The Brief

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Banking Outlook

Welcome to *Banking Outlook*, the first special banking law newsletter by Gide Loyrette Nouel Budapest. The purpose of this Banking Outlook is to regularly inform you of the recent developments and trends in the European banking market and beyond, including some neighbouring countries such as Russia and Turkey.

This issue of *Banking Outlook* summarises the main characteristics of **project bonds as an alternative source of project financing** to traditional banking loans.

We hope you will find it useful!

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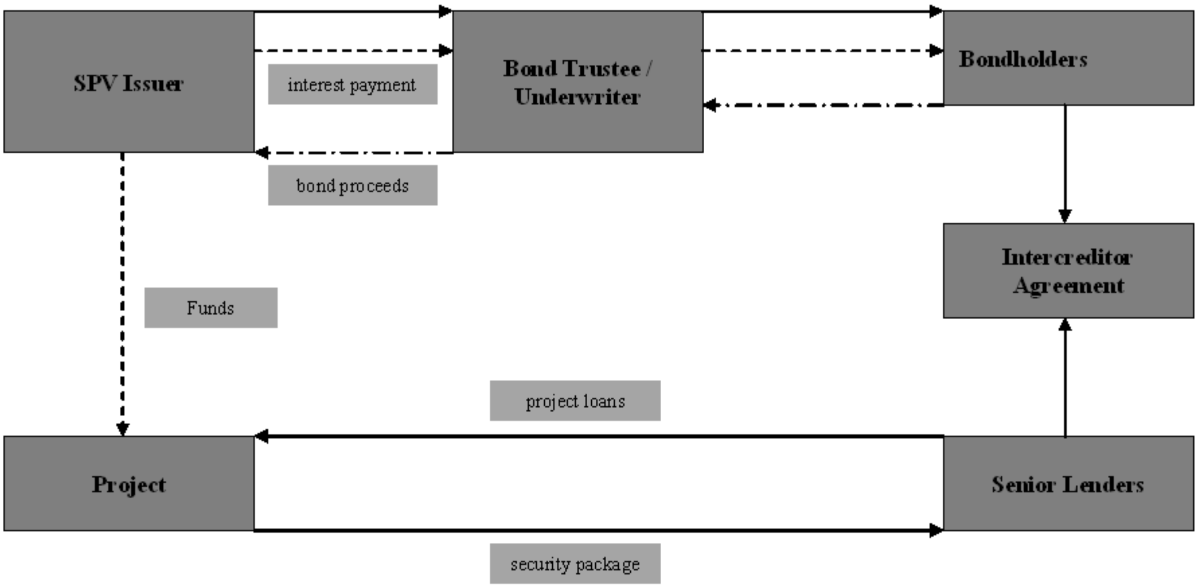
Project finance: bonds versus loans

There has been much debate recently over the suitability of bond issuances as an alternative source of project financing. However, project bonds are not a new concept. Project finance bankers have been familiar with project bonds in the UK PPP market, where a large proportion of transactions were bond financed between 1997 and 2008. Indeed, bonds have also played a significant role in the US projects markets.

Post credit-crunch, the UK PPP bond market disappeared overnight, as a result of the downgrade of the monolines[1], which had generally provided financial guarantee policies for these bonds. At the same time, the rest of the project finance markets watched as commercial banks pulled down their shutters and closed for business, leaving sponsors to seek alternative investors and :investment support. But it is not altogether a desperate tale of woe, as project sponsors were not left completely out in the cold. They had a considerable advantage over other borrowers in that they could turn to export credit agencies (the "ECAs") and development banks to support their borrowing through lean times. The result for the project finance market was not a sudden rush to issue bonds, but a resignation by sponsors to knuckle down to the more stringent lending conditions imposed by export credit backed financings.

Simple Project Bond Structure



Rating for projects

The investor appeal for PPP bonds largely derived from the fact that the bonds were wrapped: there was no appetite amongst investors to pick up the risks and administrative burden of non-wrapped bonds.

So what is the alternative post-monolines? In various European markets, there are local initiatives to incentivise investors, such as the preferential creditor status afforded to certain covered bond investors in the French PPP markets.

For other private international projects, what can be done do attract a new wave of capital markets investors? Projects themselves can often benefit from a debt rating issued by rating agencies, which can be viewed as the new "alternative" to a wrapped bond. In the same way that bank credit committees assess the credit risk of projects and price their debt accordingly, so the rating agencies apply similar criteria to projects to assess the likelihood of debt default. By having a project debt rated, the sponsors significantly increase the financing options available to them, as capital market investors will look to a credit rating when making their investment decision.

