Kick Starting the Infrastructure Finance Market

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RBC Capital Markets

Introduction

- State of the funding markets and why we find ourselves in the position that we do today
- How Governments worldwide are responding to the funding crisis
- How this funding log jam can be unblocked

What needs to be done

To help kick start infrastructure lending Government needs to

- First recognise there is a problem which won’t self correct itself but needs affirmative action
- Improve the existing procurement process
- Promote new product attractive to both banks and investors

Some Good News and Bad News

- Recession is good for essential infrastructure
  - Governments use it as a fiscal stimulus
  - Though volumes fall, roads, ports, power stations and airports continue to be used
- Infrastructure gets into trouble when it is too highly geared as a result of
  - Funding on the basis of over optimistic growth prospects
  - Assuming too much refinancing risk
- The infrastructure boom was driven by an oversupply of cheap money and an the assumption that refinancing would always be an opportunity not a challenge

The Market — Bank Debt

Funding for the PPP market has been badly affected by the current credit crisis, despite the strong fundamentals of the sector

Bank Finance

- Banks are not natural long term fixed rate lenders
- Despite this they became the dominant source in the PPP market in 2000–2007 due to tight pricing and aggressive terms
- As balance sheets have become constrained and funding more costly, these banks are now withdrawing capital from the market
- This problem has been exacerbated by :
  - The collapse of the specialist long dated, infrastructure lending banks who had lent globally — Depfa, Dexia, Eurohypo, Fortis etc. and
  - The failure of the bank syndication market so transactions have become dependent on club deals with banks committed to take & hold over the long term

The Market — Bond Finance

Bond Finance

- At the same time, access to the bond market has been restricted by the failure of the monolines who
  - Traditionally have been the route for accessing the bond markets in a number of jurisdictions for instance UK and Australia, and
  - Were willing to accept weaker credit rating than institutional investors on deals on an unwrapped basis
- Nevertheless, global bond investors are currently
  - Highly liquid
  - Underweight duration (i.e. maturity) and CPI / RPI
  - Overweight financial institutions and underweight corporate exposure
  - Keen on “utility style” credits

Some Problems Some Answers

- As a result there are a significant number of stranded PPPs around the world, where the proposed financing terms have become increasingly fanciful particularly for larger PPP transactions

- Governments now need
  - To find a solution for existing deals at preferred bidder stage due to inappropriate financing structures
  - To re-impose discipline on current bids to ensure that pricing is realistic and the financing deliverable

- We believe there are a number of ways in which Government can be more proactive in the procurement of finance by
  - Unblocking the funding markets for existing and upcoming PPPs
  - Encouraging access to both bank and non-bank sources of funding

Closures Down – Deals Continue

- 935 PFI deals closed in UK between 1995 – 2008 with a combined value of £66 billion
  - Number of signed PFI deals over last 12 months at **lowest** level since 1995
  - 34 transactions have closed during 2008 versus 60 in 2007, amounting to c. £6.5 billion
- These breakdown between
  - Defence (£3.2 billion, including £2.2bn FSTA project)
  - Education (£1.6 billion)
  - Health (£500 million)
  - Transport (Nil)
- In Europe, 22 PPPs closed in 2008 with combined value of €5 billion versus €7.4 billion in both 2007 and 2006
- In Canada, 10 PPPs closed in 2008 totalling C$4.8 billion versus 22 PPPs totalling C$3.8 billion in 2007

The Current Log Jam of Deals

Europe — challenging deals

Deal	Size & Tenor	Initial Funding Solution	Status	Expected Outcome
M25 (UK)	STG1.2bn 27 years	Syndicated Bank debt and EIB	PB	■ STG500–600m bank club deal ■ EIB and Govt funding. Refinancing incentives at years 7 and 10 ■ 100% cash sweep from year 7
Manchester Waste (UK)	STG600m 23.5 years	Bank debt and EIB	PB	■ Bank Debt, EIB + Capital contribution from public sector and additional equity support
Fife Hospital (UK)	STG300m 29.5 years	Bank Debt	PB	■ Bank Debt + Capital contribution from public sector
GSMR (France)	€600m Up to 14 years	Bank debt	PB	■ Bank debt
French High Speed Rail Schemes (France)	Up to €10bn Up to 30 years	Bank debt	Initial bids submitted	■ Bank debt and Central and Regional Government support
Nord Seine Canal (France)	Up to €4bn Up to 30 years	Bank debt and / or bond and Government support	RFQ stage	■ Bank debt and / or bond and Government support

