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Beyond banks: Alternative funds roundtable

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The foundations of project finance in the US are shifting probably for good. Roughly one-third of project banks that played in the US in 2010 are retreating or retrenching in the wake of the Eurozone crisis and Basel III. WestLB, once a market heavyweight, is now a rump asset management company, Portigon Financial Services, with no ability to lend, and shrinking management. UniCredit largely pulled out of the market in late 2011. British, French, Italian and Spanish lenders have performing, if low-yielding, project loans for sale on the secondary market. The remaining European project banks wont lend beyond 10 years, if that.

Infrastructure debt funds and mezzanine funds could fill the gap. Infrastructure debt funds are secondary market buyers, while mezzanine funds are helping to fill financing gaps in new financings or refinancings. Term loan B investors have recently shown some willingness to incur construction risk and for merchant projects, which are rarely financeable in the bank market. Some banks are trying to adapt: Santander and Prudential Capital Group, for instance, have led on dual-tranche financings for four large renewables projects. Santander leads the short-term bank pieces, while Pru offers long-term debt.

Project Finance hosted a roundtable with non-bank lenders and a project finance lawyer in New York on 15 August. They are: *David Albert, managing director in Carlyle Groups energy mezzanine opportunities group; Nick Cleary, director at Hastings Funds Management; Brian Daly, managing director at Babson Capital Management; Brian OConnor, managing director at Ares Management; Sarah Wu, executive director in JPMorgan Asset Managements infrastructure investments group; and Edward Zaelke, co-head of Akin Gumps global project finance practice.*

Brian Eckhouse, Project Finance (BE): How would characterize the state of liquidity in the US project finance marketplace over the past two years?

David Albert, The Carlyle Group (DA): On the commercial bank side, there has been a consolidation of activity, a refocusing that has reduced the number of active lenders. From our perspective, weve seen an increased number of projects that has not been able to access the commercial bank market and has been looking for alternative sources of credit capital. As for the institutional capital markets, it is a question of feast or famine: if its sizable and rated, the market today is deep and hungry for yield and able to deliver incredibly tight pricing. On the flip side, smaller projects or ones that have enhanced complexity (construction risk, merchant pricing risk, anything that falls outside the mainstream) can be challenged. Some risks simply can't be priced, despite the demand for yield in the market.

Sarah Wu, JPMorgan Asset Management (SW): From our fiduciary, asset management perspective, theres a huge amount of demand for yield by the investors. Were able to find sellers who are willing to really de-lever their balance sheets to provide the returns our investors need. This cuts across the core sectors of social infrastructure and strong high credit-quality concession type of arrangements. Youre seeing secondary investment portfolios being created. Our view is the liquidity that institutions are providing will continue to grow. I think senior debt has arrived.

Brian Daly, Babson Capital Management (BD): Theres a drive to convert everything into a yield instrument. The investments we saw several years ago with more of an equity format are now taking on the format or characteristics of debt because of the demand for yield. If you have structured cash flows in the project finance nomenclature and you have scale, you can get some incredible pricing. But its difficult to attract any capital if the opportunity lacks scale and if its off the beaten path, so its not interesting for the larger market. But for us, we can compete and invest there.

BE: Over the past year, several banks have left or have sharply downsized their roles in project finance in the US. Is this a new normal or a temporary reset?

Edward Zaelke, Akin Gump (EZ): I think it is maybe the new normal. In the renewables space particularly, the European debt crisis has been a real gut-sock. Renewables players had primarily gotten their debt from European banks and those banks for the most part are gone. You see fewer banks in the marketand these are the types of banks that dont want to take the kind of risks European banks would take. Banks are looking for yields now that are safe. If you want to take risk, it becomes equity, but those yields have gone through the roof.
So yes, I do think this shift is permanent. This is how the world is supposed to work. Equity is supposed to take equity risk and debt is supposed to get yield and thats what has finally happened.

BD: If you are around this business for over 20 years, you remember when you couldnt get financings done; there have been times when there were just a few banks there Then the business became very large and the people got comfortable with it. They seemed to get too comfortable. And everything became a cookie cutter and many projects were financed that may have a bit aggressive. But now weve gone back to a more normal state of risk and reward.

