The "Project Bonds" Initiative: A Proposal for Facilitating Investments in Europe's Infrastructures

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The Mobility Conference 2011

Milano, 7 February 2011

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The « Project Bonds » Concept

- Since 2000, more than EUR 100 bn of infrastructure assets in Europe are estimated to have been financed in the capital markets;

- Monoline-wrapped capital market issues became an important provider of liquidity for infrastructure and were placed with institutional investors (insurance companies, pension funds);

- The financial crisis has caused the disappearance of the sufficiently highly rated “monolines”, while the new requirements under Basel 2 & 3 have put pressures on banks’ balance sheets. This has significantly reduced the available long term funding for infrastructure assets;

- There is thus the need to find ways to bring back private sector financing of individual infrastructure projects, without increasing direct public funding and therefore public indebtedness.

The « Project Bonds » Concept

- « Project Bonds » were first proposed by EU President J.M. Barroso in his « State of the Union » speech in Strasbourg on 7 September 2010:

  "An EU initiative to support project bonds together with the EIB, would help address the needs for investment in large EU infrastructure projects".

- This initiative by the EU Commission and the European Investment Bank (EIB) also builds on the existing experience with «joint EU-EIB financial instruments», such as LGTT and RSFF;

- It is intended to be part of the wider « Europe 2020 » proposal aimed at revitalising the European economy, as well as of the new approach to use structural funds also as «Innovative Financial Products» within the Multi-annual Financial Framework (MFF) 2014-2020;

- Not to be confused with the « E-Bonds » of Juncker-Tremonti ("*E-bonds would end the crisis*", FT, December 5, 2010) which would be issued by a new pan-European public debt agency.The "Project Bonds" proposal does not imply any burden on public budgets.

The « Project Bonds » Concept

- There seems to be renewed interest from institutional investors to consider investments in sound infrastructure projects;

- In Italy, for instance, the EIB has underwritten a EUR 97.6m unwrapped bond linked to the construction of a 51 MW solar PV park promoted by the US company SunPower in Montalto di Castro, while SACE has guaranteed an equal amount which has been placed with institutional investors;

- The bonds underwritten by EIB are rated Baa3 (the rating of the underlying project loan), those “wrapped” by SACE are rated Aa2;

- There is also increasing investors’ interest in debt funds investing in infrastructures.

