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Banking Woes Could Send Project Sponsors To Bond Markets

By **Liz Hoffman**

Law360, New York (February 17, 2012, 6:13 PM ET) -- Project sponsors are starting to take a harder look at the bond markets as a potential source of financing now that European banks are tightening their belts, restricting access to some traditional sources of capital, project finance experts say.

Although bank financing has powered the bulk of infrastructure development over the past two decades, some of the factors making it attractive — namely its cheaper price relative to bonds — are starting to fade as European banks cut down long-term lending, experts said.

With the price gap narrowing, the similarities between long-term cash needs of typical bond investors, like pension funds, and project finance life cycles could spark a resurgence in project-related bond offerings, experts said.

“As the prices even out, some of the conventional wisdom about bond financing could start to get chipped away,” said KPMG global infrastructure analyst Darryl Murphy. “You'll start to see nonpricing factors — the natural synergies between projects and institutional investors — drive the market.”

Pension funds and insurers are natural fits for the long-term cash flows of infrastructure projects, experts said. They're used to waiting decades for full return on their investments. They tend to like investments whose revenues are tied to inflation, as many utility projects are. And with the brow-beating many of them took from heavy real estate bets in the past decade, they could be looking to diversify, Murphy said.

They've long been scared away by construction risk, but even that is less of a barrier in tough market times, said Tomer Pinkusiewicz, a global finance partner at White & Case LLP

“We're starting to see that a lot of the old excuses aren't really holding up as the financial markets have changed,” Pinkusiewicz said. “Any time the banks retract, that funding gap has to be filled somewhere. I'd expect bonds to play a much bigger role in the future.”

But there are other factors, apart from price, that might give sponsors pause before turning to the bond marks.

Bank funds can be drawn as needed, rather than arriving in a lump sum that must be managed. The upfront cash created by bond sales could create some financing snags for sponsors, said Martin Toulouse, a Baker Botts LLP finance partner.

“Depending on when you need to pay it out, you may have to hold the cash, which creates negative arbitrage,” he said.

Project financing also tends to require active monitoring and participation from stakeholders, especially during the construction phase. With bank loans, sponsors are accountable to a small group of sophisticated lenders, rather than dozens of relatively inexperienced bond investors, which one infrastructure expert called “a bunch of amateur worrywarts.”

Finally, some said stripping down a project’s complex debt structure and cash flow to a simple public bond could limit its ability to adequately fund the project, meet sponsor needs and take advantage of unique concessions — in essence, said London School of Economics professor Ian Cooper, it could “un-project finance” it.

“These things only really work because of how highly tailored they are," Cooper said. "The more you try to make them more appealing to a broader, shallower debt market, the more you risk toppling the entire house of cards."

And getting bond investors on board will be challenging enough, requiring sponsors to address key obstacles that have kept bond investors on the sidelines for decades.

The biggest is construction risk, experts said. Bond investors are skittish about anything below a BBB+ rating, and most megaprojects come in somewhere in the low BBB or BB range. While some specialized debt investors are willing to accept higher risk for higher yields, most aren't, said Mayer Brown LLP finance partner Paul Forrester.

“There is no deep infrastructure bond market for construction risk, especially for greenfield projects,” he said. “Institutional bond investors just aren’t comfortable with it.”

That problem has gotten worse since the financial crisis. Among its casualties were a handful of monoline insurers, groups like Ambac Financial Group Inc. and MBIA Inc. that had provided insurance and credit-wrapping for riskier projects. In the wake of the 2008 collapse — which drove Ambac into bankruptcy and saw MBIA downgraded to junk bond status — investment-grade ratings have been hard to come by for most project-financed undertakings.

To help secure higher agency ratings, sponsors may need additional letters of credit and parent company guarantees, experts said. Fixed-price, turnkey contracts with credit-worthy construction firms could also help ease investor concerns.

A higher equity contribution from sponsors might also be needed, said Forrester, who recommended sponsors front-load their equity early in the project's life. “Debt investors like to see some skin in the game,” he said.

But all these add-ons drive up costs and could keep bond investors from being the liquidity source many industry observers say will be sorely needed over the next several decades.

In the end, the same pressures that are driving up the cost of bank financing may soon do the same to the bond market. Solvency II is a set of still-unwritten reforms likely to require European insurers and other nonbank institutional investors to raise capital and limit long-term debt.

“I think you're going to see the cost of financing go up across the market ” Forrester said. “If you want to pay it to a bank, great; if you want to pay it to try to get bond investors interested, great.”

--Editing by Lindsay Naylor.

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