Nick Cleary, Hastings Funds Management (NC): Regulation and Basel III are already affecting banks business and their response to this is gathering momentum. In addition to regulations impact on lending, regulation is going to impact a lot of banks collateral business. Banks in infrastructure and project finance rely on the swap income to support and subsidize lending; where this becomes less valuable to banks it will be have flow on effects to their ability and willingness to lend. All the signs there are that banks are going to exit long-term lending in this market. While government support of bank funding has softened the immediate impact, it will result in significant changes to long-term infrastructure lending over time. Were strong believers that theres going to be a transition where other sources of liquidity are going to come to this market. The types of investors we work withprimarily pension funds and other long term low risk investors have a great desire to participate in this market and they now entering the market with significant commitments. The challenge faced by us all is finding a way to facilitate this change so all parties may benefit.
Looking at the global pension market, theres potentially $100 billion of new funding annually from private equity and infrastructure allocations that could be directed towards infrastructure debt. The alternative liquidity to banks out there is excellent; it just needs to find a way to participate in this market.
We believe a fund and mandate/separate account platforms are efficient ways for investors to access the market. We see the best volume and good risk adjusted returns in senior debt which an experienced and dedicated infrastructure debt fund manager can access, structure, execute and manage to achieve the best value.

BE: How healthy is the term loan B market?

Brian OConnor, Ares Management (BO): What we've seen lately, and this goes back to investors being very hungry for yield - is that second lien paper has been relatively easy to place for borrowers. There's a lot of demand and competition for second lien paper among lenders and less supply relative to first lien. First lien paper is more difficult for banks to place. We have seen that yield oriented investors will get better allocations of second lien if they have also have investment vehicles that can make commitments on the first lien tranche.

DA: The market's hunger for yield is being borne out: Energy Future Holdings just completed a small financing at pricing close to 11%. Despite the challenges EFH has faced (low natural gas and power prices, capital markets saturated with its paper), it amazes me that EFH was able to achieve a reasonably palatable pricing level that cleared the market, which it did. This is a function of investors living in a near-zero interest rate environment today and starved for current income.

This said, to Brians point, while current cash pay income is in high demand, the capital markets are still often not willing to price certain risks at all, or at least not at single digit levels. For example, providing small unrated borrowers illiquid sub-$100 million loans, or assuming construction risks on projects without wrapped turnkey EPC contracts; these are risks some, if not most, public market investors are unwilling to accept. For the few investors who are willing to bear such risks, there tends to be an absolute minimum threshold of yield to get comfortable with proceeding. This explains why some of the first lien tranches may in fact be more challenged to place than the second lien tranches because lenders require yield levels that exceed an absolute threshold in order to get comfortable with the credit.

BE: Weve seen a handful of renewables deals over $400 million in 2012 that mix short-dated bank debt with longer-term bonds. Does this pose a threat to alternative finance?

BD: During every cycle the financial world changes and its going to continue changing in such a way. There will be opportunity for us. The market always seems to find a way to access capital. There will be opportunities for us to invest our clients capital.

EZ: The smaller deals will have difficulty with the bank-bond structures because the transactional costs are going to bury them. The big deals that youre seeing have a tiering of risk, whether its first lien or second lien. But the bank-bond structure is a structure that works. I think well see morebut were see more and more deals accessing the bond market generally. If they can get a bank involved, all the better.

BD: As a structure, its from 1988. Theres nothing unusual about it. Institutions should be buying long-term paper, with the banks providing shorter-term liquidity function. Its been enjoyable watching the markets move back and forth among the structures.

BE: What kind of inter-creditor issues can arise when combining new and established sources of debt?

EZ: One of the biggest challenges with these bank-bond deals is often the inter-creditor agreements because you have two fundamentally different types of animals, trying to figure out how theyre going to live together. There are different risks and there are certain challenges that the sponsor has in bringing these groups to the table.

SW: The more complicated it gets in inter-creditor issues resolution, the more difficult it is for the secondary investors to take over from a long-term holding perspective. So its not only in deal origination that contains due diligence heavy lifting, but our investing process is very rigorous in reviews to screen out weak credits and structures.

NC: Were very focused on bringing new investors into infrastructure debt and we spend a lot of time with the existing banks and new investors to understand their issues. Theres a lot of experience in the banks and advisors that have been working in this space for a number of years. That experience in dealing with what are often very complex inter-creditor issues needs to be shared with new institutional investors. Essentially, the infrastructure market needs to embrace new investors as part of the solution and work closely and collaboratively with them.

This may require new approaches during refinancing, restructuring and how the groups of investors can make decisions and communicate these to the borrower and other creditors. Looking forward, there will be a greater variety of capital providers which will require collaboration and less reliance on established precedents to make sure all investors are treated fairly for the level of risk they are looking for.

BE: At what point do sponsors approach alternative players to help raise debt?

BO: Brian O'Connor: On the new generation side, we do get approached from a lot of developers partway through the development process. They hit a wall at some point. They have their project started, but can't get it all the way to the finish line. Big ticket items come up, like deposits on PPAs for which developers have to write multi-million dollar checks. We occasionally entertain very late stage development investments, but we are not in the business of providing development capital. However, we are happy to talk to developers during the development process and work with them to show them financing solutions we could provide once their projects are construction ready, as well as entertain potential hedging arrangements as in the Panda Temple transaction that Ares Capital Corporation co-led. That's the toughest part of the business for developers that are capital-constrained, getting a project from halfway done to construction-ready. There are not obvious places to go for financing, so they go to everybody.

