How bonds took over Canada's PPP market

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The bond market for Canadian public-private partnerships is booming. Half of the PPP concessions that have reached financial close so far this year used long-term publicly-rated bonds, compared to a third in 2010.

Investors are flocking to the instruments. New issues have been significantly oversubscribed since SNC-Lavalin and Innisfrees C$1.57 billion ($1.54 billion) McGill University Health Centre concession in Quebec closed in July 2010. The bonds set a yet-to-be-broken record of attracting more than 50 investors and marked the beginning of a trend of steadily tightening spreads on long-term PPP bond debt. Pricing is currently between 200bp and 210bp over the equivalent Government of Canada bond with large Canadian bank underwriters Bank of Montreal, Canadian Imperial Bank of Commerce, Royal Bank of Canada (RBC), Scotia Capital and Toronto-Dominion, as well as Casgrain and National Bank Financial leading the charge. Despite the competition and diminishing yields, Canadian institutional investors want more.

Spreads on recent Canadian bond issues

In an investment environment characterised by low interest rates and hyper-volatility, quality infrastructure bonds are an attractive investment alternative, says David Frei, the portfolio manager in charge of Fiera Sceptres infrastructure fixed income investment strategies.

Bank loans are slowly being pushed out. Wider spreads and an inability to provide long-dated tenors have made it difficult for banks to compete for all but short-dated construction or design-build-finance contract debt. The last full bank deal was ACS Infrastructure, Acciona and Fluors C$1.2 billion Windsor-Essex Parkway concession that was financed with a C$954 million construction loan and C$166 million soft-miniperm in December 2010. Banco Santander, Banesto, BNP Paribas, Bank of Tokyo Mitsubishi UFJ, Caja Madrid, Credit Agicole, Dexia, ING, Societe Generale and WestLB were joint arrangers of the club debt.

PPP project bonds are the current norm for infrastructure concession financing in Canada, but some market participants are concerned about the way that the bond markets have priced the risks in PPP concessions, and warn that one default could deal a significant negative blow on the budding bond market.

Market expansion

The popularity of project bonds among institutional buyers is a measure of the maturity of the Canadian PPP concession model. The financing structures are more sophisticated than corporate or government bonds, but their reception indicates that buyers have grown comfortable with the risk allocation and structures of long-term PPP concessions. A number of factors contributed to the explosive popularity of these bonds during the past year.

PPP bonds carry some risk but offer government cashflows with some additional yield compared to provincial bonds, says Heather Mason-Wood, a vice-president at Canso Investments. Even with tightening spreads they are still attractive compared to provincial and quasi-provincial issues.

Infrastructure bonds pay about a 50bp premium over the government and corporate issues outlined by Mason-Wood. The GoC benchmark long-term bond yield was 2.76% on 10 November, which is down from an average of over 4% in mid-2009. The most recent issues by quasi-governmental entities, such as the Greater Toronto Airport Authority and Hydro-Quebec, priced at about 155bp over the equivalent GoC in February and 107.145bp over the equivalent GoC in January, respectively. Comparably, Carillion, EllisDon and Fengate Capital-led Hospital Infrastructure Partners Oakvilles C$543.4 million 34-year bond priced at 205bp over GoC in July and Plenary and Innisfree-led Plenary Health Care Partnerships Humbers C$375.3 million 34-year bond priced at 210bp over GoC in October. Ontario was the provincial counterparty in both deals, which were both A-rated.

As PPP financings increased in size they needed more investors to keep bonds competitive with banks. In addition, they became more visible to potential buyers of the debt. Before McGill, few long-term concessions in the market had total costs greater than C$1 billion. The larger project bonds were then listed on the Dex Canadian bond indices, which in turn attracted additional investors, most notably index funds, to the issues. Dex requires that a bond must be larger than C$100 million and have more than 10 investors (the typical private placement has less than five) to be listed. Education was also key, with Scotia Bank, Dexia and Casgrain holding the first PPP project bond roadshow in Canada for McGill. PPP project bonds are the natural evolution of things, says Jonathan Duguay-Arbesfeld, vice president of government and corporate finance at Casgrain. Bonds were the way for the market to grow.

