

# Derby: Fixed but flexible

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The South Derbyshire Acute Hospitals PFI project bond - the largest hospital PFI to date - had a hectic ride to launch. The deal was originally structured as an index-linked bond, but lack of liquidity in the index-linked market forced the project into the fixed-rate market just three weeks before its 3 September launch.

Index-linked bonds have become an increasingly popular means with which to finance PFI projects. Over the last 20 years, no more than £300 million to £400 million has been raised on a quarterly basis through index-linked bond issues. However, exceptional volume this year - for example the London Underground £1.05 billion Metronet project, the Moyle Interconnector and the Dartford and Blackburn hospital PFI projects - has tapped out the market in the short term. Consequently, Derby is the first hospital PFI since Carlisle was financed in 1997 not to go index-linked.

The project, undertaken by Derby Healthcare, comprising Skanska BOT and Innsifree, involves the remodelling and redevelopment of Derby City General Hospital to create a new acute hospital and specialist care diagnostics centre.

The \$446.5 million (\$745 million) fixed-rate bond was priced on 3 September 2003 paying a semi-annual coupon of 5.564%. The maturity on the notes is 30 June 2041 and the pricing at issue was 75bp over the reference gilt (the 4.25% June 2032 gilt). BNP Paribas acted as lead manager and bond and security trustee, Barclays as co-manager, and MBIA as monoline wrap. The deal carries underlying BBB rating by Fitch and a BAA3 rating by Moodys.

The issue includes £35 million in variation bonds, which can be used to cover possible changes in the design of the hospital or subsequent expansion plans, and if the project runs into trouble.

The market for fixed-rate bonds is wider and deeper than the index-linked sector, a fact reflected in the take up. The bond was oversubscribed by 50%-plus with all investors coming from within the UK: two-thirds asset management companies, a third, insurance companies and a small percentage of banks and pension funds.

Market concerns that investor appetite for MBIA wrapped deals would not be there proved unfounded: MBIA has wrapped about £3 billion in the market in last year including the NATS bond refinancing, the BBC deal and Southern Water. "Considering MBIA's current issuance, we are pleased with the execution of the deal," says Luke Kisielewski, head of utility and infrastructure securitisation at BNP Paribas.

The NHS preference for index-linked bonds correlates to the Trusts receiving income from central office that is index-linked. In order to hedge out some of the inflation risk on the fixed rate deal, a fixed escalator has been put into the Trust's payment stream. Instead of making inflationary adjustments each year, the escalator is set at 2.5%, which enables payment to be as close as possible to the index-linking profile.

An RPI swap could also have been used. In this case a fixed-rate bond would be raised and the proceeds of the issue could be used to obtain an RPI swap from a bank or a syndicate of banks, thus enabling the Trust's payment stream to be more closely tied to income. However, RPI is an expensive option as it means a 37-year swap and the capacity for such an option is unlikely to be any greater than the capacity for index-linked bonds.

Derby Healthcare was appointed preferred bidder in August 2002 with Innsifree putting in 75% of the £39 million equity

and Skanska, 25%. As neither entity has extensive soft facilities management capability, this function has been subcontracted to Medirest, the healthcare facility of Compass Services UK.

Skanska and Innisfree are a frequent coupling for hospital projects and the Walsgrave hospital project, which they successfully closed late last year, set a number of benchmarks and provided a strong base on which to develop this deal. BNP Paribas was also the bookrunner on both transactions. "As much of the documentation was carried over from Walsgrave, and with experienced participants the deal was closed within twelve months of the announcement of preferred bidder," notes Kisielewski. Construction began in January this year and it is expected that the new hospital will be completed by 2008.

The Retention of Employment model, which Walsgrave piloted, will be taken a step further in the Derby project and be implemented before the start of operations. As such, Medirest took over the management of non-managerial staff in April through a Mobilisation Service Agreement with the Trust. This agreement will fall away once full operations begin and full PFI services are delivered in the new facilities. "There are inherent advantages to taking over these services at an earlier stage - it gives us a deeper understanding of our clients needs and allows us to address any concerns staff may have as early as possible," indicates Alan Gillman, senior vice president of Skanska BOT.

The Deed of Safeguard, which is now incorporated in the latest standardised formatting guide, SF3, was developed during the process of closing the Derby and Blackburn hospital projects. The need for such a protection arises from the fact that hospitals that cease being NHS Trusts and become Foundation Trusts, which is the likely case for Derby, no longer fall within the ambit of the NHS Residual Liabilities Act 1996. It is therefore not the obligation of the secretary of state to take care of liabilities alongside assets when the Trust cannot do so. "The Deed of Safeguard was drawn up to protect hospitals no longer under the control of an NHS Trust by providing a 'guarantee' that the secretary of state will, in certain circumstances, provide a payment instead to the Trust," explains Jan Sanders, partner at Ashursts Morris Crisp.

The Innisfree/Skanska team are now up against the Bouygues-led Renaissance consortium for the £800 million project for Barts and The London NHS Trust new hospitals project - by far the largest to come to market. This project will see the complete redevelopment of The Royal London and the creation of a specialist cancer and cardiac centre at Barts. Best and final offers have been submitted and an announcement of preferred bidder is expected by the end of October.

Status: Closed 9 September 2003

Location: Derby, UK

Description: PFI bond financing of NHS health services

Concession awarder: South Derbyshire Acute Hospital NHS Trust

Sponsors: Skanska and Innisfree

Debt: 446.5 million bond

Bookrunner: BNP Paribas

Maturity: June 2041

Coupon: 5.564%

Lawyers to the sponsors: Clifford Chance

Lawyers to the awarder:

Pinsent Curtis Biddle

Lawyers to the lenders:

Ashursts Morris Crisp

Sponsor's financial advisor: Investec

Government's financial advisor: PricewaterhouseCoopers

Architect: Capita Property Consultancy

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