PEBBLES, staples, and bond prospects in Benelux PPP

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While the UK government struggles to encourage its pension funds to invest in infrastructure, and the French government is still developing a Dailly securitisation structure, the Benelux region may provide a clearer template for fostering the participation of institutional investors in senior debt, and supplementing bank financing on public-private partnerships.

BAM PPP and PGGM recently signed a Eu125 million ($162 million) financing for the N33 road, which included, for the first time, an inflation-linked financing from APG, the Dutch pension fund. Shortlisted bidders have also been asked to incorporate a bond solution in their proposals for the Eu750 million A11 project in Belgium.

Both Belgium and the Netherlands came to the PPP game rather late. It was not until the middle of the last decade that a standardised procurement process emerged in both countries. However, at a time when several member states are debating the merits of using PPPs as an infrastructure procurement method, both countries have built up a fairly robust pipeline of projects.

The Netherlands has the more mature PPP market of the two, and benefits from a stronger central government. The main granting authorities in Belgium are regions or autonomous subsidiaries of regions, which has resulted in a more confused and fragmented procurement process. The more cynical observers suggest that balance sheet considerations rather than risk transfer have driven the evolution of Belgiums PPP market.

In spite of these differences, at a time when the pipeline is beginning to dry up in other markets, lenders and sponsors alike are turning in earnest towards the region. By necessity as much as anything else, both the public and private sectors in the Benelux have taken the lead in developing concession structures that will allow projects to access institutional debt.

Hard sell

In Belgium, the majority of projects are tendered at the regional level, and its northern Flemish region has been the most active. The market in Belgium is more of a Flemish market to date, although the Walloon region has launched some tenders recently, says Johan Mouraux, partner at DLA Piper. The Flemish region has used PPP structures for a number of years now, and has closed several deals recently, including the North-South Kempen road link and the ring road around Ghent.

Both North-South Kempen and the R4 Ghent were put out to tender using the DBM+F model, under which the tender for the financing is kept separate from the design, build and maintain concession. The procurement template is used in Flanders to facilitate the participation of smaller construction companies, which otherwise would not have the financial strength to maintain lender comfort.

This separation makes it hard for lenders to analyse the operational risk of a project until the building contracts are signed, and is often a cause of delays. The R4 deal closed quickly, however, and was the first project to close using a hard mini-perm without recourse to any state guarantee. The deal signed in February with Eu85.5 million in 9-year debt, split between BNP Paribas Fortis and Dexia Bank (now Belfius).

Hard miniperms are rare in Belgium. In August 2009, the Eu180 million financing for the Brabo 1 tram project in Flanders closed as a 10-year hard miniperm. Unlike Brabo 1, not to mention the forthcoming Livan 1 tram project, the R4 lenders did not benefit from a refinancing guarantee from De Lijn, the transport arm of the Flemish government.

Both lenders are providing a 30-year interest rate hedge, which should help mitigate some of the refinancing risk. However, the project is still at the mercy of an extraordinary increase in prevailing margins before the debt matures, and lenders have limited appetite for this risk. For larger future deals, the likelihood is that this risk will be shared with the granting authority.

The R4 was the first example of the private sector being entirely willing to take on this refinancing risk and market participants are confident that this approach could be used for other projects. There has also been some discussion of the refinancing risk being shared with grantors, although more important, say lenders, is that grantors structure the procurement process to allow for banks to offer this type of product.

Construction risk

Given the difficulties in raising door-to-door financing, grantors might be persuaded to help lenders offer mini-perms because of the advantages in pricing. Provided lenders can digest the major risks during the design, build and ramp-up phases, banks should not find it difficult to attract institutional investors willing to refinance them.

There are some signs that institutional investors could finance construction. Ageas recently allocated Eu3 billion of its assets under management to infrastructure debt and has been adding staff in Belgium to invest in infrastructure projects in the Benelux. Provided that the creditworthiness of a project company meets certain requirements, Ageas may be prepared to come in from the start of construction.

There are statistical observations which suggest that the construction phase is slightly riskier, but provided the due diligence is conducted sufficiently, this is something that we could be comfortable with says Benoit Theys, real estate & PPP finance manager at AG Real Estate, a subsidiary of Ageas. There are several people within Ageas who are used to the management and hedging of transactions.

But most institutional investors lack the expertise to monitor projects during their design and build phase. Few have exposure to infrastructure debt in Belgium, other than the purchase of receivables after construction. The underlying credit rating of project debt is often too low to attract institutional investors, at least at the outset of construction.

