GDL

Property & Finance Solutions

BESPOKE PROJECT FINANCE – DEBT FINANCE USING BONDS

Criteria

1. Bonds are usually issued with a minimum size of $100m.
2. Projects must meet the income, asset test and/or engineering test
3. Projects must subsequently be able to secure an acceptable rating
4. Bond terms vary, but are usually for a term of 5 to 10 years (maximum)

Overview

Debt finance via a bond issue is a suitable option to finance high yielding mining, natural resource, energy, manufacturing and infrastructure projects, where the owner has a largely unencumbered asset and seeks non-dilutive financing in order to realize the potential of the project. The key is to be able to securitize the resultant project income.

A bond issue is completely non-recourse and has several advantages over the usual equity or bank finance routes. For example, on bond maturity, the project owner is free of any liens or profit participation by a lender or investor. Furthermore, the interest coupon is fixed for the length of the bond and no personal guarantees are required.

Interest rates are at historical lows in many countries, which makes the attraction of fixed income bond financing very compelling at present. Over the next few years the likelihood is that interest rates will return to their long term equilibrium. Such a scenario could mean a reciprocal fall in bond prices, allowing the borrower to possibly exit by buying some or all of the bonds back at a discount to the maturity price and cancelling the bond. Bonds can be issued in $, €, £ or CHF and advice can be given as to the appropriate bond size, maturity and whether coupon or zero, or straight or convertible. In summary there are many different ways a bond can be constructed. The length of the bond may give the necessary leeway to structure successful financing. Also the ability to grant a moratorium period of up to 2 years may assist the construction period for a project.

Our affiliate first looks at a summary of the project to decide if it will suit the bond market and can be rated. There will be no cost attached to this initial review. If the project is deemed suitable, our affiliate will issue a bond mandate to the client. If there is doubt in the client's mind about the rating, we can arrange for a 'shadow rating', which is not usable for an actual bond, but gives a clear confirmation that a rating will be possible. This option* costs $10,000 and is stand alone; that is to say that if the shadow rating is not acceptable the client would cease their enquiry without incurring any further costs. Once rated or guaranteed, these are sold on the Eurobond market within 72 hours. **All of the rated bonds are pre-sold.**

There are three basic tests that a bond needs to pass in order to secure a rating. They are the **Asset**, **Income and Engineering Capability** tests.

Asset Test

This test is to show that there is sufficient asset(s) in the bond to cover any potential shortfall. There are several forms of asset that can be used:

	Asset Class	Face Value of Bond
A.	Cash	20%
B.	Land	20%
C.	Shares	20%
D.	Proven Reserves	TBC – usually 150%
E.	Guarantees	15%+

(These percentages are guidelines only. Each project will be assessed on its own merits)

More Collateral = Better Rating = Lower Coupon

There are no set rules, but if a manufacturing plant, refinery or infrastructure project has 10% cash to contribute, that will more than likely suffice. Likewise, if the project is to be built on unencumbered land then the bond can use the land collateral. Company shares which are traded can also be used. Again the marketability and volatility of the shares will be a factor in assessing the percentage cover required. Proven Reserves where the client holds a Competent Persons Report, a JORC report or a NI43-101 or NI51-101 report demonstrating value of reserves will be acceptable. However, the percentage value of the in ground assets should be significantly more than face value of the bond.

The key determinant here would be the "Proven" or "Measured" reserves and their ***net***

In general, when calculating the maximum face value of a bond, 90% of the ***net*** proven (measured) reserves, 50% of the ***net***

[($300M x 90%) + ($300M x 50%)] x 2/3 = $280M

This does not mean that $280M will automatically be raised. The actual amount raised will depend upon the serviceability and repayment of the bond, which comes under the income test – see below.

Where the client is looking at an infrastructure or government backed project it can satisfy the Asset test with a local, regional or sovereign Government guarantee.

Income Test

The key here is to demonstrate the ability to service and repay the debt. Typically, the project will need to produce net (OPEX) annual returns of c.22%+ (excluding finance costs) to service the anticipated coupon (dependent on the rating) but let's assume an annual coupon of between 9% and 11%, and also to repay the principle debt in full on a straight amortization basis over the maximum bond term of 10 years.

