Changing gear

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Australian toll-road operator Transurban has interests in six toll road concessions domestically and two in the United States. Chris Lynch took over as chief executive in June 2008, and has promised to take the company in a more conservative direction, in terms of leveraging and equity distributions, though it is actively pursuing concessions, and is also focusing on greenfield projects.

Despite continued problems in the credit markets, Transurban has fared better than its closest competition in the toll roads sector in the past months (see chart below comparing Transurban's share price with that of Macquarie Infrastructure Group, Abertis and Cintra). Its stock is now trading at A$5.58 (30 Sept 2008), and has outperformed the market by around 6% year-to-date, according to UBS investment research. The operator has also recently raised almost A$1 billion ($790 million) in equity.

One of Lynch's most significant changes has been to only make distributions from operating cash-flow revenues, and no longer from debt. This policy has resulted in a reduction in distributions to a guideline of A$0.22 per share. Though the share price plunged 15% to A$4.00 in June 2008 in the days after the change in distributions policy, it recovered impressively.

The full scope of Lynch's strategy has not been disclosed as yet, which has sparked both media and market speculation. Transurban has made some of its management available for interview, but Lynch has been off limits.

The project company grows up

Transurban was founded in 1995 as a project company for the CityLink road in Melbourne, and the company was floated on the Australian stock exchange in 1996. Its shareholders include the Ontario Teachers' Pension Plan, the Canada Pension Plan Investment Board, and Capital Partners' CP2 fund, each with stakes of between 14% and 15%. The company now has interests in eight assets, with a ninth in development. All its assets are non-recourse, held off the company's balance sheet.

The recent equity raising, which closed in June 2008, brought in A$898 million, with another A$100 million to follow, comprising A$659 million from the placement of 120 million shares at A$5.49 each, a deferred stock purchase plan of up to A$100 million for shareholders, and a dividend reinvestment plan accounting for A$239 million.

The proceeds from the raising have been used to refresh the company's working capital facilities, to pay down some of its corporate debt, and deleverage. Some of the funds will also be used as a reserve for investment in the M2 and M5 expansion requirements in Australia, the I-95 project in the US, and have been used for bidding on the Port Mann bridge project in Canada. That project, however, has since been awarded to a consortium of Macquarie, Kiewit and Flatiron.

Transurban has borrowings in both Australian dollars and US dollars. As of June 2008, it had A$2.884 billion and $132 million outstanding on its corporate balance sheet, and a further A$1.7 billion and $744 million in non-recourse debt through its respective project companies. According to a spokesperson from Transurban, "the corporate debt is serviced primarily from distributions from assets." The project debt consists of bank loans and bonds, both from commercial banks and institutions, and from publicly bodies such as the US Federal Highway Administration. It also funds projects through grants and subsidies from governmental authorities such as Virginia Department of Transportation.

The company's gearing, based on its August 2008 share prices, is 44.6%, though it was higher in June, at 51.6%, after the slip in share price. Transurban calculates its weighted average cost of debt at 6.83% for the Australian denominated debt, and 5.46% for the US facilities. Its 2008 corporate EBITDA was $498.6 million.

Domestic player, with room to expand

In Sydney, Transurban holds 100% of Hills M2, and it is in negotiations with the government of New South Wales and the surrounding communities, to upgrade and widen the motorway, and add new access points, cashless tolling, and change the congestion policy for morning and afternoon rush hours. It also holds a 50% stake in the Westlink M7, the Eastern Distributor (75.15%), the M4 (50.61%) and the M5 (50%), all in operation in Sydney. In Melbourne, it owns and operates the CityLink highway, which the company also suggests has the potential for upgrade.

There are a number of further opportunities for growth in the Australian market. In 2007 Transurban bought Macquarie Infrastructure Group's (MIG) interest in the Sydney Roads Group, and took control of its three assets, the M1 motorway/Eastern Distributor (71% stake), and 50% of both the M4 and M5 motorways, the last of which it plans to widen.

Transurban already held a 47.5% stake in the Westlink M7, a 40 km fully electronic toll road in the west of Sydney, together with MIG, which also held 47.5%. Both parties recently increased their stakes to 50% after the minority shareholders sold out. The 34-year concession runs until 2037. MIG announced in August 2008 that it intends to sell its interest in the Westlink M7.

