Law360

January 27, 2014

Looking Toward Project Bonds For African Infrastructure

By Ryan T. Ketchum

The infrastructure deficit is increasing in many countries in sub-Saharan Africa. A much-needed priority action plan, Programme for Infrastructure Development in Africa, has been developed by the African Union Commission, African Development Bank and the New Partnership for African Development Planning and Coordinating Agency. The priority action plan aims to address the problematic deficit by identifying $68 billion per year of energy and infrastructure investments that should be prioritized through 2020.

However, funding from governments and development finance institutions is not sufficient to finance the level of investment that is required. As a result, a number of these projects will be developed as public-private partnerships, which are able to tap private funds in the form of equity investments made by sponsors and debt issued by international and local lenders.

Bankable public-private partnerships benefit from stable and very long-term (20 to 30+ years) revenue streams. To ensure that these projects are affordable to end-users at the outset, it is essential that project companies can be properly capitalized with the right mix of debt and equity. It is also important that the tenor of the debt financing matches the economic life of the project as closely as possible.

Commercial lenders and development finance institutions have long been the traditional source of project financing in sub-Saharan Africa. Unfortunately, the availability of loans from commercial lenders has been significantly reduced by the financial crisis and the deleveraging of banks that it precipitated, and by regulatory requirements such as Basel III, which make it more expensive and less attractive for banks to issue long-term loans. As a result, the availability of loans for project financed PPPs has been constrained.

Financing Infrastructure Projects with Project Bonds in Other Markets

Pre-2008 project bonds have been used to fund the development of energy and infrastructure projects, particularly in developed markets and in Latin America.

Project bonds are bonds that are:

(1) issued by a special-purpose vehicle to raise capital for a stand-alone project with identifiable and ring-fenced revenues;

(2) repaid from cash flows generated by the stand-alone project; and

(3) subject to project-specific risks.

The volume of financing made available through the issuance of project bonds has never approached the volume made available from traditional bank lenders. Until 2008, most project bonds were supported by monoline insurers, which insured the timely payment of principal and interest and thereby enhanced the credit rating of project bonds (typically to AAA).

In 2008, the monolines collapsed due to their exposure to sub-prime residential real estate mortgages. As a result, the project bond market in Europe and Latin America largely collapsed.

In Europe, a significant amount of thought has been given to the types of measures that would be required to reinvigorate the issuance of project bonds. The European Investment Bank's Project Bond Initiative, which has resulted in the launch of the €230 million pilot phase of the Project Bond Credit Enhancement Facility, is the highest profile of these measures.

The PBCE works by separating the indebtedness of a project company into two tranches. The senior tranche is comprised of project bonds issued by the project company. The subordinated tranche is made up of either a subordinated loan made to the project company at the outset by the EIB (a funded PBCE) or a contingent line of credit that can be drawn on if the cash flows generated by the project are not sufficient to service the principal and interest payment due to the bondholders (an unfunded PBCE).

The maximum size of the PBCE that is available for a single transaction is equal to 20 percent of the nominal value of the credit-enhanced senior bonds, or €200 million.

The Castor underground gas storage project in Spain, which closed on Aug. 2, 2013, was the first project to benefit from the PBCE. The €1.4 billion bond issuance was supported by a €200 million contingent line of credit from the EIB (an unfunded PBCE). The issuance priced at 5.756 percent.

The amortizing bonds mature in 2034 and have a weighted life of 12 years. The bonds were rated BBB+ by Fitch, which is a notch above the Spanish sovereign rating issued by Fitch. This project demonstrates the market's acceptance of the PBCE structure, and the EIB's board of directors has now approved coverage by the PBCE of nine projects in six countries.

The PBCE addresses what is, in hindsight, one of the fundamental shortcomings of the monoline offering — the monoline insurer, and therefore, to some extent the rating of the project bonds that benefit from the insurance — is exposed to a wide range of risk on unrelated projects.

Toward Project Bonds for African Infrastructure

The financial infrastructure required for the issuance of project bonds to finance infrastructure in sub-Saharan Africa is taking shape. Since Ghana became the first country in sub-Saharan Africa to issue a sovereign bond in 2007, a number of such countries (including Nigeria, Kenya, Gabon and Zambia) have issued sovereign bonds. These types of issuances are important because they generate investor interest in sub-Saharan bonds and result in the establishment of sovereign ratings and sovereign yield curves.

Some existing tools that can be used to credit-enhance bonds on certain projects are outlined below, although all tools currently available suffer from problems.

Two such tools are the partial risk and partial credit guarantees issued by the World Bank. They place defined limits on the maximum amount a particular country may borrow from members of the World Bank Group with 25 percent of the amount guaranteed under a partial risk guarantee being counted against that limit.

This significantly limits the amount of financing the World Bank can enable through the issuance of guarantees. It also means that neither partial credit nor partial risk guarantees guarantee the timely payment of principal and interest.

Partial risk guarantees issued by members of the World Bank Group guarantee the repayment of principal and accrued interest in the case of defaults resulting from the nonperformance of contractual obligations undertaken by governments or their agencies in private sector projects, such as public-private partnerships.

Partial risk guarantees can cover a range of risks related to government performance, including failures to meet contractual payment obligations, frustration of arbitration, expropriation, nationalization, the availability of foreign currency, nonpayment of termination payments, and failures to issue consents in a timely manner.

Partial credit guarantees issued by members of the World Bank Group cover private lenders (including bondholders) against all risks during a specific period of time during the financing term of debt for a public investment.

Another tool is the political risk insurance issued by the Multilateral Investment Guarantee Agency. Such insurance can cover risks related to currency inconvertibility and transfer restrictions, expropriation, war, terrorism and civil disturbances, breach of contract, and nonhonoring of financial obligations. MIGA's insurance policies are ordinarily limited to 15 years, which is not sufficient to cover long-dated bonds.

The last existing tools used to enhance credit are partial credit or partial risk guarantees, issued by GuarantCo, for obligations denominated in local currency. GuarantCo will, however, only cover bonds denominated in local currencies. While the development of deep, liquid local currency issuances is a good long-term objective, the market for such issuances is a long way from becoming a reality due to limitations on the depth of the pool of local investors and other factors.

As a result of the problems outlined above, new tools are needed. Some potential new tools are under consideration.

Last year, the African Union Commission, the Economic Commission for Africa, the African Development Bank, and New Partnership for African Development's Planning and Coordinating Agency all endorsed the formation of a new fund to invest in infrastructure financing for Africa that will be referred to as the Africa 50 Fund. The AfDB will be one of the fund's shareholders. African countries, a few European countries, and other development finance institutions are expected to constitute the bulk of the other shareholders in the fund.

The promoters of the Africa 50 Fund intend to establish two segments — one that will support project development and one that will support project finance. The project finance segment will focus on delivering, among other things, credit enhancement and other risk mitigation measures geared to attract funders such as institutional investors.
These credit enhancement mechanisms are likely to be similar to those that underlie the EIB's PBCE facility.

For those interested in the development of a thriving market for the issuance of project bonds to finance infrastructure in sub-Saharan Africa, these developments are worth watching, given that: investors are clearly interested in sovereign bonds issued by African sovereigns, there is limited appetite by commercial lenders for making long-term loans available to finance infrastructure,

and the market appears to be in the process of accepting the PBCE facility that is currently being piloted by the EIB.

—By Ryan T. Ketchum, Hunton & Williams LLP

Ryan Ketchum is a partner in the London office of Hunton & Williams.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice