Timing the golden egg

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The UK secondary equity PPP market has grown considerably – rough valuations place the figure of secondary equity bought in 2004 at £400 million ($740 million). And this figure could ramp up sharply – it is estimated that some £45 billion in capital value of UK PPP/PFI projects have been undertaken since PFI's inception in the early 90s, and according to one banker, "all equity stakes are now up for grabs". At the most conservative 90/10 gearing this means that there is some £4.5 billion in stakes on the block.

Now more than just distressed assets are being bought and sold, and generic investors are looking at the market. If one deal can act as a barometer for the market, then the M40 project arguably shows how competitive the UK PPP secondary market has become. Since the concession was awarded the equity participants have changed no less than seven times.

On 28 June 2004 Carillion sold its 50% stake in the project to the other equity partner, John Laing, for £19.65 million. On the face of it this looks a good divestiture: Carillion's original equity investment in the M40 SPV was £2.2 million and it subsequently purchased additional equity from the SPV partners in 2000 and 2001. At the point of sale Carillion's equity interest stood at £13.1 million, with the sale generating an exceptional profit of over £6 million.

Yet within four months John Laing sold on this stake for £26.2 million – on 15 October through an open competition in the secondary market– realising a profit of £6.4 million. The winner of the competitive tender process was the Secondary Market Infrastructure Fund (SMIF).

Alongside SMIF, currently the most active funds are I2 (the joint venture between Barclays Capital and SG), Henderson, and Innisfree. The market is narrow in that there are only two or three funds competing for any one asset, but it is also deep, with many equity stakes up for grabs.

The UK PPP equity players as a whole can be broadly split into three groups: the primaries whose business plans revolve around construction and the need to recycle equity in completed projects to bid for new concessions; the secondary funds that are traditionally long-term holders of PPP and PFI projects that have typically reached their operating stage, with the unitary charge from the concession awarder providing investor returns; and those that operate in both the primary and secondary fields. The entities in this third camp such as Innisfree and John Laing seem well placed.

Innisfree manages three primary funds and manages one secondary fund in joint venture with M&G Investment Management, a subsidiary of Prudential. In October 2001 John Laing transformed itself from a constructor to operator after selling Laing Construction to Macquarie for £1. John Laing's UK Homes business was also sold to George Wimpey in November 2002 for £295 million and an asset disposal programme yielded £122 million. This upside is largely reflected in Laing's share price – its stock now trades at a P/E of 51, compared to the 13 of Mowlem and 11 of Carillion.

It is little wonder mainstream institutional investors are attracted to PPP equity, given the low risk and predictable yields that can be mitigated with carefully drafted sub-contracts, and the capital gains to be had from disposals. That large capital gains can be made is an indication of the different business models of investors and constructors. Constructors concentrate on the construction cost, plus unitary charges paid, plus proceeds from disposal equation, whereas investors look at the net present value (sum of future unitary charges minus discount as future payments) minus a margin for risk and a margin for acceptable returns equation.

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"We have a short- to medium-term investment horizon and will usually hold on to an asset for five to 10 years to recycle our equity," says Bob Shekleton, managing director of Mowlem's projects division. "There's not really an optimum time to divest but it's our experience that returns are optimised when packaged as a portfolio because funds are risk averse – so we look to put together a portfolio before tapping the secondary market."
Also, the size of the capital gains could point to a lack of flexibility in constructor balance sheets or a lack of knowledge about the secondary markets. True, investment is not a usual part of a constructor's business plan, but shareholders are ultimately only interested in bottom line returns.

On the secondary side, existing funds are broadly adopting two strategies to counter escalating prices: they are pushing for relationships to buy assets before a competitive auction, and secondly, with a diminished equity internal rate of return (IRR), funds are taking a conventionally more active stance with their stakes.

Shekleton says: "Investors are having a greater say in the management of the underlying asset, but this is usually at arm's length because involvement on a day-to-day basis would bring costs up for a fund."

