Interoceanica Norte real toll road

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The thriving Latin American market has just added a unique bond financing deal to its continental portfolio - the US$213 IIRSA Norte bond, issued to finance a road connecting the Peru coast with the Amazon region

The deal saw a number of international project finance institutions teaming up - Morgan Stanley, Astris Finance - as well as international law firms - Clifford Chance and Davis Polk & Wardwell. Impressive efforts were dedicated to coordinate the different legal systems involved and to present an attractive product to investors at the same time.

The result is a complicated transaction, which allows the concessionaire to get money upfront from the bond purchasers and to alleviate risk of repayment default to the minimum possible degree.

Rationale

The total cost of the 'Interoceanica Norte' real toll concession is US$220 million. The project consists of upgrading and construction works on a 960km toll road network in northern Peru.

The project is part of a wider infrastructure development strategy signed in 2000 by the twelve South American countries - the Initiative for Integration of Regional Infrastructure in South America (IIRSA), which aims to promote political and economic integration.

Within the agreement, the authorities responsible for transport, energy and telecommunications in South America are working together to implement a number of projects.

On the transport side, nine road corridors across the continent. IIRSA receives support from the Andean Development Corporation (CAF) and the Inter-American Development Bank (IADB).

Construction of the Interoceanica Norte has begun in April 2006. The existing motorway connects the Pacific port of Paita and Yurimaguas, a port on the Amazon river. The project was aimed at fostering trade between Peru and Brazil.

The road is divided in six tranches, and work will be split in two stages:

- Yurimaguas-Tarapoto and Olmos-Piura-Paita stretches
- Tarapoto-Rioja, Rioja-Corral Quemado and Corral Quemado-Olmos stretches

The contract was awarded by the government of Peru in June 2005. The consortium that won the 25-year concession comprised:

- Constructora Norberto Odebrecht - with a 17.43 per cent stake in the project company
- Odebrecht Invesimientos em Enfra-Estructura - 32.37 per cent
- Constructora Andrade Gutierrez - 40 per cent
- Grana y Montero - 10.2 per cent

Out of 960km, the concessionaire will build almost 120km of road from scratch, and the remainder work will involve refurbishment of the existing facilities. The concession involves operation and maintenance of the full road as well.

Even though the sponsors are responsible for collecting tolls, the tolls are for the account of the government and the sponsors will also benefit from a share of the revenues once they exceed a certain threshold.

Financing

Astris Finance – financial adviser branch of Dexia bank – was appointed to elaborate a financing strategy by the consortium.

Juan Pablo Crane, of the Astris Finance team in Washington, says: initially we thought about a disbursement structure that contemplated staggered draws to match the construction schedule requirements.'

'It became clear that this would not have been cost-efficient and instead we with Morgan Stanley structured a mechanism to reduce negative carry while raising all project funds upfront.'

Under the concession contract the concessionaire would benefit from:

- Irrevocable payments by the government to compensate construction once works have been accepted
- payments to compensate toll operation and maintenance
- a share of toll revenues (when tolls collected exceed the previous two payments)

With a three year construction schedule, the negative carry of a bond issue would therefore have been significantly high. Astris Finance and Morgan Stanley structured a credit link note that yields a higher rate than regular permitted investments to minimize negative carry and securitized the construction payments with a bond issue. 'Under the structure we isolated construction risk as well as operating risk for the investors', Crane added.

Subsequently, the government agreed to issue payment certificates upon completion of milestones of work. These certificates represent one of the key features in the financing structure. They are called CRPAOs - Certificados de Reconocimiento de Derechos del Pago Anual por Obras - and, most importantly, they are issued in US dollars and under New York law.

As the government accepts works from the concessionaire, the government issues the CRPAO certificates and hands them to the company. The payments under these certificates come from the Peru ministry of transportation and the CRPAOs are sold as a Peru government obligation. Once generated, they are not subject to any condition or performance obligation relating to the concession agreement.

The proceeds of these certificates are used to pay the CRPAO holder which in turn pays noteholders. Through this structure, the works progress certificates should reflect the compensation for the amounts spent on construction.

CRPAOs are sold by the concessionaire and owned by a special finance vehicle - based in Delaware - that acts between the Peru government and the bond issuer to buy the certificates. This Delaware company is owned by two companies based in the Cayman Islands, one of which is the legal issuer of the notes

A CRPAOs purchase agreement regulates this purchase. The indenture agreement regulates disbursement from the CRPAOs purchaser and the bond issuer.

As a result, the financing for construction comes from the bondholders up-front. However, the concessionaire does not benefit from it until it delivers partial works and these are accepted by the Peruvian government. Until then, the money is kept in a frozen account in New York.

Once partial works are accepted, proceeds of the bond issue flow from the account to the concessionaire, and bondholders are gradually repaid by the proceedings of the CRPAOs issue.

Construction of the road and the issuance of corresponding CRPAO obligations are expected to occur in monthly segments over a 2-3 year construction period.

Had the proceeds been held in standard trust accounts this structure would produce significant negative carry for the Sponsors (as returns from these accounts would be significantly lower than the accretion of the Senior Notes).

