

Prepping For Project Bonds

Law360, New York (August 28, 2013, 11:54 AM ET) -- While project bonds have been used since the early days of the project finance market, varying project structures and market factors make them the sort of product that becomes most popular during certain periods and less during others. It happens that current conditions are making the market ripe for project bond issuances, both in and outside of the United States. This point is proved out by the increased volume of project bonds in the market. Additionally, given the attractiveness to project sponsors of the long tenors and liquidity offered by the project bond market, there is a push by market participants to find ways of expanding the types of transactions for which project bonds may be used.

What are the variables that make for a high-volume project bond market? To answer this question, it is useful to first understand the background of project bond structures, the types of investors and qualities of project bond transactions.

Background: Project Bond Structures

“Project Bonds” typically refer to one of two types of offerings, but both such offerings involve a private issuance of notes. One type of offering is often referred to as a traditional private placement or a 4(2) private placement, which is a reference to Section 4(2) of the 1933 United States Securities Act. The other type of offering is often referred to as a Rule 144A offering, a reference to Rule 144A promulgated under the Securities Act. Notes sold to non-U.S. investors outside the U.S. are referred to as a Regulation S offering, again referring to Regulation S promulgated under the Securities Act. Both 4(2) private placements and Rule 144A/Reg S offerings can be distinguished from a public offering of notes which requires registration with the United States Securities and Exchange Commission and can be sold to the general public.

In a 4(2) transaction, the investors (often insurance companies) are either clubbed together at the beginning of the financing process or identified by an arranging bank who structures the transaction and then brings the investors to the transaction at a later stage. The Rule 144A/Reg S offering takes the form of a more traditional capital markets offering typically underwritten by an investment bank and sold to investors once the transaction has been fully structured and the transaction documents negotiated.



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Private placements are not required to be registered with the SEC. As a result, they may be sold only to investors who meet qualifications for sophistication. The SEC has five traditional criteria for private placements: (1) the type of offerees involved, including their financial capability to bear the economic risk of the investment and their degree of sophistication as investors; (2) a limited number of offerees (generally fewer than 100 or sometimes even less); (3) the absence of any general solicitation or advertisement concerning the placement; (4) access of potential investors to relevant information concerning the issuer; and (5) restrictions on resale.

As the securities being placed have not been registered with the SEC, the initial investors must undertake that they are buying for their own account and will only resell in a transaction that is also exempt from SEC registration requirements. Because the offering is not subject to SEC review there are technically no disclosure requirements. However, market practice has developed to have disclosure standards similar to a public offering, especially in connection with Rule 144A offerings.

Both 4(2) private placements and 144A/Reg S offerings share the characteristic of typically providing longer tenor debt. The desire for longer term investments means that both types of project bond investors generally prefer assets backed by long-term contracts and stable cash flows.

There are, however, several noticeable differences between the offerings that are important for sponsors to consider when deciding between the two. The first difference relates to the typical disclosure requirements for each transaction. While private placements are not subject to SEC review, underwriters of such offerings are still subject to U.S. securities law liability for material misstatements or omissions in the offering documentation.

Rule 144A offerings are typically structured as a more traditional capital markets offering with marketing to a broader group of qualified institutional buyers (known as "QIBs"). Consequently, a more fulsome offering memorandum is prepared disclosing all of the material risks and terms of a transaction. For example, a Rule 144A offering memorandum will typically include detailed descriptions of the issuer's business and contractual obligations which can be costly and time consuming to prepare.

Additionally, the market generally requires financial statements including at least one audit cycle for the issuer and from each of the entities which is underlying the credit basis for the transaction. For projects which have not previously been financed, have been financed as part of a larger corporate financing for a sponsor, or include an element of credit from an entity which does not prepare public financial statements, preparation of these financial statements can be a gating item and cause timing issues for the transaction. Finally, it is standard in a Rule 144A offering for counsel to the issuer and underwriter to each provide an opinion on the completeness of the disclosure, referred to as 10b-5 opinions. Again, the due diligence exercise necessary to provide such opinions can contribute to additional delays and transaction expense.

Alternatively, a 4(2) private placement is generally offered to a small number of targeted investors who are familiar with the project bond market. The disclosure document takes the form of something more similar to an information memorandum used in a syndicated bank financing and typically no 10b-5 opinions are provided by counsel. It is therefore often easier for a sponsor to prepare the documentation for this form of offering than a Rule 144A transaction. In a 4(2) context, the investors generally take a more active role in negotiating the terms of their investment and perform their own due diligence. The investors sign an "investor letter" pursuant to which they acknowledge that the securities have not been registered with the SEC and that the investor has had its own opportunity to perform due diligence. In a Rule 144A offering there is a broader population of QIB investors who rely on

the offering document and expect that the underwriting banks will have performed a due diligence exercise.

