Bond ambition

01/11/2007

The Latin American project finance market has seen fewer bond deals in 2007, after two years of relatively significant activity. Recent bond deals in the region have not, on the whole, been for new or greenfield projects. Rather, they have been securitisations, refinancings and acquisitions of existing projects. What happens to the bonds after they have been issued, however, may have a larger impact on the emerging capital markets than the deals themselves.

Institutions active in emerging markets, such as multilaterals, believe that assembling suitable debt packages for long-lived assets is an important factor in promoting a country's financial stability. Domestic capital markets, in particular, are often viewed as a vehicle for economic development, since they provide pension funds with a way of meeting long-dated liabilities. But there is no set way to kickstart domestic capital markets in emerging market countries. According to Bob Dewing, an infrastructure financier, the fundamentals are in having good long-term assets, and support from the development banks in the early years, until projects can issue bonds without that insurance.

Another factor in the development of the region's capital markets is that that many of the Latin American countries are not investment grade, and have low country ceilings. Chee Mee Hu, head of the Americas project finance team at Moody's, notes that Moody's recognises just four countries with investment grade ceilings in the region; Brazil, Chile, Mexico and El Salvador.

Cross border to domestic

Although there has been a solid pipeline of project finance and infrastructure deals this year, particularly from Mexico, they have mainly been financed with bank debt, and structured with the intention of a capital markets refinancing soon after close. This structure has been seen on a number of the toll road deals, and notably on the first of the FARAC roads concessions, for which a capital markets refinancing is due later this year or early next.

Franklin Minerva, managing director of global infrastructure finance at MBIA, explains that in the Latin American emerging markets, the more challenging deals benefit from access to cross-border markets, and often the maturity limits are dependent on the stability of economy; "There are limitations on the investor appetite for size and tenor with these bond financings, so sponsors may seek funding outside the market for bigger, longer or more complex deals. They can often get a better rate on cross-border issues, especially with regard to the lien status. There is little interest in subordinate tranches, and it is not possible to place them if they are sizeable."

Market speculation suggests that the FARAC refinancing will be dome domestically, as Mexico now has the sufficient capacity to avoid using cross-border bonds. Michael Schoen, managing director and head of Latin American debt capital markets at Credit Suisse, explains "the Mexican peso is currently outperforming the dollar market, and has demonstrated a robust investor base, and continued asset growth." But, he continues, "for domestic peso deals in Mexico, pension funds require high ratings."

Credit Suisse and Goldman Sachs were joint lead arrangers on the recent America Movil telecoms deal in Mexico, raising $1 billion in bond debt in two tranches, $600 million of 10-year notes with a coupon of 5.625%, and a $400 million in 30-year bonds with a 6.125% coupon. Schoen explains that though two tranches were dollar denominated, it also featured a five-year floater in pesos, and that the deal was "product agnostic; we did not have a dollar preference."

Indeed, the Mexican market is now reaching a maturity on a par with that of Chile, where its economy can sustain its deals and, often, no longer needs to seek financing solutions outside its own currency. There have been very few bond financings in Chile this year, but then the country has completed its first phase of major infrastructure works, and has not yet begun the next. However, the Ontario Teachers' Pension Plan acquisitions of two water projects in Chile, ESSBIO/Aguas Nuevo sur Maule and Esval, in August and September 2007, were bond financed, and Dresdner Kleinwort arranged $350 million in private placements entirely in the domestic market.

Dewing uses some of the deals he worked on as a model of how the Chilean market evolved. The Santiago airport bonds from 1998 were placed entirely cross-border, as the country did not have the financial capacity to handle the project at that time. For the Autopista Central deal in 2003, the bonds were half domestic and half cross-border, maximising the country's domestic exposure. By the time of the second major toll road, Vespucio Norte, in 2004, it was all done in the domestic market. This may be a model replicated in other countries in the region, and this process is already underway in Mexico.

Bonds vs bank debt

Infrastructure assets are prime candidates for bond debt, as they are generally long-term assets with steady revenue flows, which are inflation indexed. Institutional investors, pension plans and insurance companies are becoming increasingly comfortable with infrastructure assets, due to the need for guaranteed revenue many years down the line. According to Hu, "In project financing, historically 70% of deals were bank financed in the region, as with power projects. Now there are more infrastructure deals, and the assets are well appreciated by the capital markets, since they understand, say, toll roads, with long-term revenues." According to Hu, a lot of the sponsors on the Mexican toll road deals particularly, sought ratings for potential bond financings, but these were not published as the sponsors opted for bank debt instead. For a sponsor to choose a bond solution when construction risk is involved, involves a compelling, if often obscure, reason.

Hu explains, "Doing deals in the capital markets is more time consuming and more expensive than bank financing. Eventually there will be a shift in towards more capital markets deals, but they will never be predominant. The transactions are more onerous. When project is investment grade, it will only go to the capital markets if there is not enough capacity in the bank market, or if the sponsor wants visibility for the project. With capital markets deals, more is revealed, and there is more transparency with marketing the placements. It also helps with future liquidity purposes and trading securities".

In 2004, Citi and WestLB partially bond financed ICA's El Cajón 750MW hydroelectric project in Mexico. The $230 million in 144A bonds were all placed cross border. The deal was unusual in that the bond underwriter issued a $100 million bridge loan for the construction phase of the project, thus taking on some of its construction risk. Though somewhat innovative, West LB had to bring in Citi to help with the financing, as there was not at the time the capacity in the country to fund the $690 million project.

This year, ICA was awarded another hydro project in Mexico, very similar to its last; costing just short of $1 billion, also with a 750MW capacity, the sponsor referred to the project as a replica of El Cajón. However, despite rumblings to the contrary, La Yesca will not feature bond financing. WestLB arranged the $910 million senior facility, of which Banamex, HSBC, BBVA and Nord LB have each taken one fifth. The financing also included a revolver of $80 million, which West LB has also kept. The bullet facility has a maturity of four years and nine months, three months longer than the construction phase, but is extendable by a further 9 months. The structure is a less risky way of mitigating the construction risk for the lenders than on the previous deal.

Secondary markets and derivatives

While there has been a marked change in the appetite of domestic buyers for project debt, international buyers are a more diverse bunch. While European and US accounts can and do participate in cross-border infrastructure debt from Latin issuers, there is an emerging trend in the project bond market for banks such as Goldman Sachs, Merrill Lynch and

Deutsche Bank, to buy the bonds, but rather than placing them, then keep the notes on their books.

The technique allows the bank to wait before placing the bonds under more favourable conditions, if the market is not optimum. In the deals where there is an element of construction risk, by sitting on the bonds, and riding out the construction phase, the bank can benefit from the locked-in higher pricing that resulted from the inclusion of a construction phase.

The banks can also trade the bonds or write and trade derivative contracts on the notes, in the form of credit default swaps (CDS).

Where the bondholder, the underwriter in these instances, wishes to narrow its credit exposure on the debt, it can enter into a CDS contract for sovereign default, then short the bond. The bank has residual exposure to the issuer, which in the case of bonds tied to sovereign commitments is fairly small. After a project has completed construction, this will be still smaller.

Banks also do proprietary trading on infrastructure bonds. A banker familiar with the market is blunt about the angles; "Our purpose is to make money. There are a dozen ways to hedge a risk, including shorting project bonds, and going long on government bonds, and vice-versa. If the risk is adequately hedged, and the hedge costs more than the position, you can take the difference for income." Though there is a long history of CDS, and derivatives hedging in the bond market as a whole, it is relatively new for the Latin American capital markets, and even newer for infrastructure debt.

Goldman is thought to be employing CDS and other such hedging techniques with Pemex bonds, which are much more liquid. Market speculation suggests that Merrill may also do so with the bonds that it underwrote for the IIRSA Sur, though the deal has yet to finish construction, and the Ps2.7 billion ($250 million) revenue securitisation bonds for on 13 airport concessions also in Mexico, for which ICA is the majority sponsor. The airport debt featured three tranches, a Ps2.125 billion, 10-year note, a subordinated Ps325 million 10-year tranche, and a Ps355 million, 1-year floating-rate tranche. The coupon was 7.75%, and 11.06% for the subordinated tranche.

Such trading is most effective where payment streams on bonds are tied to sovereign obligations to a project, and where the risk on the payments to the concessionaire is directly associated with the country's sovereign rating, even if these payments are not considered to be on a par with sovereign debt obligations. The sovereign ratings, are a significant factor in setting the margin between the risk on a project dependent on sovereign payments, and the sovereign risk itself.

There are varying opinions about the impact of this type of financial engineering on the countries involved. The interest of the dollar bond market in the deals, as well as the associated financial structuring, allow projects to go forward and force them to be assembled more efficiently. On the other hand, bonds that serve as elements of sophisticated and intricate trading strategies for savvy investors are bonds that do not provide less sophisticated buyers with an education in infrastructure risk.

