TAKING THE PRIVATE INITIATIVE

BEING INVOLVED IN THE PRIVATE FINANCE INITIATIVE (PFI) AND PUBLIC PRIVATE PARTNERSHIPS (PPP) SECTORS HAS OPENED **JOHN HARRIS** OF INNISFREE'S EYES TO THE BENEFITS THIS FORM OF FUND-RAISING CAN BRING – AND WITH A TOTAL INVESTMENT OF £40.5BN IN PUBLIC SERVICES IN 2003/4, WHO CAN ARGUE WITH HIM?

PROSPEROUS TIMES FOR PFI

'PFI NOW CONTRIBUTES ABOUT 10% TO PUBLIC INFRASTRUCTURE FUNDING OF ABOUT £4BN PER YEAR'
JOHN HARRIS

- Some 564 private finance initiative (PFI) deals with a capital value of more than £35bn have been signed.
- Investment in schools' PFI since 1997 will total £3bn.
- There have been 68 major hospital developments worth more than £7.6bn since 1997, with 64 of these involving private finance.
- Total investment in public services is increasing from £23.7bn in 1996/97 to £40.5bn by the end of 2003/4. The PFI element will increase from £1.5bn to over £3.5bn.
- About 81% of public bodies involved in PFI projects believe they are achieving satisfactory or better value for money from their PFI contracts.

Source: PPP Forum website

Innisfree remains the largest private equity investor in private finance initiatives and public private partnerships (PFI and PPP), with 38 signed deals and commitments of £300m. Having been in the vanguard of PFI since its inception and currently fund raising it is an opportune moment for John Harris, Investment Director at Innisfree, to consider how the PFI market may evolve over the coming years.

NO LONGER AN INITIATIVE. The PFI, having started life back in 1992, can hardly be called an 'initiative' any more and is now known more generically as public private partnerships (PPP) in certain sectors and countries. It has survived and prospered following a change in the UK political landscape and now contributes about 10% to public infrastructure funding of about £4bn per year, consistently delivering high-value public sector assets on time and to budget – in case you need more convincing, for more facts and figures, see the boxout on the right.

EVOLUTION, NOT REVOLUTION. To some extent, the development of PFI has been the solving of issues in chronological order. Early deals focused on the likelihood of construction to time and budget, and the ability of contractors' proposals to meet the authority's requirements. Once built, then came government focus on refinancing, with the development of the Open GIS Consortium (OGC) voluntary code and refinancing gain share hard-coded into all new deals. Senior debt finance has been the subject of recent scrutiny, with market testing at the preferred bidder stage and the proposed development of the credit guarantee structure that will address the issue of swap break costs and the early redemption of bonds – although it remains unclear as to how banks will address the loss of such lucrative derivative products without an increase in pricing. Project bonds will continue to play an increasing role, although no one on the equity side of PFI will mourn the passing of the Spens clause.

The next subjects focus on benchmarking and market testing. Typically, with a three-year build and market testing five years thereafter, only projects signed before 1996 will have 'gone to the market'. So it remains to be seen whether incumbent fund manager (FM) providers are prepared to sufficiently sharpen their pencils to keep the business. Three questions affecting price spring to mind:

Will Nottingham's trams be the UK's last?

- Will an FM provider be prepared to pitch for the soft FM without the benefit of the hard FM and life cycle business?
- How can a replacement FM provider recover its set-up costs without being expensive compared with the incumbent?
- Will historic performance deductions simply be factored into the new price?

Applicable to most accommodation projects, and with the effects of price increases almost completely passed through to the public sector, this issue should start to exercise the grey matter of OGC and PartnershipsUK (PUK) in the not too distant. Changing tack, let's take a look at a couple of sectors with more fundamental issues against them:

LIGHT RAIL. Innisfree is the largest investor in Arrow Light Rail, the concessionaire for Nottingham Express Transit, the most recent suburban tram system to reach financial close, some four years ago. (Docklands Light Railway is excluded as it is not really comparable.)

Unlike other systems in Manchester and elsewhere, NET is a genuine PFI scheme, with government funds paid over time based on performance (would you like your rail operator to be fined if it was more than three minutes late?). Only 20% of revenue comes from the farebox. Considered the ideal solution for such schemes at the time, the financing structure was torn up and thrown away for the schemes at Leeds and South Hants with predictable results – both now languish in the sidings.

