Breaking out of the bank

01/04/2000

The launch of Europe's first dedicated project debt fund earlier this year ? the European Project Finance Fund ? promises to give investors and sponsors a first taste of what the US market has been enjoying for a number of years.

Lead investors of the fund are CIT's Newcourt Capital Inc, Stichting Pensioenfonds ABP and John Hancock Financial Services. It is modeled on the group's $500 million North American Project Finance Fund, which was launched, as the first of its kind, in 1997 and has proved highly successful.

Initial commitments to the new fund totaled some s750 million although its target level is s1 billion, which should be reached within the next few months. ?We are talking to a number of investors at the moment which will bring the fund up to its s1 billion target level,? says David Jones, director, at Newcourt in London.

The fund will provide senior and subordinated debt at fixed rates with maturities stretching to 35 years to projects within the European Union, Switzerland and Norway. It is targeted at project sponsors working in the infrastructure, power, water, environmental and transportation sectors and those involved in PFI/PPP.

That this fund was launched some three years after its US parent is telling. The US is the clear market leader in developing and implementing project funds, benefiting from a deep and knowledgeable pool of liquidity for project finance in its domestic capital markets. But US-based funds are also looking to invest abroad and one area where two big name funds have looked and continue to explore investment possibilities is Europe.

The first of these to launch was the $2.7 billion CSFB Institutional Project Finance Programme, formed in mid-1998. Through the fund, CSFB, along with its other participating institutions, provide senior debt for both US and international projects on a pro rata basis. ?While available to projects in Europe, the Programme is US dollar-orientated,? says Mike Powell, director, head of European project finance, at CSFB in London. ?Although we have considered investment opportunities in Europe, none have been included in the Programme to date. It is possible that the Programme could be expanded to include a Euro-dimension in the future.?

More recently, Chase Manhattan launched a $3 billion fund ? the Chase Global Project Finance Fund. Some $2 billion of it is devoted to investment grade projects, with the remaining $1 billion dedicated to sub-investment grade project paper.

But while there have been successful funds in the US, the use of non-traditional sources of finance for European projects has been scarce. The reasons for this are various and demonstrate the difficulties in translating US market practice into the European arena. The European Project Finance Fund may find itself without much competition for a while ? certainly from big European-based ventures.

Funds ? does Europe need them?

Perhaps, the key question proponents of project funds should ask, given the difficulties of transferring the model from the US, is ? does Europe need them? The short answer is, yes. Traditional sources of long-dated project finance will become scarcer in the medium to long term. Banks, through the syndicated loans market, have been the consistent suppliers of debt to project sponsors in Europe. This, in itself, is one of the reasons why funds have not developed earlier ? European banks have been aggressive lenders at the sort of maturities which project economics' demand. But, driven partly by the introduction of the Euro, European banks now face much greater pressure from shareholders to deploy their balance sheets more efficiently in the quest for higher returns on capital. And supplying loan product to infrastructure developments at tenors often of over 20 years is not the most efficient use of bank capital.

Nor do Europe's public bond markets offer much encouragement for sponsors, in the short-term at least. The European capital markets have not developed enough and there have been few project bonds issued through them. The problems, some of which are fairly specific to project development, appear difficult to overcome. The first, more general problem, is the requirement for high levels of public disclosure. ?Some sponsors are uniquely uncomfortable about releasing the details of their project financing plans,? says one European project banker.

Secondly, accessing the bond markets can leave sponsors in a seriously negative arbitrage position. When a bond is issued, the issuer has to draw down the full amount at the outset. But for project sponsors facing several years of no or minimal cash-flow through the construction period, they are left paying out for more debt than they need or which the project itself can support through its own cash-flows.

Nor are Europe's project originators helping the cause. Traditionally, there has not been enough deals in European project finance to achieve the critical mass to support the development of any big financing sources beyond the syndicated credit market. And for project funds you need to be able to assure your investors that the time and money they devote to the fund will be rewarded with a regular stream of suitable investment opportunities. ?A project fund manager needs to be sure he has sufficient deal flow to offer to his investors,? says Mike Powell at CSFB in London.

Promised benefits

The rationale for project funds is compelling. The equity funds promise sponsors the opportunity to deploy less of their own equity into their various deals which, in turn, allows them to re-deploy it elsewhere.

