Can Dutch PPP shift institutional interest to debt?

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While the UK government struggles to explain how its pension funds can invest in infrastructure, the Netherlands has made substantial progress in attracting institutional capital to its PPP programme. The independent Dutch Infrastructure Fund, which runs an infrastructure fund, a PPP fund and a renewables fund, numbers domestic institutions ABP and DSM among its investors. Two domestic construction companies have now struck bilateral deals with pension funds to form ventures to invest in infrastructure assets.

The Netherlands Ministerie van Financiën, or finance ministry, and Rijkswaterstaat, part of the Dutch ministry of environment and infrastructure, have now structured the bidding for the N33 road project to include a Eu140 million stapled financing from ABP. The staple, which benefits from inflation protection from the finance ministry, is the first time that institutional infrastructure debt has been so closely integrated into a concession.

Market participants are enthusiastic about the pilot deal, though nervous about the ability of private bidders to adapt the staple on offer to their own requirements. ABP has indicated that a lot of its enthusiasm for the deal is down to a straightforward availability-based risk profile, but details of how the structure would mitigate issues with construction and interest rate risk are few. Given the halting progress that Europe has made towards developing project bonds, the deal will attract attention out of all proportion to its Eu190 million size.

Spinning out

The funds have a longer exposure to infrastructure equity, and so recent activity in PPP has been concentrated on that part of projects capital structures. In May Royal BAM Group and pension fund PGGB created a 50/50 joint venture, named BAM PPP PGGM Infrastructure Coöperatie, to focus on PPP projects in the Netherlands, Belgium, the United Kingdom, Ireland, Germany and Switzerland. The target value of the JVs portfolio is Eu390 million ($522.2 million), with BAM PPP transferring Eu150 million of its PPP assets into the vehicle and the rest earmarked for new projects.

The JV is novel for the Dutch market because it establishes an indication of how differing market participants might carve up project roles as the market evolves. Many of the larger Dutch sponsors, being primarily construction companies, are more interested in the engineering, procurement and construction and maintenance aspects of PPP contracts rather than long-term equity investments.

There has been five or six local players competing at the BAFO [best and final offer] stage for projects and they have been quite successful during the last few years, one banker says of the recent activity. The market, however, is now at a point when companies need to free up capital from their existing portfolio to focus on the future pipeline.

This is where pension or investment funds can make a real difference; they allow sponsors to concentrate on the contractual duties and expertise while the investors benefit from a stable cash flow from established projects. In the case of the BAM/PGGM pact, BAM will remain in charge of bid management and services while PGGM will provide most of the equity to acquire the existing projects, while that for future deals will be split 50/50.

Pension funds are a great source of long-term funding and PGGM helps the robustness of our business, explains Henri Witteveen, director of BAM PPP for the Netherlands. Generally, contractors tend to be short-term investors and sell equity stakes in projects soon after completion. Not only does PGGM provide a long-term financial commitment but it means that we can continue to bid for larger projects across Europe without having to join a consortium to mitigate the costs and this specific risk.

Equity stakes

PGGM has already invested in projects alongside DONG Energy and Lend Lease. The BAM deal, though, was the first such venture between a developer and a pension fund in the Netherlands. From an investor viewpoint, PPP is considered one of the lower risk investments, with a stable long-term cash flow and inflation-linked returns all agreed with government entities.

Henk Huizing, head of infrastructure at PGGM, points out that such factors are attractive for pension funds, which can offer more long-term benefits to developers on a bilateral basis than as investors in third-party funds. PGGM does not have an explicit exit strategy when it comes to PPPs; we are in principle committed to stay for the entire duration of a contract, he says. This differentiates us from infrastructure funds that usually have a 10-year horizon.

It was not just PGGM courting the PPP market in 2011; a selection of equity transactions has kept the secondary market busy as sponsors restructure their business. DIF Infrastructure II purchased 80% of Dutch contractor Struktons equity and subordinated debt commitments in six concessions, while DG Infra Yield, a Dexia and GIMV-managed fund with institutional investors, formed a new joint venture with Ballast Needam, Benelux Secondary PPP Fund I, to buy up equity stakes in projects that have a total size of Eu700 million.

The two deals saw both Strukton and Ballast sell their stakes in the Groningen education and tax office and the Kromhout Barracks PPP. The Strukton portfolio also included Montaigne Lyceum; The Ministry of Finance offices in the Hague; the Harnaschpolder/ Houtrust purification project in Den Hoorn and Scheveningen; and the A15 Maasvlakte-Vaanplein.

