In recovery

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Credit markets are recovering, and capital is again flowing to infrastructure assets. But the pain for some borrowers is not over. Since the start of 2010, three high-profile deals have defaulted, and others are struggling against a similar set of problems, chief among them high leverage and poor usage. Some of the defaulted projects, however, serve areas left high and dry by the housing collapse, with no hopes of recovery even in the medium term.

The timing of the defaults might seem surprising, given that the last quarter of 2009 and the first quarter of 2010 witnessed a strong recovery in bond and bank markets. A number of deals for untried ventures including the Brooklyn Nets arena and the North Tarrant Express managed lanes financing cleared the tax-exempt bond market. But the deals that defaulted had struggled for some time, had eaten up both the leeway built into their financing for ramp-up and their reserves, and had exhausted their restructuring options.

Distressed US infrastructure projects will have to deal with a confluence of issues, among them the demise of the monolines, financial difficulties in local government, as well as, in one case, the presence of the federal government as a lender, which is unprecedented. It will make drawing parallels with previous bouts of disruption in the Australian and Chilean roads markets, as well as the power markets collapse in the US, an imprecise exercise.

Greenville grounded

The first project to default in 2010 was the Greenville Southern Connector, which missed a 1 January interest payment on its $200 million in bond debt. The Connector 2000 Association, a 63-20 not-for-profit company, was looking for a buyer that could defease the bond debt, even if this meant the road ended up in the hands of a for-profit entity. The association had hired Goldman Sachs in February 2008 to examine its options, and commissioned a new revenue study from Stantec, to no avail.

The 23km Greenvile road was financed in 1998 with a Lehman Brothers and Mesirow Financial led bond package, of which $304 million is still outstanding. The association has indicated that its assets stood at $160 million, or a little under half its liabilities, and coincidentally the road, which runs to the south of Greenville, South Carolina, has traffic levels of roughly a half of its forecasts.

The development on which the roads success was predicated simply did not materialise, and neither Goldman Sachs nor Macquarie, both possessors of strong M&A advisory franchises, could find a way to restructure or defease the debt with a trade sale. The Stantec study led to a recommendation to raise tolls, which was duly implemented in November 2009, but the gap between assets and liabilities was too great.

The possibility of a sale rested on the example of the Pocahontas Parkway, a 14km toll road, also highly dependent on real estate development, that Transurban bought from its struggling non-profit association in June 2006. It raised $410 million in debt for its $610 million purchase from Depfa, HVB, Banco Espirito Santo, but refinanced $92.5 million of this with a long-term $150 million loan from TIFIA. Performance on the road has subsequently been modest (revenue was down 1.9% in 2009, though this was a poor year for infrastructure operators generally), but lenders have not yet suffered.

Greenvilles most obvious lesson is that traffic studies need to be more accurate and less reliant on economic assumptions with huge impacts on traffic levels. Some distressed financings have economic fundamentals that justify lenders taking a long-term view of a roads prospects, but some do not, says Yuval Cohen, most recently a vice-president at Parsons Brinckerhoff. This is what business case assessments of toll projects have to come down to corridor and adjacent region economic fundamentals.

The lesson has already been absorbed at commercial project finance lenders. No bidder would raise enough debt to defease Greenvilles outstanding bonds, because banks are taking a much more conservative view of the amount of leverage that toll concessions can support. Asked about the conditions for such for-profit restructurings, Allan Marks, a partner at Milbank Tweed notes, fewer banks are active, spreads are wider and most significantly tenors are much shorter than in the pre-recession credit environment.

Banks have been encouraged to take a hard line on borrowers after their success in forcing ports acquisition sponsors to put up more equity to keep their deals afloat. The ports deals, completed in 2005 and 2006 at eye-watering valuations, and frequently structured with debt/Ebitda covenants, broke these covenants as trade volumes plummeted during the recession. Faced with default and possible foreclosure, sponsors often opted to pay down debt with equity to keep deals in compliance. In these instances they owned assets with slightly monopolistic characteristics and the ability to bounce back quickly with economic conditions.

Banks that identified similar characteristics in power projects and stuck with them during the post-Enron collapse frequently came out with lower losses on their loans than those that sold out hastily to hedge fund investors. Timing is everything, because banks that took the opportunity to be refinanced by hedge funds and B loan lenders in 2005 at slightly below par will in turn have made out better than those that held out for an IPO of these assets that did not take place in 2008 as planned.

When to be greedy

Transport lenders lack power lenders luxury in choosing the timing of their exit, because little new capital is available. Transport assets do not have scrap value, utilities as last-ditch buyers, or leveraged loan providers waiting in the wings, As Milbanks Marks notes there is not as much opportunity to create additional revenue or reduce project costs for transportation infrastructure than for a typical power project. Transport distress is much less widespread than it was in power, since a small number of roads were financed using 63-20 non-profit structures, and a similarly small number was financed using PPP structures. Turnaround specialists lament the small number of transport borrowers that have decided to hire them, though there is little business to go round.

