WHITE & CASE

Why project bonds are on the rise in Latin America

This alternative form of financing critical infrastructure projects has taken root in Brazil, Mexico and Peru, and Colombia looks to become the next market.


PRIDE RIO de JANEIRO

Project bonds are on the rise

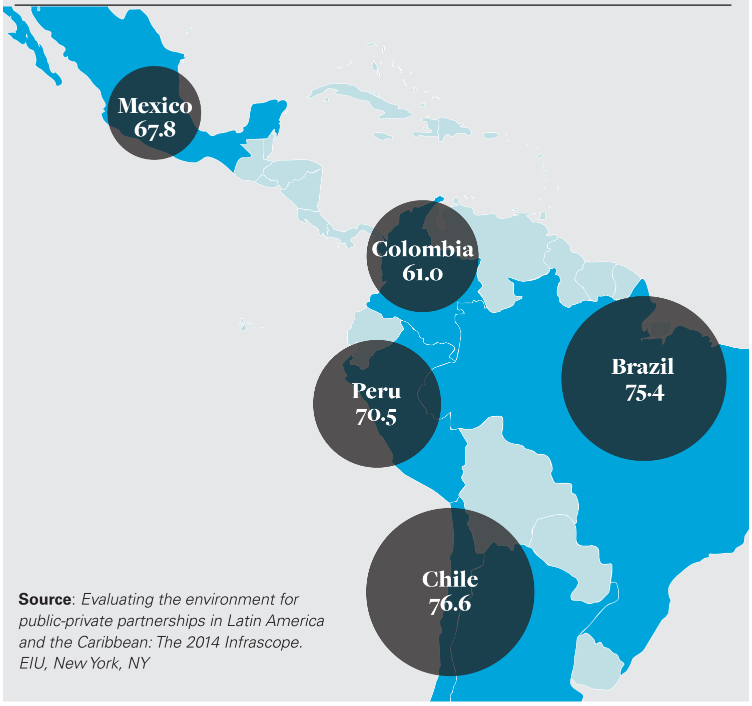
Carlos Viana, **John Vetterli**, **John Anderson**, **Sean Goldstein** and **Vic DeSantis** of global law firm White & Case analyze the key finance developments in Latin America.

Latin American project bonds continue to grow as a source of infrastructure financing, particularly as private capital is needed to close multi-billion-dollar shortfalls in spending for needed infrastructure projects in Latin America. Project bonds offer international investors attractive yields and the opportunity to participate in the region's infrastructure financing boom. Global project bond deals in 2014 totaled US$50 billion, with Latin America accounting for more than US$8 billion.[1]

And there could be more. As figures from the World Economic Forum show, countries can use all the capital they can get—and investors have ample capital and an appetite for these investments. According to the WEF, global spending on infrastructure, including transport, power, water and communications, is only US$2.7 trillion a year when it needs to be closer to US$3.7 trillion.[2, 3]

Latin America, in particular, is ripe for an increase in infrastructure investments and the use of project bonds to finance them. GDP growth in Latin America and the Caribbean is expected to increase to 1.5 percent in 2015, 2.9 percent in 2016 and 3.3 percent in 2017. This reflects stronger exports and investment, according to the World Bank.[4] In the long term, Latin America's infrastructure spending is expected to reach US$557 billion a year by 2025, with Brazil, Chile and Colombia likely accounting for a large share of regional spending.[5]

Overall PPP readiness scores 2014



Source: *Evaluating the environment for public-private partnerships in Latin America and the Caribbean: The 2014 Infrascope. EIU, New York, NY*

Project bonds are one way to attract more private investment and help meet the region's infrastructure deficit. According to PwC, there are four conditions required for a project bond market to take root: available capital outside the banking system; sufficient governance and transparency in financial reporting; balanced tax and commercial policies; and mechanisms to support credit quality.[6] These conditions already are established in Latin America, the firm said. In general, there should be an increase in public-private partnerships ("PPPs") —and the use of project bonds—if the public continues to be made aware about the potential benefits of private groups funding the construction of public infrastructure.

