Funding of privatization projects in Brazil – mitigating currency risk

In January 2019, Jair Bolsonaro took office as the new president of Brazil. The new administration has indicated that privatizations will be a strategic priority in the rebuilding of Brazil's economy in the wake of the system-wide corruption investigations which resulted in the bankruptcy or near-insolvency of several key Brazilian companies, particularly in the construction and oil & gas services sectors. To achieve its desired goals, the Brazilian federal government is revamping its Investment Partnership Program (**IPP**), an initiative created for purposes of coordinating and supervising concessions and privatizations of infrastructure projects in Brazil, to foster competitiveness and facilitate the participation of foreign investors.

The Investment Partnership Program was created in 2016 to expand and strengthen the interaction between the Brazilian federal government and the private sector through partnership contracts for the execution of public infrastructure projects and other privatization measures. Since its inception, the IPP has resulted in the privatization of over 120 infrastructure projects encompassing the energy, highway, airport, port, telecommunications and oil & gas sectors, totaling an amount greater than US$65 billion in investments from non-governmental sources. Of these projects, over one-third of them were awarded to non-Brazilian companies (either alone or in consortium with Brazilian companies). An additional 69 projects (with an estimated capex of over US$30 billion) have already been approved by the Brazilian federal government and are expected to be concluded in the next few years, covering, but not limited to, railways, ports, energy, oil & gas, mining, airports, highways and telecommunications. A further 94 potential projects have been identified and are in the process of being analyzed by the Brazilian government.

Big infrastructure projects require substantial financing (often in the hundreds of millions or even billions of dollars) and many times local financing options are limited or expensive, prompting investors to consider foreign financing (either in the international capital markets or through syndicated loans with global banks). Such projects, however, tend to generate revenue in local currency (e.g., Brazilian reais), thus creating a mismatch between liabilities in foreign currencies and project revenue in local currency. When this mismatch occurs, foreign investors may be unwilling to take the associated currency risk. This article contains a brief discussion of certain structural solutions[1] that can be put in place to shift the risk away from the investors. Using a combination of some of the technologies listed below can be effective to mitigate currency risk.

Tariff and Foreign Exchange Adjustment

When a project calls for the payment of tariffs (such as toll roads, power plants and other regulated projects), the government may include a periodic tariff adjustment formula that takes into consideration foreign exchange variations or it may index the tariff directly to another currency and adjust it periodically.

The advantages of using tariff adjustments include not having additional upfront costs to investors and the possibility of protecting project sponsors from currency fluctuations. Some of the issues include the frequency and benchmark for the adjustments (e.g., spot price or a periodic average – spot prices are generally more volatile, but an average index may result in periodic basis risk for the sponsors). One of the ways of addressing these risks, however, is the use of a range whereby if FX trades within the range, the project takes the risk, but if it crosses a threshold, the excess is passed on to consumers.

Foreign Currency-denominated Cash Flows and Structuring the Debt Profile

Another option to mitigate currency risk is to match the currency of cash flows with the currency of the payment obligations. While this is not feasible for every project, certain commodities (e.g., oil and gas) and airport projects may allow separate streams of revenue in different currencies. Having a source of payments denominated in the same currency as the debt issued to investors (most likely US dollars) creates a natural hedge in which payment obligations are matched with the source of payments. However, the hedge may not be perfect on account of a timing mismatch where there is a lag between the timing of the source of payment and the payment of the debt obligation.

[1] In addition to structural solutions, there are also third-party solutions available to investors, such as multilateral guarantees, hedging, swaps and options, which are not covered by this article. Hogan Lovells has experienced derivatives and banking teams and would be happy to discuss and explore these options with you if desired.

Overcollateralization

Overcollateralization refers to the process of posting more collateral than is necessary to secure payment of a debt obligation. In the context of financing through a credit facility or a project bond, the collateral is generally the cash flows from the project available to pay debt service.

Cash flows available for payment of debt should exceed the debt obligations – generally, the higher the ratio of cash flows to debt service (**debt service coverage ratio**), the better it is from the perspective of deal execution, which can lead to better pricing for the issuer and more investor demand. The excess of collateral is an important component of a transaction when it comes to rating agencies rating a transaction as well as investors evaluating the merits of a particular transaction – favorable ratings by rating agencies and high levels of demand by potential investors generally translate into more favorable pricing for the issuer. Projects that are currently generating cash flows are more prime for this sort of structural feature than greenfield projects where determining future cash flows and collateral levels may be more difficult.

Escrow Accounts

Similar to overcollateralization, if the currency is stable enough, it might be possible to mitigate currency risk by establishing escrow accounts to be funded from the proceeds of the relevant financing or project revenue on an ongoing basis. Funding escrow accounts periodically with a project's cash flows (after payment of operating expenses) provides project sponsors with further flexibility in terms of cash flow allocations. Escrow accounts could also be funded by use of an instrument such as a letter of credit that is drawn upon when necessary (rather than having cash on hand in the account).

Advantages of this option include having flexibility to fund the escrow accounts out of financing proceeds or project revenue and the possibility of being better received by rating agencies. Disadvantages include reducing the cash flow available to the project or sponsor and it exposes the sponsor to project risk in case of shortfalls.

Final thoughts

Addressing currency risk is not an easy task and Brazil has yet to propose a viable solution vis-à-vis the country's particularities. However, with over 500 finance lawyers around the globe and over 1,000 years of combined experience working on infrastructure deals, we are sure to help you find the best solutions to invest in Brazil and in Latin America. Hogan Lovells has been actively engaged in discussions with members of the Brazilian government responsible for the IPP to share our experience with privatizations around the globe and propose solutions to common international investors' concerns. On the ground in São Paulo and working alongside our broader finance team in New York, London and in several of our other offices around the world, we have the expertise necessary to guide investors and sponsors through successful investments in Brazil.

Contacts

David Contreiras Tyler
Counsel, New York
T +1 212 918 3619
david.tyler@hoganlovells.com

Arthur Rodrigues do Amaral
Visiting International Lawyer,
New York
T +1 212 918 3012
arthur.amaral@hoganlovells.com