Project Bonds Rise Again

The capital requirements introduced in the aftermath of the global financial crisis had a chilling effect on long-term lending by the banks. As a result, in order to meet their substantial infrastructure and energy needs, governments and project sponsors looked to innovative funding solutions from new sources of capital. This has led to the resurgence of project bonds, which offer an opportunity for sponsors to diversify their funding base by tapping into the capital available from institutional investors.

In tandem with these global developments, project bonds have also inevitably appeared in the Turkish market due to Turkey's enormous infrastructure and energy needs. This note provides an overview of project bonds, with a particular emphasis on the Turkish market.

A. Project Bonds in brief

Project Bonds are bonds issued to the capital markets in order to fund the whole or part of a project financing. The issuance documentation typically follows that of a standard corporate bond issuance, save that, additionally, the bondholders (and any other funders to the project) will benefit from standard project financing terms such as an extensive covenant package and security over the assets of the project company. Where other forms of debt are provided alongside the bonds, intercreditor arrangements will govern decision-making and enforcement rights.

Historically, in project bond financing, an issuer would receive the proceeds of the issuance entirely upfront – as opposed to following the financing needs of the project over the construction phase (as bank finance typically does). Whilst this approach is still used, particularly for refinancing, many institutional investors now offer phased drawdowns, whereby they purchase bonds over the construction period, minimising the negative carry which may otherwise apply if project companies hold funds until required. This development has made project bonds increasingly competitive against bank finance.

B. Disclosure Requirements

Sponsors wishing to access the capital markets need to consider the disclosure requirements under international securities laws and regulations when structuring their financings. These requirements can apply to the initial issuance and throughout the life of the instrument.

An offering document will generally be required if the bonds are to be listed on a public exchange (as opposed to being a privately placed and unlisted offering). The exact scope of the disclosure to be made will depend on the specific exchange. In a limited recourse project, it is often the case that brief summaries of each project agreement will be required to be disclosed in the prospectus. It is worth remembering, however, that for many projects, such as those involving government concessions or contracts, information (including contract pricing) may already be in the public domain, and therefore its inclusion in the prospectus may be less of a concern for sponsors and for the relevant authority (although this is less common in Turkey). There are certain exchanges where very little disclosure is required to obtain a listing.

Continuing disclosure obligations will include both regulatory requirements which may apply to listed bonds, such as those under the Market Abuse regulations (and relevant implementing measures) on the publication of non-public, price-sensitive information, and other reporting requirements agreed in the contracts.

The trend for contractual reporting requirements in project bond transactions follows those in bank-financed deals, with detailed regular reports to be made available that will contain detailed financial reporting, including forward-looking projections. Against this backdrop, the regulatory disclosure requirements may not appear onerous, but it is the more public nature of the disclosure for listed bonds which requires careful navigation by project companies and sponsors.

Disclosure of adviser reports, and in particular the technical adviser reports, also requires careful consideration where a listing is sought.

C. Decision-making and Control

One perceived problem with a senior financing group dominated by bondholders is the difficulty in ensuring timely decision-making (and, given "insider information" concerns, effective preliminary dialogue), particularly during the construction period when restrictions imposed under standard covenant packages may require the project company to seek numerous consents and waivers.

The solution to this varies from project to project and is largely driven by the investor base for the project bonds.

On many projects, bonds issued are initially purchased by a handful of investors, all of which tend to be "buy and hold" investors which do not intend to trade the bonds in the ordinary course. On such transactions there tends to be a more direct line of communication with the investors, more akin to the relationship-based approach of bank lenders. On some transactions, sole investors appoint themselves as the "Bondholder Representative" and act very much like a bilateral lender.

On other projects, the bonds may attract a wider and diverse group of holders. Those holders may also have varying commercial interests, particularly in a distressed or underperforming project, where the original investors may have traded out of the bonds to be replaced with more opportunistic creditors.

For these situations, some progress has been made through a fresh approach to the somewhat lengthy meeting procedures that have long been a feature of English law Eurobond documentation. Previously, bondholder decisions needed to be taken at a full meeting of bondholders, which typically require a notice period of 21 clear days and a physical meeting. Documentation now allows for direct recognition of "electronic consents" delivered through the messaging systems of the relevant clearing systems, which also means reduced time periods can be combined with "snooze-lose" provisions and low quorum requirements, so that votes can pass even where a significant number of bondholders do not participate or vote within the relevant time period.

Another possibility, which has been seen in some Middle East projects, is to reduce the number of decisions required from bondholders by relaxing the covenant package and giving obligors more flexibility to run the project as they see fit. This approach is a move towards the more typical investment grade Eurobond terms, so may be acceptable to some bond investors but is unlikely to find great favour with the more experienced project bond investors, now used to extensive restrictive covenants.

