Borrow now - pay later

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The names have changed and, in some cases, the performance. The emblems of merchant lending excess have returned, this time as consumers of ultra high-yielding mezzanine debt, structured as payment-in-kind tranches. The providers this time are the hedge funds and trading desks that constitute the lower end of the B loan market.

The names of the new borrowers are Entegra, MACH Gen, Boston Generating, Kelson Holdings and Ashmore Energy. They are more familiar to project finance lenders as TECO-Panda, PG&E NEG, Sithe Boston, InterGen's US merchant assets, and Enron's international portfolio, respectively.

All five are the most stubborn remnants of the wave of bankruptcies and foreclosures that swept the US merchant generating sector in the months following Enron's bankruptcy. Still, while Enron's collapse was the proximate cause of their distress, and the losses that lenders booked on their commitments, an equally important factor in the merchant distress of 2002 onwards was a surplus of gas-fired generating capacity.

PIK picked apart

The new debt is structured to kick repayment of principal – and interest – as far into the future as possible. It resembles the accreting swap structures that have been used on such infrastructure financings as Chicago Parking, Chicago Skyway, and the M6 refinancing in the UK.

Payment-in-kind (PIK) tranches, put simply, offer a borrower option of paying some or all of its interest obligations in the form of additional debt. This can be structured to cover some or all of an interest payment, and can be optional or mandatory. Roughly $3 billion in such tranches have been included in recent deals, and several forthcoming borrowers are likely to fold them into capital structures for their acquisitions.
PIK tranches are an alternative expression of embedded value. If lenders, or at least their proxies at the rating agencies, will only permit as much leverage as predicted cashflows will allow, PIK tranches permit a greater degree of leverage.

The process of assembling a B loan has become relatively formulaic. A sponsor works with arranging banks and rating agencies to maximise the amount of first lien debt within the BB/Ba range that an asset can support. This debt can be widely syndicated to mutual funds, money market accounts, loan funds, and actively managed collateralised loan obligations, and commands pricing in the region of 250bp.

Below this level, arrangers layer as much second lien debt on the structure as a single-B rating will support. Although this second lien debt primarily trades between hedge funds and the more aggressive loan funds, it is still rated. PIK debt has a security interest below the second lien lenders, and is often secured at an intermediate holding company rather than at the operating company.

Where PIK comes from

The origins of PIK tranches lie in two places – the leveraged loan market and the resources sector. Leveraged loans have used such structures for several years, and private equity firms have frequently used PIK structures for their acquisitions. Indeed those law firms consulted by Project Finance acknowledge that precedent documents for such facilities are relatively easy to come by.

One hedge fund manager, who, citing his occupation, wished to remain anonymous, noted that the clearest precedents for such facilities lie in the upstream oil and gas sector. Such tranches are a way of maximising leverage by mortgaging a possible large-scale improvement in fortunes.

"An oil and gas producer sitting on large unproven reserves, or reserves that will not be exploited for several years but which have a low valuation because commodity prices are at historic lows, might take out a PIK loan. They've been a feature of the business for years," The applicability of the situation to a power producer is clear. It could suit a generator sitting on assets where a future concrete development might increase asset value, or a generator that expects, but cannot bank, an increase in electricity prices or a drop in fuel prices.

The first high-profile use of a PIK concept on a power loan was probably the second lien debt portion of the Plum Point construction financing. That deal, with a total $755 million in senior debt, had a small PIK element, whereby 200bp of the $65 million second lien facility's 525bp margin could be paid in the form of additional debt. The arrangers on the deal, which closed in March 2006, were Credit Suisse, Goldman Sachs, Merrill Lynch, Morgan Stanley and WestLB.

Plum Point, as a PIK candidate, has several differences with later PIK borrowers. It is a greenfield development project, rather than an acquisition, and has a large number of contracted offtakers. These offtakers, however, are a large and complex group, and the PIK element was used to anticipate changes to its composition. (For more on their identities, search for "Plum").

Plum Point's offtakers and part owners are an overlapping group of municipal utilities and cooperatives based near Osceola, Arkansas, where the 664MW plant is located. While some of them signed up for capacity before the project reached financial close, others came in much later. The last one to sign up, the South Mississippi Electric Power Association, agreed to purchase almost a third of the project's capacity in August 2006.