The Current Log Jam of Deals

Canada — challenging deals

Deal	Size & Tenor	Initial Funding Solution	Status	Expected Outcome
Port Mann Highway	C$2,100m	Bank debt	**Closed March 2009**	■ D & B ■ Fully funded by Province
Niagara Hospital	C$600m	Bank debt	PB	■ Bank debt and / or bond with increased capital contributions from Government to reduce external financing requirement
McGill University Health Centre	C$1,000m	Bank Debt and / or bond	Shortlisted	■ To be determined
Centre Hospitalier de L'Universite de Motreal (CHUM)	C$1,000m	Bank Debt and / or bond	Shortlisted	■ To be determined

Government Action

Government Action — Europe

- European Investment Bank (EIB)
  - Providing liquidity, by increasing their participation in deals and relaxing lending criteria
    - M80 where they lent more than the sacrosanct 50% of total funding, and
    - Though education projects are outside their remit, EIB now has agreement to lend up to GBP 300 million via the UK's 'Building Schools for the Future' programme
- The European PPP Expertise Centre (EPEC)
  - Launched by EIB in September 2008 in collaboration with European Union Member and Candidate States and the European Commission
  - Designed to enable EU Member and Candidate countries to share experience, expertise, and best practice relating to PPP transactions

Government Action — UK

- UK has been indecisive to date but on 3rd March announced a programme — *"Safeguarding Government Infrastructure investment"*
- Some £15 billion of projects will be eligible, £8 billion due to close this fiscal year
- Up to £1–2 billion available to ensure that PFI infrastructure projects get under way as swiftly as possible whilst preserving the benefits of the PFI procurement method
- Key points
  - Will be run on an arms length basis and have its own credit committee
  - Price taker not maker
  - Minority lender (though reserve right to fund 100%)
  - Equal rights as commercial lenders — at least as a starting point
- Still no help to the secondary market
- Seen as a "short-term fix" to get the current backlog of deals to financial close - a longer-term plan for how PFI will be funded to be formed

Government Action — France

- The French Government is the most pro-active Government in Europe to address the issues facing the PPP markets
  - France's needs are the greatest, given the number of large PPP projects in the pipeline
- Infrastructure is at the heart of the 'Plan de Relance' recently announced parts of which are directly aimed at facilitating PPP Financing
  - A €10 billion 'envelope' has been earmarked to provide guaranties for this purpose
  - The French Government will guarantee up to 80% of the PPP consortium's senior debt on selected projects
  - The Government could also underwrite the refinancing risk following a mini-perm financing
- In addition, the CDC has a €8 billion 'envelope' to lend to large infrastructure project
- CDC is increasingly being used as a provider of stapled financing

Government Action — Canada

- Two high-profile deals have been stalled in Canada
  - Niagara Health System AFP project
  - Port Mann / Highway 1 PPP project — recently closed as a D&B
- Large pipeline across the provinces, particularly in Quebec, Ontario and British Columbia
- Provinces across Canada are considering a number of options to assist in getting PPP deals to close
  - Increased capital contributions in the form of construction milestone and substantial completion payments
  - Fast closing from bid date
  - Requirement for bidders to engage potential funders on a non-exclusive basis throughout the bid process

What else can Governments do ?

What else can Governments do ?

