Binding promise?

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Bank margins have stayed high since the collapse of Lehman Brothers in 2008 and banks had already begun to tire of providing long-dated funding. Basel III will force banks to better match their funding with their assets, a process that the Eurozone crisis has only hastened. Market participants are turning their attention to institutional investors, particularly pension funds, in the hope that they can supplement bank capacity and compensate for this scarcity of long-term financing.

The gap that needs filling is the senior debt element says Philip Vernon, partner at Ashurst. The banks are generally tending towards shorter term lending (with some exceptions) and this is driving the search for structures which will enable long term institutional investors to provide senior debt investment.

But UK pension funds involvement in infrastructure financing has historically been low, accounting for less than 2% for their total investment portfolio, and has typically been limited to equity commitments coordinated by specialist fund managers. Barriers to greater involvement persist, most importantly pension funds difficulties in taking on construction risk, as well as the fact that senior debt positions do not always offer the most attractive yields.

With talk of a revival in the fortunes of the monolines and the increasing popularity of infrastructure debt funds, options exist for pension funds seeking to take a debt position in infrastructure projects. The most high-profile development, however, is the pension infrastructure platform, led by the National Association of Pension Funds (NAPF) and the Pension Protection Fund (PPF), which both the government and the market hope will decisively shift the market in infrastructure financing.

A new hope

The pension infrastructure platform stems from a memorandum of understanding that the Treasury, NAPF and PPF signed towards the end of 2011, and forms the centrepiece of the most recent National Infrastructure Plan, which the UK chancellor of exchequer, George Osborne, hopes will boost the UKs economy by directing roughly £200 billion towards infrastructure projects across the country.

Both the PPF and the NAPF are in discussions with around 20 other pension funds, with the aim of creating a new investment vehicle that will execute investments on behalf of the pension funds, in projects outlined by Osborne in the National Infrastructure Plan. According to the PPF the final number of participants is likely to be between 10 and 12.

The NAPF and PPF want to raise between £1 billion and £2 billion in subscriptions from this group of pension funds and then issue additional debt to take their total available for investment to £4 billion, with the aim of launching the new platform in January 2013. The pension investment platform does not just involve senior debt, and deals will be executed either by one of the larger pension funds or a group of designated personnel. The platforms investments will be split 50/50 between debt and equity, indicating that the platform could just about work within the existing private capital-based framework for infrastructure procurement.

The market consensus has been positive but most market participants are cautious about whether the initiative will take off. I understand that its still very much subject to what is in the best interests of pension fund members in the UK, and they will only invest in infrastructure if they feel that it is the right thing to do to protect their interests which may not necessarily be aligned with the interests of the government says Gary Sumray, head of project financing syndications at SMBC Europe.

Theyll benchmark the terms they can get on project finance against what they can get on utility bonds or government bonds, and possibly the return is not so attractive or worth the effort for them to do so much work on what are complicated structures or risks. I would question whether there is currently sufficient appetite among many of the institutional investors for it.

With financial markets still volatile and UK gilts at historic lows, pension funds have been looking for a place to park their assets, and have typically showed interest in infrastructure because of its long-term cash flows and the low default rates on UK projects. But investments in debt, although less risky, do not offer the same rates of return as equity investments.

Its been a yield issue in the past as well as the fact that project finance is predominantly not investment grade says Constantin von Moltke, head of project and commodity finance loan syndication at UniCredit. Recent involvement of institutional investors has been very selective and driven more by opportunistic plays in the secondary market offering attractive discounts as some lenders are forced to de-leverage their balance sheets. The higher funding costs of banks and resulting higher pricing environment have been pushing yields closer to the expectations of institutionals, however, there are also other requirements to overcome to facilitate their involvement in the loan market and if spreads come down again, the yield wont be sufficient for them.

The structural barriers are still there

But there are also structural barriers to the greater involvement of UK pension funds. Most UK pension funds tend to be small in size compared to their Canadian and Australian counterparts, and do not usually have sufficient expertise to originate or monitor infrastructure project finance deals. Questions persist over how the new platform will deal with construction risk, and who will be responsible for monitoring investments during their operational phase.