Appetite for municipal counterparty and revenue risk project bonds is untested. None of the few municipal PPP deals in Canada that closed during the past two years used a bond financing. However, this may soon change as a number of large municipal concessions are either in or near procurement, including the C$2.1 billion Ottawa Light Rail Transit project and the C$400 million city of Calgary recreation centres package. Underwriters and institutional investors agree that, if a bond solution is selected, the resulting issue would probably price with a 50bp to 100bp premium over the prevailing pricing on an A-rated provincial or federal deal.

The only revenue risk bond issues have been for the operational 407 ETR and the Confederation Bridge in the 1990s. All of the recent project bonds have been for availability payment-based concessions. However, this is due more to the lack of any full revenue risk deals from grantors than to a lack of appetite among bond investors.

Pricing would probably be a lot wider on bonds that carry volume risk, says Jerry Domanus, vice president of fixed income and private placements at Standard Life Investments. But there is a place for properly structured and priced deals. Indeed, on 14 November, 407 ETR issued C$350 million in senior notes due 2041 at a coupon of 4.45% through BMO, RBC, Casgrain, CIBC, National Bank, Scotia and TD.

Risky bets

Questions remain about the ground on which Canadas project bond boom is built. One European lender who has worked on a number of infrastructure deals in the market, says they are still concerned with the ubiquitous A rating given to the majority of these issues. They say that construction and other risks are underpriced with current spreads.

Canadian PPP project bonds stand on three legs, says another lender active in the Canadian market. If one leg breaks, that deal and the market will collapse. All we need is one bad deal and the new investors will leave the market.

All but one project bond since McGill has been rated A. Rating agencies, including DBRS, Moodys and Standard & Poors, cite strong construction and operations guarantees from the contractors and relatively low payment risk with provincial or federal counterparties for their ratings. The lone triple-B issue was Dalkia, Innisfree, Laing ORourke and OHLs Centre Hospitalier de lUniversité de Montréal (CHUM) C$1.371 billion 38.8-year bond that was rated BBB (high) by DBRS and

Baa2 by Moodys in June 2011.

Cansos Mason-Wood says that the firm rates each PPP project bond BBB internally and subscribes based on that risk assumption. The various construction and performance guarantees as well as the experience of the construction and operating companies are the first criteria the fund manager looks at when evaluating an issue. She adds that not every buyer of the asset class reviews each deal in-depth and some take the view that all PPP bonds are alike a stance that could pose risks to those investors.

Domanus says project bonds are not underpriced as long as there is the 50bp premium over similarly rated public Canadian corporate bonds. The essentiality of a project as well as the sponsors relationship with the grantor are the first criteria Standard looks at when evaluating an issue. Both Canso and Standard take a more positive view of bonds for projects that have equity sponsors and construction and operations contractors that have significant experience in the type of asset covered by the concession.

Whether or not Canadian project bonds are underpriced, there is likely to be a default at one point. Lenders always assume a marginal rate of default on their loans and bond investors must assume the same for PPP bonds. The market would stumble if that happened but it might nudge sponsors towards stronger and more resilient structures in the future.

Bonds away

Market participants estimate that there will be between five and 10 rated PPP issues annually for the next few years. Based on current market appetite, which has resulted in each issue this year being significantly oversubscribed even the B rated CHUM bonds all of these deals are expected to attract similar levels of interest as long as a default has not occurred. Todays market lends itself well to true funding competitions for concessions, says the Canadian lender. Lower costs and market acceptance also allows for the diversification of projects. Infrastructure Ontario is in the midst of tendering a long-term design-build-finance-maintain concession for an electronic prescription and drug information system for doctors and patients in the province and Alberta Infrastructure a 10-year design-build-finance-operate-maintain concession for the C$40 million Evan-Thomas water and wastewater treatment plant. New sectors may not initially be well suited to bonds as their structures and risk allocations are less familiar to investors, however. ■