Is Asia ready for project bond enhancement?

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A project bonds seminar in Hong Kong was drawing to a close when a lawyer asked Frederic Thomas, senior investment specialist at the Asian Development Bank (ADB), whether the lender was considering offering guarantees or credit enhancements to encourage issuances.

The question was anticipated – the final panel was entitled ‘Is Credit Enhancement Necessary to Issue Project Bonds?’ – but until then, discussion focused on how development finance institutions (DFI) and export credit agencies (ECA) could enhance deals’ credits via guarantees.

The Credit Guarantee and Investment Facility (CGIF), a trust fund partly owned by the ADB, has already begun offering guarantees, though to corporate issuers via local currency bonds. CGIF made its debut in 2013 when it guaranteed a Thai baht-denominated $100 million equivalent issue by Hong Kong-based commodities trader Noble group. Fitch assigned the bonds a AAA local rating, owing to CGIF’s stronger credit than Thailand’s A- long-term local currency rating.

But the ADB’s Thomas wanted to talk about non-recourse project bonds that require investors to accept far more risk. He responded that the ADB was looking to imitate what the European Investment Bank (EIB) had done with its project bond credit enhancement (PBCE) product.

The ADB, Thomas said, was prepared to extend beyond the local currency market “into partial or structured guarantees to credit-enhance project bonds.” He continued: “We are looking at what the EIB has done in Europe as a model. They have provided a type of first-loss piece, which enhances the underlying credit of a project and allows sponsors to issue bonds on more investor-friendly terms. For proof of concept, we are likely to start with the low-hanging fruit, which means brownfield assets, denominated in US dollars, and in the more highly-rated jurisdictions in the region.”

But a fast maturity may prove possible in healthier Asian markets. Thomas noted that several Asian jurisdictions might be more fertile than the Eurozone’s most troubled economies: “Where are we likely to find these assets? This will most likely be in Malaysia, Thailand, Indonesia and the Philippines. Thailand, for example, is BBB+ whereas Spain was BBB- when it managed to place €1.4 billion of bonds for the Castor deal… so I think that this is a realistic target,” Thomas said of the underground gas storage deal off the eastern Spanish coast.

The European Model

The EIB’s PBCE launched three years ago with the aim of stimulating capital markets financing for large European transport, energy and communications projects. The enhancement takes the form of subordinated debt equivalent to up to 20% of total senior debt, either in the form of a mezzanine loan or a contingent credit line, which is designed to enhance bonds to an A or AA credit rating.

The first PBCE deal closed in July 2013, when the EIB provided a €200 million contingent credit facility to the Castor bond financing. Watercraft Capital, a Luxembourg-registered special purpose vehicle, managed to place €1.43 billion in bonds to refinance the original construction debt, and lent the proceeds on to project concessionaire Escal UGS. The deal later hit a snag when the project company had to halt gas injections after seismic activity was detected nearby.

The EIB has since provided the product on the £305 million senior bond financing for the Greater Gabbard offshore transmission project in the UK and the roughly €750 million A11 road PPP in Belgium (see Deal Analysis, page 32). The A7 road PPP in Germany may be the next candidate.

The PBCE provides a workable template for the ADB's product. Two of the first three EIB deals were for projects with minimal construction (if not acceptance) risk, and the first ADB enhancement candidates will also probably be operational projects. Investors can get comfortable with non-recourse credits more quickly if they do not feature construction risk, and sponsors do not have to worry about negative carry (paying full interest on undrawn bonds) on operational assets.

Potential pilot projects

The ADB will start offering the product in investment-grade jurisdictions, and is expected to look at lower-rated sovereigns when it has proved that the product can work. Thailand, for instance, has a healthy pipeline of deals, and while the liquidity in its local bank market is strong, a bond might be able to compete with local lenders on tenor, at least.

Thailand has a history procuring power projects thanks to the strength of state-owned utility Electricity Generating Authority of Thailand (EGAT). While Indonesia has tried to wean investors off demanding government support for state-owned utility PLN's obligations, and the Philippines is developing as a merchant market, Thailand has had fewer problems attracting local and international lender support.

If the ADB manages to close brownfield deals in Asia's strongest venues, it could then move to greenfield projects, and assets in lower-rated countries. But the highest possible rating on a non-sovereign entity is usually a couple notches lower than the sovereign, and would probably necessitate synthetic means to enhance the underlying country rating.

But Castor achieved ratings of BBB from Standard & Poor's (S&P) and BBB+ from Fitch, one notch above each agency's sovereign rating for Spain at the time of issuance. S&P cited the project's ability to recover costs directly from users as the reason for the one-notch difference. This should, in theory, be achievable for most projects in Asia, including power or liquefied natural gas payments, which also rely on users to cover costs.

One way of enhancing the sovereign rating of a given host country would be if either a multilateral or export credit agency provided political risk cover. But the concern is whether this would provide the desired uplift as multilaterals and other agencies usually only pay out on non-payment after 120 days at the earliest. The rating agencies assign grades based on timely payment of principal and interest.

Lessons learned from the EIB

The ADB can draw comfort from the EIB's ability to dismiss most of the early criticism that the PBCE attracted. Critics asked how the product would be adapted to procurement processes in several European Union (EU) member states, and whether the EIB would be able to cope with the intercreditor issues that would result if there was a draw on its contingent facility.

Castor is located in the EU's economically troubled periphery and is a refinancing, and the EIB had initially said that it would make greenfield projects a priority. But if an asset with as complex a history as Castor can access the bond market, then investors may assume that more straightforward assets, even those with construction risk, could proceed easily.

The rationale for the product in Asia is different. In the region's most promising jurisdictions, the local bank markets are a lot more liquid, and refinancing risk does not cause developers much distress. But Asia's infrastructure deficit is vast and banks are likely to come up against exposure limits for sectors and particular sponsors.

The EIB's PBCE product is attracting so much interest from the ADB because a partial guarantee does not involve a contingent obligation for an entire debt issue. The EIB, and potentially the ADB, can say that their product has a multiplier effect.

The ADB needs to bring a pilot deal to market to prove its credentials.