Bond Case Briefs

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Do Bonds and EB-5 Investment Go Together?

EB-5 is a growing and acceptable financing methodology as part of the capital stack in many U.S. projects, with real estate assets remaining the primary focus for investment of such capital. As other projects seek to take advantage of this opportunity to attract capital, the question arises as to whether government bond financed projects are suitable investments for EB-5 capital. In a typical structure, the EB-5 investor invests in a specially formed entity that, in turn, buys the governmental entity's bonds; the bonds finance an eligible project and the investor's money is traced to project costs. Of course, the risk of loss as a result of a default on the bonds also flows through to the EB-5 investor.

EB-5 investment in bonds related to government infrastructure projects can be a suitable investment; however, as with any investment, proper due diligence is a necessity. While the risks and benefits of an investment in a bond financed project must be evaluated on a project by project basis, there are some general principles of due diligence that apply to analysis of these investments.

The time period over which the EB-5 investor to receive the full return of his/her EB-5 investment should be a critical part of any evaluation, as bond related investments tend to be long-term, and the risk profile of a long-term obligation is different from a 5 year investment that is typical investment time frame for an EB-5 investment.

Generally speaking, the higher the quality of the bond investment, the lower the yield offered to investors. Inversely, a low quality bond product must offer a higher rate of return to an investor as an incentive to attract such investor. If there's any doubt about the ability of the bond issuer to pay off an investor on time, a high yield offering could be a poor choice as the risk of getting repaid on your investment is greater. Investors with a low risk tolerance should stick with high quality bonds even though the lower yield may be less attractive to an individual investor.

How do we tell if a bond is a high quality bond? One tool for evaluation of quality is a credit rating provided by independent institutions, or "rating agencies," such as Moody's, Fitch and Standard & Poor's. A triple A (AAA) bond is the highest rating. BBB/Baa is the lowest rating that qualifies for commercial bank investments and this rating on a bond makes it a borderline group for which, in Standard & Poor's words, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to repay the investor. Dipping below BBB/Baa ratings takes you into speculative territory. Because of their higher risk of default, such bonds must pay higher yields to attract an investor BUT "high yield" is the marketing name for what most people call junk bonds.

The fact that the bond is issued by a government entity, in and of itself, is not determinative in the analysis whether a bond investment is a suitable investment for an EB-5 investor. Foreign investors should not fool themselves into believing that an investment in a government intrinsically safer and less risky than an investment in a privately sponsored vehicle just because of the involvement of a government entity. Rather, an investor should investigate how the government is involved in the project. Is the governmental entity merely a conduit issuer of a privately owned and operated facility? Or are they providing actual financial support, either directly in the form of a payment guaranty or pledge of tax or other revenues, or indirectly through tax abatements or other subsidies?

In summary, here are a few factors an EB-5 investor should look at when evaluating the risk of any government bond investment:

1. Financial condition of the issuer of the bonds. The financial statements of the bond issuer should be evaluated carefully, in much the same way as one would review those of a private entity. Financial reporting rules and accounting principles differ for governmental entities, so particular care should be taken in the evaluation of these materials by someone who knows the rules for government accounting in the United States. The stronger the balance sheet, the greater the likelihood that the investor will receive the benefit of what is being bargained for.
2. Credit rating of the Bond. This is how the rating agency rates the strength and risk level of the investment. A triple A bond (AAA) designates a strong likelihood of repayment. Anything below that has a higher degree of risk, often offset by enticing the investor with a higher coupon rate. A bond rating of A- or lower should cause concern and the lower the rating, the higher the risk.
3. Historical track record of repayment of prior bonds.
4. Level and nature of governmental issuer involvement and financial support or subsidization of the project.
5. Length of investment. A typical bond term may be 20 years or longer. A typical EB-5 investment is approximately 5 years. Does it make sense to have principal tied up for that many years or is the investor better off getting its principal back sooner to reinvest how the investor thinks best? This is a question that can only be answered by the risk tolerance of the investor but suffice it to say, a long term investment of capital is not optimal for every investor.

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