One of the challenges of financing projects is that they are often greenfield, and therefore carry construction risk, and in some cases include reliance on unproven or new technologies. By contrast, a brownfield project will always, therefore, have a better risk profile in that it will have limited, if any, construction risk. It is the large

[1] Monolines are insurance companies that guarantee the timely repayment of bond interest and principal in exchange for insurance premiums.

element of construction risk which has always made project loans a more natural partner for projects financings, providing long amortising debt which allows sponsors breathing space on repayments until the projects are able to generate cash flow and service the debt.

The alternative to a sponsor seeking a credit rating would be to invite potential investors to undertake significant due diligence on any prospective project investment. However, whilst banks are prepared to do this for loan debt (and price accordingly), bond investors do not have the resources or the inclination to carry out the level of diligence required to verify a prospective transaction.

Why Project Bonds?

There are a multitude of advantages and disadvantages to consider before choosing project bonds over traditional project loan debt. In an evolving and radically different financial landscape, project bonds, particularly infrastructure bonds, have become a viable option for sponsors, and offer an attractive risk and reward profile for investors. In the boom days of cheap debt, bonds could not compete with the banks. They were less flexible than the tailor-made financing packages and could not compete on price.

(a) Larger Investor Base

Bonds attract a different type of investor with capital markets being the traditional investment market for institutional funds, such as pension funds and insurance companies. These investors prefer long term and fixed income assets and projects, particularly infrastructure, providing a solid investment base for their funds.

(b) Covenant Light

Commercial banks and other financial institutions expect to heavily regulate the activities of project borrowers and their sponsors. Therefore, a key characteristic of a project financing loan agreement is the large covenant package, often extending beyond the borrower to capture all other material affiliates of the borrower, in addition to the sponsors. Essentially, a project borrower will have been formed for the sole purpose of carrying out a project; so the application of such covenants will not be so onerous, but above the level of the borrower, sponsors can find themselves in a bitter battle with lenders as to the appropriate level of commercial policing needed to safeguard the financial integrity of the project.

Add ECAs (Export Credit Agencies) and development banks to the mix and there will be even further levels of covenant protection, with many ECAs having their own set of default "trigger events" which may be in addition to the event of default triggers under the common terms agreement. Another necessary element of this type of financing will be the increased information and reporting obligations required by commercial banks and ECAs, which can be administratively burdensome. By comparison, bond issuances are relatively covenant light and do not impose the same level of reporting obligations on the borrower and its sponsors. This makes bonds an extremely attractive prospect for sponsors: low maintenance and less restrictive in comparison with loan financing.

(c) Flexible Interest Rate Options

Capital markets instruments usually provide more flexible interest rate options, whereas syndicated loans normally provide for a floating rate of interest only.

(d) Security

Bond issuances have largely been non-recourse for sponsors, which has made them obviously attractive to sponsors. It is interesting to note, however, the more hybrid form of project bonds emerging out of the recent wave of global project deals, in which the senior lender security has also been extended to the bondholders. Where project bonds have made up a component of the project financing in conjunction with significant senior bank debt, the bondholders have benefited from the senior lender security package, making the bond an even more competitive option, reflected in its favourable pricing *vis-a-vis* loans. Bond holders have also benefited from guarantees granted by strong project sponsors.

(e) Realisation of Investment

Loans can be syndicated or traded on the secondary debt market, but the market for such debt is limited in comparison to the commercial paper markets. Bonds have a ready-made liquid market which makes them an attractive option for an investor who may not wish to hold the bonds until maturity.

Specific Legal Challenges for Bond Issues

Bonds have their own set of legal challenges which make them a less suitable partner for projects than loan financing. The key challenges include the following areas:

(a) Disclosure Obligations

It is not uncommon for securities laws in jurisdictions where project bonds will be sold to require the public disclosure of key projects agreements, or the material provisions of those agreements. From the perspective of project sponsors and their counterparties there will be a strong rationale to resist the release of commercially sensitive information into the public domain. The terms of any loan financing package will invariably include confidentiality obligations, and in certain cases, where the project involves the use of patented technology, these agreements may not even be provided to lenders, but 'solely to' their legal advisors for evaluation, or will be provided in a heavily redacted form, such is the desire to keep commercially sensitive information out of the public domain.

