The "menu" approach to the sovereign debt crisis and its implications for restructuring state mining enterprises

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Nothing so characterizes the dashed economic hopes of the 1980s as the newly-coined jargon, restructuring. This arcane-sounding word is popular, in part, because it can mean almost anything. Nevertheless, I shall attempt to define it. Restructuring refers to the reconfiguration and re-pricing of inputs such as labour and capital in response to deflationary pressures. The two most common uses of the word are as a change in the mix of either financing instruments or business-lines. Frequently the two are intertwined: cash infusions can come from the sale of assets, assuring a change in the product mix; or dictating a change in the business strategy of the entity.

In the troubled eighties, "restructuring" has displaced the seventies' "project finance" as the industrial financier's *raison d'etre*. The phrase has also caught on in Washington, Paris, and other capitals, where a variety of institutions are looking for new solutions to the world debt crisis. On Wall Street, the phrase "restructuring" sounds more dignified than "getting your's", though the sentiments and endeavours often amount to the same thing. In noncommercial financial circles, though, restructuring takes on other dimensions, often implying a more pervasive reworking of the economy than New York bankers and investors are used to considering.

Restructuring can refer to anything from a change in the debt-equity ratio of a private company, to the present efforts to resolve the international debt crisis, now in its sixth year. While there are considerable differences, the two are actually related. Many banks consider all loans to state-owned enterprises as essentially sovereign debt. When a state-owned mining enterprise wishes to renegotiate it's debt, a commercial bank's minerals lenders will surely have to gain the approval of the much more powerful sovereign debt committee. Moreover, some of the instruments advanced as palliatives for international indebtedness, eg, debt-equity swaps, work only to the extent that there are real assets in specific companies involved in the deal. Only last week, the IMF in its annual meeting reaffirmed its commitment to the case-by-case, "menu" approach to global debt; and this points to the continuing linkage of the debt crisis to the refinancing individual enterprises.

Accordingly, in what follows, I will try to place the restructuring of *State-Owned Mining Enterprises* (SOME) in the context of the larger debt problem, and to consider what, in fact, the much-discussed issue of financial restructuring really means to the SOMEs and other mining projects. To aid in this discussion, I will summarise some recent innovations in banking and in corporate practices.

Financial structure and the state-owned enterprise

The goal of restructuring is straightforward: to meet the enterprise's obligations to creditors and to effectively position itself to fulfil its expected economic function. The goal for everyone is a workable cash-flow structure and a reduced financial risk. Of course, each party-at-interest has its own objectives as well. To a commercial bank, this means assurance of future project performance and a rescheduling that will fall within the bank's guidelines on acceptable exposure, to avoid a charge-off. Banks may be satisfied if, in exchange for stretching out payments and lowering interest rates, the project sponsors provide a mix of equity infusion, stronger guarantees, perhaps providing recourse to previously nonrecourse loans, or related changes.

For our purposes we can take the financial structure of an enterprise as simply the total claims on assets; this is the right-hand-side of a balance sheet, ie, liabilities and net worth. The priority of these competing claims is quite important to the parties-at-interest, permitting

risk-reward trade-offs in negotiating a restructuring. Claims also vary in the degree of security that is pledged, from unsecured to secured against general project net worth, secured by specific project assets, or by off-balance sheet guarantees by the company or government entity. A few of the more common types of claims, listed in order of declining priority are:

- accounts payable;
- promissory notes payable (bank loans, trade credits);
- other current liabilities (accruals, taxes);
- secured long-term debt (mortgage bonds);
- unsecured long-term debt (debentures, preferred stock);
- net worth (common stock and retained earnings).

Of course, it may be possible to provide for a different priority in the contractual agreement (indenture); and naturally this list is hardly exhaustive.

These claims, though, are levied on assets which are of dubious value. Some mining equipment, particularly in quarrying and open pit applications, may be quite mobile and quite versatile. But high transport costs associated with a remote location may negate much of this value. Constraints on the repatriation of capital will affect foreign creditors. To the extent that book equity is in the form of capitalized costs of reserves, then there is just that much less to go around. Useful appraisals of asset value require on-site inspection by independent appraisers knowledgeable about both the equipment and the "local market" for such equipment (however that is interpreted in a given context). This is time-consuming and expensive at best, and virtually impossible in some circumstances. For practical purposes, any priority lower than that of a mortgage bond has little chance of recouping more than a few pennies on the dollar; and in many cases commercial lenders will fare little better. These prospects certainly confirm that liquidation is undertaken most reluctantly — sometimes too reluctantly.

