Project prophecies

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Lloyds project team quick facts
• Project Finance sits within Structured Corporate Finance a part of Lloyds TSB Corporate Markets.
• Gershon Cohen, former head of infrastructure at HBoS, leads the 40-strong team as head of project finance.
• There are three lines reporting into Cohen: Debt Origination, Equity & Funds and North America. Mike Chappell is head of debt origination UK. Head of equity & funds is Sameer Amin and Anthony Porter is head of North America.
• The combined project teams of HBoS and Lloyds have arranged around $30 billion of project loans over the last decade, and have a residual project loan book of $11 billion.
• While HBoS and Lloyds have concentrated their project lending in UK PPP, around 25% of the residual loan book is made up of continental European assets.
• Going forward, Lloyds will continue to lend into power projects. Lloyds will focus on government backed schemes and fully contracted projects over demand/market-based assets, with an immediate focus on the mature markets of the UK, continental Europe and North America.
• HBoS set up an established MLA project debt team with particular strength in UK PPP; Lloyds team came to the fore as an MLA in 2006/07 and has a strong list of clients.

Since September 2008, project and infrastructure finance has been one of the few banking sectors to find its feet. Investment in infrastructure has caught the political zeitgeist as fiscal stimulus directed at transport and social infrastructure can prime the economy in the short term, whilst leaving a long term legacy for growth.

The global gap between spending and actual requirement over the next 25 years has been estimated by Ernst & Young at $50 trillion. Mark Weisdorf, head of infrastructure investments at JPMorgan recently said: "Ten to twenty years from now, infrastructure could be larger than real estate."

So how can project banks make the most of the huge demand for private finance? "A bank's organisational design is a reflection of where the market is now and where it is going," says Gershon Cohen, head of the restructured Lloyds TSB project finance team recently spawned by the takeover of HBoS by Lloyds. "I've set up my team keeping in mind what the market is going to look like in the future."

Cohen is channelling Lloyds' efforts on the larger and complex deals. "We look to secure leading bank roles on large deals, such as FSTA ($3.5 billion), Greater Manchester Waste ($930 million) and M25 ($1.75 billion). Working on innovative and complex financings with the key sponsor/ developers of these projects embeds the relationships we have offering expertise and value-add to our core banking customers."

The call to focus on the bigger, more complex, deals is down to the public sector needing to leverage their manpower, time and resources on infrastructure deals that have the maximum economic benefit. "I don't believe governments' and their respective agencies will be able to afford to focus on a number of smaller deals," says Cohen.

Servicing these deals will require a core of large competent sponsors, which Cohen believes will be mirrored by a core group of big ticket MLAs. Cohen is not overly concerned with not having a traditional sub-sector team structure, "I have a team of general project finance specialists of great depth and breadth with many years of experience who can originate, structure, arrange and execute infrastructure projects requiring acquisitions, PPP/PFI, power and utilities expertise. This will allow us to target capital, financial and human, where it can best be employed."

As an example of this huge demand for infrastructure against finite time and human resources, the EIB's ramp up in capital deployment has coincided with its concentration on large projects and greater use of its intermediary lending provisions whereby capital is lent to banks to on-lend into specific projects. This has been further emphasised by plans to back the launch of a significant European Fund along with some major European State banks, with a large associated pool of debt capital.

As well as a proliferation of larger deals, Cohen also expects there to be less emphasis on deals incorporating demand and market risk as these have proved more vulnerable to the recent economic downturn. Projects with availability payment mechanics enable governments to attract more private financing at a cheaper cost. The combined HBoS-Lloyds project experience is weighted towards less risky government backed schemes in mature markets, and lighter in highly leveraged economic infrastructure acquisitions such as ports and airports. Although, as Cohen points out, "if leverage is injected conservatively and shareholders are greater aligned to the long term success of the project, then economic infrastructure projects with demand risk can be structured to be just as robust."

On government schemes

The UK Treasury has stepped in via the formation of the Treasury Infrastructure Finance Unit to support the Greater Manchester Waste deal closed at the beginning of April. However no support was required for the M25 deal that closed at the end of May.

Similar to the UK's inception of TIFU, other governments have tried various methods of support to unblock the pipeline of privately financed, publicly procured projects. In Flanders, Belgium the Flemish government has provided refinancing guarantees, France is introducing guarantees alongside its "Cession Dailly" and the Queensland government in Australia has piloted a supported debt model whereby it provides 70% of the senior debt post construction.

