Market Insight

Infrastructure Debt Capital Markets: A Progress Scorecard

London 16 April 2014, by Iain Barbour

Some observers bemoan the lack of debt capital available to support the construction of infrastructure, yet others champion the depth of liquidity across the private sector. We examine the state of play, challenging the belief that debt capital availability is constrained.

Introduction

The European infrastructure debt market has shifted considerably through the last seven years. Prior to the credit crisis, transactions were funded primarily by either bank debt or monoline wrapped bonds. Following the credit crisis, the economics and viability of these sources were challenged: monoline guaranteed bonds became less attractive to investors and more expensive for borrowers following the loss of their coveted triple-A ratings; the cost of bank capital associated with long-term, lower-rated loans escalated dramatically causing many banks to exit the market altogether and the costs associated with borrowing from those that remain to rise. In the face of this storm, new infrastructure funding stalled.

Over the last 12-18 months, long-term lending has re-emerged in the form of both bank loans and bond finance. Several major banks make long-term loans available on a cross-border basis, whilst others selectively fund infrastructure in their domestic markets. This paper evaluates progress achieved towards creating an efficient and effective debt capital markets solution for funding infrastructure projects.

The market has made significant strides towards matching the needs of institutional investors looking for longer-dated investment assets with borrowers seeking long-term finance. These institutional investors have, in many instances, adapted their 'product' to embrace loan-like features whilst borrowers have begun to embrace the notion that institutional investors are a more natural provider of long-term debt and that their take-and-hold strategy can provide long-term benefits. Against a backdrop of renewed credit appetite for the sector, we at Bishopsfield Capital Partners believe it is important for these positive steps taken through recent times to be sustained.

Project Bond Structures

Institutional bond finance has re-emerged in several forms; these include fixed-rate and index-linked bonds in both unenhanced form as well as credit-enhanced, structured bonds. In the following table we summarise the key structures used thus far:

Table 1: European Infrastructure Project Bond Structures

Debt Structure	Example	Summary Characteristics	Monitoring arrangement
PBCE Structure	Watercraft Capital SA (Castor UGS)	EIB provides credit enhancement to senior debt bought by investors	Monitoring Adviser services provided by Bishopsfield Capital Partners ("BCP") on the Watercraft Capital bonds
Wrapped bond	Holyrood Student Accommodation plc	Financial guarantor guarantees scheduled debt service on bonds bought by investors	Financial Guarantor is controlling creditor and therefore monitors the transaction
Credit enhanced bond	FHW Dalmore (Salford Pendleton Social Housing) Limited	Bank / investor provides direct or indirect credit enhancement for senior debt bought by investors. Examples include the Pebble & Commute structures	Servicer appointed
Project Bond	UPP Bond Issuer No. 1 PLC ("UPP")	Bond financing of an asset portfolio / project funded by investors	BCP provide Monitoring Adviser services on the UPP bonds
Project Bond + Loan	Scot Roads Partnership Finance Ltd ("SRP")	Bond financing of a specific asset (or group of assets), purchased by investors; pari passu loan provided by banks (potentially including the EIB)	BCP provide Monitoring Adviser services on the SRP bonds
Government guarantee	Merseylink (Issuer) plc (Mersey Gateway)	Bond financing of a project guaranteed by The Lords Commissioners of Her Majesty's Treasury ("HMT")	Each class of funders undertakes its own monitoring (including HMT)

Just as the underlying assets financed through project bonds are different (whether in construction and / or operations and ranging from accommodation based assets to roads and wind farms), so are the financing structures. Even where the above structures are used on other projects, important differences emerge in the specific transaction structures and features for those assets, although we observe that bond pricing does not necessarily reflect the range of credit and structural risks.

Status Report

If we review progress of the broader capital markets finance market against the questions posed in the European Commission's consultation regarding the Europe 2020 Project Bond Initiative[1] we can assess how far the market has evolved. We revisit the original questions, refresh them to apply more broadly than solely to the EU Project Bond initiative, and pose some further questions.

1. *What asset classes work for project bonds?*

Since the start of 2013 project bonds have financed many asset classes including roads, hospitals, accommodation (social housing and student), gas storage, and Offshore Transmission Owner ("OFTO") assets. The project assets have primarily been operational, but, more recently, include assets in construction. Some speculate that certain assets are too novel or complex to be financed through the capital markets; they highlight renewables as one such example.

On the BCP Scorecard, we award the market "B" for effort and "B" for achievement, emphasising that the capital

Effort:	**B**
Achievement:	**B**

[1] http://ec.europa.eu/economy_finance/articles/consultation/europe_2020_en.htm

markets have demonstrated flexibility through an innovative approach by presenting financing solutions that accommodate investors' needs whilst affording efficient and effective debt to borrowers; there is some distance still to go however for the capital markets to be recognised as 'open' for all infrastructure project finance opportunities.

