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Market Intelligence

PROJECT FINANCE 2023

Global interview panel led by TozziniFreire Advogados

Lexology GTDT Market Intelligence provides a unique perspective on evolving legal and regulatory landscapes.

Led by TozziniFreire Advogados, this Project Finance volume features discussion and analysis of emerging trends and hot topics within key jurisdictions worldwide.

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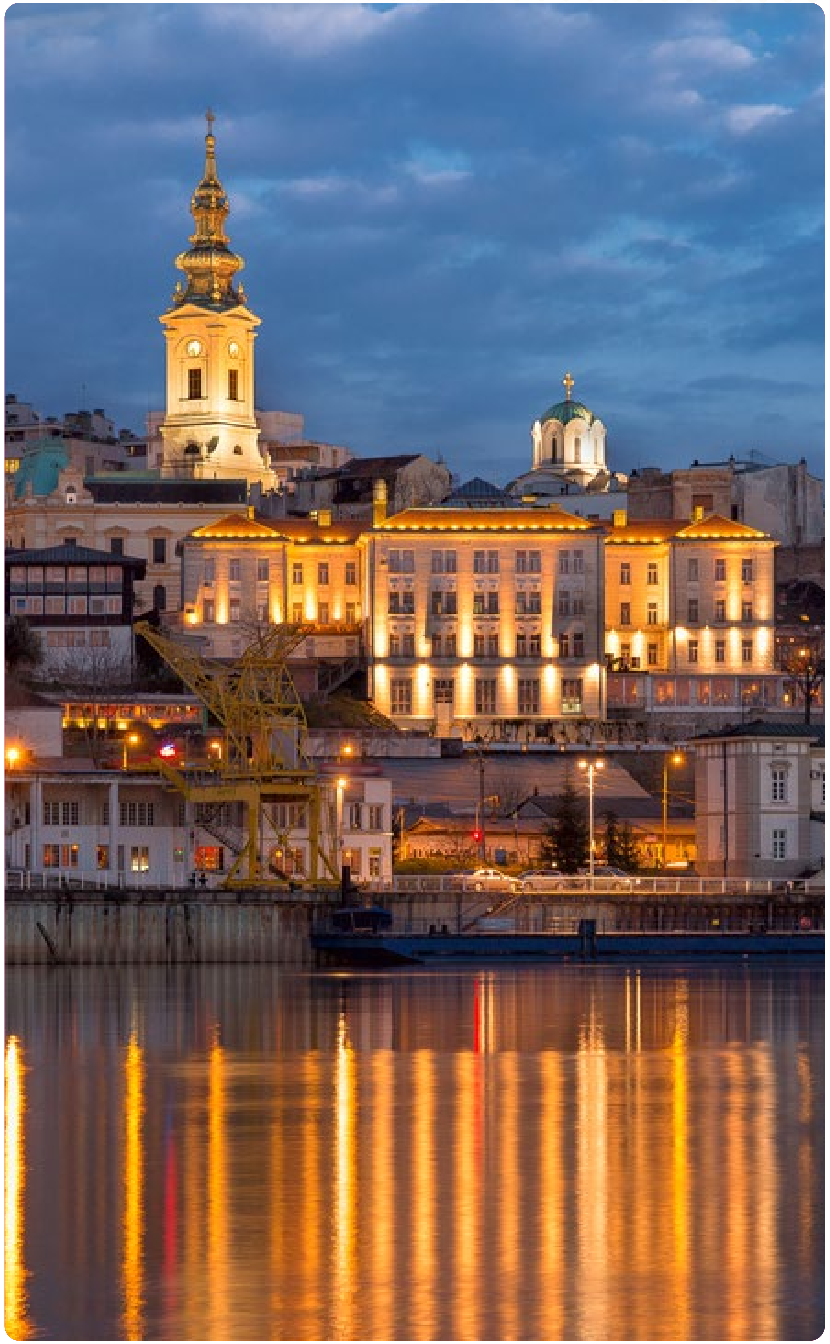

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Serbia

Dragoljub Cibulić is an expert for greenfield real estate, energy and infrastructure projects. He has a rich legal background and ability to provide clients with combined expertise on project development, financing and regulatory aspects. He has led BDK's team advising international financial institutions led by the IFC on lending to the first two PPP projects in Serbia - the Belgrade airport concession and the Belgrade waste-to-energy project in Vinca.

The Legal 500 regards Dragoljub as a leading individual in Serbia in the projects, energy, real estate and construction practice areas. *Chambers and Partners* ranks Dragoljub as a Band 1 Serbian lawyer for projects, infrastructure and energy. *IFLR1000* recognises him as a highly regarded lawyer in both Serbia and Montenegro.

