

# Project finance and the bond markets

Bonds are increasingly becoming a source of project funding. Steve Baseby, a treasury projects adviser, looks at the pros and cons of this trend.

Recently it has become viable to seek project funding from fund managers who have previously bought unsecured corporate debt, or debt secured by debenture on property. Bond investors have shown willing to spread their risk to receivables securitisation, and now to the project finance risk of one asset special-purpose vehicles (SPVs). This trend towards adopting risks previously taken by commercial banks has been driven by the funds' need to enhance yield on the ever-growing volume of money they receive in this pension-conscious world, while maintaining the relative certainty of cash flows which bonds provide.

Any discussion about how to fund a project first requires an understanding of the objectives of the given project. This is important because the new trend in bond financing projects can offer a different funding structure to that of the traditional bank facility market. It can become too easy to chase these differences as benefits in themselves while losing track of the investor's overall commercial purpose.

## Objectives

Corporate objectives can include:

- ring-fencing the financial risk in a non-recourse vehicle;
- minimising the equity input;
- minimising the debt cost;
- targeting an EPS flow;
- targeting a cash payback period;
- targeting a rate of return;
- targeting certain fix : floating interest rate ratios over the debt life; and
- diversifying sources of funding.

The first may be stating the obvious but it is important to understand the degree to which project promoters are willing to provide explicit or implicit guarantees, the latter by perhaps off-take agreements.

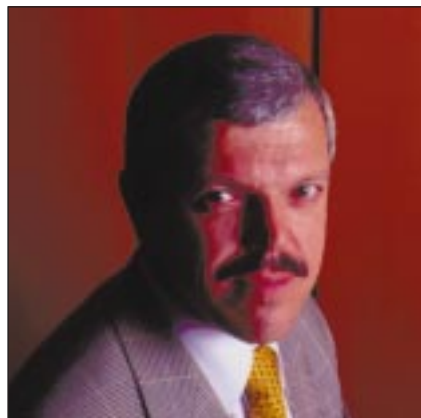
Project-specific objectives may depend on the state of the project and can include:

- proving financial capacity during a negotiation phase;
- borrowing efficiently during a construction phase;
- selling the use of novel technology to the finance market;
- reducing the equity in a completed project;
- otherwise refinancing such a project;
- maintaining flexibility in order to reorganise the project's contractual arrangements; and
- maintaining flexibility to develop the project further.

This list is unlikely to be exhaustive but it highlights the factors a corporate may have to consider when judging the value of differing finance sources. The decision process will become more complicated when a project brings together two or more joint venture (JV) partners, each of whom may have objectives that differ or change over time.

## Bank facility financing

For years, this route has offered a workable means of getting projects underway. The bank market has developed a



Steve Baseby

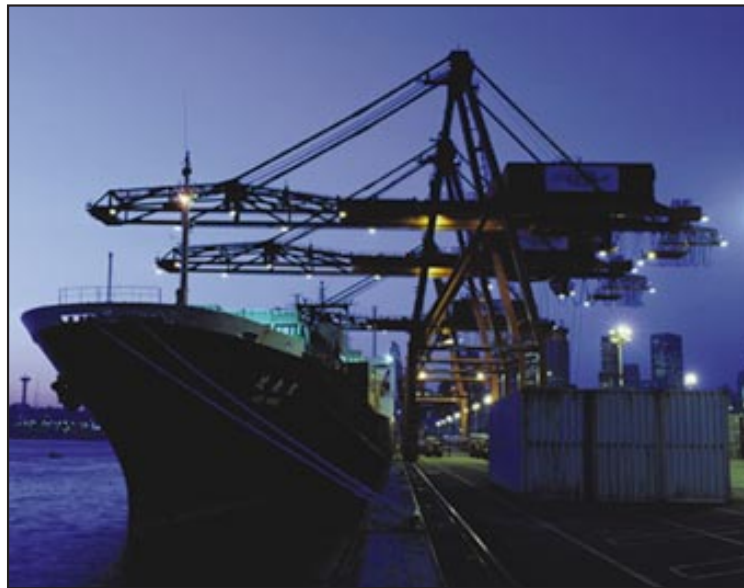
worldwide network of skills that have enabled deals to be executed in western as well as emerging economies. This does not mean that the market provides all the solutions. Indeed, its major difficulty has been a constraint on the term of the funding, which can ebb and flow as the bank markets suffer periodic liquidity constraints.

The dash for gas generation investment of the early 1990s was able to secure 18-year bank funding, which included a three-year construction period. At that time several major banks could not commit to these long terms even though the useful lives of the assets were 30–35 years, and the concept of a stranded asset had yet to become known outside the US. Shorter facility lives have become more the norm, which means that the project promoters are committed to refinancing to achieve the same overall financial structure of the earlier deals.