The debt funds offer, perhaps, even more attractive promises. The attraction of this type of fund, from a borrower's perspective, is the attempt to combine the flexibility associated with bank financing with the much longer tenors and fixed rate benefits of bonds.

?The European Project Finance fund will be flexible enough to either act as a complimentary source of finance to traditional bank finance or to finance projects alone,? says Jones at Newcourt. ?The great advantage to project sponsors is that the fund will allow them to have fixed rate debt while at the same time avoiding the costs and volatility of the swap market which they have traditionally used in conjunction with bank debt.?

These debt funds also offer the potential for much faster closure and greater certainty than in the public bond markets by having a group of knowledgeable investors already in place. ?Chase's fund was set up to facilitate institutional investor participation in power, environmental, chemical and energy project finance transactions and to deliver a source of long term capital to projects in these sectors,? says Eric Lyons, vice-president, global project finance and advisory at Chase in London. ?We achieved this by putting in place a set of investors who are comfortable with Chase's ability to assess and understand project risk. But it is not a blind fund ? the investors can assess each project themselves and even reject a deal a limited number of times while remaining in the fund. In addition, Chase always takes a position on these investments. All of this helps us deliver a fast capital markets commitment for a deal.?

The problem of negative arbitrage for projects financed through the capital markets is also tackled by these funds. ?The bond behaves similarly to a bank loan in that it features a pre-agreed drawdown pattern, mitigating the negative arbitrage risk usually associated with this type of instrument,? says Lyons.

Converging conditions

Europe's aggressive bank lenders, unsuitable public bond markets and lack of deal flow for projects have traditionally restricted the development of European project funds, in particular debt funds. But the problems do not seem to be as intractable as they appeared only a few years ago. Indeed, there are tentative signs indicating that a set of conditions are developing, more or less simultaneously, within Europe which could lead to the development of a wide-spread fund-supporting environment.

The key driver to the development of European project funds is appetite from institutions. This is undoubtedly growing. ?Some of these institutions are, while not exactly desperate, certainly increasingly anxious to find some yield pick-up over their investment horizons,? says one financier in London.

The potential investor-base for European project funds is in the process of re-orientating itself from its traditional investment products. European insurers and fund managers are having to look for greater income through higher yielding investments. At a stroke, the introduction of the Euro deprived them of one of their big areas of income ? foreign exchange and interest rate plays within Europe's many economic systems.

Secondly, these investors are having to find higher-yielding product to meet the rising demand for private pensions. ?Unlike in the US where there has traditionally been a large provision for private pensions this has not really been the case until recently in Europe,? says Jones at Newcourt. ?As such, there has not been the same pressure on fund managers to provide higher-yielding product.?

The Euro has forced the fixed-rate markets in Europe to embrace a wider class of assets and this will assist the development of European project funds. Paradoxically, however, the introduction of the Euro may have hindered investment bank-sponsored Euro-debt funds.

The investment banks that focus on European project finance face a dilemma. Since the launch of the Euro, investment banks have been working hard to develop this new capital market. If, with only a handful of suitable project deals available in Europe, an investment bank formed a dedicated fund which required the majority of those projects to be directed into it to meet the investors' requirements, how could the Euro-public markets for project paper also be developed. ?Investment banks could risk cannibalizing the development of the public Euro-capital markets with a dedicated Euro fund,? says Mike Powell at CSFB.

UK PFI sets the tone

Ironically, given the importance of the Euro in this context, the most advanced area within Europe for project funds is the UK. The trend can be traced, at least in some part, to the UK government's adoption of the Private Finance Initiative (PFI). Both equity and debt funds have been formed to meet the rise in PFI project financing. The key attraction appears to be the combination of effectively UK government risk and the higher spreads associated with project finance.

The first to move into PFI were the equity funds. And among these, Innisfree PFI Fund was the leader. ?We set up in 1995 as an equity investor and we were the first fund to target PFI,? says Matthew Webber, director at Innisfree PFI Fund in London. ?We now target Public-Private Partnerships (PPP) projects as well.? There are two funds within the Innisfree operation ? one for £85 million and the other representing some £150 million of investment capital. Investors in the funds chiefly comprise big insurance companies.

Since then there has been growth in the number of equity funds looking to invest in the UK's PFI and PPP schemes and the sector has begun to mature. Debt funds developed later but there was a clear need to find a source of long-term debt which was able to match the concession periods underlying these transactions. ?With PFI came the need for longer maturities and hence the need for non-bank funds,? says one project finance advisor in London.

