ASIA’S INFRASTRUCTURE FUNDING GAP: BONDS TO THE RESCUE?

Across Asia countries need dramatic infrastructure improvements but are struggling to channel significant capital toward infrastructure projects. Hogan Lovells’ Andrew Carey and Tauhid Ijaz argue that Project Bonds may provide an answer to this issue.

Asia’s growing populations and economies demand dramatic infrastructure improvements that require dauntingly large capital investments. In 2009, Asia Development Bank stated: "During 2010–2020, Asia needs to invest... around $8 trillion in overall national infrastructure."

Conventional sources such as governments, equity sponsors and lending banks cannot supply all this funding. Many lending banks have much lower appetites for the sector than historically was the case due partly to the increasing regulatory capital requirements associated with project finance, with some banks withdrawing from the sector as a result. Where banks do lend, it tends to be at higher margins and for shorter maturities with a move towards "semi-perm" structures, under which the borrower is given incentives to refinance through the use of "cash sweep" mechanisms and margin increases. It is yet to be seen whether the entry of non-bank lenders to different segments of the lending market, using their relative regulatory advantages to compete with the banks and meet demand that the banking sector cannot, will fill the "funding gap".

Against that backdrop, capital markets may offer a solution through the use of "project bonds". Project bonds are well suited to the stable, predictable net operating cash flows typically generated by strategic and capital-intensive infrastructure businesses and may offer cheaper funding that is of a tenor more closely matched to longer underlying project terms.

Asia is not short of capital to invest in infrastructure, whether by way of institutional investors (as the uncertainty surrounding the ability of such investors to invest in bonds as a result of Solvency 2 should be less relevant), banks themselves (as highly rated bonds are treated relatively favourably as investments under Basel III), sovereign wealth funds or others. Many countries with the greatest needs have high domestic savings rates but this capital has not historically flowed into Asian infrastructure via the capital markets. The reasons include a paucity of bankable projects; political risk; corruption concerns; inadequate policy and institutional frameworks; weaknesses in the public sector; underdevelopment of the domestic and regional bond markets generally; and the fact that specialist infrastructure funds are only a recent phenomenon. Also, sponsor concerns about tapping capital markets create some reluctance to being among the earliest movers.

These macro issues aside, perhaps Asia can look for lessons to the US, Europe, the Middle East and Australia where project bonds are more common, although, in those markets, the bonds have lately relied heavily on financial guarantees by monoline insurance companies that have largely exited the market since the global financial crisis.

These monoline guarantees provided a number of benefits, most obviously credit enhancement, since they attracted triple A credit ratings. Most projects would struggle to achieve this without a monoline "wrap" due to issues such as construction risk, sovereign ceilings, exchange rate concerns, concerns over the credit quality of contractors and other project participants and uncertainty of usage-based income.

Many of these concerns require project-level solutions but some structural solutions at the funding level can help. Thus, for example, multilateral government agencies ("MLAs") such as Asia Development Bank, and export credit agencies ("ECAs"), may provide some level of financial guarantee or credit enhancement to replace the monolines. An example of this in Europe is the recently announced EIB/EU project bond initiative, which contemplates the credit enhancement of senior secured project bonds.

Other structural enhancements can be used such as tranching - with higher-rated debt buffered by subordinated or first-loss tranches - again as contemplated in the EIB/EU project bond initiative where EIB will provide either (i) funded subordinated debt; or (ii) an unfunded partial guarantee of senior debt service payment obligations such that these debt obligations would achieve a credit rating attractive to institutional investors. Security and covenant packages can also be strengthened and aligned with bank debt via common terms agreements resulting in more rigorous contractual protection than bondholders would typically seek.

Monolines also brought the expertise and staffing required for on-going project monitoring. Bond investors have historically been more passive than bank lenders. In wrapped deals, they cede control to the monoline in return for credit enhancement. The monolines developed the expertise to monitor complex, ever-changing projects and helped shield projects from needing to interact with anonymous bondholders and from the inconvenience and expense of obtaining on-going consents, waivers etc. Again, the MLAs and ECAs may provide monitoring expertise in place of the monolines. Alternatively, and particularly where bonds provide the minority of the debt financing, bondholders may
be willing to entrust some decision making to co-financiers who rank pari passu or junior to them. Equally, as investors become more able to analyse project risk, it is conceivable that electronic voting among bondholders will be seen as a workable solution, including for sponsors looking to ensure they can seek and gain required consents and waivers efficiently.

Sponsors may be put off by securities laws in countries where project bonds are sold. Bond issues typically involve exchange listings and thus publically available prospectuses plus on-going disclosure. This disclosure can be expensive in management time and lawyer, accountant and other experts’ fees, while errors or omissions may attract statutory liability. Project information may be commercially sensitive. Transparency may be an aspect of project bonds that cannot be readily mitigated but is perhaps not so different from widely syndicated bank financing of high-profile projects in any event.

Project bonds also involve a negative carry compared to committed facilities – one reason why capital markets have been used more in re-financing bank debt once practical completion has been achieved rather than before or during the construction phase of the project. This cost, which in any case should be measured against the commitment costs of facilities, can be mitigated somewhat by mixed funding involving committed funding from facilities and privately placed partly-paid or variable funding bonds. Equally, it is often said that persuading bondholders to accept construction risk in the early phases of a project can be challenging, although it is not insurmountable provided the risks are managed appropriately.

In conclusion, while there is work to be done developing the structures, there is no fundamental reason why project bonds should not provide part of the solution to Asia’s troubling infrastructure funding gap.

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