Another possible method for streamlining the decision-making process is the appointment of an appropriately skilled third party (known as a Project Agent or Monitoring Adviser and who is not necessarily required to hold an economic stake in the transaction) to make certain determinations on behalf of creditors. However, the level of responsibility that such an entity will take on in relation to decision making varies from deal to deal and is likely to depend on the parties involved in the deal, including the number of bondholders and their level of experience in investing in similar transactions.

D. Ratings

Ratings can be key to the success of public project bonds as an investment grade rating can provide access to a broader investment base. For emerging markets, this can be a critical consideration as not all projects will be structured in a way that will result in an investment grade rating. Due to political and economic risks, external debt, and transfer and convertibility risks on foreign currency payments originating from within the country (for example, in Healthcare PPPs where it may be mitigated through currency hedging arrangements), Turkey has retained its investment grade rating with one or more of such rating agencies (principally, Moody's and Fitch). Given that sovereign ratings in some cases restrict national project ratings, the maintenance of such sovereign ratings at or above investment grade may expand the project bond market, and, equally, their decline can be expected to constrict international demand for such bonds. Some projects have also used credit enhancement in the form of subordinated credit or other guarantees, including those provided by the European Investment Bank, in order to improve debt ratings.

E. Turkish law considerations

1. Approvals

– ***Regulatory Approvals***

If a company aims to conduct a bond offering, either through a private placement or a public offering, it needs to obtain all of the required regulatory approvals (for example, the Capital Markets Board's (the "**CMB**") approval for the Turkish Offering Circular (*İzahname*) for public offerings in Turkey or an issuance certificate if there is to be no public offering.

– ***Corporate Approvals***

Under Turkish law, the power to approve a bond issuance lies with the general assembly of the issuer. The general assembly may delegate this power to the board of directors for up to 15 months. Alternatively, the board of directors may be indefinitely authorised by incorporating this authorisation into its articles of association.

2. Issuance Limits

There are certain gearing limits for the issuance of bonds under Turkish law. For non-public issuers, as is often the case under project bonds, the gearing limit is set at 3 (three) times equity. Generally, the issuance amounts required for projects in Turkey exceed this ratio. In response to this need in the market, the CMB introduced an exemption for Build-Operate-Transfer projects and projects guaranteed by the Undersecretariat of Treasury. However, there are other project structures, such as the Build-Lease-Operate Model in healthcare PPPs, and those run by the private sector alone, which do not benefit from this exemption.

– ***An offshore SPV***

To overcome the problem of gearing ratios, an offshore SPV option may be considered for those projects that do not fall under the exemptions mentioned above. However, the key factor is whether the SPV would be considered a financial institution. If so, it could benefit from certain tax exemptions (see below).

3. Security available to the Investors

Due to the potential for the investors in a project bond to change on the trading of bonds, for a public listed issuance it is key that a party can hold security on behalf of the changing group of bond investors. Under Turkish law, whilst it may be believed that laws are sufficient to allow an agent (e.g. security agent) to act on behalf of the investor there is no established case law that either explicitly confirms the validity of such an arrangement or that renders such arrangements invalid. Bond arrangers are likely to seek legal opinions to provide comfort on this point.

4. Tax[1]

The interest paid to investors in bonds issued outside Turkey by Turkish banks or companies is subject to withholding tax. There is no exception for project bonds, and such withholding tax is applied in accordance with the maturity of the bonds, as set out in the following table:

Maturity	Withholding Percentage
Less than one year	10%
One year to less than three years	7%
Three years to less than five years	3%
Five years and more	0%

Additionally, security documents may be subject to stamp tax in the amount of 0.948% of the aggregate amount stated in each security document as no explicit exemption is provided.

Where an offshore SPV issuer is used, and on the assumption that the SPV is considered as a financial institution, it may enjoy the benefits applicable to the loan financings, where the security documents are exempted from stamp tax. As to the withholding tax, the withholding taxes mentioned above will not apply but 1% withholding tax will be applicable on payments of interests on the loans to be extended from SPV (obtained from the bond proceeds) to the relevant project company.

F. Conclusion

Project bonds might offer a feasible alternative for financing Turkey's considerable infrastructure and energy needs. In particular, projects benefiting from governmental support may be considered as outstanding candidates for project bonds from a risk profile perspective and may pave the way for the development of the Turkish project bond market. Examples include: the infrastructure projects backed by the Undersecretariat of Treasury, the healthcare PPP projects with debt assumption by the Ministry of Health or green energy projects benefiting from the feed-in tariffs.

[1] This section is relevant for bonds issued outside Turkey.

Authors




David Bickerton
Partner

T: 44 207 006 2317
E: David.Bickerton
@CliffordChance.com

Clare Burgess
Partner

T: +44 207 006 1727
E: clare.burgess
@cliffordchance.com

Mete Yegin
Partner

T: +90 212 339 0012
E: mete.yegin
@yeginciftci.av.tr

Sait Eryılmaz
Senior Associate

T: +90 212 339 0060
E: sait.eryilmaz
@yeginciftci.av.tr