The NAPF and PPF have asked the government whether it could provide some sort of guarantee during construction or whether state-controlled banks could mitigate construction risk by subscribing to convertible bonds that transform into equity once the construction phase of a project is completed.

One possible comparison is in Denmark where the state-owned export credit agency is prepared to wrap project risk to facilitate Danish pension fund involvement. In October 2011, the sponsors of the 203MW Jadraas onshore wind deal, Arise Windpower and the Platina Energy III Fund, closed a Sk3.1 billion financing for the project, which included an EKF-wrapped loan from Danish pension fund PensionDanmark.

PensionDanmark agreed to provide half the senior debt for the project on the same terms as the commercial banks, DNB and SEB. The deal involved hefty negotiations with the sponsors about flexible draw and prepayment provisions, not to mention floating interest rate exposure, before PensionDanmark felt comfortable financing the deal. The EKF product is designed to enhance export financings, rather than domestic deals. But other agencies, most notably Italys Sace and Australias Efic, have provided coverage for domestic deals; Sace for a renewable project bond, and Efic for a bank-financed coal export terminal.

The UK government has yet to decide which projects will benefit from the new platform, though these are expected to fall in the transport and social infrastructure sectors and so have limited capital goods requirements, making foreign ECA participation unlikely. Some of the 40 projects earmarked for investment in the National Infrastructure Plan include the Transpennine Express line between Leeds and Manchester, as well as improvements to the M3, M25 and M56.

The most likely outcome, then, is that the UK government will provide a similar guarantee to the EKF cover during construction, since pension funds are unlikely to come on board otherwise. The new infrastructure vehicle, owned and run by the pension funds, would then finance the projects that government earmarks for a construction guarantee.

The new platform would most likely dispense with the costly fee structures that have acted as a barrier to pension funds investing in infrastructure funds in the past. Although initial returns would be used to pay off the start-up capital, the new platform would operate as a not-for-profit entity after the ramp up phase, with fees capped at 50bp.

Other alternatives

This fee structure would cast existing infrastructure funds in a very poor light, since they typically carry costs in excess of 50bp. Banks are looking to reduce the leverage on their balance sheets and the traditional avenue for shedding project exposures, syndication, is closed off. Infrastructure debt funds, for which a manager or bank acquires assets in either the primary or secondary market, have emerged as an interesting alternative.

In July 2011, Barclays, advised by Clifford Chance, became the first bank to launch an infrastructure debt fund the £500 million Barclays Senior Debt Infrastructure I. The fund will have access to any projects arranged by Barclays and will be seeded with £200 million of assets to provide a return from the start. Barclays will retain a 20% interest in each asset, alongside the fund.

An additional difficulty, at least for the bank-managed funds, is that while these funds can source primary project loans today at around 300bp, the widening spreads following the financial crisis make it difficult for banks to offload pre-2008 loans onto institutional investors, whatever the vehicle, unless they sell these loans at below par, which banks are reluctant to do. There has been a recurring theme since the onset of the financial crisis that pension funds are being approached by banks to set up funds with them says Sumray. Ultimately what the pension funds want to see is an alignment of interests. They dont want to take banks portfolio of legacy deals, just to help that bank release funding and recycle their capital.

But infrastructure debt funds do not just have to make, or buy, low- yielding senior debt investments. Aviva, which has a history of lending directly to UK PFI projects, recently agreed with Hadrians Wall Capital, an infrastructure debt advisory firm, to launch a £1 billion debt infrastructure fund, which is due to reach first close in the second quarter of this year. Aviva and Hadrians Wall, which want to raise £500 million and Eu500 million for the fund, will be making subordinated debt commitments.

Since the debt would be in a first-loss position, the buffer would help improve the credit rating of any senior debt issued by a project. Pension funds, especially in the wake of Solvency II, are facing pressure to buy higher-rated assets, and the improvement in ratings from this subordinated piece, even by a couple of notches, might bring pricing benefits.

