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Banking & Finance Alert

US Private Placements - An alternative funding source for Australian projects

WHAT YOU NEED TO KNOW

- US Private Placement bond offerings are becoming a common source of debt for Australian corporates as they seek to diversify their funding mix and take advantage of relatively cheap interest rates in that market.
- There is the potential for the USPP market to be used in the next stage of project growth in Australia, as more projects compete and struggle for funding.
- USPP investors, mainly pension funds and insurance companies, have proven to be resilient and active bond investors since the GFC.

An alternative funding source for Australian projects

2012 saw a large number of Australian energy and resources and infrastructure projects shelved due to weakening commodity prices, increased construction costs and a consequential question mark over the availability of bank debt.

Project bonds (the issuance of bonds by a project SPV to finance single-asset, limited-recourse, greenfield or brownfield projects) used to be quite common as an alternative, or complimentary, source of funding in Australia from Asian and Australian investors. However, the appetite for these investors to fund projects in Australia has significantly diminished since the GFC.

US pension funds and insurance companies have shown resilience to global market forces and continue to be active bond investors. As commodity prices start to rebound, and the global outlook becomes more positive, investment through US bond issues by these types of organisations represents a potential new funding source for Australian projects. Project bonds have been increasingly used in Latin America and South America over the past few years.

In the next phase of project growth in Australia, alternative funding sources such as these (either for the full debt component of a project or alongside traditional bank debt) will be more important than ever.

Three types of US bond issues

There are three main types of bond issues in the US.

Public offerings
Public offerings of bonds are highly regulated by the SEC under the Securities Act of 1933 (Securities Act). While pricing is generally better than for 144A issues and USPPs and the market is much larger with active secondary trading, public offerings are not suited to project finance due to high levels of public disclosure, large costs of coming to market and the Securities Act's registration requirements (in effect that the bonds are listed on a stock exchange and are able to be publicly-traded).

Rule 144A issues
A bond issue to Qualified Institutional Buyers (QIBs) (eg insurance companies or registered investment companies) under Rule 144A takes advantage of a safe-harbour from the registration requirements of the Securities Act for public offerings. Disclosure

requirements to QIBs or the SEC are limited, however the issuer needs to obtain two credit ratings for the bonds prior to issue.

Issues under Rule 144A are the primary method for non-US companies accessing the US debt capital markets. However, they are not as well suited for project finance as, once issued, QIBs are free to trade the bonds between themselves. While this increases liquidity, it consequently increases price volatility. It also makes it difficult to know who holds the bonds at any one time, let alone contact them for any waivers or amendments that may be required over the life of the project.

US Private Placements

US Private Placements (USPPs) are bonds offered to a small number of investors (primarily US pension funds and investment companies). USPPs are subject to the Securities Act but do not have to be registered if the bonds are treated as one offering, the requisite disclosures are made, there is no general solicitation and they contain restrictions on their resale (Regulation D Requirements). As opposed to 144A issues, no credit rating is required, although a rating from Moody's, S&P or Fitch is desirable.

USPPs may be suitable as an alternative source of funding for Australian projects as they have certain advantages over bank debt (discussed below). There are, however, challenges for the project SPV in a USPP issue, but these challenges are not unique to the Australian market and have been dealt with in various ways in other markets.

Advantages of USPP against bank debt

Alternative source of funding

US pension funds and insurance companies are increasingly considering investments in projects through USPPs. They are seeking longer term investments to match their long term liabilities. The introduction of Basel III's risk weighted capital requirements, with its likely reduction in available size and tenor of bank debt, increases the attractiveness for projects of these alternative sources of funding.

Pricing

While USPPs are usually priced at a small premium to public offerings and 144A issues, pricing generally compares favourably to bank debt.

No refinancing risk

A project SPV is able to issue USPPs with a tenor equal to the life of the project, tailored to match both the issuer's and investors' requirements. These longer tenors (generally 10-15 years as opposed to 5-7 years for bank debt) can mitigate refinancing risk for the sponsors of the project.