Traditionally, these considerations led investors to the conclusion that virtually any long-term debt is really pledged against the good faith and earning power of the enterprise — and they therefore looked for guarantees from a parent entity. The lender required recourse to other assets, or a sovereign pledge, or at a minimum performance stipulations such as completion guarantees. The worst case analysis was not liquidation, it was receivership. Non-recourse project finance loans — and in cases of bankruptcy or reorganization, general corporate lending — have led creditors to take charge of the daily operations of some private mining enterprises. This usually has meant the same management reporting to a new board of directors, but with changes in financing and operations leading to a positive cash flow. Normally, while the turn-around was being effected, the creditors would search for a buyer; the buyer would negotiate a price at which the new cash flow achieved an acceptable return; and the restructured enterprise would continue its (newly streamlined) existence and the creditors would have received the return commensurate with reality. After all, creditors are paid to bear risks.

The situation stands in contrast to that of creditors of *State-Owned Enterprises* (SOE). It is almost inconceivable that a SOME would enter receivership or be liquidated. Historically, however, stage-owned enterprises were generally regarded as sovereign risks, and sovereign risks were believed to be backed by all the resources of the state, which would never threaten its credit-worthiness by non-performance. This allowed state-owned enterprises to operate at breathtakingly leveraged debt-equity rates, and with low working capital reserves. The situation was not entirely cosy — there were offsetting costs to the relationship between SOE and central bank, as many in the audience know all too well. But commercial creditors did not trouble themselves with this aspect.

In the new world of the international debt crisis, things have changed. When I first undertook a survey of this subject, several New York bankers whispered that, actually, they would rather have recourse to real assets than any number of solemn pledges from central banks. They were quick to add, however, that they did not want to be quoted on this. Then, in May of 1987, Citicorp announced new loan-loss provisions, and in what was to become a widely circulated and quoted interview with *The Wall Street Journal* (1987-05-28, p 6), Citicorp President John Reed said very interesting things in print:

> "An equity investment is a better asset today in Brazil than a loan to the central bank...Our stockholders are better served if instead of having that loan, they have the same exposure in the form of a productive investment... We don't want to be in the gold-mining business, for instance. But if we think that owning a gold mine...is for a time better than having a loan to the central bank, then obviously we will go that route for a while."

Q: So you would see yourself with substantial equity investments on your balance sheets in natural resources...) Yes, but they will be investments...We're talking about doing a swap for an investment that has returns...The valuation you put on that equity is subject to negotiations.

It is interesting for this audience to note that the only concrete example mentioned was Brazilian gold mining.

The natural question at this point is how this new attitude could affect

SOMEs, but first we need to make some general remarks about restructuring state-owned enterprises.

Organisations such as the IMF view the restructuring of balance sheets as not very effectual for SOMEs. Unlike a private enterprise, which is disciplined by the capital market, a SOME is often free of such pressure, and is used as a conduit for foreign exchange and cash into the rest of the economy. Any SOME restructuring must therefore address a larger set of relationships than the purely pecuniary.

Some state mining enterprises are capable of responding quickly and positively to management restructuring. They are already free of some of the inefficiencies often mentioned in connection with SOEs, since they face competitive, international markets. As principal regional employers, they have great discretion in wage rates. It may be easier to write down the book value of old capital (frequently a precondition for recapitalization) where reserve carrying values provide a natural point of entry to the issue. And historically, it was the reserves themselves that prompted public ownership — in contrast to some other SOEs, which were problem projects inherited by the state.

Unless real management changes and insulation from politics have been made, however, recapitalization is going to be difficult. Fresh equity injections might just further destabilize things, allowing the enterprise to spend itself back to the initial problem, only now on an expanded scale. However, where meaningful change has been made in management, political accountability, and operations; then financial restructuring can proceed. In today's commodities markets, fresh equity injections by the original private participants or by retained earnings are usually unlikely. For most developing nations, the local capital markets are too thin for new equity issues. This leaves several remaining routes for recapitalization:

- the government can recapitalize, by assuming some or all of the project's existing debt; or
- existing private debt-holders can sell or swap their debt to others; or
- new participants can invest equity in the form of real or financial capital.

Today, the evaluation of these possibilities requires that we understand the new trends in international finance and particularly international debt management. We take the matter up in the next section.

Interactions with the sovereign debt solutions

It is necessary to pause and consider how the world of international banking has changed, and how the restructuring of SOMEs might interact with these changes. Although our primary purpose is to discuss the mining enterprises, it will be helpful to think about money-center (commercial) banks as dynamic institutions.

