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# Introduction to Infrastructure Bonds

*A bond is a debt instrument (an asset class) issued primarily by the government (at Federal, State and Local Government levels) and corporate entities to borrow money from the capital market at an agreed interest rate (coupon) and for a defined period (maturity). The borrower has an obligation to repay the principal and interest at specified time periods during the life of the bond. The entity that issues the bond is referred to as the issuer, while the investor that purchases the bond is known as the bondholder. Bonds are issued for a variety of reasons, including but not limited to, the financing of government budget deficit, business expansion of corporate establishments and the financing of infrastructure development initiatives. There are also a variety of bond types, however, this piece will focus on Infrastructure Bonds.*

**What is an Infrastructure Bond?**

A bond is mainly classified as an infrastructure bond (also called a project bond) if it meets all the following criteria[1]:

- Issued to finance a specific infrastructure project
- Capital raised from the bond is repaid from the cashflow generated by the project
- Bond assumes (and its performance is subject to) the specific risk associated with the project it finances
- Issued by a project operating company (typically a government parastatal, SPV or a corporate entity) with investment grade credit rating

The conventional Federal, State and Municipal Government bonds issued with some 'promise' to spend the money on outlined (or otherwise) infrastructure projects are generally not referred to as infrastructure bonds, since there may be no income stream/cash-flows associated with the underlying project/asset, and repayments to the bond holders are made directly from government tax revenues (often via a 'sinking fund'). Furthermore, there is no guarantee that the money raised will be channelled into the identified infrastructure projects as promised.

Infrastructure bonds therefore, are issued for and with the purpose of financing infrastructure projects for public utilisation. Typically, such bonds are issued by the government (or government authorised entities), corporates or an SPV, and tied to specific infrastructure project(s). The bonds are structured by financial advisers (on behalf of the issuer) and issued by an issuing house. Other transaction advisers to the bond issuance include the legal advisers and bond trustees, amongst others. Investors subscribe to the bond at a stipulated issue price, while the funds realised from the issue are deployed for the intended infrastructure project (for example, a toll road, sea port, power plant etc.). Upon the listing of the bond on an authorised securities exchange, investors can trade on the bonds at market determined prices.

Although infrastructure bonds are an emerging asset class in Africa, few examples are remarkable:

- **South Africa:** In 2013, a project-specific 15-year 11.0% coupon bond with a face value of 1 billion Rand was issued to finance 44 megawatts concentrated photo voltaic (CPV) plant, becoming the largest CPV plant in the world
- **Kenya:** The country's leading electricity generation company (with 70% public ownership), 'KenGen', issued a 10-year 15 billion Kenyan Shilling public infrastructure bond in 2009 (at a fixed rate of 12.5% per annum)
- **Ethiopia:** From 2011 through 2014, the Ethiopian Electric Power Corporation (a governmentowned power utility) raised approximately $5.8 million in a diaspora infrastructure bond issue of 5- to 10-year maturity, at a floating interest rate ranging from London Interbank Offered Rate (LIBOR) plus 1.25% to LIBOR plus 2.0% (to finance the Grand Ethiopian Renaissance Dam). The Dam is envisioned to be the largest hydroelectric power plant in Africa, with a generating capacity of 6,000 megawatts of electricity

[1] African Development Bank (2013). Structured Finance – Conditions for Infrastructure Project Bonds in African Markets. NEPAD Regional Integration and Trade Department.

### Characteristics of Infrastructure Bonds

- They are usually long-tenured, with maturities ranging from ten (10) to twenty (20) years
- They often come with credit guarantees (such as partial risk guarantee from the government) to de-risk the associated project(s)
- They are listed and traded on securities exchanges (such as the FMDQ OTC Securities Exchange)
- They often offer impressive yields that match the inherent risks of the associated projects
- They provide a reasonable safeguard to capital; hence investors explore investment in infrastructure bonds as a strategy to mitigate market risk

## What are the Benefits?

**To the Issuer**

Infrastructure bonds offer a potent funding alternative to address the infrastructure deficits across emerging economies. They have proved to be a veritable strategy for attracting private capital to the infrastructure space, following the de-risking of the infrastructure projects using government guarantees. Infrastructure bonds are a relatively cheaper, fixed and predictable source of long-term financing for specific infrastructure projects when compared to bank loans. They allow the issuer to borrow on an off-balance sheet basis since a project company (could be a parastatal) would typically be the primary obligor.

**To the Investor**

Infrastructure bonds offer relatively higher risk-adjusted yields, hence constituting an attractive investment alternative to portfolio investors and pension funds administrators. Long-tenured funds in the financial sector (particularly pension funds and insurance companies' funds) are attracted to infrastructure bonds, given that they are relatively cheap, and could be used to match longer term liabilities. The bonds are liquid, and may be traded freely on a securities exchange, hence, investors can exit the investment prior to maturity, at market determined prices. In most countries, investments in infrastructure bonds are tax deductible, offering impressive tax incentives to investors. Furthermore, investment decisions by fund managers are often easier as the project to be financed with the bond proceeds usually has a clear business case with detailed cashflow forecasts.

**To the Capital Market**

Infrastructure bonds contribute to deepening the debt capital market as they constitute an investable asset class for investors. They also enhance market liquidity especially through their attractiveness to pension funds administrators and insurance companies. Furthermore, infrastructure bonds bring more transparency to infrastructure investments, and to the Financial market as the underlying projects are usually professionally and transparently structured, and managed.

### What are the Risk Considerations?

Infrastructure bonds are not risk-free,however, theIr risk profiles are comparatively low when compared to corporate bonds. The major risk consideration for an infrastructure bond is the issuer's risk, that is, the credibility of the institution offering the bonds. Ideally, if an issuer is considered to have incompetent management, poor credit ratings, a history of failed infrastructure projects and poor corporate governance, bonds issued by such issuer are considered risky. To mitigate this risk, investors go for infrastructure bonds that are issued by institutions with investment grade credit ratings (such as AAA, AA+, AA, and AA- ratings).

Furthermore, infrastructure bonds are subject to inflation risk, that is, the risk that unforeseen inflation will undermine the value of a bond investment, which impacts on the real return on such investment. Other risk considerations include sector-specific risks (i.e. risks that are unique to some sectors of the economy) in which projects across some sectors, such as the construction sector, are generally perceived to be riskier as a result of high probability of technical failures, non-or delayed completion and cost-overruns, amongst others.

In conclusion, with the annual infrastructure funding gap for Africa estimated at US$90 billion3, infrastructure bonds offer a potentially effective funding alternative to address this deficit. For the Nigerian economy, it offers an innovative strategy that, if well-structured and harnessed, will stimulate the injection of private capital to the Nigerian infrastructure space and contribute immensely towards the development of the Nigerian DCM, even as it enhances market liquidity and offers an investible asset class (for example, for the pension fund administrators). Given the current strain in the nation's fiscal balances, Federal and State Governments, through the collaboration of key stakeholders and financial market infrastructures such as FMDQ, can explore this funding option to finance strategic infrastructure initiatives, thereby freeing up finances for other economic growth initiatives.