(b) Commitment to finance

A firm contractual obligation by project lenders to commit to the financing prior to a first utilisation under a loan facility provided certain pre-agreed conditions have been satisfied, allows financing certainty for project participants. Upon the back of such commitments, a project company may often enter into its commercial project contracts and may attract further investment through other financial products once it has demonstrated that financial resources have been committed to, and are available to it. Until a bond is actually priced, the borrower will not have a similar level of commitment from the underwriter of its bond offering.

(c) Flexibility

A key feature of loan financing for projects is that it is considered to be "tailored" to the specific requirements of the project. The terms will be project specific rather than simply generic LMA provisions. There will be an expectation, particularly with greenfield projects, that the borrower will need to approach the lenders with specific waiver and/or amendment requests as the project progresses. This is typically during the construction phase to cover any cost overruns or delay in completing the target completion date. Waivers are often sought to specific covenants to allow sponsors to restructure or re-organise internally.

Post 2008, numerous projects fell into default scenarios due to cross-defaults at sponsor level, which would not, particularly in a joint venture context, be sufficient to damage the economic viability of the actual project being financed, but would nevertheless create technical defaults which required examination and waivers from lenders. In bank financing, it is easy to identify the lenders from whom consents are required, and typically loan agreements include a "snooze and lose" provision - essentially a term of the common terms agreement or intercreditor agreement requiring lenders to respond within an agreed period of time to any request or effectively be deemed to have approved the request.

By contrast, bond covenants are generally less strict than bank covenants, and waivers may automatically be made available where the issuer obtains an affirmation of its credit rating or the bond trustee may possess discretion to approve a waiver if it is considered that such a waiver is not likely to materially impact the business or financial projection of the borrower or the project. However, this has limited use if the proposed waiver relates to a more material matter or one that requires either a majority or unanimous vote of the bondholders. The actual number of bondholders is likely to be far less manageable than a pool of bank lenders, and in some cases it may not even be possible to identify all the bond holders. This presents a significant challenge for borrowers who may require significant or frequent waivers during the lifetime of the bond.

Loan financing also provides the following flexibilities which are conspicuously absent from bond terms:

- the ability to renegotiate or refinance debt (by contrast, prepayment of bonds can carry a sizeable prepayment fee in addition to a requirement to return the par value outstanding, which will normally be of an amount which negates the overall economic benefits gained by the borrower in refinancing at a lower interest rate cost);
- the size or credit rating of a borrower will not necessarily hinder its achieving loan financing (although the debt will be priced accordingly);
- the flexibility to drawdown funds, as the borrower requires, during an agreed availability period. The project debt does not need to be drawn at once and can be cancelled, prepaid or scaled back if required;
- loan debt normally amortises and is repayable in instalments. With greenfield projects, it is usual for interest repayments to be consolidated or rolled over until the commencement of commercial production or the actual commencement of a revenue stream for the borrower (as applicable); and

- availability of both term loans and revolving facilities. The ability to drawdown and re-borrow under a revolving facility is an attractive feature of many project financing packages.

(d) Negotiating Intercreditor Arrangements

Complex project financings involve a variety of finance parties: commercial banks, ECAs, hedging banks. The interests of all these parties, as regards each other, are normally documented in the form of an intercreditor agreement. The introduction of bondholders to this arrangement provides further complexities, particularly as capital markets bond financing will often have competing intercreditor interests to the conventional loan financing. A key example of obvious conflicts includes restructuring options and "work-out" arrangements. As bond transactions are by their nature covenant light, lenders will often debate to what extent bond holders should benefit from commercial loan events of default and breaches of covenants. These issues are not insurmountable, but they do represent a considerable negotiation challenge.

(e) No Multicurrency Options

Project bonds are always issued in one currency. Traditionally, investors have favoured U.S. Dollar issuances, although the domestic bonds issued in both the UK and other parts of Western Europe have been issued in domestic currencies - euros and pounds sterling. This can present a considerable currency risk to project participants; it is not uncommon in complex project transactions to find that the borrower has both payment liabilities and revenue streams in a variety of currencies. The currencies involved depend on the geographical location of the project, its customers, and the identity of the project counterparties, particularly offtakers or purchasers, contractors and even insurers.

Borrowers can to some extent mitigate these risks by entering into hedging arrangements. However, the perceived costs of such arrangements and the termination payments thereunder can be high.

