Capital Markets - Ib

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Distinguishing financial features of infrastructure projects

- Huge negotiations costs
- Long gestation
- Massive investment
- Restraint on charging economic user fees or unwillingness of users to pay the same
- Motive: spillover benefits over a long period
- Promoters/sponsors: Usually Central/State Governments/civic bodies/public corporations

Risks associated with infrastructure projects

- Cost and time overruns
- Overestimation of demand
- Political/Regulatory risks
- Exchange rate risk
- Environmental/ecological concerns

Why are traditional financing arrangements inadequate?

- Scale of investment and limited capacity of the domestic capital market
- Likely mismatch between the project's cash flow pattern and a conventional term loan with its maturity constraints
- Equity? The wait is too long and therefore the risk is high
- Pension funds, being long-term investors are an ideal answer; but, they are risk-averse
- **SOLUTION: Structured Financing Options**

Structured Financing Options

- Non-recourse project specific financing
- Zero-coupon or Deep Discount Bonds
- Infrastructure Equity Fund
- Two-stage financing
- Pension funds (with Bond Insurance)
- Supplier's credit
- Viability Gap Funding

Credit enhancement techniques to obtain better ratings

- Cash/Reserve Account (Escrow)
- Senior debt
- Financial Guaranty (Bond Insurance)
- Government budgetary support
- Over-collateralization through cash and other liquid assets or bank guarantees

Financial Guaranty

- An unconditional guarantee to pay interest and principal to bond holders as scheduled

Applications:

- To introduce new borrowers
- To facilitate the sale of longer-maturity instruments
- To reduce the cost of funds
- To access international markets

Financial Guaranty

	Without guaranty	With guaranty
Credit Rating	A	AAA
Maturity (years)	5	5
Issue size	$500 million	$500 million
Interest rate	17.50%	16.75%
Present Value (PV) of savings @ 18%		$11.73 million
Less: PV of insurance @0.5% of debt service		$(7.82) million
Net Savings		$3.91 million