The UK's M25 mega transaction

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Financial close on the long-running M25 transaction saw 16 commercial banks club the debt on a deal that many believed would never make it away in a severely constrained financing market.

The M25 PFI project faced a range of challenges, and although it successfully attracted all the market players, the high profile deal does not herald a new dawn in project finance.

To the casual observer, the M25 [Projects Database] is a success story in that the debt was oversubscribed, however this does not signal market recovery more the political motivation to see this deal make it to financial close and clear the way for other deals to break the logjam.

All the banks that are currently active in the PF market were in on the must-do deal of the year and the M25 is now likely to stand as a pricing benchmark for credit committees in the European PPP and Transport sectors.

This deal stands as a landmark on a European scale, attracting many banks on the strength of the sponsors and [eventually] good pricing. The introduction of a cash sweep/margin ratchets was essential - long term debt is still not there for many banks.

Procurement

The M25 PFI is modelled on the DBFO structure and is considerably larger than anything the Highways Agency - which had financial advice from PwC and legal advice from Denton Wilde Sapte - has procured through PPP.

The scheme includes a Contract Review provision - which many originally thought was another Metronet-type review - but allows HA the flexibility to amend terms of the contract unilaterally. This is a novel concept, and slowed the bidding stage as parties became acquainted with the process.

There is also a change mechanism in the structure to allow the authority the flexibility to put in variations to the original contract should it be deemed necessary.

Many of the project's unusual features were superceded by the funding challenges that later bogged down the deal.

One of the key elements of the transaction was timescale. Despite the size of the project, the deal has to be ready in time for the 2012 Olympics. The M25 started procurement in 2005 when London was confirmed as the successful host city - putting massive pressure on the HA to meet un-movable deadlines.

In May 2005 HA staged an industry brief for bidders vying for the project and by June 2006 five pre-qualified consortia had submitted OBCs.

They were:

- **Amey**, Laing O'Rourke & Ferrovial Agroman
- **CircuLON** - Fluor & Transurban
- **Connect Plus** - Balfour Beatty Capital Projects, Skanska Infrastructure Developments AB, Atkins and Egis Projects
- **Flow** - Vinci Concessions, Autoroutes Du Sud De La France, Laing Roads, Carillion Construction, Costain
- **Macquarie Motorway Group** - Macquarie European Infrastructure

By March 2007 this was reduced to a shortlist of three (Amey, Connect Plus and Flow), bids were submitted in November that year and the **Connect Plus** consortium was officially confirmed preferred bidder in July 2008.

Connect Plus comprised:

- Balfour Beatty - 40 per cent
- Skanska - 40 per cent
- Atkins - 10 per cent
- Egis - 10 per cent

HSBC was financial adviser to the sponsor, while Ashurst acted as legal adviser.

Funding challenge

Shortly after the preferred bidder announcement, Connect Plus launched a funding competition. However, uncertainty started to mount as the credit crunch unfolded - and the funding competition coincided with the bottom falling out of debt market.

Connect Plus started the deal before the credit crunch reached its height. Soon followed the Lehman Brothers bankruptcy and widespread restrictions in the banking market up to the end of 2008.

The procuring authority was left procuring its largest PPP in a tight competitive environment with tight tender rules that bedded down most of the contract and risk allocation - only to discover that it now had a funding group that was asking for risk allocation that was quite different from what the market was accustomed to.

Towards the end of 2008 the financial adviser was coming in for mounting criticism for its insistence in maintaining a funding competition at the same time that the banking community was noticeable by its reluctance to support bidding teams on any transactions.

It was at this time that the Department for Transport (DfT) was wheeled out as a potential co-funder to plug any gap in the financing. A framework was then established at a time when nobody knew what the ticket sizes would be - let alone how many banks would be able to fund it.

Even in in the first two months of 2009 the sponsor was bracing itself for a significant amount of co-funding from public sources. The co-funding option and essential EIB support provided both confidence that the deal would get away.

Needless to say, the government did not want the deal to go down the co-funding route and the sponsors worked hard with HSBC to create a financial structure that was more palatable to the banking market.

Gradually banks came back to the deal as credit committees started loosening purse strings and the margins headed north to a decent return for the banks, along with reasonable swap rates and credit spreads - as well as underpinning and cash sweeps.

Financial close was achieved on 20 May 2009.

Financing

The core bank working group (BWG) included Lloyds TSB, WestLB, BBVA and SMBC, along with the European Investment Bank (EIB). The BWG line-up changed little during competition, with Dexia having been a member of the original group.

This BWG essentially drove the deal, sitting around the table with the Highways Agency and the sponsor. Essentially the BWG cooked the deal and presented it to the wider banking group. Linklaters acted as legal adviser to the banks, while Slaughter and May provided legal counsel to the EIB.