The market leader is probably Australian business recovery specialist KordaMentha, which has a 100% market share in handling bankrupt Australian tunnel operators. It oversaw the sale of Sydneys Cross-City Tunnel in 2007, raising A$700 million ($837 million at todays rates) from ABN Amro and Leighton to pay back A$620 million in debt. KordaMentha is also working on the A$630 million sale of the Lane Cove Tunnel, also in Sydney, to Transurban, this time for a little over half the MBIA-wrapped debt to which the tunnel is subject.

The Australian examples travel poorly, because both of the tunnels are located in developed urban areas, but had such high construction costs that their business case called for high leverage, and relied upon revenue studies of dubious value. By comparison with the death throes of their US counterparts, their end was swift and decisive, with the comparatively creditor-friendly Australian insolvency process takes most of the credit.

The US non-profit structure was almost tailor-made for painful work-outs, as Milbanks Marks notes: Because they rely on 100% leverage, the non-profit structures contain less of an equity cushion than a typical project financing in the power sector might. As a result, the fund transactions quite often rely on large reserves, like debt service reserves, to cover potential revenue shortfalls, but once the reserves are depleted, there is no equity sponsor available to put in more capital. In addition, the large debt service reserve accounts for many on the bond-financed, non-profit-owned toll roads can mask revenue problems and delay workouts. Also, the bond holders ability to accelerate the bonds may be limited in some non-profit deals.

Ambacs long shot in Las Vegas

The bankruptcy of the Las Vegas Monorail has thrown up a novel legal kink in the restructuring process. The monorail runs between the backs of the casinos that it serves, and thus suffers from poor visibility and from offering its users lower convenience. It was financed in 2000 with a Salomon Smith Barney-led bond issue, which broke down into an Ambac-insured $450 million senior tranche and $150 million junior tranche. Credit derivatives traders have set an initial value of 27.5 cents on the dollar for the distressed debt.

The monorail filed for chapter 11 bankruptcy protection on 13 January, saying that it could not cope with a 30% decline in convention traffic to Las Vegas and its high debt burden. Ambacs obligations to senior bondholders total $1.1 billion, if it paid out on its obligations to maturity.

It has, however, in common with other monolines, the option, but not the obligation, to accelerate some, or all, of what it owes to bondholders. Depending on a monolines resources, it might prefer to crystallise a loss by foreclosing on an asset, and pay off the amount not covered by the proceeds of a sale to maturity. Monolines, then, will not always be patient in bankruptcy proceedings. Those with policies held in segregated accounts by alarmed regulators, such as the one established for Ambacs distressed obligations by Wisconsins insurance regulator, and in which the monorail policy resides, will have a still different set of priorities

But an aggressive approach to disposing of collateral might explain why Ambac petitioned the US Bankruptcy Court for the District of Nevada for the monorails bankruptcy to be handled under chapter 9 of the US bankruptcy code, for municipalities, rather than 11, for private corporations. The filing ostensibly made little sense, because municipalities enjoy a wider range of manoeuvre in bankruptcy than private corporations. As Lewis Feldman, a partner at Goodwin Procter in Los Angeles, notes, Theres little precedent for how a chapter 9 filing would work out. The only live chapter 9 case is the city of Vallejo in California, and that case hinges on pension obligations. Unions hold the key to Vallejos restructuring, and I cant see the case applying to transportation projects.

But under Nevada law, municipalities cannot file for chapter 9 protection, and if Ambac received a favourable ruling it could foreclose immediately. Ambac argues that because the bonds had received tax-exempt treatment, because their issuer was an instrumentality of the state of Nevada, the issuer should be considered a municipality and file under chapter 9.

The possible implications of the Ambac motion have been widely discussed. One school of thought holds that if Ambac had prevailed, states might have been liable for the debts of financing conduits, though that alarming possibility is thought to be remote by the lawyers canvassed by Project Finance. But the monolines move still looks short-sighted. It is possible that in states where chapter 9 filings are permitted, a creditors position in a bankruptcy would be worse than under chapter 11.

The monorails position is intractable. It has a passenger base, but not enough revenue to service anything but the minimal debt left over after a drastic debt haircut. Even if the state of Nevada were to permit it, Ambac will struggle to find a for-profit buyer for the monorail. The borrowers best shot at redemption is in a $500 million extension of the monorail to the citys airport, though the city of Las Vegas, dealing with a collapse in gambling and tax revenues, is not in a position to support such a venture.

South Bays shot at a refinancing

The non-profit structure, even without these complications, had been losing ground to private deals for several years. A tax-exempt bond issue, even with large funded debt service reserve requirements, usually has a lower cost of capital than a bank/equity capital structure, even one with a portion of TIFIA funding. But such structures are still incapable of dealing with prolonged financial distress in the way that equity can.