Though the asset is financially successful in operational terms (according to MIG, it saw a 12.2% increase in traffic and 16.4% rise in revenues in 2007), its debt service burden is high. Still, MIG and Transurban shared an A$87.4 million dividend from the road in 2007, on the basis that its ramp-up in traffic levels since it opened in 2005 had met expectations.

MIG recently valued its 47.5% of the road at A$802.1 million, and the 50% stake has been valued as highly as A$900 million. Transurban has preemptive rights to buy out its partner in the asset. Whether it will assert this right, and moreover, whether it will be able to raise the debt and equity necessary to do so, is unclear.

UBS notes that the company's "balance sheet does not provide enough flexibility to capture these opportunities without raising additional equity, and it is likely there will be co-investment/partnering between [Transurban] and its cornerstone investors." It continues, that Transurban might make use of its toll roads expertise, and "leverage this skill-set to get a seat at the table" as a minor equity stakeholder with CPP, OTPP and CP2.

Sweet Virginia

It has already attempted to set in place a similar co-investment structure for its US assets. Transurban began operations in the US in 2003, and closed its first project, the acquisition of the Pocahontas Parkway/895 in Richmond, Virginia, in June 2006. It refinanced the asset a year later, at the same time as closing the financing for the new Richmond Airport

Connector, a toll road linking the Parkway to the airport.

Transurban's president for North America, Michael Kulper, explains that the company's entrance into the US market was at time when there was not very much competition, "In 2003, there was not significant private participation in infrastructure in the US, it was an emerging market opportunity. There was a lack of supply of public sector funding, increased congestion in large cities, aging infrastructure and challenges in replacing it, all of which suggested to us that the North American market would open up to private participation. We anticipated it could follow the trends of Australia and Europe."

Its most recent project is the $1.9 billion Capital Beltway HOT (high occupancy/toll) lanes, currently under construction in Northern Virginia (see box). A Transurban/ Fluor consortium has also been selected by VDOT for its I-95/395 HOT lanes project, using similar concepts as Capital Beltway.

The I-95 project involves a 94km route for buses and traffic from Arlington to Spotsylvania counties. The project will expand existing HOV (high occupancy vehicle untolled) lanes from two to three lanes and extend existing HOV lanes 28 miles south to Spotsylvania, and will include a HOT lanes aspect. Details of the scope of the project can be viewed at www.virginiahotlanes.com.

Though the financing solutions for the project have not yet been decided, the project is expected to cost more than $900 million and may be eligible for tax-exempt debt under the same federal support programmed it used for the Capital Beltway deal.

Transurban launched its first unlisted investment fund in 2007, DRIVe (Direct Road Investment Vehicle), into which it divested its US assets. The company has transferred its Pocahontas Parkway and Capital Beltway assets to DRIVe, and plans to do the same with its I-95 project which is under negotiation and is due to close in 2009. Transurban currently has a 75% stake in the vehicle, and has previously said it wants to sell down its interest in DRIVe to a 30% stake, but a spokesperson for Transurban indicated that this plan is being reviewed.

CP2, through a number of investors, holds much of the remaining 25% of DRIVe. According to the UBS research, Transurban "has not been successful in attracting investors to this vehicle and it is becoming increasingly obvious that unlisted/pension funds are unwilling to invest directly in infrastructure (alongside toll road operators such as TCL)."

But the funds with stakes in Transurban all have a history of investing directly in infrastructure, though they find it difficult to increase their stakes in Transurban directly, because of foreign ownership restrictions on some of the Australian assets. They could, however, invest in DRIVe.
Transurban also recently bid, though unsuccessfully, for two more US projects, independently of DRIVe: The Pennsylvania turnpike lease (a concession which is now effectively dead), and the Port Mann bridge project. According to Kulper, there were a number of reasons for DRIVe not participating in these bidding processes, including the political risk attached to the turnpike, and its brownfield nature.

Listing and leverage

Transurban is anxious to distinguish itself from fund managers such as Macquarie and Babcock & Brown, which have battled suggestions that they are too conflicted to properly serve shareholders, and too stretched to develop the necessary operational expertise. Kulper notes that, "many of our competitors are fund managers, whereas Transurban is a listed company and we have internalised management. It's a fundamentally different model, which we believe delivers core competencies, in relation to our operational, project development and delivery capabilities."

However, the DRIVe fund is a move to breaching some of the differences between Transurban and its Australian toll roads peers. Whether the DRIVe model will be replicated remains to be seen; Kulper says the possibility of launching more funds "is not something that is being contemplated at this point in time."