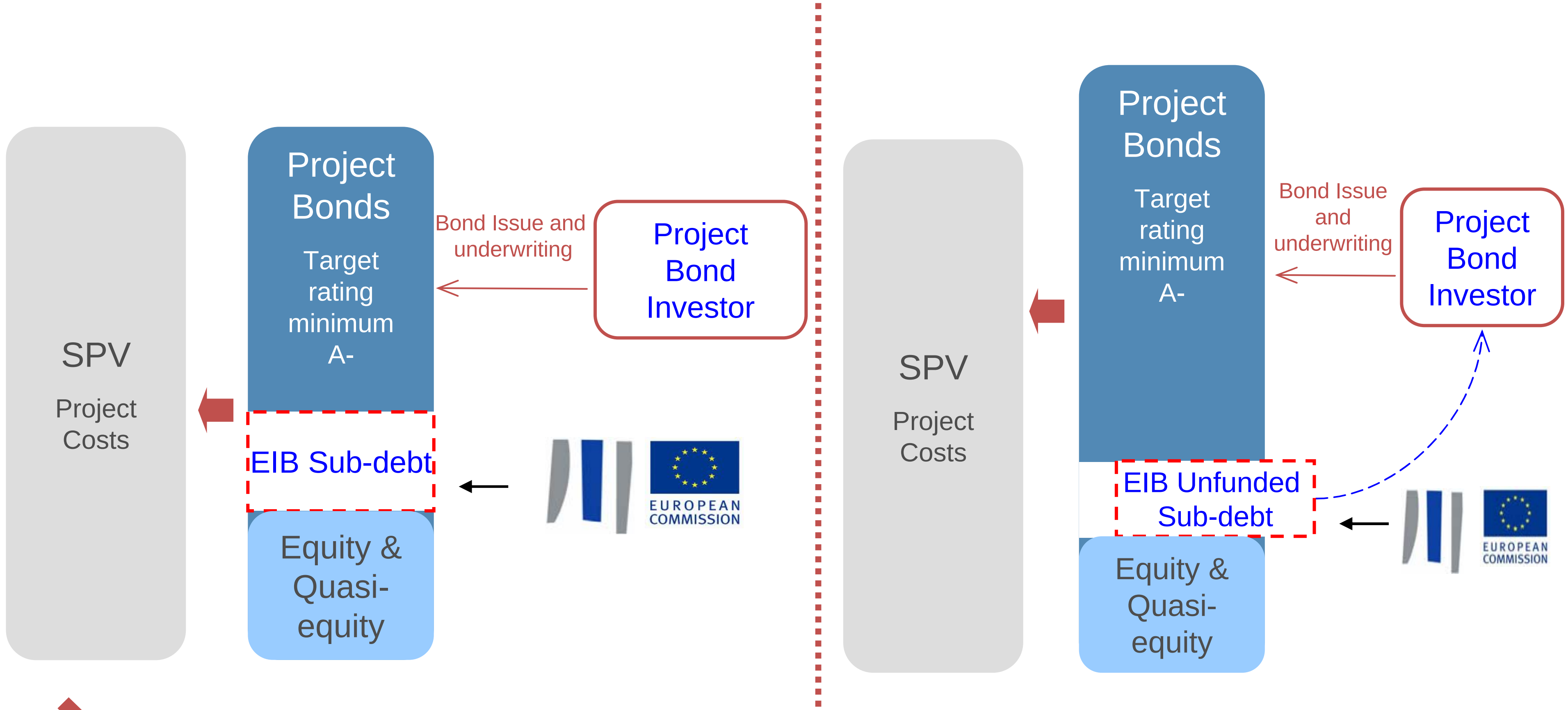
The « Project Bonds » Concept

- Monolines provided debt service guarantees ("wraps") in respect of the senior debt/senior bond issues of project companies;
- Project companies issued debt at "stand-alone" ratings of at least BBB-. By virtue of the monoline's AAA rating, the wrapped bonds benefitted from a AAA rating, thus eligible to most institutional investors;
- Monolines also provided financial structuring, credit assessment and monitoring services;
- They also played, within inter-creditor structures, the role of controlling creditors;
- The "project bond" model is intended to provide an alternative to the "monoline-wrapped" infrastructure bond market.

The « Project Bonds » Concept

- Rather than providing guarantees directly to senior debt holders, the "Project Bond" concept is based on the idea, familiar from the securitisation market, of "tranching" an issuer's debt into several layers of different seniority;
- Here, the Project Company would "tranche" its debt into Senior Project Bonds and Subordinated Loan Tranches, the latter under-written by the EIB, either in a funded or unfunded form;
- If properly structured, the EIB's intervention will "credit enhance" the Senior Bonds issued by the "Project Company" into a A - AA rating, thus making these bonds (the "Project Bonds") eligible for the portfolios of institutional investors;
- The EIB will then partially transfer the credit risks taken on the Subordinated Bond on to the EU via appropriate risk sharing mechanisms.

Project Bonds – How They Could Look



EIB Sub-debt participation can be combined with different types funding sources (bonds and other senior loans)

EIB Unfunded Sub-debt participation can be flexibly used and structured in order to ensure target rating.

- Covers funding shortfalls during construction
- Comes on top of a fully funded structure
- Revolving capacity, available until the end of the project

Possible Role of the EIB

EIB's participation could provide substantial benefits to the Project Bond investor