It is important the role played by the BWG is not under-played as this team successfully negotiated the finance documents and project documents for the wider group, making the project bankable.

In total 16 banks were credit approved for the M25, and it could have been closed with just 12.

The deal ticked many of the boxes for the banks:

- it was in an OECD (Organisation for Economic Co-operation and Development) country
- solid promoter - the HA has a good reputation in the market, well established from previous projects
- high profile transaction - the M25 is one of the most famous motorways in Europe
- strong sponsor group - Balfour Beatty and Skanska
- credit was structured sensibly
- pricing was good when it closed - possibly on the low side with the benefit of hind-sight

Most of the commercial banks came in on a common ticket size of £65 million. Much to some of the BWG banks' chagrin, bigger ticket players (even banks that had secured approval for £100 million tickets) were scaled back in a move that smacks of even-handedness above wisdom.

The £65 million commercial bank line-up was:

- Barclays Capital - hedging bank
- HSBC - hedging bank
- Lloyds TSB - hedging bank
- Bank of Tokyo-Mitsubishi UFJ
- BayernLB
- BBVA
- Calyon
- Dexia
- KfW
- RBS
- SMBC
- Société Générale
- WestLB

There were three banks on the lesser tickets:

- NAB - £43.5 million
- Helaba - £36 million
- Natixis - £30 million

The total project debt is £956 million including the £247 EIB LC facility and £709 million in commercial debt.

The EIB loan has a fixed rate of 4.938 per cent plus a margin of 55bps, with a maturity in 2036 (27 year tenor).

- **structured finance facility** (non-guaranteed) - £160 - 75bps dropping down to 55bps after release condition is satisfied
- **guarantee LC-backed** (letter of credit) facility - £247 - no margin, but margin of 55bps when LC drops away, over five years

The margins on the 27-year commercial tranche debt are:

- 1-7 years - 250bps
- 8-10 years - 300bps
- 11-27 years - 350bps

The interest rate swap and CPI swap were fairly standard for such a deal - between 35 and 40bp.

Cash sweeps are as follows:

- year seven to 19 - 50 per cent cash sweep
- year 19 onwards - 100 per cent cash sweep

The conservative base line assumption is that it won't be refinanced and the banks will be stuck in the deal for the duration. However, there is a high probability that it will be refinanced after seven to 10 years.

Operational gearing

The Connect Plus consortium is taking over the operation and maintenance of the entire M25 as well as widening certain stretches to improve traffic flow.

It is responsible for the ongoing maintenance and upkeep of that asset and the construction element of the deal is worth a fraction of the overall deal. The project includes a great deal of lifecycle risk - taking on an existing road - and the funders had to become comfortable with this aspect.

To get around an increase in costs and potential default, the state can make an additional annual payment to cover cost increases. If this support is not needed, it goes back to the state.

The operating leverage was a key element of the structure - the level of operating cost is high relative to the level of debt, so that the project is overly sensitive to increases in the level of underlying cost.

This additional payment was a credit enhancement to make the project more robust.

Skanska Balfour Beatty will add 40 miles of additional capacity to the M25 between Junction 16 (M40) and Junction 23 (A1 at South Mimms) and Junction 27 (M11 at Bell Common) and Junction 30 (A13 at Thurrock). The design for the widening programme will be carried out by Atkins. As part of the contract, Skanska Balfour Beatty will also refurbish the A1 (M) Hatfield Tunnel.

Work started in May 2009 and widening will take place within existing highway land. It will be delivered in phases by 2012.

Conclusion

For a deal of this size, the M25 was a success on many levels - it was high profile transaction that was well managed and brought the banks it needed to the table at the right time to get it away and build confidence in the UK construction sector.

The question many are asking after the M25 - and a run of other PPP financial closes in the UK - is whether there is still a market for long-term debt.

There is a cadre of banks that are keen to keep on funding PPPs - RBS and Lloyds Banking Group at the front of the queue with a little encouragement from government - along with many of the funders from M25 line-up that have a remit to lend.

This deal has gone some way to restoring confidence in the funding market and project finance, but in terms of pipeline the M25 is a one-off.

In terms of UK transport PPP - there are a number of small streetlighting and highway maintenance PFIs in the pipeline, as well as long-running schemes such as the Forth Bridge and the second Mersey crossing. Stickign with transport, there are a number of other PPPs coming up - including IEP and DTR - that will continue to test the capacity in the UK.

For all the hard work that went into getting this deal away, it required minimum support from the transport department and did not have to call on the recently launched Treasury Infrastructure Finance Unit (TIFU).

The M25's legacy is a positive feeling in the market that a transaction of this scale was able to make it to financial close in such a market. Had it failed to make it away, it would have sounded a death knell for UK PPP.