Market Insight

BISHOPSFIELD CAPITAL PARTNERS

Can project debt be made accessible for institutional investors?

London 29 July 2014, by Iain Barbour

This is a somewhat different type of Market Insight than you are used to. Rather than analysing a market development, we share with you some of our conclusions from the borrower and investor feedback we received in relation to our Project Finance Monitoring Advisory business. We examine why maintaining a transparent, efficient and effective reporting and decision-making framework is increasingly seen to be fundamental to balancing the needs of investors and borrowers.

Introduction

The financing of an infrastructure project requires the creation of a covenanted structure that provides the borrower the scope within which to operate in an efficient and effective manner, whilst affording creditors sufficient control to promote debt service coverage and covenant compliance through the transaction life. It is achieving the balance between the borrower's aspirations for flexibility and the lenders desire for control that creates the perennial challenge.

With Monitoring Advisory we have introduced a sustainable solution, promoting a credible working relationship between borrowers and investors designed to ensure that the institutional investor marketplace can interact with borrowers as effectively as bank lenders do. In this regard we emphasise that a different approach is required given that a borrower is unlikely to know the identity of all (or at least some of) its institutional debt investors and these same investors will have different levels of experience and market knowledge. So what do investors and borrowers actually look for?

Investors tell us that they seek:

- Transparency relative to asset and transaction performance, evidenced through clear and regular reporting
- A right to be heard and participate in material creditor decision-making
- A clear framework to protect them from inadvertently becoming an "insider"
- Sensible covenants sensitive to transaction performance affording greater control in the event of under-performance

Borrowers' expectations are also increasingly clear:

- The right to manage the project without undue creditor interference

- Filtering of sensitive, proprietary information from general disclosure
- Informed creditor(s) with whom to discuss any matters arising where covenant flexibility may be required

Effective reporting structure

A project finance transaction is a hybrid between a corporate and asset-backed financing; it is typically non-recourse whereby cash flows generated by an asset(s) are used to service defined debt obligations. The debt is secured on the project contracts and the underlying physical assets.

A clear covenant structure will be created. This, when combined with clear reporting, robust monitoring and clear creditor rights, affords investors and lenders a protective environment, whilst engendering an operating framework within which the borrower can manage the project.

So what should such reporting encompass? We advocate that reports should be regular, concise and present a clear summary of the project status. The reporting should be two tiered. Firstly, there should be concise, summarised reports available to all investors, and secondly there should be those that are reviewed by a specialist creditor representative.

The summary investor reports should focus on exception reporting enabling investors to identify where a project is challenged and more sensitive to under-performance. The reports should clearly identify:

- Project and transaction parties, identifying any changes
- Ratio performance, clearly benchmarking the ratio outputs against prescribed minimum and target criteria
- A project summary, describing progress against key milestones and budget
- A risk summary, highlighting the project status against identified risk categories
- Covenant compliance, benefiting from affirmative and unambiguous statements

We recommend that such reports are delivered at least annually for operational projects and more frequently (at least semi-annually) for projects in construction. We also believe that, to the extent certain triggers are breached on the transaction, more frequent reporting should be required.

The second, more detailed, reports reviewed by a specialist creditor representative, will encompass technical reports (typically prepared by engineers and other specialists), management accounts and project budgets.

All reporting needs to be reviewed against expectations and forecasts. The transaction will benefit from a complex, audited financial model against which project progress can be reviewed. On a bilateral lending arrangement, a lender will typically have the resources and competence to receive and analyse all of the information available. However for multi-creditor structures the depth of resources, range of knowledge and understanding will likely vary significantly.

Information needs

We advocate that the reporting should be covenanted, with obligations imposed on borrowers and rights for creditors not only for under-performance but also for failure to deliver reporting in the manner required. So what are the types of information 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 and matters arising may need to be discussed with relevant parties.

- 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.
- Forward purchase 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 likely 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 programmes are due) and towards the end of the financing life.
- Key party changes; if a key party needs to be replaced then analysis will need to be conducted of potential service providers and the termination / appointment process managed.
- Covenant compliance; compliance is no less important post-construction as during construction. Regular reports will be available and need to be reviewed, validated and any matters arising discussed.

