Bond age

01/04/2001

The use of project bonds to finance public services has become so commonplace in the UK that it barely raises a banker's pulse. But over the Channel in Euroland, the structure is still extremely new and untested ? a large-scale Euro-denominated project bond issue has yet to be completed in the region. And it is to the Eurozone that the arrangers of these deals are turning, convinced that the region represents huge potential for business over the next few years.

While the conditions certainly exist for development of project bond?funded infrastructure programmes, the speed with which these deals are likely to happen varies widely from country to country.

The main driver behind the rate at which Euro-denominated project bonds will grow is the level of appetite among investors for them. ?These have to be investment grade projects ? although sub-investment grade bonds can be incorporated to increase the total amount? says Sue Dale, director of asset securitisation at ABN Amro in London.

Dale, along with colleague Robert Rees, was hired by the Dutch bank in May last year with a specific remit to boost its project bond business. Both were previously with Barclays Capital. Dale explains that the environment for bond issuance in Europe is changing in two fundamental ways ? both of which will benefit the project bond market.

The first change is in the types of maturities that can be achieved. Project bonds typically need the long maturities and average lives that are available in currencies such as sterling ? anywhere from 30 to 40 years. But these types of maturities simply aren't available with the Euro. ?There has never been a long maturity market in the Euro at the non-sovereign, supranational level,? says Dale. Indeed, the longest project bond issue maturity that has been seen so far is that for the Stade de France deal back in 1998 ? 15 years. The deal, which was arranged by CSFB, was structured as a 15-year bullet with a wrap from monoline insurer FGIC. The bond issue was denominated in French Francs and carried a coupon of 5.25% over the 15 years. The deal was revolutionary at the time, and there were widespread predictions that the project bond market was set to take off in Europe. While there have been deals since, particularly in the Iberian peninsular, the growth has probably not been as spectacular as many would have hoped.

But all that could now be set to change. ?The market has changed so much since Stade de France,? says Michael Redican, director of project finance at Deutsche Bank in London. ?There has been a wholesale change in the European investor base ? but it is an evolution rather than a revolution,? he says. Redican reckons that there is now investor demand for long-dated 25-year paper ? but only for the right deal. ?There is demand for the right transaction, with a wrap,? he says. ?For triple-B paper with a 15 to 17 year maturity there is still not great liquidity.?

The change has come about due to a change in the European pensions industry. Demographic changes in the Eurozone mean that while there are now four workers for every one pensioner this figure will be pushed to two workers per pensioner by 2030. There is therefore great pressure being exerted by governments in the region to push people into pay-as-you-go private pension schemes. The resultant growth in pension funds in the region is extremely good for project bonds as it means one simple thing: there are an increasing number of investors out there with long-date liabilities which want to match them with long-dated assets. ?This will give a huge push to the longer maturity bond market,? predicts Dale.

But this is not the only factor working in the bond market's favour. The advent of the euro has removed one significant source of yield for the region's investors ? currency trading. These investors are, therefore, increasingly prepared to move down the yield curve to triple-B level in order to maintain yields ? boosting demand for investment grade bonds. Investors are becoming more sophisticated but there is still a long way to go. ?There is the potential for project bonds to develop as a distinct asset class,? says Dr William Willms, vice president at Deutsch bank in London. ?But the investors will be different players from the euro high-yield market. It will have to be a very targeted sell,? he says. Dale agrees. ? The good thing is that the deal is triple-A but the bad thing is that it will have a minimum 18 year average life,? she says.

New investors

But the introduction of the euro also means that there is a raft of new investors that are now able to enter the project bond arena. These are the small, local banks which were simply not large enough to compete before. ?The introduction of the euro means that local banks are now able to syndicate deals all over Europe,? says Willms. ?Project finance is a business they want to get into,? he explains ? adding that the majority of the road deals that have been done so far in Portugal and Spain have been syndicated within those two countries. The fact that most deals will be government sponsored also means that there may be incentives for local banks to support them. But there are limits as to how far these banks can get involved. The fact that they are small means that their balance sheets will be very quickly filled up by one type of credit risk and BIS ratios mean that they will have to move to be more in line with Standard and Poor's and Moody's. Many such banks are also now faced with the loss of government support. ?In Germany, for example, the Landesbanks have been very aggressive in bidding for [PFI] deals. But the EU will now go after state-supported Landesbanks and it will be difficult for them to remain competitive,? says Willms.

One thing is clear: arrangers cannot simply take the UK experience and translate it into deals in Europe. The cultural and jurisdictional differences across the region mean that each transaction will almost entail starting from scratch. And while there have already been a number of private deals in the UK, transactions in continental Europe will be limited PFI and PPP schemes. Portugal and Spain are firmly ahead of the pack and are attracting the most attention from the project bond market. Portugal closed its first shadow toll road deal in October 1999, the $700 million Beira Interior transaction. That deal involved a $388 million 20-year project loan and a $358 million 25-year European Investment Bank (EIB) facility. But there are high hopes that a new toll road development in the south of the country may yield its first project bond.