Morgan Stanley designed and underwrote a credit-linked note, tied to the credit of the Peruvian sovereign, in order to enhance the yield on cash held in trust and minimize the Sponsors' negative carry.

Christian Asmar, at Morgan Stanley in New York, said: 'the credit-linked note was a key structural component of the deal.'

'Our thesis was that since the Sponsors are effectively paying for sovereign risk during the accretion period, they should earn returns commensurate with that risk profile.' Asmar adds, 'the credit linked note is the mechanism which allows them to earn this return efficiently while tailoring disbursements to exactly match their construction schedule'.

Once development milestones are reached, proceeds of the bond issue flow from the account to the concessionaire, and bondholders are gradually repaid by the proceedings of the CRPAOs issue. Furthermore, a letter of credit of US$60 million, provided by the IADB, supports the government's obligations to the project.

In case of surplus revenues, these are split 80 per cent government and 20 per cent concessionaire. The sponsors are also providing:

- construction performance bond of $10 million
- concession agreement performance bond of $10 million

The bond instrument

The deal priced on 5 August and closed on 11 August. The bonds have a maturity of 2024 and priced at 8.75 per cent - which is equivalent to 350bp over the 2025 treasury, roughly 50bp more than the cost of a 10-year credit default swap for the Peruvian sovereign.

The issue had a rating of BB/BB/Ba2 (S&P/Fitch/Moody's), the same as the sovereign's ceiling with the exception of Moody's, which has Peru at Ba3. The issue was split in two tranches - one to be traded under the 144A rule and one under the REGS rule.

Legal framework

The project and especially the bond instrument are regulated under different legal system. This allows maximum premium, as every part of the project was implemented in the most suitable legal environment.

The sponsors' legal counsel was Clifford Chance (international) and Roselló Abogados (local). The underwriter's legal counsel were Davis Polk & Wardwell (international) and Rubio (local).

Stephen Hood at Clifford Chance in Sao Paulo said: 'This a complex project, with a very well designed structure. The bond offer is under the New York state law, and the concession agreement is under the Peruvian law.

'With the local law firms, we had to make sure that the CRPAOs - which were governed by New York law - were also enforceable under the Peruvian law, as federal government obligations, ' he adds.

'However, we had to organise the sale of the CRPAOs to the purchaser company as a legally transparent one. We saw that there were more established precedents in the English law for this type of sales.

'English courts have ruled have been more consistent with these transactions. The CRPAOs are then governed under New York laws, but their sale was put under English laws.

'Through this manoeuvre, we could make sure that this can be considered like a common international securitisation.'

Conclusion

Because construction has started in April, the CRPAOs have already generated around US$28 million. Construction is expected to finish in the first quarter of 2009 - throughout this period, the certificates will be issued and will generate around US$460 million in two phases:

- Phase 1 eliglible CRPAOs - beginning to pay in October 2008
- Phase 2 eligible CRPAOs - beginning to pay in November 2009

Both issues will pay semi-annually in April and October, generating US$30m per year.

Investors are participating in a high-yield transaction, and much effort was dedicated to isolate the risk for them.

Delays are not expected to prejudice noteholders, but they will have a negative effect on the sponsors. If the maximum allowed delay is reached, the CRPAOs are no longer produced and the credit-linked note will back the bonds.

Shortfalls from the usage of the road would be financed collectively by:

- credit-linked note
- IADB letter of credit
- existing CRPAOs
- cash available in collateral accounts

Inflation and currency risk are avoided by as the issue of the CRPAOs in dollars.

Although there are some similar precedents transactions in Europe, this is the first of its kind in South America. This deal could represent a milestone in the bond financing sector, as well as being one of the first pure PPP projects in Peru.

The project at a glance

Project Name	IIRSA Norte
Location	northern Peru
Description	upgrade and construction of Pacific of a 960km motorway linking the port of Paita on the Pacific with Yurimaguas, a port on the Amazon river
Sponsors	IIRSA Norte consortium - Constructora Norberto Odebrecht, Odebrecht Invesimientos em Enfra-Estructura, Constructora Andrade Gutierrez, Grana y Montero
Operator	IIRSA Norte consortium
Project Duration (Including construction)	25 years
Construction Stage	construction started in April 2006
Total Project Value	US$220 million
Bond Issue	US$213 million
Name	IIRSA NORTE FIN
Maturity date	30/05/2024
Coupon	8.75 per cent
Currency	USD
Trading rule - first tranche	144A - NYSE
Trading rule - second tranche	REGS
Backing intruments	CRPAOs - Certificados de Reconocimiento de Derechos del Pago Anual por Obras - issued by the Peru government IADB letter of credit Morgan Stanley credit-linked note
Participant banks	Morgan Stanley
Financial Adviser to sponsor	Astris Finance
Legal adviser to sponsor	Clifford Chance (international), Rubello (local)
Legal adviser to underwiter	Davis Polk & Wardwell (international), Rubio (local)

Date of close	11 August 2006