For M&A transactions, we are approached by private equity sponsors seeking acquisition financing very early in the process. We also receive inbound calls from sell-side advisors looking for staple financing, or seeking an anchor investor. On refinancing and restructuring opportunities, we may be contacted as soon as potential issues arise, or as late as several months prior to the maturity date.

DA: If a borrower is able to obtain the quantum of capital it seeks from a commercial bank, then we typically are not even in dialog with them. Were normally having conversations with borrowers who either dont fit the mold of what a commercial bank typically lends to, or who seek a level of leverage that a commercial bank simply cannot provide. So when do we engage borrowers? Were having discussions with companies and projects at all stages. On the power side, we will look at financing any project once it has all its permits and material contracts in place (or just before this stage in order to proceed expeditiously). On the oil and gas side, we will take development risk but need proved reserves as collateral to extend a facility.

BE: Brian, Ares and Morgan Stanley recently led a financing for Panda Power Funds merchant gas-fired project in Temple, Texas. B loan investors have previously been loath to assume construction risk, but this deal got donealbeit at a heavy cost to the sponsor. How did it get done in this climate?

BO: It's not contracted in the traditional sense with a PPA or heat-rate call structure that investors have gotten comfortable with in the past. Instead, the project purchased a revenue put option which essentially provides a gross margin floor. And it's construction, so it starts to winnow down the list of investors who would be interested. CLOs, for example, are generally constrained from taking construction risk.

To get a deal done with this profile in this market, the sponsor must believe its own story, and be willing to put up a material amount of equity. That's one change since the last cycle, where sponsors could finance through the first, second lien, and mezz, with relatively thin equity and get the deal done in a highly leveraged structure. That's more difficult today.

BE: Nick, were seeing infrastructure debt funds pop up or expand their tentacles into the US. What variables convinced Hastings and others that this is a worthy market to play in?

NC: Weve had success in infrastructure debt over the last 12 years, but the universe of experienced managers for core infrastructure in OECD regions, such as North America, is still quite small which may constrain fund growth. Over the last year, weve been surprised by the number of reverse inquiries from our infrastructure equity investor base, and our pension fund clients looking for tailored mandates which combine infrastructure debt and equity in a single complementary solution. These investors are looking to participate in assets which are low-risk with a reliable cash yield which infrastructure debt can deliver at a fair risk adjusted premium to other fixed and floating rate debt from corporate, financial and sovereign issuers. Combine this with the long term structural changes to bank lending which creates the opportunity for new investors to participate, the stars are somewhat aligned for infrastructure debt funds to be one of several platforms by which institutional investors can participate.

We see a great opportunity in what we call Alternative Fixed Income, which is appropriately structured and investment-grade senior debt as a private loans to core infrastructure projects and issuers in OECD regions. This is well-aligned to the objectives of the pension funds were talking to who are looking for the more traditional, project finance-type of infrastructure assets which are high BB to stable BBB rated assets with attractive risk adjusted return characteristics.

The opportunity is very global; that is, international investors looking for US assets and US investors looking for the best value infrastructure debt opportunities internationally as well as in the US. This creates an issue of how you deal with currency risk in infrastructure debt funds? Currency hedging in the Basel III environment will certainly be more expensive and will probably require cash collateralisation for funds which can be a drag on returns. Finding the most efficient party to assume the currency risk will be is a key issue to expansion of core senior debt infrastructure debt funds. We see part of the solution being simplified funds focusing on specific currencies and regions with investors or borrowers being best placed to manage the currency risks.

BE: Sarah, at what point in the life of PF loans do these investors become interested? Is there a yield point?

SW: Our core strategy is designed as post-construction. Theres also the yield point to our investors. Echoing Nicks point, our investors are looking for strong, solid investment grade and they want Libor plus 200bp and over. We do think, at the moment, that the supply market can meet it. So were quite confident that we can continue to deliver the returns to our investors.

BE: In the third quarter of 2011, buyers of loans on the secondary market complained that sellers were unrealistic in their expectations, which kept trades to a minimum. But sales have since been closed. Is the spread between bid and ask prices narrowing?

NC: Theres still a fundamentally large gap between buyers and sellersnot just on the sell side, but the buy side, as well. As a fund manager, we have strong relationships on the buy side and on the bank side. One of the things were doing is trying to bring the two sides together to a position which offers fair value for both sides. This will require existing lenders to be frank about the market value of their loans, but will also require understanding from buyers about the asset class, risk profiles and what returns they can expect.