Another main difference between the 4(2) private placement market and the Rule 144A market is the level of oversight expected by investors in each offering. As a more traditional capital markets offering, Rule 144A investors are typically represented by an indenture trustee and the covenants in the primary financing document, the indenture, are designed to provide an issuer greater flexibility in operating the project. This greater flexibility results from the fact that Rule 144A notes may be widely held by QIB investors who are difficult to organize and less interested in the day to day operations of the asset than the ability of the asset to provide stable and steady cash flow.

QIB investors have a certain amount of liquidity as they can resell to other QIBs. 4(2) investors, on the other hand, tend to be more similar to commercial banks in their interest level with the ongoing operations of a project. Covenants for these investors are typically designed to provide greater oversight than that afforded Rule 144A investors. While the Rule 144A transaction may provide challenges in its execution, given the disclosure standard and transaction process, sponsors are rewarded for this extra effort with easier covenant compliance.

Factors Dictating Project Bond Volumes

Favorable Project “Inventory”

So, what are some of the key factors which dictate the volume of project bonds (be they 4(2) or Rule 144A bonds) during a particular business cycle. As noted above, the key factors include both the particular characteristics of projects then available to be financed and general conditions in the various financial markets which traditionally provide financing for projects.

The power market in the U.S. provides a useful example of how the particular characteristics of projects affects the volume of project bonds. Project finance during the time when the U.S. power market was changing from a utility generation model to an independent power producer model, was based on long-term contracts with creditworthy offtakers. Although initially, the market was dominated more by commercial and syndicated bank financings, as bankers became accustomed to diligencing and analyzing such transactions and the contractual framework and technology risks for projects, and as comfort grew with these points, the ability to finance these projects through the project bond market increased, culminating in a Rule 144A offering for a large power project in the Northeast in the early 1990s.

As the U.S. power market moved away from fully contracted projects and more to a merchant model after the 1990s, the prevalence of project bond offerings diminished. Currently, however, while many gas-fired projects built in the U.S. during the 1990s continue to operate in the merchant market, the U.S. renewable power market is dominated by projects with long-term contracts with creditworthy offtakers. These projects are therefore ripe to take advantage of the project bond market, particularly as renewable technology also is becoming increasingly commercialized.

Clearly, projects which have characteristics such as those found in the early to mid-90s U.S. power projects and now in the U.S. renewable power market — long-term contracted, predictable revenues from stable creditworthy customers using proven, reliable technology and providing a fundamental service — are prime targets for bond investors. When there exists a critical mass of such projects available to be financed, activity spikes in the project bond market, particularly when the conditions in traditional financing markets are challenging.

Latin America provides a similar example to the U.S. power market of the effect that the existence of projects with the above characteristics has on project bond volumes. In the 1990s, two sectors in Latin America in particular tapped the project bond market with frequency. In the oil and gas sector, refinery financings required significant sources of capital and offered long term offtake arrangements with large international oil companies. In the power sector, several countries which had traditionally been viewed as favorable for investment, such as Mexico, were privatizing the sector using long-term contracts with government entities that were similar to taking sovereign risk. Thus, a pool of projects with what was viewed as long-term stable revenues existed. The project bond market followed these developments and several project bond transactions were closed during this period.

Latin America today is again enjoying a favorable investment climate. In fact, many Latin American countries have weathered the international economic difficulties which began in 2008 better than the U.S. and Western Europe. As a result, quite a number of projects throughout Latin America have proceeded through development and construction during this period across a number of industry sectors — power, oil and gas, transportation infrastructure and other social infrastructure. A number of these projects benefit from strong support from the relevant governments. Others benefit from sponsorship from large multinational energy companies. Finally, a number of governments (Mexico being a key example) have announced major infrastructure investment plans to ensure the continued growth of their economies. Thus, there exists a healthy inventory of projects as well as a likely healthy pipeline of projects, with characteristics which are very attractive to project bond investors.