This report looks at how four Latin American countries finance, or could finance, infrastructure with project bonds. Peru, for example, is in the process of rolling out its planned six-line metro transit system for the City of Lima, with Line 1 fully operational and Line 2 (and part of Line 4) currently under construction; for Mexico, a new airport in Mexico City is being developed, together with a number of road, water and desalination projects. Brazil has a long track record of project bond financing for oil and gas drilling (in the international capital markets) and power and toll road projects (in the domestic market), which could be models for financing other types of infrastructure projects, particularly projects within the US$64 billion infrastructure program recently announced by the federal government. Colombia is poised to be yet another innovator in PPPs and project bond financing with an announced US$20 billion, 40-project program and strong support from multilateral development agencies.

1 "Project bonds: Their growing role in global infrastructure finance," White & Case, *Project Finance International.*

2 "Investing in Infrastructure: The Trillion-Dollar Gap," *The Economist,* March 22, 2014.

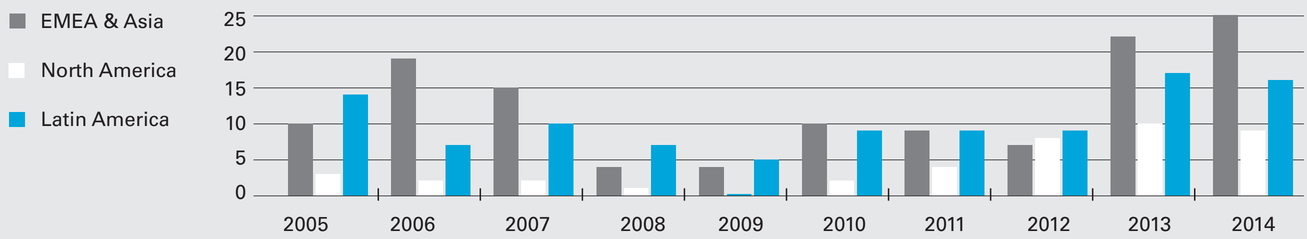
3 "Infrastructure Investment Policy Blueprint," p.6, World Economic Forum, February 2014. Prepared in collaboration with Oliver Wyman.

4 "Global Economic Prospects: Having Fiscal Space and Using It, Recent Developments," The World Bank, January 2015. Includes table of country forecasts.

5 "Capital project and infrastructure spending: Outlook to 2025," PwC, with research support of Oxford Economics.

6 "Capital Markets: The Rise of Non-Bank Infrastructure Project Finance," p.6, PwC.

EMEA & Asia, North America, Latin America



Source: *Project Finance International*

BRAZIL

Since 2011, the year President Dilma Rousseff was elected, through April 2015, the Brazilian real had lost almost 50 percent of its value versus the US dollar. Brazilian sovereign debt was recently downgraded from BBB to BBB- by S&P. In early 2015, Brazil's annual inflation hit its highest level in nearly ten years. Petrobras has lost more than three quarters of its market value since 2007 and earlier this year wrote off almost US$17 billion relating to graft and overvalued assets.

Brazil continues to have pressing infrastructure needs, but with the nation facing a record budget deficit and an economic crisis, the government has taken actions to cut spending, including cuts on public funding for Banco Nacional de Desenvolvimento Econômico e Social (BNDES), the state-controlled institution that has been responsible for approximately three-quarters of all capital expansion loans in Brazil with maturities of longer than five years.[7] Companies have long depended on BNDES for subsidized credit at rates cheaper than those available from commercial lenders. But commercial banks, rather than picking up the slack, have been cutting lending in light of the economic scenario and increase in default rates. And the Petrobras corruption scandal, which also involved several major Brazilian construction companies, has caused delays in key infrastructure projects.

This might sound like a pessimistic environment for financing new developments. However, Brazil does have a history of successful and innovative project bond financings. The willingness to be creative may present an opportunity to help fund infrastructure in a challenging environment.