The new project involves the construction of a 127-kilometre east-west route, which will link the main tourist destinations of the Algarve ? the country's principal tourist destination. The road is due to become a toll road in 2002. Cintra, a subsidiary of Spanish construction company Ferrovial, won the 30-year concession to operate the road in February last year. Banco Santander Central Hispano (BSCH) is understood to be advising on the financing for the project. Cintra, in consortium with Constructores del Norte, won another toll road concession in the country last month, with the award of a euro330 million contract to operate an 113 kilometre toll road in the north of the country. The new road will run between the cities of Oporto and Caminha.

What the project bond market needs is a successful, high profile transaction to be completed ? which will act as catalyst for further deals. Such a deal will have to be triple-A rated, which highlights the very important role to be played by the monoline insurers in the development of this market. Chris Wrenn, director at Financial Security Assurance (FSA) in London, believes that there is good appetite for long-dated euro paper but that investors want the security of a monoline wrap. ?It is a seal of approval on a deal,? he says. ?It all boils down to pricing and capacity. The value we add is arbitrage.?

Wrenn explains that the types of deals that are likely to come out of Europe will be very large ? probably larger than those that have so far been seen in the UK. He believes that the role of the monolines will, therefore, be crucial in enabling such large amounts to be raised. ?We are always needed in order to clear that last euro50 million or euro100 million,? he says. But large-scale infrastructure projects present the monolines with relatively complex situations, particularly if there are both bond and loan tranches in the deal.

Repeating Drax

Such a bank/bond structure is likely to remain some way off as the first such deal in the UK was only completed last year. It was the $1 billion AES Drax Energy and AES Drax Holdings deal to refinance US-based AES Corp's Drax Power Station in North Yorkshire. The deal involved the issue of 10, 20 and 25 year bonds which refinanced the original bank debt put in place when Drax was acquired by AES in 1999. There were 50 banks in the original Drax syndicate. But the question of different groups of creditors being involved in the event of a default is an important one and the monolines have been working with the EIB to thrash out intercreditor agreements that everyone is comfortable with. The perception is that the monoline will insist on being the controlling party in the event of any such default, but this is denied by Dominic Nathan, director at FSA in London. ?We want as much control as is necessary to represent the group of bondholders,? he says. ?It doesn't affect our risk ? it is just a decision-making process. But it adds a layer of complexity to the deal.?

Wrenn and Nathan say that their main concerns in looking at a deal are firstly, the likelihood of the project being able to service the debt and secondly, any legal and event risks that could make it difficult to exercise necessary remedies. Intercreditor agreements rank third in their list of concerns. But what are the concerns of the sponsor? ?The key question for the sponsor is what can a bond deliver that a loan cannot?? says Dale at ABN Amro.

The top two considerations for the sponsor are pricing and average life. The main selling point of a bond issue is that it can offer a longer maturity than would be possible with a loan. ?In the Drax deal, the banks did not want to take merchant risk after 15 years,? explains Michael Redican at Deutsche Bank, which was co-global coordinator on the deal along with Goldman Sachs. The 25-year paper in the deal was rated triple-B. Another UK private power station deal, the 1997 Sutton Bridge transaction, also saw a bond issue used to stretch the maturity after banks were again unwilling to take merchant risk after year 15. That deal was co-advised by BZW and Merrill Lynch. The bonds issued as part of that deal run until 2022. ?The bond market [in the UK] has taken risks where the bank market would not,? says Dale at ABN Amro.

Another benefit that a bond issue can bring to the sponsor is access to a different investor base. This gives the company the option of not having to tie up its existing credit lines and exhausting its relationships with the lending banks. Bonds are far more ?hands-off' than bank lending, which can be an advantage. But the disadvantage is that they will probably have a less flexible covenant package as a result.

Portugal and Spain are clearly far and away the most likely sources for bond issuance in the near future, but other European countries are showing keen interest in the structure and are enacting legislation that will remove some of the hurdles to the development of true project finance.

Two ongoing concession-based projects in France ? the Millon Viaduct project in the south of the country and the A28 toll road project in the north ? have been cited as possible sources of deals and in Italy recent legislation enacted to facilitate securitisation will help the development of the bond market. The Netherlands is also a likely candidate ? having already privately funded infrastructure projects for some time. The Wijker Tunnel project in that country was completed nearly 10 years ago and the Netherlands has readily embraced deregulation in its infrastructure and transportation sectors. Greece has announced a roads programme but potential deals are still some way off. In other countries things will take longer. ?Specific legislation has had to be introduced in Germany to allow the charging of tolls on new bridges and tunnels, and the progress of PFI has been slow,? says Willms at Deutsche Bank.

Central and Eastern Europe could, however, be a good source of business ? although maybe a little further down the line. Many of the countries in this region have enthusiastically embraced the concept ? if not the reality ? of PPP to speed up the replacement of their crumbling infrastructure. The largest dollar-denominated project bond in continental Europe last year was for an issuer based in Poland. The $450 million transaction was for Polish telecoms operator Polska Telefonica Cyfrowa and was lead managed by Citibank.

Although yet to boom, everyone is agreed that the Euro-denominated project bond market has huge potential. ?There is every chance that you will see each country doing two or three of these transactions a year which amounts to a huge market,? says Chris Wrenn at FSA. FSA is staffing up in anticipation and has set up a separate group to focus on the project bond market. The group is five-strong in London and a sixth person will be added in Madrid, where MBIA already have a representative. ?Every country will do this in its own way and some will shy away from the more controversial deals such as those for defence, prisons and healthcare,? says Wrenn.