As a result, there has been in 2012/2013 a fairly high level of project bond activity coming out of Latin America — particularly Peru, Brazil and Mexico. In 2013, the Latin American project bond issuances include Brazil's Odebrecht issuance of \$1.7 billion backed by drill-ship charter and service agreements with Petrobras and Rodovias do Tiete's \$475 million infrastructure bond supported by its concession from Artesp to operate a 415 km toll road in the state of Sao Paulo. Several toll road-related peso-denominated local project bond issuances have come out of Mexico, including Isolux Infrastructure's \$330 million issuance to refinance its Saltillo-Monterrey toll road in Mexico and IDEAL's issuance supported by a portfolio of four toll roads.

This follows an active year in 2012 during which, among other project bond issuances, the Oaxaca II and IV wind project bond issuance was successfully concluded. The Oaxaca II and IV wind projects were strong candidates to tap the project bond market even though they were the first renewables project to do so out of Mexico. Oaxaca II and IV benefited from having completed construction and having a long term offtake contract with the Mexican state-owned utility, CFE. The pipeline for the balance of 2013 and early 2014 is promising as well with rumors of issuances out of Colombia to support airport expansions and power and oil and gas development, and continued activity out of Peru in the power and transport sectors and Brazil and Mexico in a number of sectors, particularly the energy sector.

Another recent trend catalyzing project bond issuance relates to the current state of development and operations for projects coming to market. The project bond market has historically not been a useful tool for construction financings. In general, construction financings require significant lender oversight given the various issues that could arise during the construction process. As noted above, Rule 144A investors are not interested in overseeing these issues — and are not easily managed. Additionally, Rule 144A investors are not accustomed to the multiple borrowings required for construction financings and therefore noteholders prefer to fund their full proceeds on a single date. This causes a sponsor to incur costs equaling the difference between the interest rate paid on the notes and the amount earned on the proceeds deposited in an account, a cost often referred to as “negative arbitrage.”

While 4(2) investors are more accustomed to managing through project issues, they too have less flexibility than commercial banks in their funding mechanics. While the 4(2) market has shown increasing flexibility in addressing this funding issue through mechanics such as funding amounts into a project account over time according to a set schedule and releasing such funds only in accordance with typical construction draw conditions, the investors generally prefer a steady funding schedule which is less conducive to a construction process where schedule changes may vary funding requirements.

Currently, there are a number of projects seeking financing or refinancing which have already managed through the construction process. These projects are tapping the project bond market. In some cases, bridge loans or mini-perms from syndicates of commercial banks are maturing and must be replaced. In other cases, sponsors are seeking to free up scarce commercial bank capacity for their construction projects so are replacing their existing commercial bank facilities on completed projects with project bonds. Finally, in other cases the opportunity provided in the project bond market to lock in long term, favorably priced and flexible funding especially for completed projects is luring sponsors into the project bond market.

Ripe Market Conditions

A final catalyst of the current project bond activity is the state of the financial markets, both that of the project bond market and of other sources of financing for projects. The commercial bank market, traditionally an extremely active and deep source of project financing across all industry sectors, continues to struggle as it has since 2008 both with liquidity constraints and constraints on tenor. Hence, the rise of mini- and maxi- perm financings (which generally raise concern among sponsors due to the inherent refinancing risk) and the club bank/agency financings (which can result in complex and lengthy intercreditor negotiations). Multilateral and export credit agency financings continue to require intensive due diligence and negotiation processes and thus long lead times for execution, as well as strict oversight through tight covenant packages.

Finally, while local sources of funding for projects in Latin America have expanded significantly and in some jurisdictions such as Peru displaced international funding, constraints due to the depth of the funding available and the competitiveness of pricing remain. In contrast, the project bond market currently has access to significant pools of capital looking for long-term, stable investments. Particularly, in the case of a Rule 144A issuance for a project which has been in operation for a few years and which was previously financed, execution of a project bond issuance can be relatively quick and painless and the ongoing oversight burden minimal.

Conclusion

While volume has been increasing for project bonds, there are some challenges ahead, particularly in the emerging markets. As referred to above, project bonds are best used in transactions with long-term, steady cash flow streams. As investors have an increasing number of transactions to choose from, there will be an effort to increase the quality of offerings. In the emerging markets this could create opportunities for multilaterals and development banks to step in and enhance the perceived credit quality of projects through products like bond wraps or partial credit guarantees, which could guarantee or all or a portion of a note issuance.

It is clear that the project bond market offers significant benefits to sponsors requiring significant amounts of capital with projects that can sustain long tenor debt. However, sponsors should understand the differences between the investor types and the costs and benefits of each private placement structure. With market participants looking to address issues which have made project bond offerings less attractive in the past, such as funding and credit quality issues, there could be ample opportunity to tap the current market.

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