Dragoljub Sretenović is a partner with 10 years of experience and is part in the finance practice group of BDK. Dragoljub advises banks and corporate borrowers on acquisition, project and working capital financing. Dragoljub is also experienced in matters related to insurance, banking regulations and distressed debt. Most recently, he advised JP Morgan in relation to the financing of the Morava Corridor, one of the largest ongoing infrastructure projects in the country; BNP Paribas on the financing of the new bridge in Belgrade; and BNP Paribas and UniCredit on the financing of the wastewater treatment facility, also in Belgrade.

He received recognition as a rising star in the banking and finance, projects and energy practice areas by *The Legal 500* in 2021.

1 What have been the trends over the past year or so in terms of deal activity in the project finance sector in your jurisdiction?

The Serbian project finance industry used the period of extremely favourable financing conditions to attract a steady inflow of overseas investments. For a developing market, it was important to establish this track record of successful transactions and lay the groundwork for future expansion. The market also found ways to endure and even thrive through the effects of the covid-19 crisis. Some of the most complex projects, such as the financing of the construction of a waste-to-energy facility in Belgrade, were closed during the first wave of the pandemic.

On the other hand, the 2022 toxic mix of geopolitical tensions, the war in Ukraine, the energy crisis, the recession and the rise of inflation and interest rates, has to date been much more difficult to absorb and led to a decline in dealmaking at one point. The mitigating factor is the geographical diversity of investors in Serbia, including those from Middle Eastern states who have fared well and remain active and open to new opportunities. Also, investments in certain sectors may still be highly rewarding despite debt becoming costlier and putting pressure on the returns to the equity holders. We are cautiously optimistic that these may generate sufficient activity to keep the wheels of the industry turning until the macroeconomic environment improves.

2 In terms of project finance transactions, which industry sectors have been the most active and what have been the most significant deals to close in your jurisdiction?

There is an enormous demand for environmentally and climate-friendly projects, especially in the renewable energy sector.

Dragoljub Cibulić

Dragoljub Sretenović

Alongside Serbia's commitment to decarbonise its economy, which was expressed in an early draft of its National Energy and Climate Plan and the EU-backed Declaration on the Green Agenda for the Western Balkans, the growth of the sector has also recently been aided by the quest to diversify the country's energy sources.

Historically, a crucial part of the investment allure of renewables was government subsidies. Developers would remove most of the market risk by pre-selling their electricity to a state-owned utility at a fixed above-market price. The Serbian government recently introduced a new set of incentives for renewable energy production based on feed-in premiums (ie, a mechanism consisting of a payment of premiums for renewable energy production on top of the electricity market price). The scheme has to date received only a lukewarm response from the major stakeholders owing to concerns that the maximum purchase price for electricity produced from wind

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is set too low. In any event, although it certainly helps bankability, government support is no longer absolutely essential for the delivery of projects, as the cost of producing renewable energy has fallen and energy prices are rising.

The government's ability to subsidise the local green industry and develop its own projects will depend on the state of public finances and the prospects of raising new capital. In 2021, before financing conditions in international markets tightened, Serbia had launched its first-ever €1 billion green bond. The proceeds have and will be used to (re)finance projects for renewable energy, green buildings, energy efficiency, pollution prevention and control, waste water management and eco-friendly transportation.

The state budget for 2023 shows that the government has not given up on its plans to borrow €1.8 billion in loans for the construction of solar plants and wind farms, and up to €1.6 billion in loans for the construction of a pumped storage hydropower plant.

Other items in the budget indicate massive public spending this year and the prospect of raising an unprecedented amount of new debt to fund investments in public infrastructure. In today's environment, those plans come with an elevated risk of overstretching public finances. Serbian borrowing costs from international markets has more than tripled since the end of 2022, and the public debt:GDP ratio has moved closer to its statutory limits. This means that the government will have to be selective in terms of which projects will be fast-tracked to boost growth. The appetite for ways of delivering projects via off-balance sheet mechanisms, such as public-private partnerships and concessions, is also increasing. The most successful examples of these models are the financing of the Belgrade Airport concession and the construction, operation and maintenance of the Vinča waste-to-energy facility.

3 Which project sponsors have been most active in driving activity? Which banks have been most active in providing debt finance?

Although there is a growing number of domestic developers that have become mature and well established, and have specialised and experienced teams, most investments still come from abroad. In terms of geography, one of the distinct characteristics of the Serbian market compared to the rest of the region is that foreign debt and equity capital comes from many different sources, including the EU, the US, China, Russia and the Middle East.