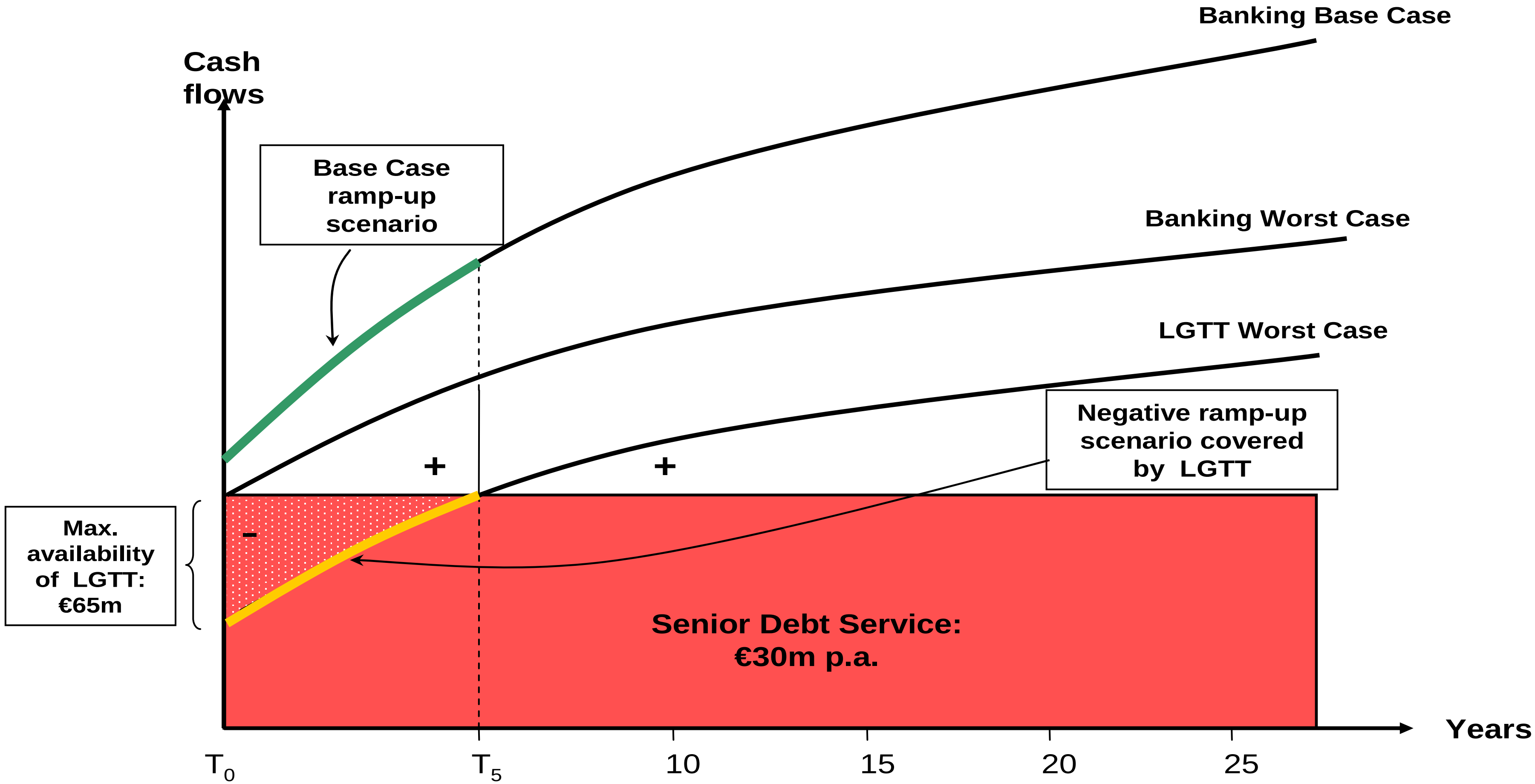
Project Bond investors need		EIB provides
Good investment-grade credit rating	→	Target of at least strong investment grade
Shield against project risks	→	By injecting sub-debt, provides protection against a wide range of risks at project-level
Diversification	→	Separate asset class
External project due diligence they can rely on	→	Extensive DD during appraisal / structuring
External financial analysis of the project	→	Thorough financial analysis during appraisal / structuring
Monitoring and surveillance post financial close	→	EIB participates in monitoring the project
Appropriate well functioning inter-creditor regime	→	EIB could act as controlling creditor within the inter-creditor framework

LGTT

- A role similar to this is already played by the EIB within the so-called “Loan Guarantee Instrument for TEN-T Projects“ (LGTT) Financial Instrument;
- LGTT, like “Project Bonds”, is a common initiative of the EU and EIB, where credit risks relating to the initial operating period (i.e., up to 7 years into the operating period) are jointly taken by EIB and EU according to a Risk Sharing Agreement;
- LGTT is a subordinated unfunded (guarantee) product, and is designed to provide cover to senior (bank) lenders offering stand-by facilities to infrastructure projects in the transport sector;
- If called, the LGTT will solidify into a subordinated loan, repaid after all senior lenders.

