Project bonds in the Middle East: Releasing asset value and financing the future

Latham & Watkins LLP, DIFC, Gulf Bond and Sukuk Association and Thomson Reuters hosted a conference on the potential for project bonds to become a mainstay financing option for projects in the Middle East. Banker Middle East caught up with partners Craig Nethercott and Nomaan Raja, and senior associate Chirag Sanghrajka of Latham & Watkins LLP for their views

What are project bonds and how has the project bond market developed in the Middle East?

"Project bonds are capital markets instruments that are used to finance or refinance project assets. Whilst the capital markets have been a regular source of funding for projects in the US in particular, the project bond market in the Middle East has been slow to take off and to date there have only been a handful of project bond issuances from the region.

"A number of theories have been advanced for this. For many years, Middle Eastern projects have benefited from a deep and liquid pool of local bank liquidity, supplemented by a large number of active international banks. Whilst the global and European financial crises have resulted in many international banks reducing their exposure to projects in the Middle East, the local banks have remained a cost-effective source of financing and any potential funding gap has been met by increased activity from export credit agencies and development banks.

"However, in recent years, project sponsors have become increasingly focused on the need to release bank lending capacity that may be locked up in operational projects, in order to fund the construction of new projects. At the same time, institutional investors (particularly US-based pension funds, asset managers and similar investment funds) have focused on emerging market project bonds as a long-term asset class that matches their long-term liabilities profile, and offers a better yield than can be achieved in the low interest rate environment prevalent in developed markets. These two factors together have made project bonds an increasingly attractive financing option for sponsors, and recent issuances such as the Shuweihat 2 project bond and the Sadara project Sukuk have highlighted the market's potential in the Middle East."

Can project bonds be used to finance the construction phase of a project? What factors get bondholders comfortable with assuming construction risk?

"Project bonds can most certainly be used to finance the construction phase of projects – as the recent Sadara project Sukuk has shown. However, whether in practice bondholders are willing to assume construction risk will usually

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Craig Nethercott, Partner at Latham & Watkins LLP

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Senior Associate, Chirag Sanghrajka of Latham & Watkins LLP

depend on the completion guarantee that sponsors are willing to offer–few bondholders will be prepared to bear the risk that the project fails to achieve completion without a robust completion guarantee from a creditworthy sponsor.

"If project bonds are not available as a financing option for the construction phase of a project, they can nonetheless be incorporated as a potential element of a project's financing mix at a later stage through a mini-perm funding structure."

What is a mini-perm financing structure?

"Mini-perm funding structures typically come in two varieties. Hard mini-perms are medium-term bank financings (typically with a tenor of eight to 10 years) that the project company will use to finance the construction and early operation phases of the project, and refinance with longer term debt (such as a project bond) before maturity. They have historically been unpopular as they expose the project company to the risk of default if the financial markets are not able to accommodate a refinancing before the hard mini perm's maturity. Lenders will usually require the sponsors to bear this risk.

"Soft mini-perms, on the other hand, tend to be longer term bank financings, with tenors of 15 years or more. The project company is usually incentivised to refinance the soft mini-perm before maturity through periodic increases in the margin or the application of increasingly strict cash sweep provisions, but is not subject to the more immediate refinancing risk that characterises the hard mini-perm. As a result soft mini-perms have tended to win greater acceptance amongst project participants – for example, a mini perm financing option has most recently featured in the proposed financing for the Abu Dhabi Water and Electricity Authority's Mirfa IWPP."

> Project bonds are rarely the sole source of financing for a project – they must usually be incorporated into the rest of a project's capital structure

What are the major risks or pitfalls in a project bond issuance process?

"Disclosure is often cited as one of the most complex and time-consuming aspects of a project bond issuance. Many projects constitute critical infrastructure in the host country and the terms of offtake and supply contracts may be commercially sensitive – this can be difficult to reconcile with the disclosure and due diligence requirements associated with project bonds, particularly if the bonds will be marketed to US-based investors. Disclosure can also prove a challenge for projects which benefit from completion support from their sponsors as, in many such cases, the disclosure and due diligence requirements may also extend to the sponsors themselves. There is no substitute for careful preparation and good judgment in assisting a project company and its sponsors to navigate through the disclosure process in a manner that balances the competing demands of confidentiality and transparency.

"Project bonds are rarely the sole source of financing for a project – they must usually be incorporated into the rest of a project's capital structure, usually alongside commercial lenders and export credit agencies. As a result, intercreditor issues can be of particular sensitivity, and the resulting decision-making and enforcement mechanics may be a product of a number of factors. For example, if a project's financing includes a significant component of export credit agency-sourced debt, this may need to be reflected in "veto" rights for the export credit agencies or an additional category of voting thresholds that effectively requires export credit agency approval for certain decisions. Another factor that may be important is the relative maturity of the project bond debt and the bank financing – bondholders may be less inclined to defer to commercial banks and export credit agencies in the decision-making aspects of the intercreditor arrangements if the amortisation profile of the bank debt results in commercial lenders and export credit agencies having less "skin in the game" than bondholders at an early stage in the project's financing plan."