If the income is derived from the sale of a commodity at spot price, this would be acceptable. This would also be true for gold, copper, oil & gas etc.
Where the commodity is not quite so well known it may be necessary to have a long term sales contract with a recognized third party. This could be a company or a government. If the project income was through an off-take agreement that would usually suffice. If the income comes from passenger traffic e.g. a railway or a toll road then the income will need to be securitized to the Bond Trustee.
Overriding, all income from whichever source needs to be paid through the Bond Trustee. This is so that the bond trustee has first call on the income to service the debt and build up sinking fund reserves for the principal repayment.

Engineering Capability

This test is needed to establish the capability of extracting a resource out of the ground. There may be a deep water offshore oil field rich in reserves, but of little value unless there is an engineering solution to extraction. The BP disaster in the Gulf of Mexico demonstrated how challenging some engineering solutions can be, and not always with happy endings.

Likewise, where a new technology is being used on a renewable energy project, the rating agency will need comfort as to the success of a field demonstration plant or alternatively an engineering and production bond from a reputable company or insurance risk on failure.
Competent management is also critical to the successful running of a project and so this test will additionally consider the quality and qualifications of the personnel chosen.

Process

The bond management team provides a turnkey service which includes:

• Advice on appropriate bond size and maturity, coupon or zero, straight or convertible.
• Management of due diligence to shape it into the format acceptable to the rating agency.
• Advice on setting up of an offshore bankruptcy remote special purpose vehicle (SPV) to issue the bond, usually Luxembourg.
• Securitization of the project cash flow.
• Arrangement of price insurance where appropriate.
• Recommendation of legal, accountancy and trustee bank (rated at least 'A').
• Management of submission to rating agency e.g. Standard & Poor's, Moody's or Fitch.
• Arrangement of bond ISIN number and registration with Euroclear, Clearstream as required.
• Arranging bond screening on Bloomberg and Reuters.
• Sale of bond. Once rated or guaranteed, these are all sold on the Eurobond market within about 72 hours.

TIMESCALE

The general functions of the bond manager take but a few weeks. However, with natural resource projects, the due diligence enquiries can take some time. In summary, the rating agency needs to be satisfied on the following points:

• Is the stated resource there and what is its value?
• Can it be extracted successfully per the mine plan and/or feasibility study?
• Is there a ready market for the mineral to be extracted?
• Is the management team competent?
• For renewable energy projects: Are PPAs in place?
• For infrastructure projects: Is there a valuation report on the land?

Of course, the answers to these questions are largely in the hands of the client. Where the client has employed mining consultants and engineers of international repute in the preparation of their submissions, the due diligence process is very rapid.

Once the due diligence has been completed satisfactorily, the next stage is to engage the rating agency to obtain the rating. The timing here is dependent on the workload of the agencies, but, as a general rule, the process should take less than three months. From time to time agencies offer a fast track service but this entails additional fees, currently anything up to €70,000 (c$95,200); this means that, once the submission is checked and accepted, the rating will be obtained within a defined period, usually 14 days. In this instance the bond can potentially be issued and sold within 5 weeks of completion of the due diligence. So if the client is ready to go from the outset then the whole process, albeit more costly, can be concluded extremely quickly.

COLLATERAL

The rating agency will require that collateral is vested in the SPV. This may be cash, shares or other instruments, including the project's assets. For this purpose, cash or near cash is best and the amount of collateral required will be about 15%-20%. However, if other assets, including JORC, NI43-101 and NI51-101 reserves, are to be used, the requirements will be higher. **More collateral = better rating = lower coupon.**

SPECIAL PURPOSE VEHICLE (SPV)

The SPV is a bankruptcy remote special purpose vehicle set up exclusively to issue the bond concerned. By that, it means that the Client is not required to provide personal guarantees. Its directors are nominees chosen by the local lawyers. It is vested in the trustee bank.

It has no bank accounts except with the trustee bank, which will have a mandate covering all disbursements. The client will approve of and countersign the mandate.

The SPV will own, or have pledged, sufficient assets to collateralize the bond. The client will have an option to acquire the SPV for $1 on bond retirement. The client may then repatriate the assets or maintain the operation in the chosen jurisdiction. The trustee bank's duty is to the bondholders. Therefore its first requirement is to have sufficient funds to service the bond. This includes the annual coupon and payments to the sinking fund. Often, where project cash flow will start sometime after the bond sale, a repayment holiday can be arranged. It is not normal for such a holiday to be longer than two years.