In a perfect market with perfect knowledge, all buyers of secondary assets with an equal view on risk would have the same view of net present value of a project. With funds becoming more aggressive the market is moving towards that idiom and falling discounts. But arbitrage plays made by the likes of Laing will still be possible for the foreseeable future because of the pre-emption rights of existing equity players and the short term hold positions of constructors.

Talking shop...

A secondary equity roundtable featuring: Gary Neville, director of secondary markets, John Laing; Barry Williams, director, Secondary Market Infrastructure Fund; Martin McCann, partner, Norton Rose; and Steven Proctor, director, Henderson.

PF: What is your perception of the current PPP secondary equity market in the UK, and Europe? And what do you see as the main factors shaping the current state of the market (e.g. an abundance of infrastructure assets, liquidity of the primaries, lack of alternative investments)?

Gary Neville, John Laing: This is clearly a growing and increasingly competitive market. Individual projects in the primary sector are tending to be of larger values, with extended construction periods that may lead to a short-term dip in the number of secondary assets available until these projects reach the operational stage. Those companies that are able to invest in both phases will be at an advantage, particularly as contractors' views on the necessity to retain equity continue to modify. Equally, the public sector's view with regard to long-term equity tie-in of contractors seems to be changing.

Barry Williams, Secondary Market Infrastructure Fund: The PPP secondary equity market currently performs an important role in providing liquidity to infrastructure project developers. This is essential in the UK to facilitate the development of further primary PPP deals and will be equally so in Europe in the near term.
The supply of capital is unquestionable with over £1 billion made available to provide this liquidity. As asset backed private equity has become an increasingly attractive investment class the supply of such capital to the infrastructure sector should, subject to the maintenance of a benign macroeconomic environment, be assured.
Demand for liquidity has also been firmly established in 2004 with over £400 million invested. The medium term challenge for participants in the secondary market is to improve the quality of the management and guardianship of these assets, both to protect returns to investors and improve the public sector perception of PPP deals.
There are two key obstacles to the further development of these businesses. First, as mentioned above, is the need for a stable real interest rate environment. Second, is the need to encourage greater latent liquidity in PPP transactions. Presently, the restrictions on liquidity placed by project finance lenders, equity investors and the public sector are unhelpful in stimulating a flourishing secondary market. Such restrictions are often unnecessary and drive the secondary market 'underground', opening it to unfounded criticism.

Martin McCann, Norton Rose: The important factor is that a wave of the early projects has recently gone into the operating phase. This has shown the deliverability of the underlying PPP asset under fixed price D&B contract; and

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enabled the reality of operating under the payment mechanics to be tested. Reality is that the large majority of PPP projects that have closed to-date have been in the UK. Almost all of those reaching the operating phase are in the UK. What seems to be shaping the market is the fact that a number of the contractors that hold equity simply think that they can realise a better return from their equity by selling it now, with no residual project risk, than if they retain their investment and continue to be reliant for their return on the proper operation of the project. The secondary players see further efficiencies to be gained in these projects, including, of course, the efficiencies of scale given the scale of their portfolios.

While many disagree with me, I think that the poor performance of the stock market in recent years has made a whole raft of new investors look at the PPP package of simple service contracts, 14-15% IRR, and Government credit in a new light. The secondary market is definitely this year's story in PPP. People have been writing about it for years. At last it has arrived.

Steven Proctor, Henderson: In the UK, PFI sponsors find themselves with large, illiquid investments in PFI. In many cases this commitment constrains their ability to bid for more transactions. This new constraint is unwelcome because the UK government has continued to announce social infrastructure developments throughout the UK.

Increasingly sponsors have pursued strategies that will release some or all of the capital tied up in their existing projects. Over the course of 2004, PFI sponsors, at first tentatively and now with increasing confidence, are approaching secondary PFI investors with a view to a sale.

The criterion for a sale differs between vendors. Some want to retain an interest in their developments whilst releasing some of the value their efforts have created. Others want to fully exit and leave the business of long-term asset management to companies with a longer investment horizon and a low cost of capital. Still others need to find capital quickly; these "accelerated" sales have often been for relatively low prices and not all market participants have been interested in buying the assets.