Developers from Gulf States, buoyed by high international energy prices, have recently increased their presence in the country and the region. Among them, the United Arab Emirates stands out as a home to major investors in Serbia, including a company developing a US$3.5 billion mega-project on the Danube riverfront in

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Belgrade, but also as a lender and strategic partner to the Serbian government.

Serbia is a candidate for EU accession, and most trading and other investment activities are performed with the member states. Also, the Serbian financial sector is deeply integrated in the European framework as the parents of most of the country's biggest banks are based in the EU. Although 2022's financial statements of those lenders and other European banks showed significant profits and strength of their capital and liquidity positions, those results have not translated into higher lending activity.

Chinese financial institutions have also been very active and now employ typical project finance structures more often than in the early days of the Belt and Road Initiative. Some interesting interplays have started to develop, such as the projects funded by Western banks and guaranteed by China's export credit guarantee agency. In one example, the state took a loan of around €200 million from BNP Paribas and UniCredit Bank, which is secured by Sinosure and will be used for the construction of the wastewater treatment facility in Belgrade. This shows that financial institutions from these jurisdictions will not always necessarily compete but may complement each other.

The role of international financial institutions such as the European Bank for Reconstruction and Development and the International Finance Corporation continues to be crucial for the industry. Although they pursue market-based financial returns, these institutions often agree to back projects meeting their objectives and policy requirements, which otherwise would not be financed solely by commercial banks. National development financial institutions, such as Proparco, the German Investment and Development Corporation and the Development Bank of Austria, are also present in the market as single lenders or participants in multi-lender facilities.

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Until recently, with a few exceptions, domestic banks rarely participated in multi-hundred million financings arranged by foreign lenders, other than as account banks, onshore security agents or providers of local currency working capital or VAT facilities. However, there are indications that foreign lenders will soon face greater competition for deals in Serbia from the biggest local banks.

4 What are the biggest challenges that your clients face when implementing projects in your jurisdiction?

Despite gradual improvements, Serbian law rules on capital controls still cause headaches for deal participants. The law is nominally liberal in that in general it allows debt and equity investors to invest and repatriate their capital freely. However, routine cross-border legal and economic transactions may be restricted; non-residents may be prevented from exercising their set-off rights, residents may be prohibited from transferring some of their receivables

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to non-residents and foreign non-EU lenders may be unable to receive prepayment of a loan before a certain time, to cite just a few examples. Not all restrictions are explicitly set in law; certain procedures that were intended to assist the government and central bank in keeping track of the balance of payment (ie, for statistics) effectively impose obligations on parties in cross-border transactions, sometimes in a way that is essentially prohibitory. While we cannot reasonably expect that all those restrictions will be lifted before Serbia joins the EU, surely there are limitations that could still be relaxed or removed outright today without any harm to policy objectives.

The laws on granting and enforcing security still have loopholes, including some that a newbie lender from a more developed market may find difficult to understand, let alone factor into its risk analysis. To give another example, Serbian law's pledge over bank accounts is useless if the project company goes bankrupt. It is also flawed outside bankruptcy because it can generally only cover the balance in the account at the time the pledge is created. This requires the parties to enter into complex maintenance arrangements, which in turn create administrative and monitoring nuisances. Previous attempts to fix these shortcomings have not met the expectations of the industry actors, but we see no reason why these could not be managed soon.

On the other hand, foreign sponsors and lenders have much to gain from the Serbian government's continued efforts to attract direct investments, especially those that stand out in terms of their size, the reputation of the investor, or other actual or perceived impacts on the local economy. Serbia offers a wide range of incentives, including investment grants, reduced or waived employment taxes and the supply of subsidised land or buildings. In addition to this, Serbia has a great number of bilateral investment treaties and some of them offer, among other standard provisions for treaties

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of this type, a complete waiver of customs and VAT costs, a waiver of procurement procedures, expedited administrative procedures, including expropriation of land required for strategic projects, and other forms of government support.

5 Are there any proposed legal or regulatory changes that may give rise to new opportunities in project development and finance? Do you believe these changes will open the market up to a broader range of participants?

Serbia issued a seven-year green bond in international markets on 17 September 2022. The proceeds of the issuance were intended to be used for further support of renewable energy production, investments in eco-friendly transport infrastructure, the construction of drinking water treatment and sewage treatment facilities, waste collection and management infrastructure, and for other environmental purposes. At the end of the third quarter of 2022, almost €880 million had been allocated, whereas the government announced the allocation of the remaining €120 million in 2023. Furthermore, the state budget for 2023 provides that the government may grant up to €800 million of loans for the construction of solar plants and up to €1 billion of loans for the construction of wind farms. We expect this framework to produce a steady stream of environmental, social and governance-conscious projects in which private investors can collaborate with the public sector.