COSTS

Essentially, there are five stages of fees or costs. Most costs are not due and payable until after the bond proceeds have been received:

1. Set up and Due Diligence.
2. Professional Due Diligence.
3. Rating.
4. Placement.
5. Success fee.

Combined these should not normally exceed c.5% of the **FACE** value of the bond whereas c.4.7% are back end success related (ie after bond proceeds are received).

1. SET UP AND DUE DILIGENCE COSTS:
(a) These are usually covered by a monthly 'retainer' payable in advance of $10,000 ($15,000 if an expedited rating is requested) from the date of mandate to issuance of bond.

(b) If the client chooses the jurisdiction of Luxembourg, the SPV capital required is $12,500 and there is a setup fee of up to $17,500 to include the provision of a director.

2. PROFESSIONAL DUE DILIGENCE: This is, of course, highly variable, depending on the complexity, size and perhaps most importantly the quality of the Client's preparation and paperwork. If the Client already has in place a Competent Persons Report, an N143-101 or N151-101 report, JORC report, a Power Purchase Agreement or current valuation report then the costs may be negligible and quite possibly zero.
Legal fees are an unknown. These are the costs for preparing the Offering Memorandum for the bond issue. Costs vary enormously. The bond provider advises the Client to put aside $80,000 for this. The better the quality of the law firm employed, the more the rating agency will review positively.

3. RATING: The bond's price or value is totally dependent on the rating it gets from the rating agency, S&P, Fitch or Moody's. Their fees vary depending on office location and have an element relating to the size of the bond. As a minimum fees vary from $70,000 to $130,000. As a maximum they would be 6 to 6.5 basis points of face value. By way of example a $500M bond would attract a rating agency fee of $300,000 to $325,000 (in USD or Euro equivalent).
It is also not unknown for a rating agency to additionally charge a post-bond proceeds fee of anything up to €140,000 (c$190,000).

4. PLACING COSTS: These should not exceed 1.35%.

5. SUCCESS FEE: The bond provider charges 3.25% (less the amount paid under Item 1).

Front end costs are Items 1, 2 and 3. Given the nature of the bond envisaged herein we would recommend that a budget of $60,000 for Item 1 be earmarked.

As mentioned above, the due diligence costs can only be estimated on a case by case basis.

If the Client has an up-to-date Competent Persons Report or N143-101 filing, PPA, valuation etc then the due diligence cost and timing may be negligible or zero. However, if the Client does not have the necessary reports then he/she can either

prepare these documents first or work in tandem with the bond provider to complete them.

Item 3 Rating: On the basis of a face value of $100,000,000 the rating fee should not exceed $127,800. Effectively, the bond will be issued and placed within 3 – 5 banking days of receipt of the rating.

On the basis of a **$100,000,000** face value bond on these indicative terms, the total fees would be: -

Pre bond Issue (ie before bond proceeds received)

Bond provider Professional Packaging	$30,000
Luxembourg company	$30,000
Legal's	$80,000
Rating Fee	$127,800
Contingency (eg forex)	$32,200
	$300,000 (0.300%)

Post bond Issue (ie after bond proceeds received)

Placing Costs:	$1,350,000
Rating Fee	$190,000
Success Fee (less retaining fees already paid)	$3,220,000
	$4,760,000 (4.760%)

TOTAL COST OF FUND RAISING = **$5,060,000** (5.060% of the face value of the bond)

*OPTION: As stated previously, all rated bonds sell, but a rating is a prerequisite for our underwriters. However, some clients may be nervous about the rateability of their bonds. Therefore, we have arranged a special concession to supply a 'shadow' rating for bonds preparatory to engaging the bond provider in a full bond preparation. This involves an upfront cost of $10,000 payable directly to the rating agency. This takes about 10 days, as no due diligence is required, since due diligence statements are taken to be true. Receipt of this 'shadow' rating enables the client to make an informed judgement whether or not to proceed. The client is required to sign the bond providers mandate first, which requires no further commitment other than the first month's due diligence fee. Thereafter the bond provider will prepare the submission to the 'shadow' rating agency.

For further information or to enquire as to whether your projects meets the basic bond criteria, please contact:

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E&OE: *This is not a quotation nor a contract nor any part thereof. The above fee figures are given for guidance.*
Variations can be occasioned by a number of factors including, but not limited to, complexity, size, jurisdiction, foreign exchange rates, underwriting and diligence etc.

(Exchange rate assumed: €1/$1.36)