2. *Can construction be financed through a project bond?*

It is evident that institutional investors have become more flexible; historically, challenges frequently levelled at the project bond model included the cost of carry for pre-funded construction contracts. In the original wrapped bond model, the structure was typically fully funded at financial close with surplus funds deposited in guaranteed investment contracts; whilst the associated negative carry was an economic drain on the structure, it was not significant enough to make the structure uncompetitive.

Several projects featuring construction have now been successfully bond funded using new funding models.

By way of example, the recently closed Scot Roads Partnership transaction minimised the impact of negative carry through the introduction of forward purchase bonds and streamlined inter-creditor communication by introducing a monitoring adviser role. These are examples of bond market innovation to meet the practical challenges of construction and other risks.

Against the BCP Scorecard, we award the market "B" for effort and "A" for achievement. Whilst the structures to facilitate construction risk financing have been developed many market participants have yet to engage.

Effort:	**B**
Achievement:	**A**

3. *Have project bonds thus far attracted a broader range of institutional investors to the sector?*

The investor universe has expanded significantly and many observers claim that it is not a lack of available liquidity that currently constrains the market, but rather a limited project pipeline. We observe:

- Private placement institutional investors and investment managers willing to invest up to around €300 million directly in projects with the investment typically in listed bond form
- Public bond institutional investors and investment managers; these investors will typically invest primarily in listed public bonds and subject to maximum holdings (frequently circa 10%)
- Institutional investors and investment managers offering bespoke, unlisted, loan-style facilities

The investments may be made directly, or through an investment management entity. Managed investment brings a broader range of investors to the market, including, potentially, private client investors. We also see certain institutional investors co-investing alongside traditional bank lenders or EIB.

Against the BCP Scorecard, we award the market "A" for effort and "A" for achievement.

Effort:	**A**
Achievement:	**A**

4. *Is there a role for credit enhancement in facilitating the conclusion of financing packages?*

Several credit enhanced structures have come to the market. These include three EIB enhanced project bonds, a few other subordinated credit structures, several

monoline wrapped transactions and one public transaction using the UK Government guarantee scheme.

The range of structural solutions highlights that the optimal 'enhanced' structure has yet to be defined. Many observers argue that enhancement should be reserved for more credit 'intensive' assets such as renewables, construction projects and those from more challenging geographical locations. We believe that the value should be defined in multiple ways:

- *Investor access*; the EIB PBCE structure has demonstrated provision of broader investor access: Watercraft Capital was reported as being widely distributed to institutional investors. The wrapped solution has been targeted to, we understand, selected institutions where the financial guarantor's higher credit ratings are valued, increasing market penetration.

- *Improved economics*; the results relative to this benchmark are more opaque; we, however, would not expect the value of enhancement to be defined solely through economic savings.

- *Efficient execution*; we believe that enhancement does improve execution certainty due primarily to the greater investor access afforded through higher credit ratings.

Effort:	**A**
Achievement:	**B**

Against the BCP Scorecard, we award the market "A" for effort and "B" for achievement. The jury is still out regarding the role that enhancement plays in this market; if, however, we allowed ourselves a "B+" score the market would probably achieve this here, recognising the role that enhancement structures have played in creating confidence in capital market financing solutions.

5. *What project bond credit ratings are sufficient to attract investors?*

Some investors, especially those participating in the public bond markets, will buy in larger ticket sizes the higher the rating, reflecting various factors including risk appetite, underlying client mandates and capital charges.

Historically there was a view that if a bond wasn't credit-rated at least single-A then it could not be sold into the debt capital markets. Recent transactions show that this is not the case; investors will buy bonds rated triple-B. Many investors observe that the risk / reward dynamic is optimal for project finance debt rated triple-B at financial close due to the rating uplift potential as the project migrates from construction to operations. We note that such rating migration is most evident under the Moody's methodology.

Effort:	**A**
Achievement:	**A**

We award (or should we say rate!) the market "A" for effort and "A" for achievement.

6. *What is the impact of different initiatives on maturities and price?*

The bank-loan project finance market has in recent years offered a greater availability in short- to medium-term financing arrangements. The higher liquidity premiums imposed on banks for longer-dated structures pushed financing costs higher for such debt structures making them less competitive. There are reports of an increasing number of banks re-entering 20-plus year senior debt lending at competitive pricing levels as bank funding costs fall.

The debt capital markets offer match-funded solutions for borrowers. The all-in pricing now competes with bank loan pricing, and, in the

more liquid markets, offers a more economic all-in cost after taking into account the cost of interest rate hedging of floating rate bank loans.

With long-term fixed rate coupons remaining at historically low levels, the attraction of locking in borrowing costs for the project term has become compelling for many. Secondary fixed-rate spreads for operating infrastructure assets (carrying strong triple-B ratings or low single-A ratings) are presently evident in the range of 130 to 150 basis points over gilts[2]. We would expect primary spreads for a triple-B rated investment to price at spreads of about 200 basis points over the relevant gilt for the more complex funding structures, with construction involved.

