DEAL ANALYSIS: Pendleton social housing

08/10/2013

After a spell during which old-style project bonds wrapped and unwrapped staged a comeback, providers of newer types of credit enhancement had to prove they were relevant to a market in apparent rude health. But first the European Investment Bank made the debut of its project bond credit enhancement by providing a Eu200 million contingent facility on the Eu1.43 billion Castor gas storage project bond.

Together Housing has priced a £82.601 million (£132.5 million) bond issue for special purpose FHW Dalmore (Salford Pendleton Housing), using a mixture of senior and subordinated bonds. The subordinated bonds act as funded credit enhancement, and constitute an option for when the EIB product is impracticable or unavailable.

FHW Dalmore (Salford Pendleton Housing) plc

STATUS
Priced 17 September 2013
SIZE
£95.1 million
DESCRIPTION
Enhanced project bond financing for redeveloping 1270 homes
SPONSORS
Chevin Housing Association (50%) Pennine (50%)
SENIOR BONDS
£71.71 million
SUBORDINATED BONDS
£10.891 million
MATURITY
2042
LEAD MANAGER/BOOKRUNNER
Investec
ISSUER MANAGING AGENT
FHW Capital
BOOKRUNNERs LEGAL COUNSEL
Berwin Leighton Paisner
GRANTORS LEGAL COUNSEL
Addleshaw Goddard
MANAGING AGENTS LEGAL COUNSEL
K&L Gates
SPONSORS LEGAL COUNSEL
Devonshires
INSURANCE ADVISERS
Marsh, JLT
TECHNICAL ADVISER
EC Harris

The class A and class B bonds for Pendleton listed on the Irish Stock Exchange on 17 September 2013, though each class has only one buyer. The deal is the first two-tranche unwrapped listed bond transaction for a PFI project, and draws on the credit enhancement structure devised by Hadrians Wall Capital, which requires the presence of a powerful managing and monitoring agent to cope with intercreditor issues.

In June 2011 Salford City Council, one of several local authorities that make up Greater Manchester, awarded a 30-year PFI concession to the Pendleton Together consortium, led by Together Housing Group. Together housing is a group of non-profit housing associations, and two of them, Chevin Housing Association and Pennine Housing 2000, each own half of the project company, Pendleton Together Operating.

The bidding dragged out over four years, in part because the UKs 2010 public spending review put social housing projects on hold. The £130 million Pendleton social housing PFI concession involves refurbishing, managing and maintaining 1,270 existing houses and flats on the Pendleton Estate in Salford, Greater Manchester. The construction is due to be completed by early 2017.

Keepmoat Regeneration is the subcontractor for the works, even though it emerged from a restructuring in 2012. Keepmoats poor financial health is one reason why an unwrapped project bond, which would need to lean on a strong contractor balance sheet, was not feasible.

This project is part of a wider £650 million 30-year scheme to renovate the Pendleton Estate, which the Together Housing consortium will manage. The 11-year redevelopment period will involve building 1,600 new homes and creating 10 hectares of new green space. After ten years of lobbying from the city council, the governments Homes and Communities Agency confirmed its approval of the scheme in September 2013.

The Pendleton Together consortium originally looked at financing the first phase with bank debt from a club of Allied Irish Bank, Nationwide and Cooperative. But in May 2013 it mandated Hadrians Wall Capital to arrange a bond financing, after feeling that the banks did not offer competitive enough pricing. The mandate was a shot in the arm for Hadrians Wall, which was founded in 2009 to develop a new form of credit enhancement for infrastructure financings.

Hadrians Wall Capitals structure involved splitting the projects debt requirement into a senior bond component (90%) and a subordinated bond tranche. The Aviva Investors Hadrian Capital Fund 1, which Aviva and Hadrian's Wall launched in February 2010, and which had closed in May 2012, would buy the subordinated bonds and an institutional investor would purchase the senior bonds.

Hadrians Wall had lined up Pension Insurance Corporation as a buyer for the senior debt, but Hadrians Wall and Aviva decided to wind down their fund in July 2013 because they did not expect it to have sufficient opportunities. But the sponsor still liked the funded subordinated enhancement product.

Three advisers from Hadrians Wall, led by Glenn Fox, created a new s entity FHW Capital, which continued providing senior debt due diligence. FHW Capital formed a joint-venture with Dalmore Capital that would control the issuer and serve as managing agent for the bonds. The managing agent on a two-tranche issue enjoys broader powers than a typical bond trustee, and having two firms in a joint venture provides insurance against the disappearance of one of the two firms.

The managing agent and Investec, the bonds lead manager and bookrunner, managed to hold the interest of Pension Insurance Corporation in the senior bonds Gravis Capital, an institutional investor that has made mezzanine and subordinated debt commitments in the past, took the place of the Hadrians Wall/Aviva fund. According to once source familiar with the transaction, more than one provider was interested in the senior piece.

Pension Insurance Corporations £71.71 million of class A senior bonds priced at a 5.414% coupon and Gravis Capitals £10.891 million Class B bonds priced at 8.35%. Both classes have a 29-year maturity and pay coupons semi-annually. The issuer on-lends the proceeds of the debt to the projects operating company as a single senior loan. While the senior/subordinated ratio is 87/13, the project company only makes one repayment.

The non-profit sponsors are contributing nominal equity of £1,000, and a subordinated sponsor debt commitment of £12.5 million. The council is also making unitary payments of £36.167 million during construction. These payments, together with equity sub-debt, and the proceeds of the senior loan from the issuer together meet the total project cost of £131.285 million.

The sponsors will make a 14% return on their contributions over the life of the concession, assuming that 35% of project costs are indexed to inflation, and inflation averages 2.5% per year. But the bond documentation features a lock-up provision that traps remaining cash after senior debt service for the benefit of the class B holders in the event that the senior debt service coverage ratio falls below 1.3x, or the contractor fails to meet target long-stop completion on its works programme.

To mitigate some of the risk of using Keepmoat as contractor, the financing benefits from a £3 million construction reserve and £3 million equity reserve, a £4 million letter of credit in favour of the project company from Lloyds, a 15% performance bond, and a parent guarantee from Keepmoat. Lloyds became Keepmoats main shareholder after the 2012 restructuring, though another bank with a similar rating can replace it if necessary.
But the deals main novelty lies in the way it defines the rights of the managing agent.

It stratifies these into Level 1,2,3 and 4 rights, and gives the agent discretion to decide which roles, for instance, replacing a contractor, or redenominating the loan agreement, would sit at which level. Levels 1 and 2 require noteholder direction, level 3 requires prior notice, and noteholders can call a meeting if they wish to call for a veto, while level four gives the agent full discretion.

These sort of powers are essential to managing intercreditor issues, and had to be even more clearly defined after the departure of the Aviva fund as subordinated investor. But the bankers behind the funded enhancement say that it is in some respects cleaner than the unfunded option. It does not, for instance, need to define when a contingent obligation is triggered.

Pendleton was not the only opportunity for the structure to make its debut one of the bidders on the Glasgow College non-profit distributing PPP abandoned it in favour of a bank deal. FHW will now need to prove that the funded enhancement will work on larger projects, its original target audience.

But it may find a different customer base to what it intended. The EIB enhancement was thought to be good way of coping with revenue risk, but may be best used to mitigate political risk. Unwrapped project bonds will be an option for financings with strong sponsors and contractors and low gearing. Pendleton indicates that smaller deals with smaller contractors might be the biggest beneficiaries of the funded enhancement.