Taking the Groningen and Kromhout projects as examples, both were amongst the first social infrastructure PPPs to reach financial close in the Netherlands in 2008. Strukton and Ballast were co-sponsors with John Laing, which maintains its stake in the PPPs but has access to a UK-listed vehicle, JLIF, with whch it can recycle equity commitments. The projects attracted solid financial backing and finished the construction phase in the last year or so.

The operating company, Strukton Integrale Projecten, will remain responsible for the day-to-day management of these interests, says Erik Hermsen, director at Strukton Integrale Projecten. The released capital with this sale ensures that we can continue to play a leading role in future PPP projects as a provider of equity.

The equity sales underscore how advanced the Dutch PPP market has become. While the country has not closed multi-billion euro deals every year, there is a good portfolio of decent-sized projects that have been successfully financed and completed on time and in budget. Likewise, the documentation is fairly standardised now, and this stability is attractive to investors.

Debt sources

The emergence of an institutional market is always a positive sign, say sponsors. Banks tend to invest money at minimum risk and maximum profit; they are less inclined to invest in long-term projects but pension funds can deal with it differently, Struktons Hermsen comments. Pension funds want to be paid to compensate for inflation, and the government is reluctant to do that when banks charge a flat rate. But if you consider the investment over 20 years, for example, financing from a pension fund can be 10% cheaper than a financing from banks, Hermsen adds.

There is, however, only a limited number of pension funds with the capability and resources to invest in the sector, so competition for their attention will be intense. But they could reshape the project finance market. The crisis in Europe, Basel III, and continued pressure on liquidity and leverage ratios continues to put long-term financings under stress. As such, banks and sponsors are looking at alternatives to traditional long-term door-to-door project financings.

Bonds for PPP have been mainly restricted to jurisdictions such as Canada, where all equity PPP concessions in 2011 were financed with bonds, and the UK. Mainland Europe, however, has seen very little activity or appetite for PPP bonds thus far. Pension funds may decide, much as they are increasingly dispensing with third-party equity managers, to provide debt directly rather than rely on a bank to structure a bond deal for them.

But larger deals, requiring larger debt commitments, will require a liquid market, which in turn will require sponsors to get bonds structured, rated and listed. Says PGGMs Huizing, I think more and more infrastructure debt will be provided through bonds, for the larger projects. The uncertainty about the banks ability to provide long-term debt definitely means that a bond is one future solution to that problem.

The Dutch market tends to have smaller PPPs, between Eu100 and Eu300 million, which may not be weighty enough to require a bond and would be manageable for banks or one or two pension funds acting alone. Larger deals are more problematic, although sources point to the epic Eu4.4 billion Schiphol-Amsterdam-Almere (SAA) motorway initiative as one programme that could potentially need a bond financing once it reaches the contract signing stage.

Sponsors are still most comfortable with banks, however. Witteveen adds that BAM does think about including bonds, but a successful deal may still need more time to develop. I am not sure there is the confidence to make a bond financing achievable for PPP in the near future. The process is still too expensive so the traditional bank debt solution is [presently] preferable.

Another wave

The changing landscape of equity holdings could not come at a more pertinent time for the Dutch market. After a wave of deals a few years ago, 2011 did not see any notable deals close but 2012 will be busy.

The Eu190 million N33 concession involves 39km of road construction from Assen to Zuidbroek and now has three shortlisted bidders, BAM PPP, John Laing with Dura Vermeer and VolkerWessels, while the first stage of the SAA programme, the A1/A6 section, is also due in 2012. There are also the tenders for the Brede School Joure Zuid PPP, the Groningen tram project and the Supreme Court scheme amongst the up-coming potential deals.

In addition to the N33 and the SAA, the government recently earmarked another batch of projects they intend to procure as PPPs, Witteveen says. This means there should be a decent amount of deals coming to the Dutch market which should keep things busy in the next few years.

Market interest is growing but high investment requirements also hinder the participation of many parties, Struktons Hermsen remarks. He points out that grantors can do something about this, for example, by increasing tender fees, asking for less detailed plans and shortening the selection process by choosing a preferred supplier faster. Furthermore, he says Strukton has been advocating more projects involving local government.

The successful use of the staple on the N33 will provide a vital spur to the development of an institutional debt market. But while infrastructure and pension funds may like long-term investments, they are less keen on assuming construction risk. A two-stage financing, where commercial banks provide debt for the construction phase of a deal before a long-term project bond is issued to refinance the deal, could be a potential solution.

The outlook for pension fund equity participation is clearer. Huizing is in no doubt that there will be more JVs in PPP or other infrastructure sectors between developers and pension funds. Weve already been approached by a number of developers about linking up and we expect to close one or two more JV agreements in 2012, he concludes.