One innovation started in the early 2000s, when commercial banks and international export credit agencies (ECAs) financed the purchase and operation of drilling rigs and drillships in deep water offshore Brazil. Against the backdrop of the commercial banks' tighter capital requirements, project bonds placed in the international markets through Rule 144A/Regulation S offerings emerged as an alternative to refinance projects' existing bank loans. This innovation allowed commercial banks and ECAs to finance the construction and operation of additional drilling vessels.

US$1.69 billion

Amount of Odebrecht Oil & Gas 6.75% project bond in August 2013

In 2010, the initial Norbe VIII/ Norbe IX drillships project bond showed how flexible structures could be used in the capital markets to refinance assets under construction. The bond received an investment-grade rating. In order to mitigate investors' aversion to construction and other types of risk, the structure included payments backed by a Petrobras charter agreement, a cash flow waterfall, reserve accounts, a cash-trapping mechanism and a construction completion guarantee by the Export-Import Bank of Korea.

Another innovation came about in 2011, when the Brazilian government created fixed-income instruments designed exclusively to finance infrastructure projects. The initial issuances of these so-called infrastructure debentures were primarily focused on energy and toll road projects and subscribed by local investors. The debentures, which were denominated in reais, were intended to attract foreign investors as well, but high hedging costs discouraged foreign investment, as did the availability of more attractive Brazilian sovereign debt.

Odebrecht Oil & Gas's groundbreaking US$1.69 billion 6.75% project bond in August 2013 met additional needs of Brazilian oil and gas operators and was the Brazil-related project bond at the time. The deal not only refinanced existing drillships backed by charter contracts—with terms that would be shorter than the expected term of project bonds—but also financed a large portfolio of drilling vessels. The deal was designed to allow the issuer to add new vessels to the structure upon the issuance of additional notes by pledging the additional vessels both to existing noteholders and to new investors (cross-collateralization). Since certain of the charter and services agreements would expire before the maturity of the notes,

7 "Brazil Retreats on Cheap Loans, Posing Risks to Economy," Paulo Trevisani, *The Wall Street Journal*, January 7, 2015.

highly complex documentation was put in place to mitigate rechartering and refinancing risk. The structure included mechanisms for the retention of excess cash flows and balloon payment reserves to address the added complication of non-amortized debt. The structure was successfully used again in February 2014 with the issuance of US$580 million 6.625% additional notes, adding the ODN Tay IV vessel to the structure as additional collateral.

Brazil recently announced a US$64 billion infrastructure spending package that is intended to rejuvenate its slumping economy, which the government has forecast will contract by 1.2 percent this year. More than a third of the new spending is planned in 2018 and the remainder in 2019. Nearly US$28 billion will be invested in railroads, US$21 billion in highways, US$12 billion in ports and nearly US$3 billion in airports.[8] This package contemplates a portion of BNDES financing for the relevant projects, based on sector—45 to 70 percent of financing for highways, 35 to 70 percent of financing for ports, 35 to 70 percent of financing for airports and 70 to 90 percent of financing for railways. Notwithstanding the amounts of BNDES participation, the package also contemplates that a material portion of the projects may be financed by local infrastructure debentures. This appears to be an important step towards decreasing BNDES's participation in the financing of infrastructure projects in Brazil and using domestic project bonds and other sources of funding to meet the infrastructure financing needs.

Outlook

With this backdrop of successful and innovative project bond financings and the ongoing need for liquidity, banks and Brazilian companies are considering the continued use of the project bond structure for oil and gas and other types of infrastructure assets, such as private port terminals. Time will tell, but project bonds, which benefit from strong collateral packages and risk mitigation structures, may be well received by investors that are in the process of restoring their confidence in Brazil.

MEXICO

A compelling need for infrastructure investment, a pipeline of long-term contracted projects and groundbreaking structural reforms combine to make Mexico an attractive market for project bond origination. While the drop in oil prices has adversely impacted the government's investment budget, Mexico figures to continue providing targeted opportunities for project bond investors.

