Future Road Map

Financing projects through bonds

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The Association of Southeast Asia Nations's (ASEAN) infrastructure needs are huge. Due to the economic viability, or rather the lack of it from a commercial perspective, many of these needs will go unfulfilled. In recent years, the takeaway from conferences seems to point to a lack of feasible projects despite the availability of funds to finance them. How do we move forward? This article attempts to put together a road map to finance projects via bonds.

Why bonds?

Many projects can become viable with support of debt financing. Here, three basic characteristics stand out as most critical – matching currency, long tenors and fixed interest rates (see box).

All these three attributes can only be delivered by domestic local currency bond markets. Across the region, save for Malaysia, access to debt financing, typically making up up to 80 per cent of the project's capital structure, remains principally via the banking sector. With Basel III's emphasis on banks having adequate, stable funding sources to back up illiquid long-term project loans, it is clear that a disintermediated solution via the respective local currency bond markets will be the way forward.

Local bond markets in Southeast Asia

ASEAN's local currency bond markets are extremely diverse with fairly well-developed markets in

Indonesia, Malaysia, the Philippines, Singapore and Thailand; a nascent Vietnamese dong market; and the other countries without one. At the Credit Guarantee and Investment Facility, this is what we focus on – developing the ASEAN bond markets further. Developing these markets is vital for project bonds to fulfil the infrastructure needs of the region.

While local currency bond markets are a prerequisite for project bonds, strangely, a bond market does not guarantee the emergence of project bonds. Amongst ASEAN bond markets, only Malaysia's ringgit bond market stands out with more than $50 billion equivalent of project bonds or corporate issues related to the infrastructure sector outstanding. Beyond its cumulative size, comprising up to 20 per cent of the overall corporate bond market, more impressive is the depth of the ringgit market as evidenced by PLUS Berhad's mammoth RM 30.6 billion ($9.7 billion) issuance in 2012, with tenors reaching 26 years.

Since the 1980s, Malaysia has executed a comprehensive plan to develop the ringgit bond market with a series of steps, which included a comprehensive regulatory framework. Other developmental interventions, including the abolishment of withholding tax and creation of domestic rating, pricing and guarantee institutions, have helped pave the way forward. A thriving ecosystem of trustees, institutional investors and asset managers has since emerged to make it one of the more developed markets in the region.

The depth of the ringgit project bond market, if proliferated around Southeast Asia for the respective local currencies, is the only visible solution to the region's infrastructure financing needs. As such, one should study Malaysia's success in making infrastructure project bonds an attractive asset class. It should be noted that it took close to 20 years of trials and tribulations between the first ringgit project bond issued by YTL Power Generation and PLUS Berhad's 2012 issuance. Three critical ingredients to this success stand out – Malaysia's immense long-term savings, strong projects and an experienced project finance talent pool in the capital markets.

Matching currency

When consumers pay for using infrastructure and utilities in Southeast Asia, they pay in their respective local currencies. It is therefore imperative that the debts of a project company be raised in matching currencies. Raising project debt in other currencies, if we remember the Asian financial crisis of 1997–98, is a recipe for disaster. Since many of the ASEAN currencies have illiquid or non-existent cross-currency swap markets to attend to the long-term debt requirements of a company undertaking a project, it is best to avoid any currency mismatch altogether by borrowing in the right currencies.

Long tenors

Two positive attributes are infused into a project's economic viability with access to long-tenor debt of 20 to 30 years, as opposed to 5 to 10 years. First, the tariff/rate per unit can be dramatically reduced as the principal repayments get spread over a longer period, boosting affordability and usage levels. Second, the project's exposure to refinancing risk and higher interest rates dissipates – making the project inherently more creditworthy.

Fixed rates

Projects with floating rate debt are exposed to a considerable level of interest rate movements, particularly in times of crises. History has taught us that this risk remains relevant in many of the emerging economies in the region. Trouble is, with large amounts of debt, an increase of 1 per cent to 2 per cent can have a very significant impact on the project's debt servicing capabilities, let alone 5 per cent to 10 per cent.

Long-term savings capacity

The fundamental ingredient to finance infrastructure is a country's savings propensity, particularly for the long term. By tallying up the total long-term funds available from pension funds and insurance companies, one gets a fairly accurate assessment of the project bonds' potential to fulfil the country's infrastructure needs.

Singapore's Central Provident Fund and Malaysia's Employees Provident Fund (EPF) rank amongst the world's largest sovereign pension funds in size but no other Southeast Asian country has institutionalised long-term savings anywhere near the size of these funds – these today exceed $200 billion each. Although this will take some time, boosting mandatory long-term savings is a critical first step. The second is to manage them well.