The developer, LS Power, wanted to start financing as early as possible, before it had all of its offtake contracts in place. Once these had been assembled, Barclays Capital pitched LS, which was in the process of selling Plum Point and other projects to Dynegy, and equity provider EIF Group on a monoline refinancing. The resultant $819 million 30-year loan, wrapped by Ambac and placed with Royal Bank of Scotland in April, was the first wrapped bank deal in the US market.

Time for the distressed merchants

The next deal to launch with a PIK element was the Boston Generating refinancing. This was the merchant portfolio's second refinancing, a $2.1 billion combination of first lien, second lien and PIK debt that recapitalised two merchant gas-fired plants for their hedge fund owners.

The financing, on which Credit Suisse and Goldman Sachs were lead arrangers, closed on 4 December 2006. It consisted of $1.4 billion in first lien debt, priced at 225bp over Libor, a $400 million second lien priced at 425bp, and a $300 million PIK tranche for holding company EBG Holdings, which is understood to be priced at 700bp. Boston Generating has since merged with Astoria Generating, owner of a New York City-based fleet that also relies on capacity payments, as US Power Generating.

The recapitalisation took advantage of the introduction of a capacity payment system in New England, which allows for fixed payments to generators both to encourage the development of generation capacity and to increase regional grid reliability. While such payments do not provide all of the projects' revenue, they provide a useful base component, one with much greater certainty than spot market electricity sales.

The recapitalisation refinanced $800 million in debt that K Road power had raised for the assets' hedge fund owners in October 2005. It also paid them a $1 billion dividend. The second refinancing monetised the benefits of the new capacity payments system, while the $300 million PIK serves to anticipate further improvements in margins in the New England market.

The three-plant MACH Gen vehicle, formerly PG&E National Energy Group's last construction financing, on the other hand, is still waiting for the upturn. Of its $1.59 billion refinancing, led by Bear Stearns, Deutsche Bank and Morgan Stanley, fully $853.9 million is in the form of a second-lien payment in kind facility. A hedge from Citigroup covers the 2,452MW portfolio's $740 million first lien debt, while the second lien debt is primarily at the mercy of improvements to margins in the markets where it operates.

When the financing closed it was unclear whether the Millennium project, in Massachusetts, and the Athens plant, in upstate New York, would benefit from capacity payments. Athens, as well as the third plant, Harquahala, located in Arizona, may also benefit from transmission projects that would markedly improve their range of markets and margins. Nevertheless, the hedge funds that control MACH Gen have reaped a substantial return on their investment in the projects' $1.075 billion in construction debt, which they purchased at a substantial discount to par.

Trading and turnaround

The Entegra, formerly TECO-Panda, portfolio sports a PIK tranche almost as large as that of MACH Gen. It has a contractual profile – largely merchant – that is roughly similar, and lacks the benefit of capacity payments. The construction debt of the two portfolios had the same arranger – SG – and Entegra's structure was the inspiration for that of MACH Gen.
Entegra TC's PIK debt is secured at the intermediate Entegra Holdings company. It is necessary because Entegra is already the subject of a $350 million gas hedging facility, which Citigroup closed in May 2006. The hedging facility is senior secured, and prevents additional lenders from taking a first lien interest over the assets. The borrower also supports $480 million in second lien debt.

Entegra's assets have a total capacity of 4,300MW, of which 510MW was under a 10-year tolling agreement when Credit Suisse, Goldman Sachs and Lehman Brothers launched the refinancing in March. Entegra is far from recovery, since its total debt, at roughly $1.68 million, is much less than the $2.1 billion raised for its construction.

Kelson Holdings raised $1.7 billion in new debt against its merchant portfolio, a portfolio that consumed $1.67 billion of debt in construction. Kelson, a subsidiary of Harbinger Capital Partners' debt funds, is the most completely merchant of any of the recent PIK financings. Its four assets do not benefit from any capacity payments, hedging arrangements, simply a mixture of short- and medium-term contracts.

Kelson and Entegra demonstrate the recent acknowledgement by capacity owners that plentiful liquidity in the subordinated debt market means that they do not have to surrender all of the benefits of an improvement in power prices to hedge counterparties. Despite competition between the investment banks' trading arms, lender-friendly hedging arrangements often force borrowers to give up the benefits of unusually good power margins to counterparties.

Time to get out?