The key market driver for 2004 has been the arrival of three secondary equity investors into a market starved of liquidity. The increased competition has driven asset prices above the "hurdle" many primary investors had clearly been waiting for. In addition, potential vendors now have a range of partners to choose between. This increased choice gives them the assurance that they are receiving a fair price and, where a prospective partner proves to be unsuitable, an alternative.

The European secondary market is less advanced than the UK market. Europe would appear ready for a secondary market to develop but, as yet, very few transactions have been seen. European project sales could be a growth market in 2005/06, but with a wealth of opportunities appearing in the UK market, many investors are not actively pursuing these transactions.

PF: What is the short to long-term outlook for the market?

Gary Neville: Increasingly aggressive pricing with a surfeit of funds chasing a limited pool of mature yielding projects in the near term, coupled with the secondary funds facing the very real problem of how to manage the assets they acquire without the introduction of a costly infrastructure which could potentially limit returns.

Barry Williams: The short-term outlook is positive, with an increasing number of transactions being closed in 2004 and the potential for a similar number of transactions in 2005/06. As the secondary funds mature into asset holding businesses in the medium term it is likely that Europe will be an increasingly attractive arena for future secondary business. Longer term the infrastructure businesses which are created will seek to attract more competitive capital sources and, I believe, become major participants in the European infrastructure sector.

Martin McCann: The short-term outlook is very good as the glut of projects that closed in 2001/2002/2003 are completed. As long as there continues to be strong activity on the primary side then the secondary market will remain strong. As the pension underfunding in continental Europe bites, it is clear that all governments will have to adopt a form of PPP. Thus while most secondary funds are primarily UK based at the moment, they are likely to become truly pan-European within the next 10 years.

Steven Proctor: The market has huge potential. The par value of equity invested in UK primary PFI transactions is in the region of £3.5 billion. At current market prices this equates to a total market size of between £7.0 billion and £10.0

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billion.
In addition, the UK government is already consulting with key secondary market players to ensure that a liquid secondary market will exists for two of the largest new PPP initiatives, Building Schools for the Future and LIFT.

PF: What particular deals, if any, do you see as defining the market?

Gary Neville: I would have to say the recent M40 deal, because it demonstrated that liquidity exists for a true market transaction which was neither a contractor exiting the equity side, nor a distressed sale.

Barry Williams: It is early days to hypothecate on particular deals. I consider that, in the UK, the earliest deals of note are those that involved a willing vendor (as opposed to a distressed one) as these demonstrated the genuine value on offer.
Martin McCann: I imagine everyone would put forward one where they were involved. Any project where there have been frequent transfers of equity and loan stock over a period of time reflecting the different phases of the deal. A good example is the M40 project.

Steven Proctor: John Laing's purchase of the Hyder Consulting portfolio in 2001 was arguably the first true secondary market transaction. The transaction was at a good price and demonstrated the value of PFI assets to the market at large.

PF: Post construction and with historical concession data, most assets are relatively low risk, but an open competition for assets at this stage puts a premium on these assets. So, do you see secondary players accepting more risk by joining primaries at a less advanced stage?

Gary Neville: I do not see the institutional secondary market players moving up the risk spectrum, as I don't feel their mandates from fund backers will allow such a move. The next development over time may be the emergence of investors buying in at the preferred bidder or financial close stage where the premiums will be lower due to the element of construction and ramp-up risk remaining in the project. Corporate participants such as Laing will continue to be active in acquiring both primary and secondary assets where attractive to do so, as they feel able to evaluate and manage the associated risk profiles.

Barry Williams: SMIF has always been prepared to purchase assets at financial close. However, it is unlikely that secondary funds will become heavily involved in transactions before financial close, as this would place significant resource constraints on such businesses.