In 2003 Cohen was instrumental in delivering the first UK PFI which provided long term bank guarantees for a State funded project (New Oncology Wing at St James University Teaching Hospital). "Like the UK's credit guarantee finance, I doubt whether these various schemes will have any significant long term impact on the requirement for private sector capital," says Cohen. "More importantly, however, these initiatives show that government is having a healthy dialogue and active interest in the financing process – the more they engage the better the long term outcome of the project, in my view. When PFI first took hold within the UK, the government was too remote from the financing. They had little say until after the refinancing gains from the first wave of projects."

Although Lloyds has a loan book containing both LIFT and BSF deals – whereby the government has championed is strategic partnership model with a government agency a partner in the equity – Cohen has reservations about the schemes: "I have issues with them because I believe they are over-engineered for what they are. The model might be worth the effort for large deals, but I'm not sure whether there will be significant long term benefits for a string of smaller assets."

On deal metrics and the secondary markets

There are encouraging signs that competitive tension is returning to the bank market; debt margins for UK PPP have fallen from a high of 350-400+bp at the beginning of 2009, to around 240-280bp.

"Debt margins should never go below 200bp again, even in a fully competitive market" says Cohen. "The reason is that when bank margins were 60bp, banks were not properly pricing capital for risk or adding in the cost of funding and a liquidity premium. Once you do the analysis you don't require a complex algorithm to demonstrate there is a floor above 200bp."

As well as long term debt margins, Cohen is bold enough to make predictions for pricing metrics for 2010, and provides a historical comparison of where pricing for a typical UK PPP project has been:

	1998	**2006**	**late 2008**	**2010**
Debt pricing:	140-150bp	60bp	350bp	220-240bp
Upfront fees:	150-200bp	60-70bp	300-400bp	250bp plus
Hedging fee:	18-20bp	5bp	40-50bp	15bp plus

Fees are likely to better represent the intellectual capital of banks, which Cohen believes should stay around 2%. "I don't expect fees to move in step with debt margins."

Tightening debt margins is a direct sign of increased competitive pressure among banks. Given Cohen's judgment that the project market will be built around a select core of MLAs, he expects the syndication market to return in 2010, as those leading banks increase their ticket sizes and realign second-tier banks, that are currently MLAs in clubs, into buyers in the secondary market. Large sponsors will actively encourage this trend toward larger tickets and underwriting because they prefer to work with two or three expert banking teams rather than a club of say, 15, where the sponsor must clear the last request of the last bank to achieve close.

Lloyds is maintaining a strong focus on distribution in readiness for the market upswing. "From the point of view of capital management we've adopted a portfolio approach around distribution," adds Cohen. As well as syndicating debt, Lloyds previously closed its Eu1 billion project finance synthetic securitisation in October 2008, with Eu126 million of notes placed with a third party. Cohen expects to see further activity in this area.

"Banks have different drivers for securitisations – liquidity, credit or capital," says Cohen. "We currently have access to central government support on the liquidity side which is an interim measure and freeing up capital will be a major driver going forward. The key to a successful programme is transparency and investor confidence in the sector. Hopefully we should see the revival of securitisation markets in the near future."

In terms of distribution on a project-by-project basis Cohen sees a greater role for the capital markets as a holder of long term project debt, with bonds as an increasingly viable option for infrastructure projects. However, Cohen does not see 25-year debt being the sole preserve of the bond markets but a blend, and even in refinancing Lloyds would look to continue to participate as a lender in the project for its long term stable remuneration, although at a low hold size post syndication.

On infra funds

Cohen has plans to progress a second social infrastructure fund late 2009 or early 2010. This fund would follow on from the success of HBoS's $700 million secondary social infrastructure fund which was launched and closed at the end of 2008. Four pension funds came in, with the bank retaining a major cornerstone investment in the fund which comprises stakes in 47 UK and European PFI projects.

The new fund will be a primary social infrastructure fund, so will contain more risk than the first fund with a mandate to make investments at bid stage. The fund will have a portfolio value of around $800 million, and will invest in availability-backed projects in the UK and continental Europe. Lloyds will seed the fund with some of the on-balance sheet equity it currently holds.

Lloyds will maintain a cornerstone investment in the fund, and will look to time the launch to coincide with an upswing in investor mood. The fund will focus on attracting investors from the UK and European pension funds sphere. "We will continue to be cornerstone investors in these funds, so the bank's interests are aligned with investors'. I don't think we will return to the days where infrastructure funds will be remunerated along the lines of private equity. Unlike some of the Macquarie and Babcock infrastructure funds we are not looking to invest in over-leveraged acquisitions in the economic infrastructure space – ports, airports and power. Instead, we will be focused on social infrastructure, predominantly availability payment based, PPP schemes."