But some distressed for-profit borrowers might turn to a non-profit tax-exempt bond-financed issuer to buy out their project, if public bodies agree and rating agencies sign off. Goodwin Procters Feldman notes that some of the constituent parts of the Transportation Corridor Agencies, the joint powers authority that runs several toll roads in orange County, California, were once unsuccessfully operated by private entities, before being returned to public hands and financed with tax-exempt debt.

The option has been among the ones that the lenders to the South Bay Expressway are considering. South Bay is the lone for-profit concession among the three to default this year, and the first on which the US Department of Transportation is a lender, through its TIFIA programme. (For more background to the troubles of the 14km toll road, search SBX and SR125 at www.projectfinancemagazine.com)

South Bay suffers from a combination of poor revenues and contractor litigation that has buried the poorly performing project in legal bills. The sponsors, two funds formed by Macquarie, have written off their equity, and the project company filed for chapter 11 bankruptcy protection in March. South Bay, running to the east of San Diego, is carrying $340 million in bank debt led by BBVA and Depfa, while since the default, another $140 million in debt and $30 million in capitalised interest owed to TIFIA ranks pari passu.

The sponsors put in $170 million in equity, and the project benefited from roughly $132 million in public grant funding. Even with the equity written off, as Macquaries Atlas Roads Group has done, the debt load looks daunting relative to revenues, which are thought to be roughly a third of forecasts. The project also has to contend with a mechanics lien, which the contractor for the road, a Washington Group/ Fluor joint venture, has filed against the project.

The best indication that the borrower was considering a bond recapitalisation comes from its hiring of Imperial Capital, a Los Angeles-based investment bank, as its financial adviser. Imperial is well known as a specialist in high-yield financings, and had been working with the project company since February 2010 on a proposed restructuring. Its co-heads of restructuring worked at Giuliani Capital, which was subsequently bought by Macquarie, and it advised Panda Ethanol on its banruptcy, on which BBVA was among the lenders.

Both the United States Bankruptcy Trustee and BBVA objected to the Imperial hiring, the former because of the engagement letters indemnification provisions, and the latter because of the fees that Imperial would collect. The original engagement suggested that Imperial would collect the greater of $1.25 million and 1% of any successful restructuring, on top of a monthly fee of $150,000. Particularly galling to the lenders was the provision that Imperial would collect a fee of 0.6% even during a sale to an existing participant on the transaction.

The arrangement has since been modified, with BBVAs blessing, to a monthly fee of between $150,000 and $200,000, although the arrangement does not appear to preclude Imperial from collecting financing fees on a recapitalisation deal. At present that has not been any public tension between TIFIA and BBVA, though it is conceivable that the USDOT could be asked to remain in the project as part of any settlement, though it has said in the past that it would not consent to unequal prepayment structures.

The bulk of recent filings in the SBX case concern the authorisation of fees to legal and other advisers on the restructuring, though meetings of creditors were set to take place as this article went to press. Macquarie is understood to have a continuing role in the restructuring, and might emerge as the manager of a restructured non-profit South Bay under a performance-based management fee structure.

Yet another alternative

Cohen, who has in the past worked on the formation of non-profits, thinks that in the long term a road like South Bay can be restored to health. It might take 15-20 years, but theres a rationale for the road in the long term. We need to engage patient sources of capital, seeking inflation-adjusted returns through a longer prism, to carry projects through. He cites the example of Chile, where the countrys Ministry of Public Works restructured concessions with revenue risk to make sure lenders got repaid over time while limiting the upside available to equity (for more on the process, search for the initials MDI).

Local government in the US will not have the same ability to provide minimum revenue guarantees to distressed toll projects, and are more likely to be looking at ways to monetise still more transport assets to raise funds or eliminate financing obligations. Chile, which combined some of the problems facing US concessions, including poor growth, and monoline-wrapped bonds, still offers the best model for what US authorities could do.

But its government was focused on keeping domestic pension fund lenders whole, a priority that US governments may not share. Government might be prepared to assent to toll increases, and the indenture for some bond financings forces issuers to raise tolls to meet revenue shortfalls. Alternatively, where this option exists, government might encourage a comparatively healthy toll authority to take on a poorly performing road, or to be the vehicle for the construction of new sections. Moodys, in recent research on the US toll sector, has warned that distress in local government makes the second scenario a possibility

But new financing structures and generous grantors will only do so much. Revenues on some roads, for instance, appear to be impervious to toll increases. The San Joaquin Hills Transportation Corridor Agency, one of the Orange County roads financed with tax-exempt debt during the mid-1990s, has raised tolls aggressively in an attempt to counteract lower vehicle numbers.

Economic weakness in the area served by the road has made demand for the road increasingly elastic. The most recent increase, notes a recent Fitch affirmation of its BB rating on the projects $2 billion in debt, appears to have led to a decrease in revenues. Fitch indicates that in a downside scenario, the road might reach a payment default in 2020-25. Until then, its debt service reserve should keep it ticking over.