

Introduction to Infrastructure Bonds

A bond is a debt instrument issued by the Government (Federal, State and Local), Agencies, Corporate entities, Supra-nationals, amongst others, to borrow money from the capital market at an agreed interest rate (coupon) and for a defined period (maturity). A bond represents a long-term financial obligation of an entity. It is a fixed income investment in which an investor loans funds to the entity who borrows the funds for a defined period of time at a variable or fixed interest rate. 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, amongst others. This month's edition of FMDQ Learning will focus on Infrastructure bonds, its fundamentals, including its characteristics, benefits and risk considerations.

Definition of Infrastructure Bond

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

- 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

Infrastructure bonds, therefore, are issued for and with the purpose of financing infrastructure projects for public utilisation. Typically, 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, housing, road, sea port, power plant etc.). Upon the listing of the bond on an authorised Securities Exchange, such as FMDQ, investors can trade the bonds at market determined prices.

Characteristics of Infrastructure Bonds

- They are usually long-tenored, with maturities ranging from ten (10) to twenty (20) years
- They often come with credit guarantees (such as partial risk guarantee from the government or entities) to de-risk the associated project(s)
- They are listed and traded on Securities Exchanges (such as FMDQ)
- 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

Benefits of Infrastructure Bonds

- **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. Infrastructure bonds are a relatively cheaper, fixed and predictable source of long-term financing for specific infrastructure projects when compared to bank loans
- **Investor:** Infrastructure bonds offer relatively higher risk-adjusted yields, hence constituting an attractive investment alternative to portfolio investors and pension funds administrators. Long-tenored 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
- **Capital Market:** Infrastructure bonds contribute to deepening the DCM 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

Risk Considerations

Infrastructure bonds are not risk-free bonds, however, their risk profiles are comparatively low when compared to other 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. Investors therefore prefer to invest in 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) whereby projects across these 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 over-runs, amongst others.

Conclusion

Globally, infrastructure contributes to economic development by increasing productivity and providing amenities, which enhance quality of life and business as well as economic activities. The DCM provides a key avenue through which infrastructural growth can be sustained to promote economic development, and Nigeria has taken a cue from model markets such as the United States, United Kingdom and Malaysia, which have used the strength of their DCM to power growth, fund and set up viable infrastructure projects to support development for the good of their citizenry.

Given the current strain in the nation's fiscal balances, infrastructure bonds have offered a potentially effective funding alternative to address infrastructure deficits. FMDQ, in collaboration with market stakeholders, will remain steadfast in its commitment towards the development of the DCM, and provide the requisite platform to power infrastructure growth, thereby fostering the development of the Nigerian economy.

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