While tapping retail savings with retail bonds seems plausible, getting retail investors to understand project finance and commit to long maturities will be an uphill task. However, in some countries, where retail investors already own equity in project companies, retail project bonds may be issued with greater market education and development.

For countries with a clear savings capacity gap, attracting long-term savings from abroad quickly becomes a priority. However, to do so, there needs to be sufficient sovereign credit standing and investors' faith in the long-term future prospects of the country – two elements that remain elusive in many countries in the region. If too daunting a task, governments would do well to establish a clear legal and regulatory framework for specific sectors like power and water to be accompanied by certain warranties or guarantees of rights to address untenable risks that are often associated with the overall sovereign risk of the country.

One possible source to fill this savings gap is the surplus savings that exist in some countries in Southeast Asian and other developed Asian countries. Bursting at the seams, these surplus savings need a home and neighbouring countries should focus on how to access them. Malaysia's EPF, for example, has an enviable portfolio and experience in project bonds. The key challenge is how to get project bonds from other countries into their conservative investment portfolio. To do so, other governments need to make their projects and bonds (including those from the greenfield stage) an acceptable asset class.

Strong projects first

Unlike in more mature markets (where project bonds tend to be considerably riskier relative to risk-free bonds given the conservative guardians of long-term savings), project bonds in countries with underdeveloped bond markets need to be developed as a highly rated, low-risk product. If the first few project bonds default, the whole asset class gets junked fairly quickly. So, the key to developing the asset class is to put out strong project bonds first. Greater risk and return opportunities can be introduced once there is investor confidence to consider them.

Experience and expertise

While these are bonds in form, in substance project bonds make up an asset class that cannot be simply passed to a fixed income desk that manages sovereign debt and corporate bonds. Even the risk management desk needs a different perspective – from the risk model to concentration limits. Building project bond capability requires commitment and investment in experienced minds.

This asset class also requires different perspectives on other fronts. Investors need access, time and expert advice. Investors also need support with respect to consent management and, when things do not go as planned, restructuring. The use of a reliable pool of consultants and advisers that work for bondholders, although paid by the project companies, will need to be introduced as a standard.

Steps forward

As many of the ASEAN countries in the region should not have to wait 20 years, a faster way forward is needed and perhaps focus can be placed on the following key areas by both governments and the private sector.

Governments keen on financing infrastructure with project bonds need to mobilise private sector savings towards this asset class. A comprehensive framework with coordination amongst all related parties – ministries of finance, tax departments, central banks, insurance and pension fund regulators – is critical to focus on building onshore capacity as well as to attract offshore investors.

Onshore, government agencies need to formulate supportive regulations to make project bonds attractive to build up sufficient investor appetite. If life insurers are subject to punitive capital charges for holding project bonds relative to other assets by regulation, the spigot to this key source of long-term, fixed rate local currency funding gets turned off – as well as any aspiration for a project bond market.

To amplify the need for coordination to attract offshore bondholders, in many countries, foreign direct investors get enticed with tax holidays but foreign bondholders are slapped with a withholding tax. Perhaps, if not the whole market, consider exemptions for project bonds, if plugging the infrastructure deficit is indeed a priority.

For private sector interest, the notion of "aggregation" should be pursued. There is not enough scale for the respective funds and fund managers to tackle an asset class that comprises numerous asset types in multiple jurisdictions individually in a segregated matter. Perhaps a mega fund (with the necessary privileges and immunities to operate in challenging jurisdictions) to aggregate private interest in project bonds can be a solution to overcome the challenges of assembling the experience and expertise required. In any form, either housed under a new multilateral umbrella or totally private, this aggregated mega fund can help structure projects and bonds on behalf of a larger pool of investors.

Such experience and expertise are required to make projects more "bondable" from two angles. Like the human vision, one eye focuses on helping governments appropriately allocate project risks as well as returns between the government, bondholders and sponsors. The other eye focuses on structuring project bonds including using "bond technology" – already in use by banks and corporates to raise a variety of hybrid debt and equity – to enhance the safety of the senior tranches. Consider "perp" and "coco" terms or variations of these incorporated into both senior and junior bonds customised for the specific project to balance risks and returns.

While these steps seem aspirational, the incontrovertible reality is that despite abundant savings in the region, the infrastructure gap canyon cannot be filled with only bucket loads of intervention. It is time to put things in the right perspective to have a 20/20 vision on how to move project bonds forward. Only then can we start building the road ahead. ■

As Vice-President, Operations, CGIF, Boo Hock Khoo's work focuses on developing local currency bond markets in ASEAN. He spent 20 years in the ringgit bond market with stints that included overseeing the infrastructure portfolio at RAM Ratings and assisting to establish Danajamin, Malaysia's first financial guarantee insurer.