PABs: favoured financing

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Tax-exempt private activity bonds have been a ubiquitous source of funding for P3 projects in the US over the last decade. As of 1 August (2018), around $8.38 billion in private activity bonds (PABs) had been issued for 23 projects, with $2.63 billion allocated and approved by the US Department of Transportation for an additional five projects.

PABs are a type of tax-exempt municipal bond, which at present can only be authorised for transport facilities that will be used by the public. They are used on deals where the private sector is playing a significant role but they have to be authorised by the US Secretary of Transportation. A conduit issuer on behalf of a private entity can then issue them for highway and freight transfer projects. Sponsors of projects benefit from fixed interest rates and lower financing costs compared to taxable options.

The first P3 project to use PABs was the I-495 Capital Beltway HOT lanes project in Virginia which reached financial close in December 2007. The year's biggest P3 deal, it entailed the build, financing and operation of two new HOT lanes along a 14-mile stretch of Virginia's Capital Beltway under a 75-year concession.

In the last few years, institutional investors have increasingly been eyeing the US P3 space given the propensity for fixed-rate long-term tenors on debt that are relatively low-risk and offer higher yields.

Private placements can be used on a range of projects that have investment grade characteristics. They are very much applicable in the power, energy and infrastructure sectors. Private placement bonds can be very useful in bid situations because they can be committed in advance – like a bank financing. They can have very long tenors (upwards of 40 years) and are well-suited for greenfield projects due to the delayed delivery option which reduces negative carry during construction. They are also useful for projects with revenues and cash flows denominated in hard currencies other than US dollars, without imposing currency risk onto the issuer/project.

The first private placement deal in the US was the City of West Lafayette's Purdue University. A Plenary-led private sector consortium reached financial close on State Street redevelopment P3 in March 2016 – the first US P3 availability project where the bid included a privately placed bond with fixed credit spreads.

The deal structure included a short-term credit facility and long-term private placement bonds with SMBC acting as sole lender on the credit facility and agent on the private placement. Babson Capital was understood to be among one of the buyers of the private placement notes.

The $15 billion cap

Following the signing into law of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) by former President George W Bush on 10 August 2005, $15 billion was made available to finance key infrastructure projects in the airports, water ports, mass transit, water and sewer, and surface transport sectors. Given that over $11 billion worth of deals have already been financed using PABs and there is still a pipeline of projects that need to be financed, the question arises – what next?

President Donald Trump addressed this very issue earlier this year (2018) when his administration proposed lifting the cap and expanding the use of PABs in other sectors including:

- hydroelectric generation
- flood control and storm water facilities
- rural broadband facilities

However, former President Barack Obama previously announced a similar expansion to the programme in 2015. His administration wanted to build on the existing PABs structure through tax-exempt Qualified Public Infrastructure Bonds (QPIBs). These would have cost $4.8 billion over the next 10 years from 2016 to 2025.

These plans were never realised and since the Trump administration's own PABs announcement, there has been little progress.

A veteran investment banker says: "Private activity bonds have been in use since the mid-2000s when legislation was introduced that allowed for up to $15 billion worth of infrastructure projects to be financed. At that time the assumption was that this would be used up quickly but given the long-term nature of procurement processes in the US there is still funding left."

New kid on the block

The Canadian market has been using private placement bond financings for a number of years. Canadian pension funds and life insurance companies are the main proponents, viewing them as long-term investments.

In the US, in a very low spread environment, taxable private placements are increasingly competitive with PABs. Beyond the pricing being close, private placement can be committed in advance and be delivered on a delayed basis, neither of which can be done with tax-exempt debt.

Barney Allison, a partner at Nossaman, says: "Private placements may be competitive with PABs since you can get fixed spreads over long-term US treasuries which are still historically low right now. There seems to be an appetite among investors for long dated fixed rate private placement deals where you can negotiate a draw down feature during construction vs having to capitalize interest in a PABs deal."

The second deal to close in the US using private placement bonds was the Long Beach Courthouse P3 in California in May 2016. The project's financing package involved a combination of short-term bank debt, long-term private placement bonds and sponsor equity. The project was also the first social infrastructure PPP in the US to be financed using a taxable private placement solution. The $239 million, 34.5-year average life private placement bond issue was entirely covered by Allianz Global Investors (AllianzGI), marking their first social infrastructure PPP investment in the US. Barclays was agent on the private placement.

Tom Rousakis, senior managing director at Ernst & Young Infrastructure Advisors, says: "We continue to see increased use of private placements in the US infrastructure markets, driven by the types of projects being contemplated as P3s. One of the biggest drivers will be increased activity in social infrastructure, as this class does not enjoy the same tax exemption benefit as transportation projects. Moreover, projects that want to avoid the risk of delay and cost from project 'federalization' may view the taxable markets as providing better overall value."

Rousakis continues: "There are interesting headwinds to note. The industry has been exploring approaches to social infrastructure P3s that would allow them to be financed with government tax exempt bonds through 501c3s or other structures. Moreover, we are seeing increased interest in taxable muni bonds, which would tap a wider taxable investor base, many of whom were investors in Build America Bonds nearly a decade ago. Both of these would impact demand for private placements."

Another deal, the $408 million Marion County consolidated justice complex PPP in Indianapolis which featured a fully committed private placement bond issue at bid stage was cancelled in 2015 after being embroiled in local city and county politics.

Allison adds: “We are seeing more interest in the market in trying to come up with tax-exempt governmental bond solutions for P3 transactions vs private placement, particularly for projects that aren’t eligible for PABs.”

The Los Angeles World Airports (LAWA) Consolidated Rental Car (ConRAC) facility is the next major transport project in line to close, most likely by the end of the year. It will be financed using a combination of equity and private placement debt with JP Morgan and RBC acting as placement agents.

The veteran investment banker adds: “PABs certainly are the favoured funding mechanism for transport projects but private placement financing is certainly gaining momentum. This is mostly because certain projects do not qualify, such as ConRAC. It does not connect physically to an airport terminal so a strange quirk in the legislation means it cannot be financed using PABs. But this is an unusual case. I think going forward we will continue to see private activity bonds being used to finance transport projects but other debt instruments such as private placement will always have to be considered.”

Social infra and PABs

At the end of 2017, a piece of legislation was introduced for private activity bonds to be used on social infrastructure called Public Buildings Renewal Act of 2017. If signed into law, it will permit the tax-exempt financing of certain government-owned buildings by expanding the definition of “exempt facility bond”.

A qualified government building is a government-owned building or facility that consists of one or more of the following:

- elementary or secondary schools
- a facility of a state college or university used for educational purposes
- a public library
- a court
- a hospital, health care, laboratory, or research facility
- a public safety facility
- an office for government employees

The bill excludes buildings or facilities that include specified recreational equipment or are used for the primary purpose of providing retail food and beverage services, recreation, or entertainment. It caps PABs for social infrastructure at $5 billion.

Rousakis adds: “Technical factors continue to drive attractive pricing from all these financing vehicles and tax-exempts continue to provide the most attractive pricing, especially after taking into account the greater call flexibility embedded in this market.”

The US infrastructure market has certainly become more comfortable using P3s and given the number of deals, alternate financing structures will be welcome. It is almost impossible to predict where rates, spreads or the overall market will go but all things being equal, the private placement market will continue to grow in the coming years as and more sponsors become accustomed to executing with them. PABs will continue to be the favoured financing tool though given the success of so many P3 deals over the last decade or so.