# Decreased supply drives record-low Canadian PPP yields

03/01/2013

Governments around the world embrace bond financings as means of funding infrastructure projects, but few have delivered on the scale that Canada has. Indeed, the robustness of the Canadian bond market is the subject of widespread envy, and is poised to grow in sophistication.

But despite the high volumes, and limited openings for bank lenders, government has so far been unwilling to stretch the bond markets capabilities. Bond deals in Canada are typically oversubscribed, hinting at investors hungry for larger tickets, and spreads continue to tighten, with PPP bonds setting record lows on two occasions this year.

New participants, including retail investors, continue to trickle in, benefiting a larger number of Canadian PPP issuers. Saskatchewan is about to launch a PPP procurement agency, and municipalities have begun in earnest to procure infrastructure using PPPs. Assets that come less frequently to market, including schools and stadiums, may account for a larger proportion of future financings.

**Tightening margins**

A healthy of supply of deals was one of the most important factors in creating a vibrant infrastructure bond market. Canadian provinces show an unmistakable zeal for PPPs, and in several of them, including some initial sceptics, the model is now practically institutionalised. The Canadian federal government has become increasingly enthusiastic. In 2009 it launched PPP Canada, which established itself by spreading knowledge about PPP  not to mention funding from its P3 Canada Fund. The federal government has instituted a screen that requires departments to consider PPPs for all large projects.

Canadian lenders boosted the market by shunning offering tenors beyond 10 years. While European and Japanese lenders initially edged the Canadian banks aside, their presence in the PPP market is increasingly patchy. The appetite for PPP bonds can be attributed to the greater debt sophistication in our capital markets investors, which is itself attributable to the absence of alternative outlets for Canadians with project finance credit skills, says Duncan McCallum, managing director of RBC Capital Markets public sector and infrastructure group, probably half in jest.

Bonds have increasingly surmounted bank debt as the preferred PPP financing product in Canada  particularly for long-dated debt. The gap left by banks globally has encouraged the creation of debt funds to invest in PPPs and I expect to see more investors, such as retail bond funds entering the Canadian market, says Nicholas Hann, executive director at Macquarie Capital. After all, the risk-adjusted returns on PPP bonds are more appealing than traditional corporate bonds because they are relatively low-risk.

Competition between buyers in the bond market has cut into the yields on offer. More than 70 institutions play in Canadian infrastructure bonds. Orders arent getting completely filled, so that leads to lower pricing, says John McBride, chief executive officer of PPP Canada.

Before project bonds became mainstream, spreads over equivalent government of Canada bonds on PPP paper could be as much as 400bp. Recent deals saw spreads fall to between 185bp and 200bp, in part reflecting increasing standardisation in this market. The PPP market has certainly matured and in fact it has become ultra-competitive on all fronts: equity, debt, design/build and operations, McCallum says. Bond investors are now looking at a combination of reduced spreads and increased risk associated with very tight construction margins.

But there is still room for the market to develop. PPPs are still not liquid in the secondary market, notes Sean St. John, co-head of fixed income at National Bank Financial.

**Playing at the short end**

Short-term bonds increasingly compete with banks as a means of bridging projects to the receipt of completion payments once they reach acceptance. Long-term bonds are used to monetising availability payments for the post-completion operations and maintenance of assets. Pension funds and life insurance companies favour long-term assets with modest yet stable spreads, and life companies in particular are comfortable with unrated bonds. Another tier of investors seeks short-term returns from completion payments.

But short-dated bank financing remains competitive with these short-term bonds, and short bank and bond tranches may appear on the same deal. In May 2012 Cintra and SNC Lavalin, closed a C$871.4 million ($878.52 million) package for the 407E extension PPP in Ontario that included a bank facility alongside a short-term bond and a 33-year issue.

In Europe banks hope that they might be able to interest sponsors in a medium-term mini-perm financing that would be replaced with a bond financing at an indeterminate point after completion. There has been little interest in the combination in Canada, however. Banks either go very long or (increasingly rarely) very short, and cannot even rely upon lengthy construction periods to make their ability to stagger draws attractive. The C$3.1 billion CHUM hospital in Quebec featured a four-year construction period and financing-related expenses of C$839 million, much of that down to negative carry. But its BBB-rated C$1.37 billion debt financing was placed entirely in the long bond market.

For smaller deals the private placement market is an option. On these unrated issues, sponsors typically struggle to raise more than C$200 million, so they tend to favour rated bonds for financings above that threshold. On rated issues, sponsors target a minimum rating of BBB+, says Eric Lieder, vice-president of finance at Hochtief P3 Solutions North America. But the sweet spot for pricing remains single-A, and sponsors than can provide enough financial support for construction contracts to reach that level typically do so.

**New risks**

But a slew of lower-rated transport financings may be near market, including the C$2.1 billion light-rail project in Ottawa. Smaller deals in Victoria and Surrey, British Columbia, also loom. These projects feature new or different risks. The next batch of deals will have new factors, such as tunnelling risk, which may make the risk profile more complex, Lieder says. Those issuers that fall below BBB+ may go for unrated private placements instead, should the project size allow for that market to be utilised.

For many of these projects, however, government contributions will make the private financing component of total project costs comparatively small. For the design-build-finance-maintain (DBFM) Ottawa project, on which the ACS-led Rideau Transit Group was named preferred bidder as Project Finance went to press, the federal government and province of Ontario are each contributing C$600 million, and Ottawa is assigning C$479 million in tax receipts to the project.