- Run a funding competition post Preferred Bidder
- Stapled Debt — Procuring Authority sets the funding parameters and sources the debt
  - Attractive to debt providers encouraging them to offer lower cost funding
  - Gives the Authority more control and confidence over funders and structure selected
  - Bidders remain free to offer more competitive solutions

Some Solutions — Alternative Funding Options

- A Bond solution — Unwrapped Bonds
- A Bank solution — Mini-Perms
- A Public Sector solution — Guaranteed Debt

Unwrapped Bonds

- Capital markets remain a natural fit for long-term infrastructure assets
- Market remains open — several long dated bond issues for Utilities and Housing Associations have been successfully launched in last couple of months
- Comparison in Europe is largely with utilities and indicates maximum liquidity would be achieved for bonds rated BBB+ / A-
- This rating can be achieved by a variety of structural changes though the key with the rating agencies seems to be construction risk mitigation

Other issues to Address

- Confidentiality
- Institutional investors have to date relied on the monolines for surveillance

Mini-Perm Structures

- Mini-perm structures are common in North America and match investors more closely.
  - Banks understand construction risk
  - Capital markets want long term stable yield
- Mini-perm — strong incentives to refinance early (i.e. margin step-ups, dividend restrictions, cash sweeps)
- A mini-perm structure relies on a capital markets take-out be it into the bond market or the bank market
- Who takes refinancing / term-out risk — price and availability of term market?
  - For highly geared structures equity could not reasonably take these risks
  - Some flexibility could be achieved by long term-out periods (e.g. 5 years of steadily ramping margins post completion)

Example — M25

- Structured as a “soft” mini-perm
- Combination of commercial bank debt, EIB and Government funding
- 27 years debt with refinancing incentives in years 7 and 10 in form of
  - Margin step-ups
  - Cash sweeps
- Strong construction package
  - L / C for a % of construction price
  - Joint and several guarantee from parent companies
  - Gearing of 80:20
- Implied rating of low investment grade
- Pricing starting at LIBOR + 250bps stepping up to LIBOR + 350bps
- 20 banks have shown an interest but how many will turn up at the party?!

Government Debt

- Financed by public sector either through grant, debt or guarantee
- Range of models have been tried and tested and largely abandoned
  - DBFT where project is transferred to Authority on construction completion e.g. Evergreen
  - Equity only models where the Authority provides all the debt e.g. RSME
  - “Cession Dailly” — model in France and the Netherlands where Government guarantee is triggered on construction completion
- Public / Private co-lending seems to be the preferred direction in which certain European Governments are heading

BUT

- It raises inter-creditor issues particularly where Government lends more than 50% of debt
- It raises potential conflicts of interest between Government as lender and Government as Procuring Authority
- Will it stifle the bank debt market?

Conclusions

- Appropriately structured and priced infrastructure remains a very attractive asset class
- Sudden loss of appetite for long term lending NOT an issue of credit quality nor a sector specific to PFI
- Governments can help in a variety of ways
  - They can improve the procurement process and ensure maximum available capital is sourced
  - They can encourage the development of new product and stimulate new sources of finance
- All are relatively easy to implement and all require minimal changes to the PFI procurement process and documentation

Appendix

Landmark Deals over last 12 months — Bank Debt

Deal	Size & Tenor	Funding Solution	Closing Date	Pricing
FSTA (UK)	£2,200m 23.5 years	Bank debt	February 2008	■ BBB+ externally rated ■ LIBOR + 105bps
Kromhout (Netherlands)	€265m 27 years	Bank debt	July 2008	■ Unrated ■ EURIBOR + 100bps
A30 (Canada)	C$1,100m 30 years	Bank debt	September 2008	■ Unrated ■ CDOR + 170 – 225bps
Lieftenshoek Tunnel (Belgium)	€840m 35 years	Bank debt EIB	November 2008	■ Unrated ■ LIBOR + 105bps ■ Cash sweeps ■ Margin step-ups ■ Gov. guaranteed lending rate for 4 years
Douro Interior Highway (Portugal)	€767.5m 27 years	Bank debt	November 2008	■ Unrated ■ LIBOR + 230 – 250bps ■ Cash sweep from year 8
M80 (UK)	£300m 32 years	Bank debt EIB	January 2009	■ Unrated ■ LIBOR + 190 – 210bps ■ EIB more than 50%

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