LGTT

Mechanics of LGTT liquidity support



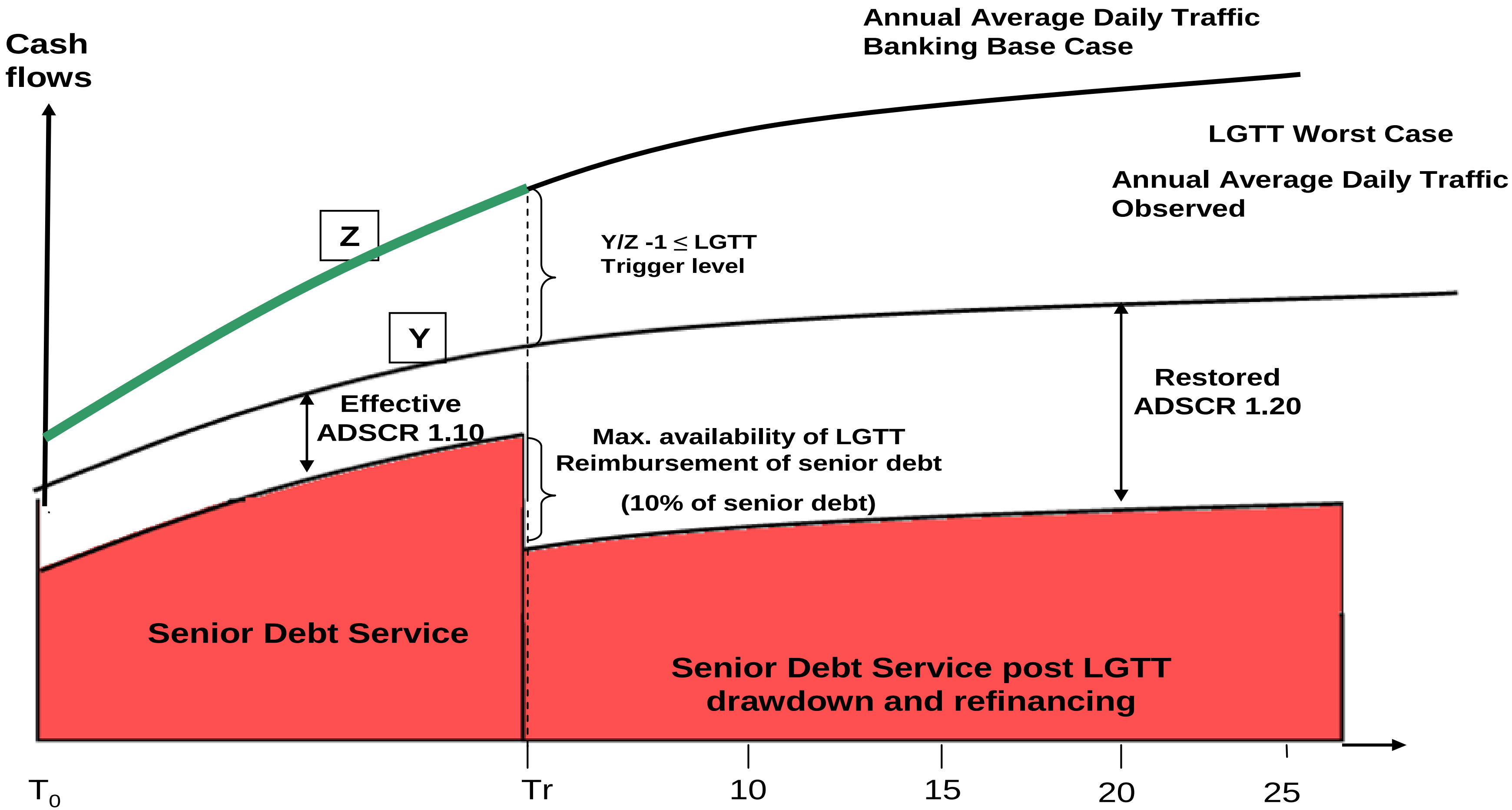
To: Start-up of project operations

T5: End of guarantee period

Senior debt amount: €500m

LGTT

Mechanics of LGTT single drawdown

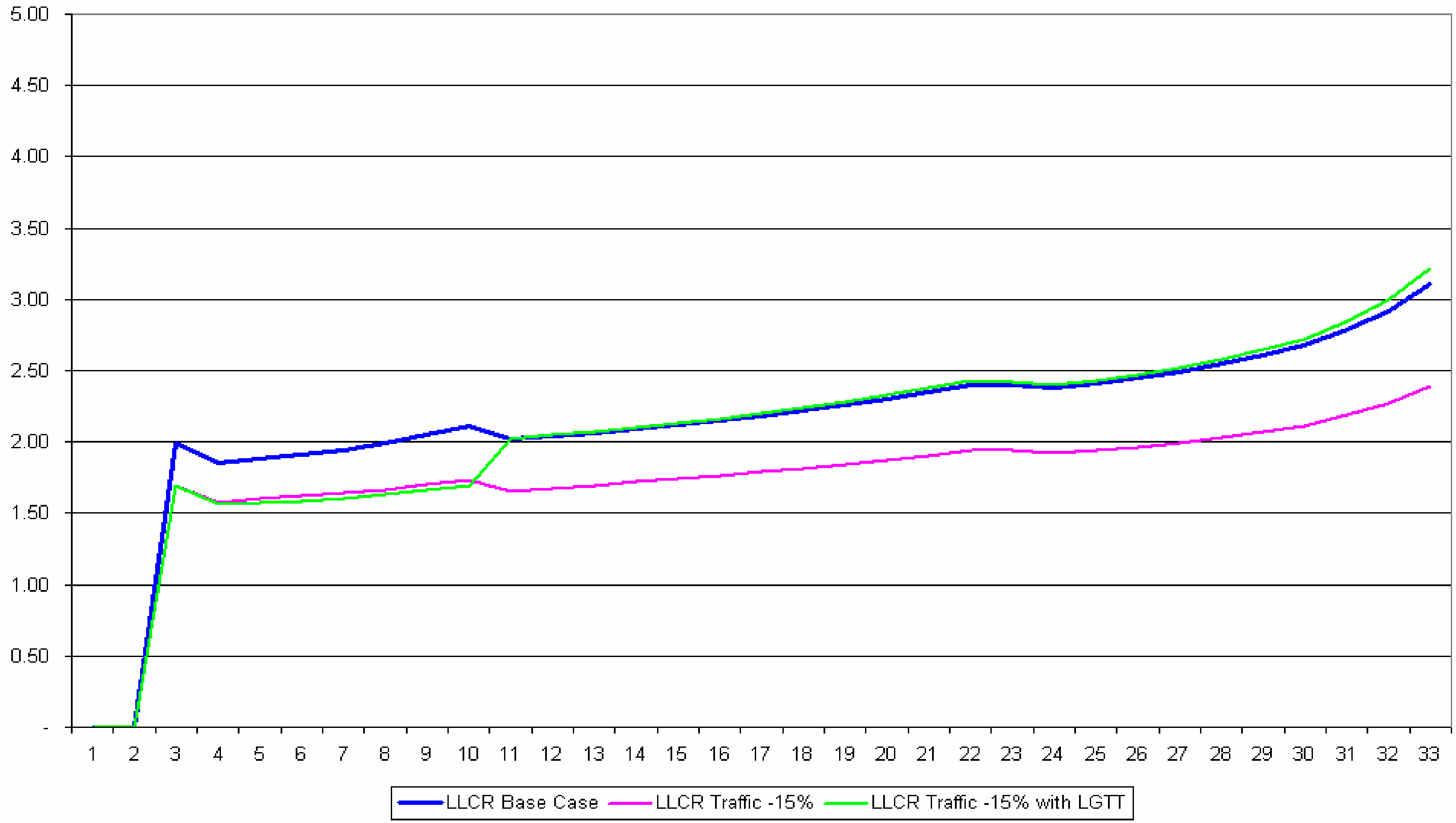


To: Start-up of project operations

Tr: Refinancing date

LGTT

LGTT Use Brings Project's LLCR back at base case level (single draw down)



LGTT

- The LGTT became operational in 2008, just when the crisis hit. Since then the following transactions have been finalised, for a total of EUR 140m:

- List of LGTT financed by EIB:
  - Baixo Alentejo (LGTT 25m€, project cost 458m€) - Portugal
  - IP4 Amante Vila Real (20m€/430m€) - Portugal
  - Autobahn A5 (25m€/480m€) - Germany
  - C-25 Eix Transversal (70m€/820m€) - Spain

- The current pipeline comprises 16 LGTT transactions for a total amount of EUR 1.4 bn, foreseen to enhance roughly EUR 15 bn of total investment costs.