But design-build-finance-maintain concessions appear ascendant. PPP Canada, in particular, favours greater long-term private sector involvement. The O is critical to the risk transfer, McBride remarks about operations for water and wastewater projects. You add more value for money.

Water and wastewater PPP projects will be prime candidates for DBFOM concessions. For example, the Evan Thomas water and wastewater plant in Albertas Kananaskis Country will be a DBFOM. PPP Canada expects to contribute C$9.95 million from its P3 Canada fund to the 10-year concession, on which EPCOR is the preferred bidder. An increasing number of municipalities are examining PPPs for their water and wastewater projects, says Carol Beaulieu, PPP Canadas vice-president of business development.

**Quiet year in the market**

If the infrastructure bond market proved particularly hungry for paper in 2012, it was not completely because of the presence of new investors. Two deals in Alberta set new pricing lows in 2012: the C$535 million bond financing for the Anthony Henday NE PPP priced at 187bp over the equivalent government of Canada bond, followed by 185bp over the same benchmark for the C$87 million issue for the Alberta schools alternative procurement III PPP. Both issues were oversubscribed.

But a relative scarcity of available assets may be the main explanation for this spread compression. Bond issuance rated by DBRS fell sharply in 2012 compared to 2011, from nearly C$3.481 billion in 2011 to C$655.2 million in 2012 (at least up until 4 December). Short-term rated bond volumes are also down, though to a lesser degree, slipping from C$649.9 million in 2011 to C$450.9 million in 2012 (again, up until 4 December).

We went from a world where hospitals dominated the programme. That meant we came to a market very regularly with bite-size programmes. That created numbers of opportunities, says Bert Clark, chief executive of Infrastructure Ontario. Its not like two or three years ago, where RFQs and RFPs were coming regularly. That said, it looks like well be bringing one new project to market every six to eight weeks.

While the bond market has not experienced particular volatility in recent months, the PPP market can suffer from political headwinds. Provincial and local elections in a number of key jurisdictions may serve as another explanation for the fall in issuance in 2012, though the number of deals will likely be comparable to 2011. There is still a little time for 2012 to catch up. Multiple large PPP concessions closed toward the end of 2011. Id call it a refreshing of the pipeline, says one manager at a major Canadian sponsor.

**Governmental support**

But budgetary constraints are unlikely to temper governmental support for PPPs. Infrastructure Ontario recently added 19 projects to its pipeline, which includes a C$10 billion transit programme for four projects, despite a reported C$13 billion deficit in the provinces fiscal year that ended 31 March. And while the large transit projects may dominate headlines and potentially a majority share of future financings, DBRS still expects social infrastructure projects to account for the bulk of projects that provincial authorities tender.

A look at the 2013 federal budget reveals governmental support for PPPs where they add value for taxpayers, PPP Canadas McBride says. The agency is close to completing its third round of procurement, as it moves forward with its fourth round. PPP Canada reviewed applications for the fourth round in September, said McBride, and announcements of successful applicants will be made early in 2013. Political considerations do prevail, of course. PPP Canada, for example, has narrowed its focus to projects that promote jobs and growth. The agency has identified four sectors that it believes will serve that objective: water, wastewater, waste disposal and transportation, which includes transit.

And despite governmental backing for these large transit projects, there is some trepidation. Governments dont generally want projects to be too big, says Grant Headrick, senior vice-president at DBRS. Extremely large projects may strain the ability to place the debt, which could hurt pricing. Equity may have to take bigger chunks of construction costs for transit projects, acknowledges one developer. You may see more players in the equity box for larger projects, he says.

**Focus on transit, transportation**

One of the largest looming deals is the proposed $3.5 billion New International Trade Crossing, which will connect Windsor, Ontario, to Detroit, Michigan. Canadian governments have long supported the crossing, wanting to shift traffic from the Ambassador Bridge, the lone, ageing span connecting the cities. Officials are hopeful that the bridge will be ready for traffic as early as 2018, suggesting that any financing will come to market in the next year or two.

Construction of the bridge appears increasingly inevitable, which was not necessarily the case in late 2011. In the third quarter of that year, a Michigan state senate subcommittee rejected legislation to establish a state-run authority to procure and manage a DBFOM concession of up to 50 years for the toll bridge. Canadas enthusiasm for the bridge  and for PPP  may have kept the deal alive.

In June 2012, the Canadian federal government agreed to manage the procurement of the bridge  including segments built on US soil. Canada will probably procure the bridge using an availability-based DBFO contract, but has indicated that it will charge tolls. Almost as important, Michigan governor Rick Snyder has emerged as vocal champion of the bridge.

Snyder promises that the bridge will be built. The decision has been made from a political point of view, Snyder said recently. The International Trade Crossing has completed its environmental permitting process, though it awaits approvals from the US secretary of state and Coast Guard, as well as a US presidential permit.

Québec, Ontarios neighbour to the east, has in recent years become more sceptical about the use of DBFM contracts, but plans a C$5 billion replacement of the Champlain Bridge over the St. Lawrence river in Montréal. The federal government is intimately involved in the development of the project, and a DBFM procurement is very likely. Those two projects, McBride says of the Detroit-Windsor bridge and the Champlain replacement, really demonstrate that the federal government is a major player in PPP to supplement whats been done at the provincial level.

*Antony Collins also contributed to this article*