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

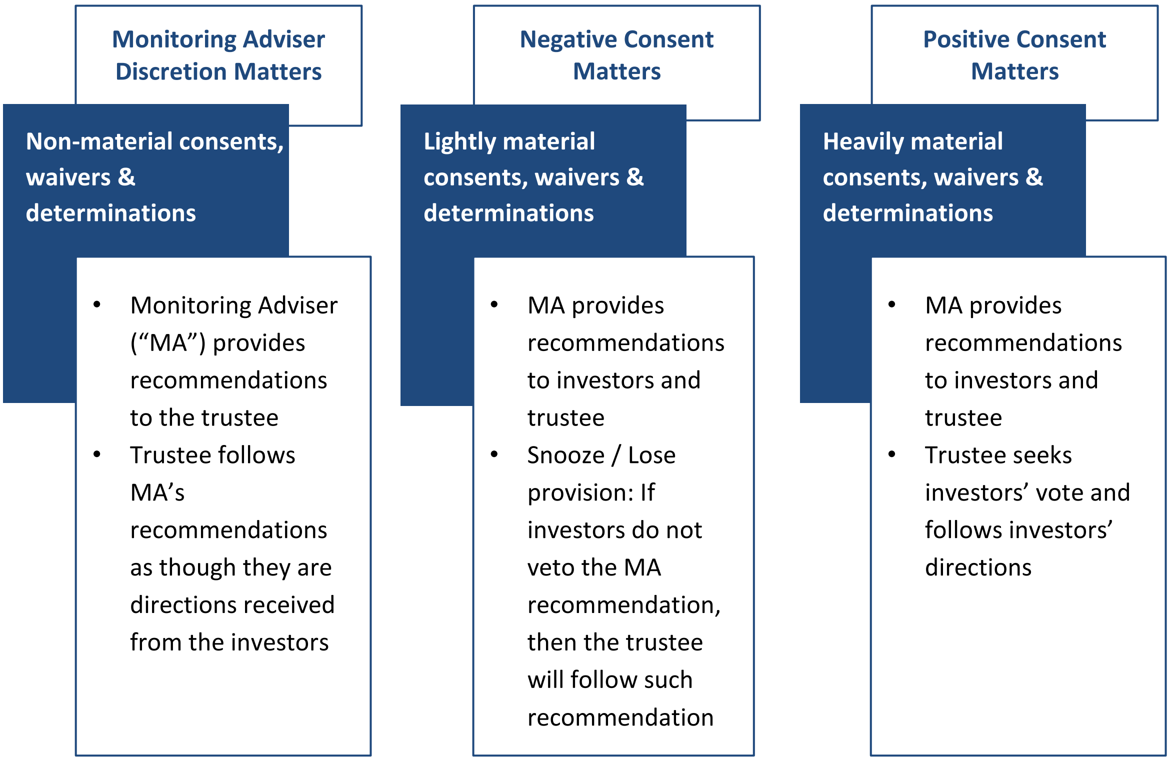
Investor decision-making

It is evident that the surveilling and monitoring project finance transactions requires dedication and a level of resource not typical in many debt capital market sectors. Furthermore, maintaining the staff possessing sufficient familiarity with not only the transaction in question, but also other comparable reference transactions is essential if consistent and timely decisions are to be forthcoming from creditors.

This leaves borrowers with a stark decision: enter into a financing structure with few covenants and contemplating limited creditor interaction or embrace a harmonised creditor decision-making framework. Fear of ineffective and uninformed creditor communication may steer borrowers towards the perceived simplicity of the former approach. A novel service has been developed and implemented that addresses these fears; it is simple, cost effective, creating a communication conduit with creditors to complement an efficient and well-managed project.

This service encompasses the dedicated and specialist provision of ongoing monitoring and surveillance for project finance transactions on behalf of all creditors. This is complemented by a multi-tiered investor decision-making model that ensures that the monitoring adviser (as a creditor representative) can interact with the borrower whilst respecting creditor wishes. Figure 1 illustrates the three typical decision-making categories advocated for heavily covenanted debt securities, although we note that there should always be a further layer added for entrenched, extraordinary voting matters.