But getting an idea of the proportion of bonds funnelled to proprietary trading desks compared to buy-and-hold investors is difficult, and the resultant number is unlikely to be static. Whether similar techniques might be applicable to deals where the payment streams on project bonds are more complex than government repayments of construction financings is also unclear clear. The anonymous banker believes it to be theoretically possible as, he says, "more liquidity equals more options". He could not cite any instances where it has happened, however.

Brazil and Argentina

Though there have been a few bond deals in Brazil, its infrastructure debt capital markets are still considered to be in infancy by bankers focusing on the region. BNDES, the Brazilian development bank, still has a dominant role in the country's project market.

The recent awards of seven federal toll road concessions, which total 2,600km of highway, five of which went to OHL, further suggests an increase at least in the supply of project finance debt in the country. The winners have not yet been settled on financial structures, and financings are likely to face delays, since the awards have been contested by the other bidders.

Other than Odebrecht's recent $300 million bond issue of 10-year notes to fund three subsidiaries in oil & gas, infrastructure and construction, there has been little infrastructure-related bond action in the country. Says one banker, of Brazil, "Intuitively, the local currency should allow for greater leverage, as there is no currency risk. However, Brazil has high interest rates, so it can sustain less leverage. BNDES controls the PPP programme, and is concerned with the ramifications of sharing public assets with private companies, and so its construction companies therefore want to move outside the Brazilian market."

Another banker, familiar with the market, but who also wishes to remain anonymous lest he jeopardise his deals, says that the bond market in Brazil "is a mess". He continues, "the only lender willing to be involved in projects in the region is BNDES, the lender of last resort. There is no trust in the long-term market. The government has to demonstrate that it is committed to making these deals work, and at the moment, it does not have the capacity to do so."

Commenting on Argentina, he says that, conversely, "it once had the capacity for project bonds, 15 years ago or so, and its original toll roads were executed entirely in the domestic markets. It is now recovering from its financial crisis, and the medium-term bond market is looking increasingly robust in terms of infrastructure projects."

The credit crunch

The latest financial crisis, however, centres on the dollar debt market. Though the recent crises in the markets have not had a marked impact on the Latin American debt capital financings, there is still a pervasive caution through all the markets. "Institutions are now more concerned with the credit risk in the market than previously," says Minerva, "In the late '90s, banks were pushing back from having these assets on their books, but that changed. Now it is back to some extent, since the credit crunch."

Despite the general caution, the deals have been paused, rather than disrupted. Schoen points out that, "despite the close down in the markets in August and September, the Latin American capital markets have had an extremely good year, and this will still be the case even if no more deals close in 2007."

One of the difficulties with the market at the moment is with the monoline insurers and their future. A number of sources commented that before the markets suffered as a result of the credit crunch, using monolines made a lot of sense to get efficient pricing. But, as Hu notes, "monoline wraps need underlying investment grade ratings, and not a lot of the Latin America projects are investment grade." The case for the monoline insurance on these bond deals could rebound as the ramifications of the credit crunch lessen, and more Latin American projects move towards investment grade ratings.

The markets are, though a little slower, still producing robust financings, including one that priced in early November. The Panama Canal Railway Company has just issued $100 million of 19-year, senior secured bonds underwritten by Morgan Stanley. The proceeds will be used to prepay loans from the IFC and shareholders, to fund a $3.6 million debt service reserve, to fund $20 million of capital expenditure over the first two years. Though the sponsor, a 50/50 consortium of Kansas City Southern and Mi-Jack, was expecting the notes to price for a coupon of 7.5%, Morgan Stanley priced them 50bp lower, at 7%, upon issue.

A number of market sources also hailed the Petroleum Company of Trinidad & Tobago (Petrotrin) $750 million bond issue in May 2007 as a good indicator of market sentiment. The proceeds are to fund its refinery upgrade programme. Citi underwrote the 19-year notes, which were rated Baa2/BBB+ (Moody's/S&P). Nevertheless, though Petrotrin is 100% state-owned, the issue was rated below that the Baa1 sovereign ceiling.

Thus while the credit crunch, and a number of completed national infrastructure programmes, have contributed to a lull in the number of deals in 2007, the pipeline of refinancings of Mexican in the domestic capital markets is likely to provide a steady stream of business. The new and increasing use of CDS and derivative trading around project bonds may even allow sponsors to maintain access to the market in the absence of sustained demand from overseas accounts. But robust domestic markets are still the preserve of Chile and Mexico.