The death and rebirth of infrastructure debt markets

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Three years ago, things seemed bleak for project finance in the infrastructure sector. The monoline funding model had long-since 'died' an inglorious death and few options remained for securing project finance. The credit and liquidity crisis had seriously reduced bank debt lending; institutional investors were hoarding not investing; and governments were refocusing their priorities onto austerity measures.

What was clear was that the markets would require some form of credit enhancement vehicle if infrastructure deals were going to continue to be financed and attract institutional investment from the bond market. What was less clear was how that credit enhancement would be achieved, who would shoulder the risk and under what terms.

Only the good die young

As always, necessity drove innovation. In late 2010 KPMG produced a report on project bonds within infrastructure, with reference to the Hadrian's Wall Capital Fund (HWC) initiative.[1] The report explained how the fund was intended to provide a 'first loss' tranche of debt (as 'B Notes') that would be impacted first under any project loss scenarios. The idea was that this would enhance the risk profile of the remaining debt (the 'A Notes') to a more attractive rating.

By many metrics, the idea was fairly successful. The fund reached its first close last year and is about to close its first deal (the USD133 million (GBP85 million) Salford social housing project). So, it is somewhat ironic that the fund recently announced it would wind down, returning the money to its investors (Aviva, the Development Bank of Japan and European Investment Bank (EIB)).

Some would argue that this simply reinforces what everyone already knows about Europe's debt financing markets. But the reality is that the main HWC team will likely continue on, albeit in a new guise, by sourcing the mezzanine debt required for the credit enhancement from various other sources on a deal-by-deal basis.

So what caused HWC to fail and what does this tell us about the wider market? In part, HWC's demise is due to competition. Keen observers will note that – shortly after the EIB signed up to the HWC fund – consultations started on the EU Project Bond Initiative (PBI) which uses a similar model but with a guarantee tranche rather than a funded tranche to provide the credit enhancement. As a result (and given the EIB return criteria), the PBI product offers a more cost effective solution for project sponsors than that offered by the HWC product.

HWC's death is also related to a wider-spread malady: a lack of deal flow. Slow deal flow and increased competition from various sources may still spell the untimely end for other similar initiatives. It's already believed to be hampering the larger wholesale roll-out of the PBI product which will soon reach its first close on the Castor gas storage project in Spain.

[1] Project Finance and the Capital Markets – Bridging the Divide, KPMG International, 2010

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Not quite dead yet

So what other options have emerged over the past three years? Well, the benefits of the mezzanine-type approach to achieving credit enhancement are now fairly universally accepted, but success has been somewhat more difficult to achieve. This is mainly due to the lack of deal flow which has prevented standardizing the main issue around the complexity of allocating the relative inter-creditor rights of the subordinated first loss piece.

However, some encouraging examples have emerged. For example, in the UK, Prudential M&G's close of Alder Hey hospital used a credit enhanced structure (funded by Prudential M&G themselves), while in the Netherlands, Ballast is using a credit enhanced structure provided by a bank debt facility (the ING PEBBLE structure) and was recently awarded Preferred Bidder status on the Zaanstad prison project.

It also seems that the monoline model – which it turns out was not quite dead yet – is staging something of a comeback. Assured Guaranty closed the Leeds social housing deal in the UK and others are expected to soon follow.

It almost feels like the small and often challenging social infrastructure market (particularly in housing and universities) has become the world's hotbed for the development of institutional debt solutions. Legal and General recently financed the University of Hertfordshire project in the UK while Allianz is about to close the Paris Music Hall project (albeit with the benefit of the Dailly tranche which is effectively government guaranteed).

Government gets involved

While activity has been generally limited to the private placement institutional market, there are signs that larger public bond deals will follow. The recently announced Priority Schools Program in the UK, for example, includes a plan for an 'aggregator' to finance five batches of school projects using none other than the credit enhanced mezzanine financing model (some argue, however, that this arrangement may be overly complex given the total financing need of just USD1.1 billion (GBP700 million)).

The UK, clearly following France's lead with the Dailly Law, has also introduced the UK Guarantee Scheme (UKGS), which is expected to provide greater financing support to infrastructure projects as the UKGS can take construction risk where the Dailly facility does not. But while the UKGS is flexible, it is typically being used much like a monoline (to guarantee the debt) and therefore investors are essentially buying government-guaranteed debt with no project risk.

Emerging from the coma

And what about the good old banking market? The truth is that activity has never really abated and many project sponsors have found that – for the right sponsor and project – bank debt solutions remain available. The recent Thameslink deal closed with a USD2.65 billion (GBP1.7 billion) bank debt solution (albeit a legacy deal) and in the Netherlands, the A1/A6 road project was bank financed. All signs indicate that European banking appetites are increasing.

So, as I look back on the events that have occurred since the HWC report in 2010, I'm struck by the fact that we are now operating within a vastly different market than we were just three years ago. Yes, deal flow remains a challenge (particularly since it masks the true liquidity in the market) as does the financing of mega-deals. But the fact remains that there are now a wide array of financing options for sponsors to consider and – with new multilateral, ECA and government interventions coming online all the time – more options should soon emerge.

*To access a copy of the original *Project Finance and the Capital Markets – Bridging the Divide* report, click here

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