Debt supporting operating infrastructure assets with less sensitivity to specific concession lifespans has evidenced extending maturities of up to 50 years.

Effort:	**A**
Achievement:	**A**

Given the evident success on both maturities and pricing, we award the market "A" for effort and "A" for achievement.

7. *How is investor decision-making managed on the different project finance structures?*

Certain standards are evolving for investor decision-making and also surveillance. We believe the standards are best judged against investors' and borrowers' expectations.

Investors tell us that, whilst they do not generally have the resources to manage matters that are less material, they do seek:

- Regular periodic reporting and compliance certification
- Transparency relative to asset and transaction performance
- Escalated monitoring rights if a transaction under-performs materially
- A right to be heard and participate in material creditor decision-making
- Control over the appointment and scope of monitoring services
- A clear framework to protect them from inadvertently becoming an "insider"

Borrowers' expectations are also increasingly clear:

- Certainty of a decision outcome within specific timescales
- Filtering of sensitive, proprietary information from general disclosure
- Consistent creditor dialogue with a relationship point-person
- An informed counterparty representing the creditors

All of these features can be delivered through a tried and tested monitoring services model. Given the focus on surveillance, just how important is this aspect to a project bond? This may be best understood by illustrating examples of the surveillance and decision making required for a typical project bond through construction and operations:

Construction:

- *Project status reporting*; this entails receiving detailed status reports on all aspects of the construction programme from technical advisers. These (typically monthly) reports need to be reviewed; matters arising may need to be discussed with relevant parties. This is a critical creditor protection in relation to

[2] Source: RBC Monthly Corporate DCM Pricing Update dated 3 April 2014

construction milestones, funding shortfall tests and longstop date monitoring.

- *Cash disbursement control*; significant payments to key parties need to be monitored against the project plan to ensure that funds are disbursed for legitimate purposes in relation to works performed.
- *Forward funding commitments*; if funds are drawn progressively through construction then conditions precedent will need to be satisfied prior to such drawings.

Operations:

- *Maintenance programme management*; key to protecting the value of the asset will be a consistent, considered and robustly implemented and monitored maintenance programme.
- *Reserve account management*; a typical transaction will involve building reserves for maintenance and other anticipated matters over time; expenditure from these accounts needs to be controlled to ensure that funds are used for the intended purpose.

Both construction and operations:

- *Waiver, consent and variation decision-making;*
  - *During construction;* a detailed and extensive controls matrix is likely to be defined. Controls will range from notifications that events / milestones are achieved (these require review by creditors) whilst others will require explicit creditor consents or determinations.
  - *During operations*; experience dictates that consents and waivers, when they occur, will often be material. We anticipate that the volume of creditor interaction will be cyclical with peaks recorded during the first few years following construction completion (as operational teething issues are resolved), mid-lifecycle (when the initial full maintenance programme is due) and towards the end of the financing life including, if applicable, hand-back requirements.
- *Key party changes*; if a key party needs to be replaced then analysis of the potential service providers will be needed and the termination / appointment process must be managed.
- *Covenant compliance*; financial and other covenant compliance is no less important post-construction as it is during construction. Regular reporting will be available and must be reviewed, validated and any issues arising must be resolved.

During both construction and operations, it is important to inspect the asset providing security and responsible for generating the cash flows that will cover debt service. It is also essential to meet regularly with those responsible for delivering the project to its end-client / customers. However, most projects (and, indeed management teams) find it challenging to manage visits from multiple parties and therefore a coordinated approach between creditors is essential.

Effort:	**B**
Achievement:	**B**

Against the BCP Scorecard, we award the market "B" for effort and "B" for achievement reflecting that the jury is still out on which monitoring model offers the optimal communication mechanism and control between borrower and lender. We believe that whilst each model has merit, it is critical to deliver to borrowers and investors a more robust and efficient decision making process for when (not if) a borrower needs to engage its creditors. Whilst provision of creditor

monitoring services inevitably carries some upfront costs, in the long run this will lead to smoother decision making which in turn will save the borrower both costs and time. The cost of getting this right more than offsets the cost to all stakeholders of a dysfunctioning project.

Conclusion

Turning back to our scorecard, there has been real progress with the introduction of institutional investors as providers of long-term debt for infrastructure.

Effort:	**A**
Achievement:	**B**

We award an "A" for effort recognising that, eighteen months ago, there was much talk about institutional investors and infrastructure debt finance. Today there are multiple examples where institutional investors provide such finance; as we have highlighted, there is still work to be done before institutional investor finance can be regarded as a project financing solution of choice; hence the score of "B" for achievement.

Looking forward, we hope that, with some banks re-entering the project finance lending market, this does not see the significant progress made in introducing institutional investors to infrastructure debt reversed. We remain confident that the debt markets have turned a corner and some of these new funding models are here to stay. We encourage institutional investors to continue to expand their geographic and asset-type horizons: there are many markets still searching for and which can benefit from their long-term funding appetite.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you

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