Bonds bombing

Basel IIIs restriction on banks lending activities could spur sponsors to send more projects to the capital markets, but UK pension funds have essentially been absent from the project bond market since the collapse of several monolines in 2008. There have been no viable candidates to fill the vacuum left by the monolines, and those monolines left standing have had more success writing secondary market business or relaunching themselves as adjuncts of the export finance industry.

The European Commission launched a public consultation last year on its 2020 Project Bond Initiative along with the European Investment Bank. The initiative is designed to help sponsors access debt from institutional investors, using either some sort of guarantee or a first loss piece, either of which would make the credit rating of infrastructure projects high enough for pension funds to participate at sponsor-friendly yields.

Even if these enhancements lower debt costs and reduce bondholders exposure to construction and operational risk, institutional investors are still not equipped to monitor their holdings properly. The concern, I think, will be that frankly what really is needed (by issuers as well as investors) is not only for someone to provide some credit enhancement, but also for someone to do the project monitoring. Historically in wrapped bond deals the monolines have performed this role but it would likely prove quite a burden for the EIB says Alex Carver, partner at Freshfields.

In December 2011, Catalyst Healthcare, the holder of the 30-year Worcester hospital PFI contract terminated Ambacs guarantee on the £92.7 million of bonds issued by the project company in 1999 and replaced it with Assured Guaranty. The agreement is the first new monoline wrap in roughly four years in the UK, and is a change from the old monoline model, where issuers paid the fees. Here, the costs of the wrap were passed on to the bondholders in the form of a 30bp coupon reduction, from 5.87% to 5.57%.

Bondholders were willing to accept a decrease in income in exchange for a meaningful wrap, after Ambac entered bankruptcy protection. In the current low interest rate environment, the lower coupon is still relatively attractive for a double-A asset, and investors could free up their limited allocations for lower-rated debt, where the Worcester bonds had languished since the Ambac downgrades.

Assured Guaranty is seeking to repeat this model for other projects, possibly for issues up to £500 million in size. But monolines, whether Assured or a rumoured new venture from Goldman Sachs, would need to find other takers for the secondary product, or pick up new primary business to convince investors of their relevance.

My guess would be you will see the occasional replacement if the deal is right for all parties commented one adviser. Moreover, my sense is that there will also be some new deals with a monoline involved, but they will be few and far between. I dont see this as being a sea change in the market, unless somebody comes into the market with a similar sort of product as Assured.

This time will be different?

Beyond the lack of available guarantors, there are other issues that have traditionally disadvantaged bond financings. Negative carry, involving paying interest on bond proceeds before they are required during construction, and the prepayment penalties that come due with any refinancing, means that bonds are traditionally viewed as less flexible than long-term bank debt.

But there is a lot of political willpower behind greater institutional investor involvement, especially with the new pension infrastructure platform. Although NAPF and PPF are gearing up for a formal launch next year, their proposal still falls short of the £20 billion number George Osborne mentioned when he struck the agreement last year.

Market participants are sceptical that this represents the sea change in infrastructure financing that government is hoping for. Will this [the pension infrastructure platform] be a replacement for the banks? Its going to take sometime for that to happen and it is not clear whether it ever will says one senior infrastructure banker.

But governments as diverse as Chile, Mexico, Canada and the Netherlands have sought to foster the development of institutional debt markets through the development of new instruments or concession structures. The UKs approach to facilitating the entry of institutional capital into infrastructure projects is beginning to look outdated.

According to Vernon: I think what people are trying to do here is to pull together all these different strands and see if some liquidity can be created for infrastructure projects from pension funds. Maybe there can be more pension funds doing what Aviva does, maybe there can be a resurrection of the monoline wrapped bond market, and maybe other funds can invest via intermediaries or through a first loss structure such as Hadrians Wall or the EIB project bond. He adds: There is a clear need for senior debt in the infrastructure market. If you look at the governments National Infrastructure Plan and its ambitions over the next few years, the funding needs to come from somewhere.