(f) Cost of Carry - Greenfield Projects

One of the most significant downsides for any project borrower of bond capital markets debt is the challenge of meeting its payment obligations during the construction and start-up of a greenfield project. The timing of the bond issue can have a significant impact on the economics of the project financing. A bond is typically funded in a single issuance. If that funding represents a significant portion of the project debt, such funds may not all be required initially by the borrower to meet its immediate payment obligations, and will therefore need to be credited to an escrow account until the funds are needed for the project. As a consequence, interest shall continue to accrue on the bonds from the date of issue at a rate which is unlikely to be offset fully by the interest the borrower will earn on the escrowed bond funds deposit.

The Future of Project Bonds?

The attractiveness of project bonds for both investors, and sponsors is being addressed, with initiatives at both the domestic and international level to encourage further liquidity for projects. The initiatives address both the legal and administrative issues associated with project financing namely, the need for a more uniform set of covenant provisions for incorporation in project bonds and the provision of adequate project due diligence on behalf of investors.

What makes project financing so versatile, and resilient, is the ability to create a robust financing package from a variety of different financing products. In the same way that project lenders, particularly in the MENA region, have incorporated Islamic financing into conventional financing packages, it is likely that project borrowers will, in the current market, seek to incorporate elements of bond financing into conventional project financing structures. It is unlikely that borrowers or sponsors will ever seek to replace loan debt entirely with capital market debt as the complexity and tailoring required for greenfield and complex cross-jurisdictional projects do not make bonds a natural bedfellow for private project finance. However, in the context of refinancings or expansions for existing projects with proven cash flows and credit ratings, they provide a ready source of liquid and cheap funding.

Project bonds have their challenges for both sponsors and investors but they clearly have their place as another financing resource for project sponsors which can be incorporated alongside a more conventional financing package. The future looks likely to see more transactions which marry bond and loan financing for large scale projects.

Based on an article by Fiona Gulliford (Gide Loyrette Nouel London) published in the Bankers' Law volume 4, number 1

Infrastructure bonds - the EU Initiative

"*An EU initiative to support project bonds, together with the EIB, would help address the needs for investment in large EU infrastructure projects*"

(J.M. Barroso, President of the European Commission, “State of the Union” speech 2010).

In the past, capital market issues were an important source of financing for infrastructure projects. Pre-crisis capital market finance for greenfield infrastructure came from bonds guaranteed by monolines. However, since the financial crisis there have been few new issues guaranteed by such monolines. Additionally, the sovereign debt crisis and pressure on banks’ balance sheets from higher regulatory capital and other requirements (Basel II and III) have constrained other sources of long-term infrastructure financing. There is therefore a need to find new ways of financing infrastructure projects.

Since 2010, the European Investment Bank (EIB) and the European Commission (EC) have been engaged in an extensive consultation to develop new financing products as the European Union’s "2020 Objectives" anticipate the need for investments totalling EUR 2 trillion in the transport, energy and information and communication technology sectors.

The EIB and EC’s response to this challenge is the "*Project Bond Initiative*" (PBI). The pilot phase of the Project Bond Initiative was established in 31 July 2012 by Regulation No. 670/2012. The Project Bond Initiative will be managed by the EIB and the pilot phase (2012-2014) will cover 5-10 projects in the fields of transport, energy and broadband that are at a relatively developed stage of the bidding and financing process. The PBI has the potential to deliver funding of EUR 4.6 billion.

The initiative uses a financial technique known as 'credit enhancement'.

How PBI will work

The bonds will be issued by the project companies themselves, not the EIB or the EU Member States.

Under the Project Bond Initiative, the EIB will be able to provide eligible infrastructure projects with Project Bond Credit Enhancement (PBCE) in the form of a subordinated instrument – either a loan or contingent facility – to support senior project bonds issued by the project company (Senior Bonds).

By providing support at the subordinated debt level, the initiative would enhance the quality of the senior debt. By improving the credit rating of the senior tranche (the Senior Bonds), it will reduce the long term financing costs for the project entities and make it easier to place the bonds with institutional investors. Any financing provided under the instrument would be subordinated to the project bond, which ranks ahead of the EIB's credit enhancement facility in priority of payment.

Credit worthiness and particularly "the credit rating" of Senior Bonds is of crucial importance for institutional investors who look for a minimum rating according to their reserve requirements and performance targets. The Project Bond Initiative is expected to attract institutional investors, such as pension funds and insurance companies, who are keen to invest in predictable cash flow generation projects through the credit enhancement of bonds issued by the project company, i.e. the sponsor of the project. The credit enhancement raising senior debt and the implementation of the Project Bond Initiative would be done through the EIB. There are many differences between the PBI and monolines. Among them, it should be stressed that the Project Bond Initiative is aimed at the A- to AA range, and is based on the EIB’s capacity to deliver subordinated loans; support would be available during the construction phase. This last point is very important since institutional investors are reluctant to take this risk unless it is mitigated through any form of risk-sharing.