There is some light at the end of the tunnel, however. With the first passengers boarding in Nottingham, it is likely to lead to one or two line extensions. There are also schemes under development in Merseyside and Edinburgh, as well as London. Success in Nottingham will be critical to the sector's development and will shape the financing solution.

'TRANSPORT HAS BEEN A FAVOURED SECTOR IN MANY COUNTRIES, PERHAPS IN PART BECAUSE OF A WEALTH OF WILLING CONTRACTORS AND IT BEING LESS POLITICALLY CHARGED THAN, SAY, HEALTH, EDUCATION OR DEFENCE'

HEAVY RAIL. And you thought light rail was difficult – in case you had not noticed there has been rather a lot of comment in the press about the amount of infrastructure spend that is required to bring our railways up to 21st century standards. Even in the past few weeks, the case has been made for high-speed lines to be developed to allow for the expected economic expansion that the airports and roads alone will not be able to cope with.

On top of this, London is considering at least four major cross-London rail projects, with a combined capital costs running into the tens of billions. PPP has been mooted as one possible solution to schemes of such cost, bearing in mind government borrowing constraints. However, with deals of this size, investors and contractors will be betting the ranch. So unless the projects can be divided into bite-sized chunks, in terms of money, time or both, it is going to prove difficult.

The proposed Design-Build-Transfer structure is clearly unattractive to private equity; we are not in the business of bridging loan finance. With contractors likely to be cash-constrained and equity funding needed to keep the projects off balance sheet, some fresh thinking will be required.

PPP OVERSEAS. PPP has been readily exported to a number of European counties, with further opportunities developing in North America and Australia, where they have pursued their own version of PPP for some years. Transport has been a favoured sector in many countries, particularly in Spain and Portugal, perhaps in part because of a wealth of willing contractors and it being less politically charged than, say, heath, education or defence.

Clearly, the area for massive infrastructure development is within the European Union (EU) accession countries, where a combination of poor quality infrastructure and limited public funding (especially if they wish to comply with Maastricht criteria) is likely to lead to a proliferation of PPP projects.

Two key areas of risk that need to be overcome are legal framework (a pre-requisite for senior funders) and currency risk, which is a large and almost impossible to mitigate risk for equity over the life of a 25-year-plus concession. The latter is likely to be more simply resolved by entry into the euro; the former will require individual states to legislate the necessary frameworks.

It would not be surprising if PPP in these countries overtakes that in countries such as France and Germany, where progress in off-balance sheet financing has been slow and the indigenous players are often perceived as being too powerful to compete against. This is not for the faint-hearted, but the returns could be impressive.

THE SECONDARY MARKET. There remain only a handful of equity investors (evenly split between managed funds and banks investing their own money) engaging in primary PFI deals in the UK and it seems unlikely that this position will change. Not only are there significant bid costs to be digested, but the lead times for transactions between pre-qualification and financial close is measured in years, not months, and, even then, cash returns for investors are not realised until after a construction period that typically ranges from 18 months to five years. For an established player such as Innisfree the dealflow is there, but for new entrants this time lag presents a considerable barrier to entry.

Clearly, this is not the case in the secondary PFI equity market, where the process is more akin to that of classic private equity, where sale and purchase documents, and then due diligence, can be agreed if not in weeks then in a few months. It is these factors that have resulted in the creation of a number of secondary fund vehicles in the past few years, including Innisfree's own joint venture with Prudential.

The willingness of these funds to offer contractors the ability to recycle their capital will be critical to PFI continuing to deliver the £4bn or so of public sector assets that it has achieved over the past few years. On the assumption that this equates to £400m per year of equity, the secondary market in PFI is likely to grow and grow. This is good news for the secondary market, possibly even better better news for the primary market.

PLUS CA CHANGE, PLUS C'EST LA MEME CHOSE? No, I don't think we will see much PPP in France, but it sums up the future for PFI. Some sectors and countries will re-invent PPP; others will continue for the next decade as they have for the last. But one thing is for sure, PFI/PPP is a British success story and here to stay – so get used to it.

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