We will take 1982 as our base year. During an 18-month period, beginning in the autumn of 1979, dollar interest rates doubled. By 1982, recessionary pressures had ushered in low growth rates in much of the developed world, and the beginning of the present persistent commodity price depression. But by the end of 1982, commercial banks had lent over 300 GUSD to non-OPEC developing countries and East European countries. (About one-third of this had been lent to Mexico and Brazil.) American banks were particularly heavy lenders to Latin America (about 130 GUSD), and West German banks were big lenders in East Europe. The majority of the loans of US commercial banks were made by nine big money-center banks. They had managed to lend LDC's and East Europe over 350% of their combined capital (See Table 1). So far, the only banks which have lost money on this lending are those which lent to now-failed private enterprises, and those which lost their nerve and sold their debt at a discount. However, if I may be forgiven a reference to Shakespeare, "So foul a night clears not without a storm."

These dreary figures are often cited as the reason that commercial bank lending to developing nations has dried up. Indeed, by 1986 the major currency outflows had been replaced by relatively small but nevertheless real cash inflows. However modest these inflows seem to banks, many of you are all too aware what a significant change this has been to your economy. Many mining-for-export countries have naturally evolved into economies where both income and demand originate at the port and from there spread into the country. The whole economy is organized around servicing this sector and recycling this income, with little differentiation between nominal income and nominal capital; and now bit by bit, this money has not just stopped; it is being drained out again.

It was the problems engendered by traditional (contraction-oriented) restructuring that the Baker Plan was supposed to remedy. One of the hallmarks of this grow-out-of-debt plan was the provision of new bank loans. And in fact, commercial banks have lent more money; but with increasing restiveness. This is one of the problems of the Baker Plan, and though the Mexican restructuring was accomplished, it may have been a Pyrrhic victory.

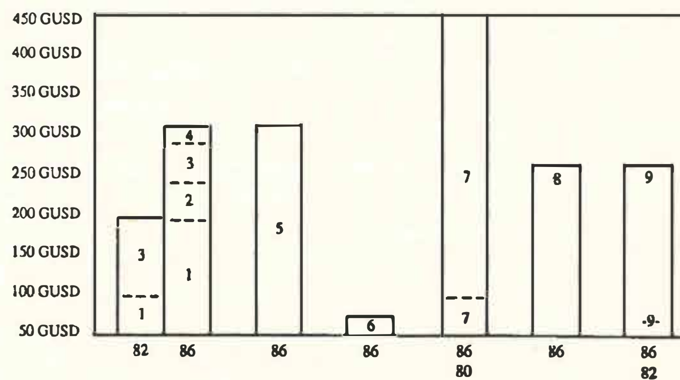
We can best understand why by recognizing the second trend in international lending which has occurred during this period. This is a major and unprecedented shift in international finance, away from bank loans to capital market borrowing. And banks themselves are among the prominent agents engineering this change. Figure 1 shows the extent of these shifts. The two main components of this shift have been securitization, both directly by the borrower, and also

by the bank; and new instruments, often tradeable, intended to redistribute risk. By early 1987, off-balance sheet commitments by seven of the biggest US banks had reached 1400 GUSD, compared to 55550 GUSD on-balance sheet commitments (including loans). These risky new waters are sometimes cited as reasons for the securities-risk downgrading of such formidable banks as Citicorp, Mannie-Hannie, and Paribas. However, thus far at least, banks have *only* got into trouble with their traditional activity — lending.

This leads us to the present, third phase of debt management. This is often called the "menu" approach, since it consists of case-by-case application of highly specific remedies. Table 2 shows some of the instruments which have been proposed. Although the Argentinean restructuring is referred to as the first application of the "menu" approach, these instruments predate that agreement and as can be seen are widely applied.

Table 1 helps explain Table 2. For example, if one wonders why banks like Midland and First Interstate are willing to act as brokers for Peru's commodity sales, one need only recall the secondary market discount on Peru's sovereign debt.