Mexico has a robust track record of project bonds being used to provide takeout financing in the energy and infrastructure space. For example, the refinancings of the Oaxaca II and IV wind farms involved Rule 144A/Regulation S project bonds of about US$148 million and US$150 million, respectively, in each case as post-construction deals without recourse to the shareholders. In addition, Offshore Drilling Holding (ODH) (controlled by Grupo R, a leading Mexican oilfield services company), refinanced its Centenario and Bicentenario ultra-deepwater drilling platforms through a project bond transaction in 2013. The ODH deal also included a structure allowing for future financings supported by additional shared collateral.

As in other jurisdictions, however, project bond investors have been reluctant to assume construction risk and therefore project bonds have not been widely used in Mexico to finance greenfield projects. While *certificados de capital de desarrollo* (CKDs) are a capital markets solution designed to attract infrastructure investment by pension funds (*afores*), they have yet to be as widely utilized as hoped due in part to a cumbersome regulatory framework.

Outlook

Looking ahead, there are expected opportunities for investors over the near and medium term. Some projects that provide the potential for long-term contracted revenues favored by project bond investors include the natural gas pipelines and independent power projects being bid out by Mexico's electricity utility, Comisión Federal de Electricidad (CFE), the Ramones natural gas pipelines being developed on behalf of Pemex and the latest batch of toll roads currently under construction. Also, energy reform and other structural reforms should spur a significant increase in investment in Mexican infrastructure going forward. A critical mass of new projects, together with enhanced sponsor or third-party completion support, may also incentivize project bond investors to assume some construction risk and finance greenfield projects.

PERU

Peru is a globally recognized innovator in project bonds and, recently, has had the strongest track record in the region in terms of using them for infrastructure investments, according to Fitch Ratings.[9] The success of Peruvian project bonds can be attributed to two key factors. The first is the strength of Peruvian pension funds and their willingness to invest in these products. The second is a legislative structure of payment mechanisms and supporting regulations developed by the Peruvian government that mitigate completion risk and provide for predictable government payment streams that are not subject, in large part, to operating risk.

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Project bonds are one way to attract more private investment and help meet the region's infrastructure deficit.

8 "Brazil unveils US$64 billion infrastructure plan to spur growth," Damian Wroclavsky, *Business Insider, AFP*, June 9, 2015.

9 "Peru's Long Project List Shows Funding Progress," *Fitch Wire*, April 11, 2014.

Through ProInversión, Peru's private investment promotion agency, the country has set up PPPs to finance construction and operation of the transportation, water and social infrastructure sectors. These PPPs, among other important attributes, provide for the issuance of government-issued payment certificates (GIPCs) upon the completion of identified milestones in the works that form part of the concession. The PPPs also allow for the securitization of those certificates into bonds as a takeout of equity or guaranteed construction bridge financing. Peruvian pension funds have accounted for much of the institutional investment in these project bonds although ProInversión is actively seeking out foreign investors.

Outlook

While the growth in its overall economy isn't expected to be as robust in 2015 or 2016 as it was in 2014, the Peruvian government still wants to spend money on infrastructure. Recently the government said it would increase infrastructure spending by 20 percent annually.[10] The spending hike is intended to offset a 50 percent cut in spending by the country's regional governments over time.

Because there is a presidential election in 2016, the government may slow down awarding projects, but the pipeline is still relatively robust. As of April 30, 2015, there are 19 projects to finance through 2016 needing US$4.9 billion in investment, according to ProInversión.

COLOMBIA

Colombia could be the next frontier for project bonds in Latin America. The country needs an estimated US$50 billion over six years to cover a large infrastructure deficit, including US$25 billion for a national highway plan that is part of the so-called "4G" program.[11] A well-capitalized infrastructure network will be needed to support Colombia's strong economic growth, which Moody's has updated to 5 percent to 5.5 percent over the next five to ten years from 4.8 percent.[12] Last year, Moody's upgraded Colombia's government bond rating to Baa2 from Baa3.