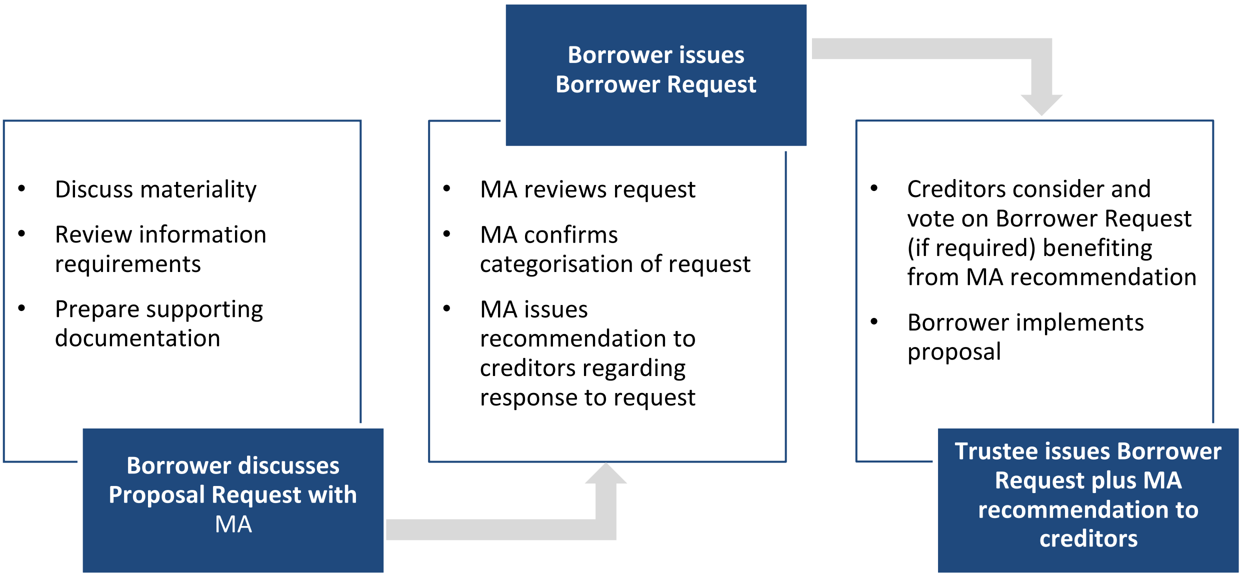
Figure 1: Decision-Making Categories



The multi-tiered approach ensures that more operational / administrative matters that do not, in themselves, present material credit considerations can be managed efficiently. The approach also offers flexibility: for creditors looking for greater involvement and control, the Discretion Matters category can be dropped ensuring that creditors maintain the option to express a view on all matters regardless of their materiality but still benefiting from an independent monitoring party's advice.

In Figure 2 we illustrate the Bishopsfield Capital Partners' ("BCP") decision-making process.

Figure 2: Decision-Making Process



Key tenets to this process are:

- Certainty of a decision within a prescribed timeframe (a maximum of 25 business days is required, but the agreed timetable for a specific decision will typically be significantly shorter)
- Formative interaction with a single, informed creditor representative; this should streamline the process and ensure that the consent request is presented in a creditor-friendly manner

Institutional investors tell us that they seek a transparent approach to information disclosure whilst not wanting to become inadvertent “insiders”, potentially having bond liquidity impacted. The aforementioned approach to monitoring minimises this risk. The pre-consultation phase of the decision-making process enables the borrower to discuss a real or hypothetical decision situation with a creditor representative to ensure that it is ‘packaged’ in a manner that is likely to make it attractive to creditors.

The monitoring adviser will make a clear recommendation to creditors. This will identify the benefits and risks to creditors and assist in corralling their opinion. Without such an opinion-corralling recommendation, investors become less likely to reach consensus; this increases the risk of the financing structure becoming an administrative impediment to an efficient project.

Conclusion

Has the monitoring adviser framework brought value to date? Thus far there have been several consents, waivers and determinations across the transactions where BCP acts as monitoring adviser. Whilst some have been relatively straight-forward, others have involved significant analysis, discussion with the borrower and third-party advisers (including lawyers, accountants and technical advisers). Parties to the process have observed and continue to comment on the positive impact the role brings to these transactions. All of the borrowers have emphasised the value having a monitoring adviser has brought as they develop their reporting framework; this value has encompassed development of compliance certificate reports to an in depth analysis of construction reports. We challenge borrowers when we receive information and reports that are either inconsistent with expectations, or, on occasions, lacking clarity.

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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