Kulper remains ambivalent about whether Transurban's future ventures lie in listed or unlisted vehicles: "There is a lot of chatter in the market about how listed stocks are down and how unlisted money is out there looking for a home. The competiveness of listed and unlisted equity will move over time, in accordance with market conditions, but look at the Pennsylvania turnpike; the preferred consortium was a combination of listed and unlisted equity."

Comparatively speaking, Kulper continues that, "we fund assets non-recourse, and we look at how best to do it asset by asset. But the world has changed over the last year and just as with every other asset type, toll roads have re-priced, the debt is more conservative and it costs more to obtain." He adds, "the equity for publicly listed toll roads assets has priced down by about 20% to 30% over the last year"

In terms of financing constraints, Kulper continues, "Flex is more prevalent, and projects are more conservatively leveraged, but good projects are still getting funded, as evidenced by Capital Beltway. Robust transactions are still getting done, but the bar is higher than it used to be." If current conditions continue, there may be a wave of infrastructure assets hitting the market. But according to Kulper, Transurban is not interested in diversifying its asset base; "our expertise is as a toll roads operator."

While the market is sinking, Transurban has managed to keep its head above water. Its resilience could be attributed to its conservative investment policies, and an early and swift reaction to the credit crisis by deleveraging, and aligning its distributions to cash flow. It did not move with any great enthusiasm into fund management, and market conditions, as much as strategy, have limited its success here. DRIVe met with an underwhelming reception, and management is reluctant to discuss its plans regarding ventures beyond pure toll-roads operation.

Transurban has, to date, played its strengths well, and ridden out recent hits to, for instance, its US portfolio. But its reluctance, so far, to go into specifics of the new strategy suggests that it is delaying making any large decisions, other than to mitigate existing risk exposure, until the markets are less volatile.

------------- Capital Beltway rides the crunch--

Transurban two projects in the US to date have both been located in Virginia: the Pocahontas Parkway, which closed in 2006, and the Capital Beltway deal (with Fluor, which has a 10% equity stake in the project), which reached soft close at the end of 2007, with the senior debt funding mid-2008. The Virginia Department of Transportation (VDOT) awarded both deals. Details of both financings can be found by searching the deal name at www.projectfinancemagazine.com.

The Capital Beltway HOT lanes project was funded in a particularly troubled credit market. It was the first deal in the US to take advantage of both the TIFIA and private activity bond (PAB) federal support programmes simultaneously, and also features funding from VDOT. It has also been hailed by private sector and government as a model for future congestion relief, as it employs a variable pricing structure, and gives drivers the option of paying to drive in the faster lanes.

Goldman Sachs underwrote the $589 million of 40-year PABs, which were placed in the tax-exempt short-term bond market in June 2008. The bonds carry an 8-year letter of credit arranged by DEPFA Bank, which also acted as financial adviser to the consortium, National Australia Bank, Banco Espirito Santo, and Bank of Nova Scotia. The LC covers principal and interest, and in the event of a delay in payment, the letter of credit providers would pay the bondholders directly. The project company would then have 45 days to repay the LC banks. The letter of credit banks would also take over the bonds in the event that they cannot be remarketed. Debt service on the bonds, which begins at the end of construction, involves only interest payments for the first 25 years, after which the bonds fully amortize to maturity.

In terms of the gearing, Transurban's Kulper says that "the Beltway transaction reflected market conditions at the end of last year." He continues, "Market conditions do not have a direct impact on the size of the equity cheque we write, but difficult market can constrict the amount of funds we are able to raise for a project."

Transurban swapped 100% of the debt to an index of 70% of Libor, at which level the tax-exempt SIFMA index tended to track Libor at the time of financial close, in addition to the fixed-rate payments it makes at 3.6% (the swap rate, plus the margin on the swap, plus the credit enhancement fee). In their first week of trading, the PABs paid a nominal coupon of 1.9%. However, in recent months, the SIFMA and LIBOR indices have seen unprecedented divergences, and the SIFMA seven-day index, has risen from hovering around the 2% mark to nearer 8% in the aftermath of the recent financial market mayhem, though it has since subsided.

According to a source at Transurban, "the project, like the rest of the market, is experiencing a higher cost of funding in the short end of the market. While this is obviously not ideal, the funding of the project has built in contingency to deal with unexpected events both on the financing and construction side of the project. As the market settles, I think everyone expects more traditional relationships between taxable and tax exempt indices to once again occur."