Now indeed, there are funds which finance both the debt and equity elements of a PFI deal on their own. ?The Norwich Union Public Private Partnerships fund was set up in 1997 with the aim to be the first institutional property investor into the PFI market,? says Jeremy Tilford, director, at Norwich Union PPP. And that means the unique position of financing the entire project ? not just providing the equity. ?We take prime development risk and operating risk on these investments ? we do not shelter behind a special purpose vehicle,? says Tilford. ?We manage these primary risks and contract out the delivery of the associated services.?

The fund, which specializes in the health and community sectors, has one operational project in its portfolio, two which are under construction and a further two which are due to reach financial close shortly. The motivation behind setting up the fund is simple ? a search for yield. ?We view PFI investments as an attractive alternative to investing in Gilts and similar financial instruments,? says Tilford.

Last year proved a difficult one for UK PFI funds with a lack of schemes ready for financing ? a theme which has been more permanent in continental Europe. This year however, the UK PFI deal flow is expected to pick up. ?There are many more projects due to come to market this year,? says Webber at Innisfree. ?Competition among both equity and debt providers for PFI is growing noticeably in the UK.?

While neither Innsifree or Norwich Union PPP proclaim any plans to move into continental Europe as the UK market grows more crowded, there is likely to be more PFI-style opportunities across the continent in the next few years. ?Outside of the UK, PFI type deals are not quite there yet in Europe,? says Jeremy Church, associate director of project finance, at Duff & Phelps Credit Rating Company in London. ?Spain and Italy are probably the two most developed markets for this type of transaction but it is likely to be a year or two before deals get off the ground.?

If the spread of PFI systems across the Continent offers the best prospect for European-wide fund development it will have to deal with issues which neither UK or US funds need to deal with. European funds will have to deal with varying sovereign ceilings. For projects in some European countries funds will only be available if the deal features external credit enhancement in the form of a monoline wrap. ?We are likely to see a migration of credit risk insurers from the UK into the European project market and over the next few years they could become very active,? says Church at Duff & Phelps.

Educating investors

What is holding back the development of these funds is the lack of a knowledge base among the potential investors. ?Until the introduction of the Euro, a number of European institutions had never bought a credit product,? says one banker. ?Since then they have started to buy corporate bonds and have clearly had to develop some new investment criteria.? And as these institutions expand their investment criteria in the search for yield, they should eventually begin to focus more on project paper. This will be done through a series of incremental steps into niche markets, which will increase the breadth and depth of their knowledge and ability to take project risk.

?Most project risk tends to be around the triple-B level,? says Church. ?The increasing use of monolines in European project finance will allow investors who are restricted to invest in triple-A rated paper to gain some exposure to projects.? In effect, monolines will provide one of European institutional investors' first lessons in buying project paper.

This in itself will be a valuable tool in the development of institutional appetite for project paper and will mark an early step in the education of these investors in project finance risk ? perhaps the most important single factor in the growth of European project finds. ?Developing investor understanding is the key to getting the market off the ground,? says Church at Duff & Phelps.

Another form of incremental development of non-traditional sources of finance for Europe could be through the securitization market. A growing convergence of structured product appetite across Europe may give a further dimension to project funds. As investors in certain structured markets such as securitized credit-card receivables or mortgages, for example, develop greater understanding of the product's characteristics they may choose to broaden the diversity of assets supporting the technique. In this way, a wider investor basis for enhanced project risk may develop in Europe.

In time, the growth of a substantial European private placement market should mark the watershed for institutional investment in project paper and as the precursor to a wider group of dedicated project funds, as it was in the US. ?The private placement market is an excellent way for investors to tap into project risk knowledge on a closed basis,? says Church. ?It provides investors with a fluid process of knowledge acquisition.?

Acquiring the ability to assess and price project risk is the most important skill Europe's investors needs to develop to ensure that its only dedicated project finance fund is not without much competition for too long. ?It is a great advantage for a project fund if you can tap sophisticated investors who can move quickly on investment proposals,? says Powell at CSFB. ?This gives issuers the confidence that the investors will understand their projects and that their behaviour will be predictable. I think European institutional investors still have some way to go before they reach this level.?