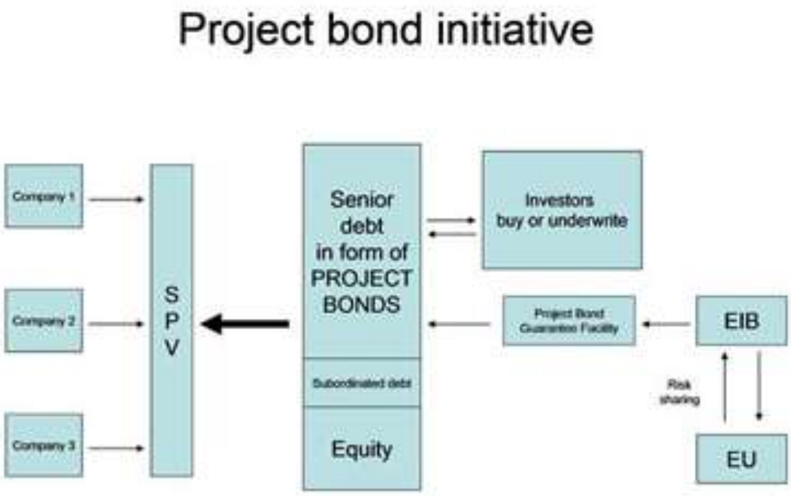
Moody’s (2011) highlights the Europe 2020 Project Bond Initiative, stating that "it would be capable of credit-enhancing senior secured project bonds issued by PFI/PPP projects from low investment-grade to single-A ratings". The credit enhancement could be achieved through a funded subordinated debt, or an unfunded partial guarantee of senior debt service.

Standard & Poor’s (2011) states that, if implemented properly, this Initiative could provide "the credit support either by guaranteeing the debt service payments of such bonds, or by the EU taking a subordinated position in the project". The guarantee structure provided for credit enhancing would be available during the project’s construction phase, which is not the most attractive phase for investors. If this credit risk mitigation works and is well accepted by the market, this Initiative could be a trigger for the project bonds market and in infrastructure financing in Europe.

The proposed mechanism of the initiative will:

- be limited in amount from the outset (capped at EIB and EC commitments under the instruments), with a maximum size of individual transactions of up to the lower of EUR 200 million or 20% of credit-enhanced senior debt;
- as subordinated debt, target an uplift of the project rating to A- or AA rather than AAA;
- be based on the EIB's capacity to deliver subordinated loans, not necessarily its rating;
- only target the EIB's core business, i.e. infrastructure financing;
- only support robust projects;
- benefit from the EIB's proven due diligence, valuation and pricing methodologies.

Example of the structure of the Project Bond Initiative



Source: European Commission, 2011.

What are the core requirements for an eligible project?

The Project Bond Initiative is targeted at projects in trans-European networks of transport (TEN-T) and energy (TEN-E), as well as broadband and information and communication technology (ICT).

The following general conditions will also apply:

Requires bond market infrastructure

PBCE is available to bond-financed transactions and not to bank-financed transactions.

Requires Ring Fenced Assets

A core requirement of the PBI is that the support of the initiative is directed at developing specific eligible infrastructure assets rather than merely supporting corporate balance sheets. Consequently, the initiative requires that eligible assets be ring fenced. Whilst a range of security structures can be considered, the repayment of the Projects Bonds and PBCE facility will typically be determined by the performance of the ring fenced assets.

Robust project

EIB will require that the project (i.e. before PBCE is taken into account) have a robust financial structure. There is no minimum project size, but investors may require critical mass.

There is no minimum capital value threshold for PBCE projects. Whilst public bonds have traditionally been used for larger infrastructure transactions, private placements have been used for smaller transactions. The use of PBCE can be considered for the credit enhancement of either public bonds or private placements.

Conclusion

The Project Bond Initiative is timely but requires being active, flexible and responsive to the execution required from capital markets. One of the key drivers of this initiative will be the established mechanism for credit enhancement achieving the minimum A- threshold required by institutional investors. If this initiative is successful, Europe could start taking off with new capital markets for project bonds, which could be attractive for investors.

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