LGTT

- "Project Bonds", as currently conceived, have points in common with LGTT, but they would extend the LGTT experience to:
  - Other categories of project-related risks, possibly including construction, operations, performance, traffic etc. ;
  - A wider sector eligibility range, potentially extending to: transport, energy, environment, and ICT;
  - In principle, both unfunded and funded structures, depending on the project's characteristics and requirements. As in the LGTT, in the unfunded version, once EIB guarantee is called it would crystallise into a subordinated debt.

« Project Bonds » - Possible Technical Features

- It is currently expected that the credit enhancement provided by EIB under the contemplated unfunded or funded subordinated schemes could go up to given percentage of the senior securitised project debt;

- This would ensure debt service protection in the vast majority of scenarios during project's life;

- Traditional equity/own funds requirements to be met, i.e. subordinated debt supplied by EIB is not meant to replace promoters' equity/shareholder loan contributions;

- Underlying projects would need to satisfy EIB's ordinary assessment criteria, that is projects must be technically robust and financially sound.

« Project Bonds » – The Process

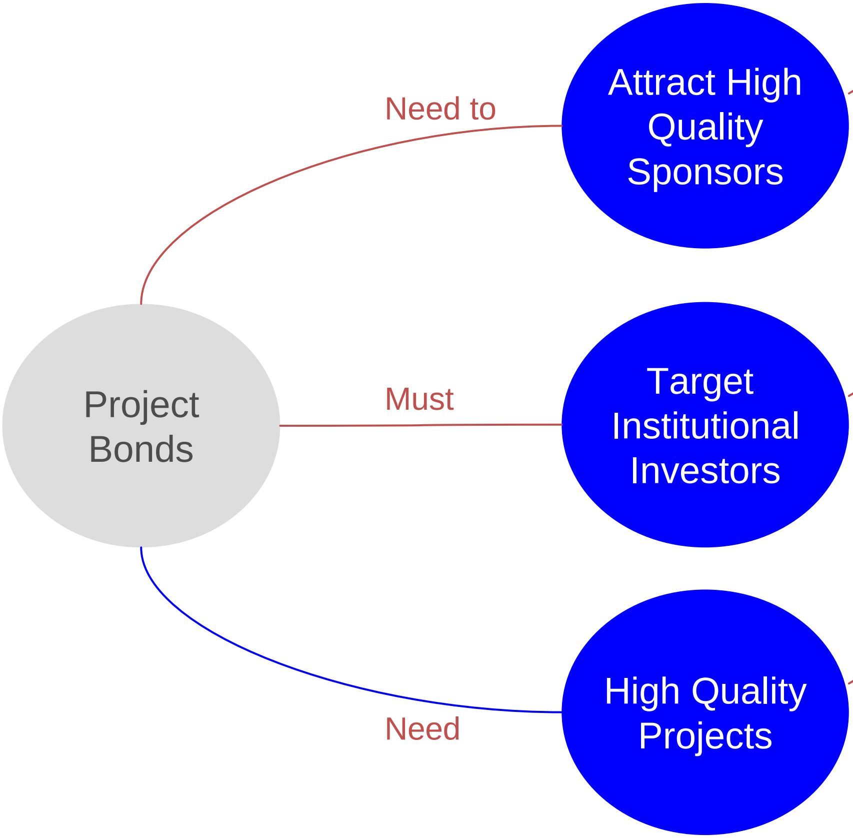
- The "Project Bond" proposal will be shortly circulated for public consultation, including to banks, institutional investors, in order to collect views, observations and suggestions;

- Once the results of this consultation are integrated, the aim is to have a fully fledged proposal ready by mid-2011 in context of the next MFF Framework preparation, and of having the Europe 2020 Project Bond initiative operational in 2014;

- The EIB is cooperating closely with the EU to help this happen.

Conclusion - Why « Project Bonds » ?

In order to be meaningful and successful Project Bonds must gather a varied set of conditions



Represents a **cost effective** financing alternative and offers liquidity although it must **compete with traditional commercial lending**

Offer **strong rating** (range from A- to AA) to grant the access of institutional investors like Pension Funds and Insurance Companies **bringing liquidity at competitive cost**

Well structured projects with all usual features in terms of lenders protection (reserve accounts, performance bonds, liability caps etc.) that can offer **high quality cash flows** allowing to achieve investment grade rating

➔ The overall Project Bond proposal must be a competitive alternative based on high quality asset cash flows and parties