The major attraction of facility remains its apparent flexibility. A small group of banks can be brought in as underwriters during the closing of the project's contractual stage. The bankers are used to finalising the deal within pre-approved parameters from credit committees which are themselves nowadays often contactable around the clock. The promoters can obtain varying degrees of assurance of funding from the banks to close contracts with third parties, such as fuel suppliers or customers. Problems in construction or operation can be managed by calling a meeting through the agent bank. The promoters can explain their problems to a generally expert audience.

Any subsequent physical or commercial redevelopment of the project can be accommodated in a facility agreement by waiver or modification. However, inventive investment bankers are likely to be able to replicate all these factors within a bond structure. The degree to

which this may or may not be possible for any particular deal today will rely more on a bank's historical presence in this market relative to a fund manager's rather than the technicalities of the deal itself. It is simple fact that banks are likely to employ project-specific experts, such as engineers and credit analysts, while fund managers may lack the resources to carry out even the credit analysis as the flow of bonds increases. The kickback is that if something goes wrong it could result in a syndicate of 20-plus bank experts to manage!



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### **Bond market financing**

The bond market can offer longer-term maturities. A low interest environment means that the slower repayment can accelerate the cash available within a project for distribution, and this may appeal to an NPV, IRR analysis or cash payback analysis-driven organisation. Alternatively, it will increase year-on-year interest costs within the project. This may not appeal to an EPS-driven organisation, depending, of course, on how it does its books.

Bond markets have also shown an appetite for heavily leveraged deals with debt equity ratios better than the 85 : 15 to 90 : 10 typical for bank financed project financings a few years ago. This may suit new promoters, or those looking to re-finance extant projects, although banks are reactive and are likely to match any trend in this regard.

Gearing up with a bond re-financing may make cash available at bond issue which otherwise may not have emerged for years. Similarly, extending the maturity with a bond issue may provide interesting NPV advantages. However, care needs to be taken to ensure these are not illusory. Increasing debt in one part of a business will reduce it in another. Was that the objective? Creating a cash pile in a project-finance SPV may not mean it is readily accessible outside the SPV if that was the objective.

NPV analysis assumes the discount rate is known and is reliable as a forward-looking measure. The discount rate for corporates moves closer to their

debt rate as they follow the trend for gearing up; at the extreme ends of the scale, playing with the timing of cash flows becomes an irrelevance.

The major perceived drawback of bond financing remains the difficulty of seeking approval for post-issue changes to the project structure. Typically one will deal with a bond trustee who will have limited capacity to negotiate on behalf of the bondholders. Beyond that the trustee must attempt to raise a quorum of bondholders to get a decision. (Against this the cosy meeting with 20 readily available bankers begins to look attractive.) Bond documentation can be fairly specific on what to do in such an event, but the more one swings the decision towards the trustee the less marketable a bond may become.

### **Which is cheaper?**

Of course, cheap debt may be the sole objective. However, in the normal run of events the costs are likely to be similar. Both markets require upfront fees. Both will base the interest rate on an underlying factor, be it government bond or LIBOR, and today's swap market appears willing to convert the basis for almost any reasonable maturity. Both will apply a similar risk margin.

Any substantive difference is likely to be due to the state of the differing funds providers, but both markets remained reasonably synchronised through the Asian/Russian crisis of late 1998, although the banks lost liquidity through bad debt provisions while fund managers continued to receive liquidity.

However, any sustained period of price difference is bound to be arbitrated out unless one of the markets is pressed to withdraw for regulatory reasons.

A more intrinsic reason for a cost difference is likely to be the lender's comprehension of the risk. As I noted earlier, the fund managers may have neither the technical nor the credit analysis resources to be in a position to understand fully the credit risk of a particularly complex engineering project, or the portfolio of projects in which they would hope eventually

to invest. Their normal course of action would be to look to the credit rating agencies to provide the analysis and monitor the credit value over the debt life. However, project finance by its nature is likely to be over one asset on a non-recourse basis, and this is unlikely to achieve ratings above the bare minimum investment grade without some form of guarantee.

Guarantees may be available in the form of high-quality customers tied to offtake agreements, or high-quality suppliers and operators, but the non-recourse nature of a project financing is likely to bias the risk towards the project finance SPV. In any case, the trend is towards projects with increasing degrees of market exposure. Explicit guarantees can be available in the form of insurance wraps, but these cost money and insurers have indicated a preference for multi-asset projects while project financing is often over one asset.

### **The main objectives**

I hope the above has clarified some of the arguments for and against the developing use of bonds for project finance. The main message is to define the promoters' objectives and then look for the source of finance, and not to be driven by the first marketing man through the door. ■

*Steve Baseby has worked for British Telecom and Southern Electric during and following their privatisations. His work includes corporate treasury in its broadest sense, taxation and insurance.*