The European Investment Bank is rolling out one potential solution on the upcoming A11 road PPP. The EIB has pledged to lend to the project company, either through a first loss piece or contingent credit line, up to 20% of its senior debt requirement. This would act as a credit enhancement to allow a sponsor to issue project bonds (for more on the initiative see News Analysis, p28 this issue).

The remaining bidders for the A11 are Jan de Nul, DG-Infra and Van Laera; Besix, Eiffage, Heijmans and Stadbader; Colas, DIF and Strabag; and BAM PPP and CFE. Bidders submitted best and final offers in October and were asked to outline both a bank and bond financing. Via-Invest, Flanders granting authority, will name a preferred bidder in January and will then decide which solution the winner will use.

Credit enhancements

The EIB programme coincides with the emergence of private sector initiatives. The most advanced of them is the Pan European Bank to Bond Market Loan Equitisation, or PEBBLE, which ING has developed. PEBBLE is similar to the EIB initiative, insofar as banks provide subordinate debt commitments in order to enhance a projects underlying credit rating to a level that will allow it to issue senior project bonds.

Commercial banks would provide 15% of the debt, and this commitment would term out after 10 years. The remaining

85% of the debt would take the form of senior project bonds with a maturity of 25 years. A bank or banks would act as controlling creditor and would handle administrative duties such as waiver requests.

ING hopes to create standardised documentation to allow sponsors to use the product regularly. The bank suggested the Eu800 million A1/A6 road expansion project in the Netherlands as a possible candidate, and some of the shortlisted bidders submitted best and final offers at the end of October using structures that were compliant with the PEBBLE model.

Rijkswaterstaat, the Dutch procuring authority for transport and water projects, named a consortium comprising Boskalis, DIF, Hochtief and VolkerWessels as preferred bidder in November. The winning consortium is understood to have offered a traditional bank solution during the bidding stage rather than a PEBBLE structure, so ING will have to wait for another candidate to present itself. PEBBLE should be most useful in meeting a shortfall in funding on larger infrastructure projects, which often, through sheer size, struggle to assemble a straightforward bank financing.

Inflation busters

The Netherlands has made the most progress in attracting institutional capital to its PPP programme. I think that recent initiatives to attract institutional investors to infrastructure debt in the Netherlands have been encouraging says Roland Theuws, a senior vice-president at Rabobank. There is a political debate at the Dutch pension funds, which actually have a large amount of money available and could potentially be used to invest in the Netherlands.

In November, BAM PPP and PGGM signed the financing for the Eu125 million N33 road PPP in the north-east of the Netherlands. The deal included a stapled financing from APG, the Dutch pension fund, for 70% of the senior debt during the operational phase. The pilot project was designed to test the appetite at institutional investors for senior project debt.

The Dutch Ministry of Finance is providing inflation protection on the availability payments that serve as the source of debt repayments to APG. Pension funds long-term liabilities are usually inflation-indexed, so obtaining inflation protection was critical in attracting a commitment from APG. The project will not draw on the APG commitment immediately, and the lender had to be confident that changes in benchmark yields would not leave its commitment out of the money. APG was confident that the inflation protection would act as a sufficient proxy to compensate for any movements.

The market will need to wait until operations start at the project to see if the product works as planned. Future development is more likely to be geared towards larger projects, because these projects will find it hard to raise large amounts of project debt without substantial sponsor guarantees or public sector lender support.

There are few banks that are active in the market for long-term debt at the moment says Henri Witteveen, a director at BAM PPP. For the larger deals, its very unlikely that you can find enough banks and bring them together in order to raise the amount of debt required. When you need just one or two banks for some of the smaller accommodation projects its possible to find long-term debt, but for the larger deals its definitely trickier.

Sea change?

After the collapse of Lehman Brothers in 2008 banks began to tire of providing long-term funding. Subsequent developments, chief among them to introduction of the Basel III capital adequacy regulations and the Eurozone crisis, are only likely to accelerate this trend. Whereas Basel II only aimed at setting minimum solvency requirements, Basel III introduces liquidity coverage ratios, which will reduce the ability of lenders to provide long-term illiquid debt commitments by forcing banks to better match their funding with their assets.

Diminishing bank appetite for long-term debt is likely to continue. Banks may finance projects in the future using hard miniperms, although expecting the private sector to take on refinancing risk is often difficult, and it has only been shared with the state in a few instances in Belgium so far. Finding active owners of project bonds has been a struggle.

The difference between a corporate bond and a project bond is that you cant as a bondholder sit back for 30 years, says

Helga Van Peer, partner at Allen & Overy. The project will be signed, and usually shortly afterwards there will be a change to the project. You can get banks to sign off and waive things, but how do you get a mass of bondholders to sign off on changes? The market is responding creatively to this issue, but I think it remains one of the main challenges.