But such leverage comes at a price. PIK tranches have an effective interest rate of roughly 12%, and by the end of their term a principal balance can have doubled, depending on movements in base rates. A $300 million loan might turn into a $615 million obligation.

Prepayment, though, can be expensive too. Break fees will vary according to the year in which the borrower attempts to prepay. Typically in the third and fourth years after financial close a borrower will attract 3% and 2% fees, respectively. In the first two years, the borrower will need to pay a make-whole premium calculated as the difference between the net present value of the deal with PIK interest, and the NPV of the same sum invested in US government debt. For the same notional $300 million, the make-whole premium might be $45 million.

Should the PIK reach maturity, and the assets underlying it not have increased in value enough to spur a refinancing, the PIK holders would gain control of the asset. This would probably be achieved without disturbing the first and second lien lenders, provided these tranches stayed current. Certainly ratings agencies have, to date, stayed relatively quiet on the subject of such an increase in leverage, suggesting that are viewed as having equity-like characteristics.

Potential losses are high in a default situation, and since PIK lenders are normally secured at the holding company they will have little say in the event of a default on a portfolio's senior debt. They may have to provide consents in some instances, including a change of ownership, and generally offer more control than owning a warrant to buy equity in a power portfolio. During a bankruptcy hearing, however, PIK lenders with holdings larger than the senior debt might be able to influence proceedings.

The most recent PIK financing, for Ashmore Energy, illustrates the attractions of such leverage to a growing power producer. Ashmore is the successor to Prisma Energy, itself the reconstituted vehicle for some of Enron's international assets. Its owners are funds managed by Ashmore Investment Management, a London-based emerging markets asset manager.

Ashmore's financing is much more difficult to compare to its forerunner's capital structure. While some of Enron's international assets were project financed, many more were financed using the intricate, and in some cases illegal, structured finance techniques that brought Enron down. Moreover, all of Ashmore's assets are located outside the US, are often contracted, and much more at risk of emerging markets political risk than commodity prices.

Ashmore's $560 million PIK, part of a larger $2.06 billion recapitalisation, reflects the new owner's assumption that asset prices will improve. This includes a $1 billion seven-year term loan refinancing the bridge loan that Ashmore used to buy the assets out of Enron's bankruptcy, and a $500 million working capital facility. The bookrunners were Credit Suisse and JP Morgan.

The new owner has ambitious plans for international expansion: it is cited as a bidder for Globeleq's portfolio, and recently hired the management of Meiya Power to build a business in Asia. The PIK tranche appears to be as much a bet on the success of this strategy as a bet on the improvement in the assets' financial health and value.

Toggle tryouts

While bankers expect PIK tranches to remain part of the market in the immediate future, portfolios with the embedded value of Entegra and MACH Gen are now relatively few. More common will be toggle features, whereby some of the margin on second liens will be repayable in kind at the borrower's discretion.

Both the Plum Point and KGen deals used PIK elements in this way. And these are becoming much more prevalent on second lien loans, in particular Kelson's second lien, a $470 million loan, and the second lien financing for Broadway Gen, the name for Mirant's gas-fired portfolio following its acquisition by LS Power.

In short, in an environment where fewer assets come to market with opportunities for drastic improvement, full PIK tranches will no longer be necessary – a point illustrated by the covenant-light loans on Broadway Gen: Lead arranged by JP Morgan, Barclays Capital, Credit Suisse and Lehman Brothers, the financing broke down into a $800 million first lien term loan, a $250 million second lien, and $165 million in additional letters of credit. It also featured considerably relaxed covenants on waterfall structures and some relaxation on the ability of the sponsor to retain the proceeds of disposals rather than use them to pay down debt.

New names, familiar faces

Borrower	Old name	PIK size	Pricing	Bookrunners	Launch
EBG Holdings	Sithe Boston	$300 million	700bp	Credit Suisse and Goldman Sachs	Dec-06
MACH Gen	PG&E NEG	$853.9 million	na	Morgan Stanley, Deutsche Bank and Bear Stearns	Jan-07
Kelson Holdings	InterGen US	$150 million	850bp	Merrill Lynch	Feb-07
Entegra	TECO-Panda	$850 million	700bp	Credit Suisse, Goldman Sachs and Lehman Brothers	Mar-07
Ashmore Energy	Enron	$560 million	na	JP Morgan and Credit Suisse	Mar-07

Source: Project Finance research