Steven Proctor: The possibility of secondary investors joining primary investors by investing in projects pre-completion will be determined in part by the investment philosophy of the secondary investors. A corporate investor may choose to apply lower return requirements to a higher risk environment (pre-construction), but a fund will have predefined investment criteria that it must stick to and may be disinclined to do so. I think that where competition actually occurs the secondary investor will apply a less aggressive pricing methodology to the investment for sale.
For most vendors, in the majority of situations it would seem imprudent to sell investments too early. If projects are sold at an early stage, it is unlikely that the vendor will achieve the higher price associated with selling a substantially de-risked project at the end of construction. Many sponsors are now seeking to bridge their investments into the secondary market rather than sell during construction.
Primary investors are adding value by structuring and negotiating the transactions. It seems unlikely that secondary investors will seek to enter this arena and as such there will still be a premium associated with their activities.

PF: Are there any lessons to be learnt from the fate of Jarvis? Will its experience make funds more risk averse?

Gary Neville: The lessons to be learned from Jarvis are not exclusive to the PFI arena. The dangers of rapid expansion – presumably fuelled by cross-subsidy between operational and investment businesses leading to finely priced contracts and investments – which requires very close management, particularly sensitivity to programme delays, is common to many industries.

Barry Williams: It is important to note that all PPP concessions are reliant, to a large degree, upon the performance and creditworthiness of sub-contractors. Equally it is unlikely that these sub-contractors will remain unchanged over the 25-

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to 30-year term of the projects. The lessons learnt to date are positive, with recovery plans successfully put in place for many of the projects that involved Ballast Nedam. The resilience of the asset class actually improves the PPP story to investors. However, it is also fair to say that all participants will closely monitor the Jarvis situation to see how these projects recover.

Martin McCann: Funds invest a vast amount of time doing due diligence on new assets coming to the market. While the fate of Jarvis is well known, their portfolio was aggressively bid by a number of major players.

Steven Proctor: If anything, this situation reinforces something most investors already know – it is better to hold a diversified portfolio of assets. Over the next thirty years it is almost certain that a high profile company will undergo a financial crisis that threatens individual investments. The best way to avoid a loss is to apply a good credit policy and maintain appropriate contractual controls.
To date, no Jarvis project has actually defaulted, crystallising a loss for third party investors, it is hard to tell what the effect of the current Jarvis situation will be on the market. Depending on what happens to Jarvis developed projects over the next year, this situation could conceivably reassure the market.

PF: Is too much money after too few assets? If so, is the solution to look to other markets, or JVs with constructors?

Gary Neville: At present, I believe there is "too much money chasing too few assets" and despite the increasing quantum and value of projects in the pipeline I think this situation will persist as PFI becomes a recognised asset class characterised by predictable yields which offers an attractive alternative to other investment products in the current economic environment.

Barry Williams: At the moment this is certainly not the case, with over £400 million of liquidity provided by participants in 2004, over 30% of available capital.

Martin McCann: I think there is a lot of money in this market at the moment. However, the reality is that the same secondary players seem to be winning time and time again. They simply see efficiencies in assets where others do now, thus enabling them to lower their price of necessary to win, thus further giving them efficiencies of scale etc.

PF: To facilitate the growth of a secondary market, what developments are needed, if any, on the public and private sides?

Gary Neville: I have three suggestions: Firstly, these projects are not entirely akin to financial assets and require a different level of management to ensure continued success both at the operational and client facing levels. The need for continuing dialogue with the public sector client and a sensitivity to the issues affecting them is paramount.
Secondly, many funds seem to be structured in such a way as to rely on an exit for the "promoters" of the fund, either through a float or securitisation in the relatively near term (roughly three years). The wider market will need to gain a greater understanding of the financial dynamics, risks and management issues associated with these types of assets in order for the exits to be effected successfully – see below.
Thirdly there is increasing acceptance of PFI/PPP assets as an asset class within the investment community and we are likely to see greater participation from pension funds either directly or through asset managers. This suggests that discount rates will continue to fall.

Barry Williams: The secondary market performs a valuable function in the UK PPP arena. It is important for this market to be fostered if the supply of equity to future PPP deals is to be guaranteed. Presently, the public and private sectors seem to be tacitly encouraging this market. However, it is critical to improve the latent liquidity in infrastructure projects to realise fully the benefits on offer and PPP participants should continue to be pro-active in doing so.

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