There is a lot of variety in credit, from distressed debt or quasi-equity opportunities which can yield more than 10%, to high-yield which can range from CCC to BB rated loans which can yield from 4-10%, to stable investment grade loans yielding around 3-4% because they all have very distinct risk profiles. The intimate and detailed understanding of the differences in risk and return which is most developed in banks needs to be shared with the buyers so they can understand how an asset aligns with their risk appetite and this can narrow the bid/ask prices.

There has been a lot of focus on discounts to par as a measure of value, but this does not necessarily align with value because loan quality, loan pricing and tenor, or the lenders desire to exit a position are all factors. A 20-year loan priced below 1% may sell at a large discount relative to a 20 year loan priced at 3%, but both can offer the same return; there will just be a different allocation between the capital gain and cash yield components.

One of the things thats happened recently for the banks is the pressure to sell has faded. Thats brought some stability but regulation and higher cost of funding for banks will make it important for them to continue looking for orderly and sustainable ways to recycle their balance sheets through selling assets. A significant number of banks we deal with know they have to change their models and how their balance sheet is used. They do know they have to be realistic about market pricing, but potential buyers need to appreciate that most assets available are well performing and banks are not sellers at any price.

BE: What is the level of activity in the secondary market?

SW: Its fairly active in both aspects on the investor side as well as the seller side. Our investor base is global, thats Europe, North America and Asia. Pension plans and insurance companieseven bond investors that have already had private placement experience in the spaceare very interested in our strategy. That does reflect the entire market change and dynamic of introducing the alternative capital sourcing to this industry. On the bank seller side, clearly the European banksthe traditional project finance playersthey have the largest supply pipelines. We also get the most phone calls from them.

BE: Will this new source of capital play a role in project restructurings?

SW: No. Our investors are looking for risk-free, boring stuff. They really do like long-dated paper. They really just want to clip coupons and put it to the bottom drawers.

BE: What types of equity and mezzanine plays are available in this marketplace?

BD: Outside of renewable power, there are not many long-term offtake contracts that allow you to layer the mezzanine debt on top of the more traditional senior debt structures. We do see a number of opportunities. They are largely concentrated in the renewables areas.

BO: In our view, it's currently a tough market for traditional mezzanine investments. Traditional mezzanine investors in the power sector tend to be absolute-return investors looking for mid to high teen IRRs often with highly restrictive prepayment protection for a period of up to 4-6 years. That's quite a spread above where a well-structured project can source senior debt, especially in todays low interest rate environment. That makes it tough to source and structure transactions because you start to bump up against what the equity return sponsors are looking for when you seek traditional mezzanine investments. So it has to be very opportunistic, perhaps there is a timing issue, a partial bridge loan component, a partial PIK toggle feature, or a sector that is dynamically evolving with limited financing activity among commercial banks and Term Loan B lenders. We believe that the Ares Private Debt Group can provide competitive, flexible capital solutions and can underwrite larger transactions than some of our competitors because we have a larger balance sheet and a stronger syndication platform.

EZ: We saw a lot of mezz debt in the last couple of years because of the US Department of Treasury cash grant program. That program lent itself well to adding mezz to the overall debt package. But with that program going away, we see very few developers thinking that mezz debt is part of the package. Theyre thinking more about finding more equity.

BD: Theres no equity risk thats charging 6%. Theyre all following the tales of the MLPs and real estate investment trusts looking for a cost of capital thats not particularly realistic for the risks.

BE: David, Carlyle in 2011 closed a small deal for Enova and SAICs biomass project in Plainfield, Connecticut. This was originally a commercial bank deal, but that fell through. What does this deal say about the larger bank market?

DA: Timing was sensitive on Plainfield: the project sponsors needed to move with incredible speed in order to be certain that the project would qualify for the 1603 cash grant. However, in August 2011, the lead French commercial bank on the deal was challenged to move forward given the European debt crisis. The combination of these factors led to Carlyle's appointment as sole senior financing party to the project.

BD: Theres a wonderful gap where if it was just built and it was just perfect, lots of people would line up and take the risk. When there is risk, theyre looking at us and complaining that their cost is too high.

BE: Any final thoughts?

DA: People around this table have a tremendous amount of capital to put to work and an appetite to take risk that really runs from early stage to late-stage. The risk ultimately borne by each party is reflected in its cost of capital. Sarah's JPMorgan fund can buy debt as tight as Libor plus 200bp.

Barring very early-stage development, in which project owners are trying to obtain their permits, there usually is a way to raise the required credit capital to bring a project to fruition. Everything you hear, its a bifurcated market (with an abundance of liquidity for certain credits and a dearth for others), I think that while that is true, theres still a demand to put capital to work. This should bode well for developers and project owners out there.