No interest rate hedging or amortisation required

USPPs, typically structured with fixed coupons and a bullet principal repayment, make it easier to obtain fixed-interest rates for the life of the project, removing the need to interest rate hedge or amortise over the life of the project.

Flexible covenants

Although more restrictive compared to public offerings and 144A issues, USPP covenants are usually more flexible for issuers than bank debt covenants, allowing more freedom and flexibility to run the project. Covenants for bonds in brownfield projects tend to be more incurrence-based than maintenance-based, resulting in less day-to-day oversight. USPP investors also tend to accept looser maintenance covenants for greenfield projects than banks.

Challenges to USPP issue for a project SPV

Increased regulation

While SEC regulatory requirements for a USPP are less onerous than for a public offering, and no credit ratings are required (as opposed to the two required for a 144A issue), there are regulatory hurdles to be cleared for the SEC to classify the issue as a USPP under the Regulation D Requirements. There are comparably minor regulatory requirements for bank debt.

Amendments, waivers and consents

It is rare for an issuer to attempt to contact USPP investors with a request for an amendment, waiver or consent. It is even rarer for USPP investors to consider, let alone accede, such a request in the same way that a syndicate of banks might.

Execution and pricing risk

Underwriting is rare in USPPs and most issuers have no commitment until pricing, which by its nature is very volatile. This presents a challenge for a project SPV as funding is required at set times and the project SPV may not be able to wait for the market to move in its favour. This has a flow-on effect to the viability of the project.

Negative carry
The certainty of a single bond issue is preferred by USPP investors. As funding requirements are staggered through the construction phase of a project, the project SPV will accrue interest liabilities to the USPP investors on the total amount of the debt from day 1. This leads to "negative carry" of interest commitments to the extent that the project SPV is unable to invest the excess money at an equivalent interest rate.

Construction risk
All projects contain the risk that the construction of the project is not completed in time, delaying revenue from the project and increasing the risk that the project SPV is able to pay interest to the financiers. Construction risk is mitigated to some extent in bank debt funded projects by linking drawdowns to construction milestones, and the establishment of project accounts to avoid leakage. However with the preference for USPP and other bond issues to be fully drawn on day 1, this risk is increased for USPP investors or bondholders. Construction risk in greenfield projects has been a major roadblock to USPP and other bond issues.

Further, there is a risk for the project SPV where a degree of flexibility as to timing and funding mix is required for a project. Obtaining consents from USPP investors to deal with changes to the construction process can be a more difficult process than with a bank syndicate, and prepayment is expensive as the project SPV is required to make investors whole.

Solutions

Early discussion with concession holders and USPP investors
In a concession process where USPP funding may be used, it will be important to engage in early discussions with the concession holder and USPP investors as to how the process and timetable to financial close will differ from that of a traditional bank debt financing. The earlier the challenges outlined above are discussed, the earlier appropriate solutions can be considered and found.

While negative carry is a risk that must be borne by the project SPV, the increased regulatory regime and execution and pricing risk are issues to be considered by all participants in a project finance. For example, in relation to minimising execution and pricing risk, bridging finance could be put forward early in the concession process as a possible solution in certain circumstances.

Mitigants to construction risk
Bondholders in mature project bond markets are increasingly accepting construction risk for sponsors with a proven track record or where a robust construction performance security package is provided, for example a construction contractor parent guarantee supported by a letter of credit.

In less mature markets, credit guarantees from multinational development banks and government agencies are sometimes sought and needed to mitigate construction risk for bondholders.

Where such options are not available, one solution is to focus on brownfield projects, where construction is completed (or largely completed) or minor capital expenditure is required. Project sponsors will gain experience working with bondholders and bondholders will gain experience in structuring bonds around projects, in both cases with negligible or reduced construction risk. As that mutual experience grows, project SPV can begin to assess greenfield projects with some form of credit enhancement as potentially suitable for financing through USPPs.

Funding for thought

The road to financing an Australian project through a USPP would be long and complex. However, as more projects compete and struggle for funding, alternative sources such as this must be explored. By discussing and assessing the risks involved, we move closer to opening up USPP investor investment in the Australian project finance market.

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