Figure 1
Innovations in international banking
International borrowing has grown, but loans are declining;



Legend:
1 -- Straight & other bonds
2 -- Floating rate bonds
3 -- Bank loans
4 -- Note issurance and other facilities
5 -- Interest-rate swaps
6 -- Currency swaps
7 -- Futures
8 -- Options
9 -- US asset-backed securities

Table 1
Loan exposures in Latin America in 1986
(in GUSD)

Bank	Mexico	Brazil	Argentina	Venezuela	Peru	Total Capital
CITICORP	2.8	4.6	1.4	1.1	9.9	80
BANKAMER.	2.5	2.7	0.4	1.3	6.9	95
MANUF.HAN.	1.9	2.2	1.5	1.0	6.6	126
CHASE MAN.	1.6	2.8	1.0	1.2	6.6	101
JP MORGAN	1.2	1.9	0.9	0.4	4.4	69
CHEMICAL	1.5	1.4	0.4	0.7	4.0	93
MIDLAND	1.9	2.0	0.9	N/A	4.8	84
LLOYDS	1.7	2.0	0.8	0.6	5.1	90
BARCLAYS	1.1	0.7	0.6	0.3	2.7	37
SECONDARY DISCOUNTS	56–58%	73–75%	62–65%	72–74%	16–19%	

Of perhaps most interest to us today is the multi-level debt-equity swap. The typical procedure is as follows: an investment banker (or similar party) buys sovereign debt at a discount in the secondary market, perhaps paying 70 MUSD for debt with a principal value of 100 MUSD. The banker redeems the debt, receiving say 90 MUSD in local currency from the nation's central bank. The banker earns an immediate local currency profit of 20 MUSD, and the central bank officially retires the full 100 MUSD debt. The banker invests the locally-denominated 90 MUSD in the country, or else exchange the currency to another entity contemplating local investments.

This practice, fairly new, is being undertaken in a growing number of countries. Mexico and Chile are most often cited in this regard. Other than the central banks, the parties with the most to gain from this approach are the US commercial banks with heavy sovereign debt loans. However, under US accounting rules, a bank selling a loan for a discount must report a loss from the transaction. Few US banks will wish to do this, but they have already been serving as middlemen in the process, and gathering off-balance sheet fees in the process. Citicorp and Bankers Trust have received the most attention in this regard. And Citicorp's John Reedhas openly encouraged the idea of direct commercial bank involvement. And, given the spread between the secondary market discount and the full face value of the debt, why not? Capturing half this spread would be more lucrative than their middlemen fees. The future or direct US bank involvement will probably depend on associated changes with US accounting and regulatory practice. Recent Federal Reserve actions have relaxed the ability of commercial banks to convert loans into equity, and not just in the financial sector, and Citicorp has indeed begun some conversion.

In the meantime, the magnitude of the sovereign debt makes current activities little more than a drop in the bucket, though perhaps quite significant to individual Third World enterprises. Mexico and Chile, the two most active nations in the debt-equity process, have each con-

Table 2
Proposed new instruments for managing international debt

Instrument	Countries	What it does	Expected result
Debt-equity swap	Mexico, Chile, Argentina, Brazil, Venezuela, Ecuador, Phillippines	Banks sell loan to third party who exchange with central bank for local currency to invest in local industry	Debt eliminated, new investment stimulated.
Debt-commodity swaps	Peru	Bank manages export sale, pockets fee	Export industries helped, preserves $.
Factoring	Japan	Banks sell loans at discount to factoring co.	Tax deductions and stronger balance sheet.
Exit bond	Argentina	Low-interest goverment bonds in lieu of existing debt	Reduces need to refinance and continue.
Investment notes	Philippines (P.I.N.S)	Local currency notes in lieu of interest; tradable and matures	Hard currency saved, investment gaind via D/E swap.
Retiming	Chile, Mexico Argentina	Varies — incentives for multi-year, early agreement, few interest payments	Easier management of loan payments, renegotiations.

cluded more than two dozen such deals, but as of end 1986 these deals amounted to 300 MUSD for Mexico, 280 MUSD for Chile, compared to total indebtedness of 97.3 GUSD and 21.5 GUSD, at the time, respectively.

Concluding remarks

In ending my remarks, I am conscious that I have raised a number of issues and resolved none of them. However, in a roundtable discussion such as this, that is all for the better. I would like to direct the attention to the natural questions raised by my treatment:

- What constitutes a successful restructuring, in the eyes of the state-owned mining enterprise?
- Which financial innovations might lead to a decline in indebtedness? Which, if any, might lead to fresh capital?
- Are there any role-models for restructuring state-owned mining enterprises?
- Can financial rehabilitation in the relatively strong economies of much of Latin America be applied to other regions, particularly in sub-Saharan Africa? In Eastern Europe?
- Finally, how different is the experience of those of you dealing with West German and Japanese banks from American and British bank practices?