Kosinj, HE Podsused (43 MW) and HE Drenje (39 MW) – power plants
- building of other, small renewable sources of electric power

The development of HEP business system is heading toward development of other energy activities as well, for example, distribution and sale of gas, but also toward providing sufficient quantities of gas for electricity and heat production. For these reasons HEP started the Project of LNG terminal construction, which is of large importance not only for Croatia, but also for the whole Europe. The total investment in LNG terminal is estimated to 1.6 billion Euros, and HEP will participate with 10%.

Besides, HEP expressed the interest for participation in construction of an *underground cable* between Croatia and Italy, which is of key importance for future trade in electricity and development of electricity market in general. The construction of an underground cable would put HEP in a position to deliver electricity to the market where electricity price is significantly higher than in Croatia and Eastern Europe. For this reason the period of return on investment is much shorter, compared to similar investments.

The reform of the Croatian energy sector gradually introduces prerequisites for opening of the electricity production and supply market. Similar processes also unfold in the region, providing HEP with an opportunity for *strategic business linking* with business partners in Croatia and abroad, and expanding business in the Eastern Europe.

The described investments for the period 2007-2013 are shown in the table below (in mil. HRK)

2007	2008	2009	2010	2011	2012	2013
3.287	4.436	4.481	4.247	3.190	2.171	1.846

Capital investments in 2007, in accordance with management decision, will be financed from the following sources, and the similar structure of financing is expected in the following years:

Available amortization	33,78%
Estimated available amortization brought forward from 2006	6,21%
Connection fees	14,38%
Estimated connection fees brought forward from 2006	5,61%
Loans in use	18,49%
New loans	21,53%
TOTAL	100%

The company plans envisage further intensive capital investments, in accordance with the defined vision of the Management, which *«sees HEP as an integral corporation becoming the regional market player, Croatian energy cluster, with multiutility approach concept, and one of the driving forces for improvement of the Croatian economy.»*⁴

Owing to good business results, stability of business operations, good relations with the most important financial institutions, good image and relatively low investment risks for investors, HEP will continue its presence on the domestic and foreign money and capital market and utilize all available and acceptable products offered by financial industry.

It is very likely that HEP will appear on the stock market through initial public offer (IPO), based on which HEP will get its price, i.e. market value for the first time. Of course, this is a complex and time-consuming process that requires great knowledge of all participants (consultants, investment bankers, management, lawyers, auditors, PR experts, etc.), in order to provide that the market price, reflecting investors' expectations about future value of shares and economic growth of the Company, is as realistic as possible, and make IPO itself timely and successful. It should be kept in mind that in case of HEP the decision about IPO will be made by the Government, in accordance with the existing Law on HEP privatization. The funds raised in the process of initial public offer will be utilized in the way determined by the owner.

Also, it is expected in the future that HEP will be, owing to better business results and surplus funds, more often assuming the role of an investor in debt securities and shares and shares in investment funds. In its investments, according to policies and procedures, HEP will be guided by the security rule, that is, maximum profit with acceptable risk level. For that purpose the reorganization of the Sector of corporate finances and treasury implementation are planned, that will efficiently manage liquidity and risks in financial operations of HEP.

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