In parallel, as mentioned, the government introduced a new regulatory framework for the development of renewable energy projects in 2021. Following the negative response from the investment community and internal disputes from government stakeholders on the scope of incentives, the new government is preparing amendments to the regulatory framework, which should

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unlock development of a number of renewable energy projects during 2023.

6 What trends have you been seeing in terms of range of project participants? What factors have influenced negotiations on commercial terms and risk allocation? Are there any particularly innovative features?

Serbia is largely dependent on foreigners for inflows. As mentioned, the project financing market in particular has to date relied on multilateral development financial institutions for support and long-tenor debt funds. In general, Serbia is a very lender-friendly market. The leverage ratios of the project companies rarely exceed 70 per cent, and sponsors are very often required to provide additional forms of support, especially during the construction phase. The market is currently fragmented, and there are only a few cases of developers with a richer local track record of multiple financings, so relationship lending is not common.

Foreign export credit agencies are becoming increasingly important and have added further liquidity fuel in the form of guarantees to their nation's sellers of goods and services purchased by Serbian buyers. Sinosure, China's main state-owned export and credit insurance company has already been involved in a number of transactions and is reportedly interested to participate in future transport and energy infrastructure projects in Serbia. At the end of 2021, Serbia agreed to a €430 million loan from JPMorgan Chase Bank, NA, London branch, that is guaranteed by UK Export Finance. The proceeds of the loan will be used for the construction of a motorway in Serbia, and it is the first export credit deal concluded by the UKEF for projects in Serbia. In 2022, JPMorgan arranged another facility for the same purpose in the amount of €400 million, and that is covered by MIGA.

7 What are the major changes in activity levels or new trends you anticipate over the next year or so?

We see a sharp increase of investors' interest in projects outside the capital city. Although the Serbian economy is highly concentrated around Belgrade, there have been a number of successful foreign direct investments in a few other cities, and their prospects are growing. With the revival of the industry comes the need for investment in roads, power grids, water treatment and management systems, sludge disposal, etc. Entire parts of the country have similar issues and infrastructural needs, and this creates an opportunity for equity and debt investors to 'commodify' projects based on the same approach, documentation, lenders' support and so on. In part, these prospects will be driven by the government's strategy (eg, there have already been indications that some small-scale PPP projects could be bundled into one contract increasing their bankability).

The increased demand for electricity and decarbonisation of the energy mix in favour of renewables will eventually have to trigger heavy investment in electrical grids and infrastructure. Some projects intended to manage future challenges posed by intermittent energy supply are already in short-term plans. The Serbian Ministry of Mining and Energy has announced an ambitious investment plan to boost the country's energy capacity. Among other things, it provides for the construction of two pumped storage hydropower plants, Bistrica and Djerdap 3.

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The Inside Track

What three things should a client consider when choosing counsel for a complex project financing?

First is experience. It takes a lot of resources to close a project financing transaction, so counsel must be capable of managing and assisting efficiently. No one wants to lose time on reinventing the wheel. Second, counsel should be able to read the situation well and know when it makes sense to dig in and when to be diplomatic. Arguing about hypothetical scenarios and legal theories is often a waste of time. Finally, counsel must always be honest with the client and with other deal participants, not only for ethical reasons, but because of future deals and relationships.

What are the most important factors for a client to consider and address to successfully implement a project in your country?

Each project is unique, but most first-time investors will have mixed experience with the local regulatory environment. The good news is that most of the problems can be solved with good planning. For example, parties may want to spend a bit more than their average time drafting and negotiating financing term sheets for the project because this is a good opportunity for them to discuss the regulatory risks and limitations and see how these can be fairly allocated. Clients understandably want to avoid learning about a major issue in a late phase of negotiating their transaction documents.

What was the most noteworthy deal that you have worked on recently and what features were of key interest?

We are advising Metito, one of the Middle East's leading water development companies, on its two projects in Serbia with a planned investment of approximately €50 million. The project's aim is to solve the Zrenjanin's age-old problem with drinking water supply, but also with the management of the wastewater. These also pave way for an increase in the involvement of private capital in the Serbian water sector in which the projects have to date been predominantly financed by public money. In the next few years, we can expect a wave of investments in this field, and the legal and financial structures that were used in Metito projects in Zrenjanin will likely be replicated.

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