In order to coordinate the framework for infrastructure development and investment, Colombia created the National Infrastructure Agency (ANI), in charge of the public bidding, negotiations and awards of infrastructure concessions through public and private partnerships. ANI also is responsible for the design, maintenance, operation and administration of the country's transport system. The US$50 billion 4G program has been structured in three rounds, of which the first has been completed and awarded. It includes highway, road, water, rail, port and other projects worth in excess of US$4 billion. On April 10 of this year, ANI opened the second round of 4G projects for bidding of approximately US$6.3 billion worth of projects, including additional highway, road, tunnel and bridge projects, several of which have been awarded and some of which will be awarded in the following weeks. Unlike the first round that consisted mostly of local developers, the government has shortlisted several foreign developers for this second round.

Because of the size and scope of Colombia's infrastructure program, international investors, investment banks and multilateral development banks are playing larger roles. CAF, the Andean Development Bank, last year approved a US$1 billion senior debt fund for infrastructure in Colombia, with the bank investing US$50 million.[13] A group of banks and private equity funds reportedly is raising more than US$2 billion for infrastructure investment, and a leading bank plans to raise up to US$1 billion for a Colombia infrastructure debt fund.[14]

Outlook

We expect that Colombian project bonds will be significantly different than Peruvian GIPC-securitizations. Colombian PPP concessions present a different risk matrix. There are no GIPC structures and the PPPs expose lenders to significant completion risks related to social matters, and to significant operating and liquidity risks once the project is completed and operating. These differences provide a significant opportunity for new investors and advisors to enter the market and add significant innovation and value. There is a need to create multi-sourced transactions customized to an individual project's requirements. This structuring will include the use of bridge or semi-permanent loans during construction; some form of project sponsor and/or third-party completion support; and liquidity facilities to cover liquidity risks during the project's operating periods. Project bonds would likely be used as a takeout of bridge and/or construction financings—or perhaps as permanent financings from the outset—if significant third-party completion risk enhancements are provided by multilateral agencies, Colombian sub-sovereign entities or other investment-grade creditors.

Colombian project bonds are being designed to court the cash-rich Colombian pension funds, which have more than US$70 billion in assets available for investment. The bonds also could be marketed to other international pension funds and insurance company investors. There is worldwide demand for projects involving long-term infrastructure that have government-backed concession payments. If the government continues to award construction contracts at its current pace, Colombia could evolve into an established international project bond market within the next three years. ■

*For more of our thoughts on project bonds and capabilities in the area, **click here**.*

10 "National government boosts spending to support economic growth," Colin Post, *Peru Reports*, April 11, 2015.

11 "Colombia's US$50 billion Infrastructure Need Attracts BTG," *Ashmore, Bloomberg*, Cristiane Lucchesi & Christine Jenkins, December 4, 2014.

12 "Colombia's Credit Rating Increased by Moody's One Level to Baa2," *Bloomberg*, Christine Jenkins and Oscar Medina, July 28, 2014.

13 "CAF approved a US$1 billion senior debt fund for infrastructure in Colombia," *CAF news release*, July 16, 2014.

14 "Colombia's US$50 billion Infrastructure Need Attracts BTG," *Ashmore, Bloomberg*, Cristiane Lucchesi & Christine Jenkins, December 4, 2014.

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Project bond primer

Project bonds finance a variety of investments in transportation, communications, energy and other infrastructure. The bonds' proceeds are used to provide limited recourse, or nonrecourse, financing to a single-purpose vehicle that owns, develops and builds a project. Buyers include insurance companies, pension funds and other long-term investors.

THE BENEFITS

Project bonds are appealing because they can match long-term liabilities to long-term cash flows from projects (maturities extend 20 years or more). The bonds themselves often offer stable returns at higher rates than similarly structured sovereign debt. They usually have low volatility and little correlation with other asset classes. They have flexible financing structures and can be adapted to include multiple assets and projects.

possible maturity of 20+ years

THE RISKS

Besides the general risks associated with bond investing, including interest rate risk, project bonds may have some specific wrinkles, including construction risk, negative carry and political risk.

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