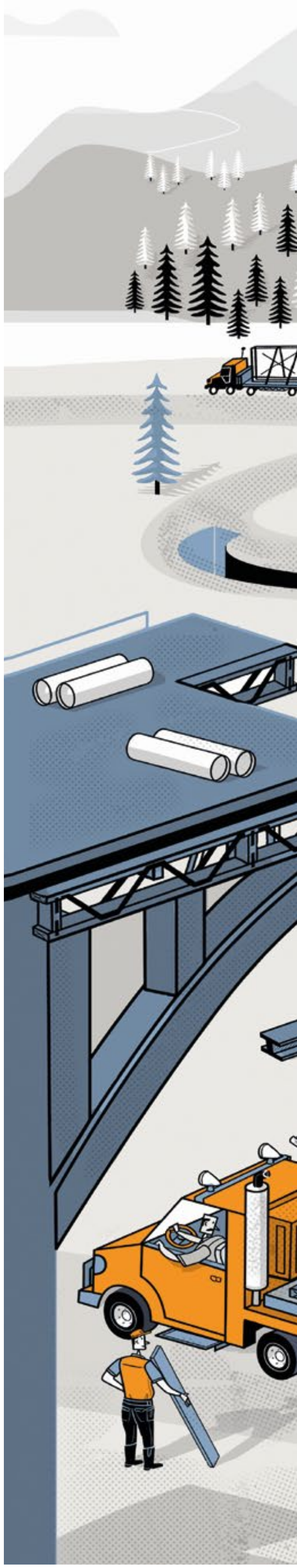
If you build it...

Boosted by transport and renewable energy investment, institutional investors continue to increase their commitment to project finance. Paul Golden reports



Good news for investors who favour infrastructure projects: data from online intelligence service IJGlobal indicates that the global project finance sector closed significantly more transactions last year than during the previous 12 months. The number of deals rose by more than 10% to 859, although total transaction volume was up only marginally ($309.1bn compared with $308.4bn in 2014).

Data provider Dealogic recorded a similar increase in the number of projects closed, but recorded higher figures for global project finance volumes in 2015 ($422bn). Europe, the Middle East and Africa (EMEA) accounted for 37% of the total market, up from 33% in 2014, with 299 deals completed.

Energy received the largest amount of investment worldwide, although in Europe transport was the largest sector by volume.

These figures underline the view of Michael Wilkins, MD, infrastructure finance ratings at Standard & Poor's, that there is very strong appetite in the capital markets for infrastructure project exposure, both equity and debt.

"Commercial banks have been interested in debt exposure since the early days of project finance in the 1990s, and this level of interest has risen in recent years, particularly among northern European and Japanese institutions," he says. "The other source of finance is institutional, including pension funds, insurers, sovereign wealth funds and asset managers, who are looking for long-dated exposure with stable cash flows."

Banks (commercial, multilateral and export finance) account for 80% of total project finance, he adds. "Banks like transportation projects backed by large multinational developers acting as sponsors."

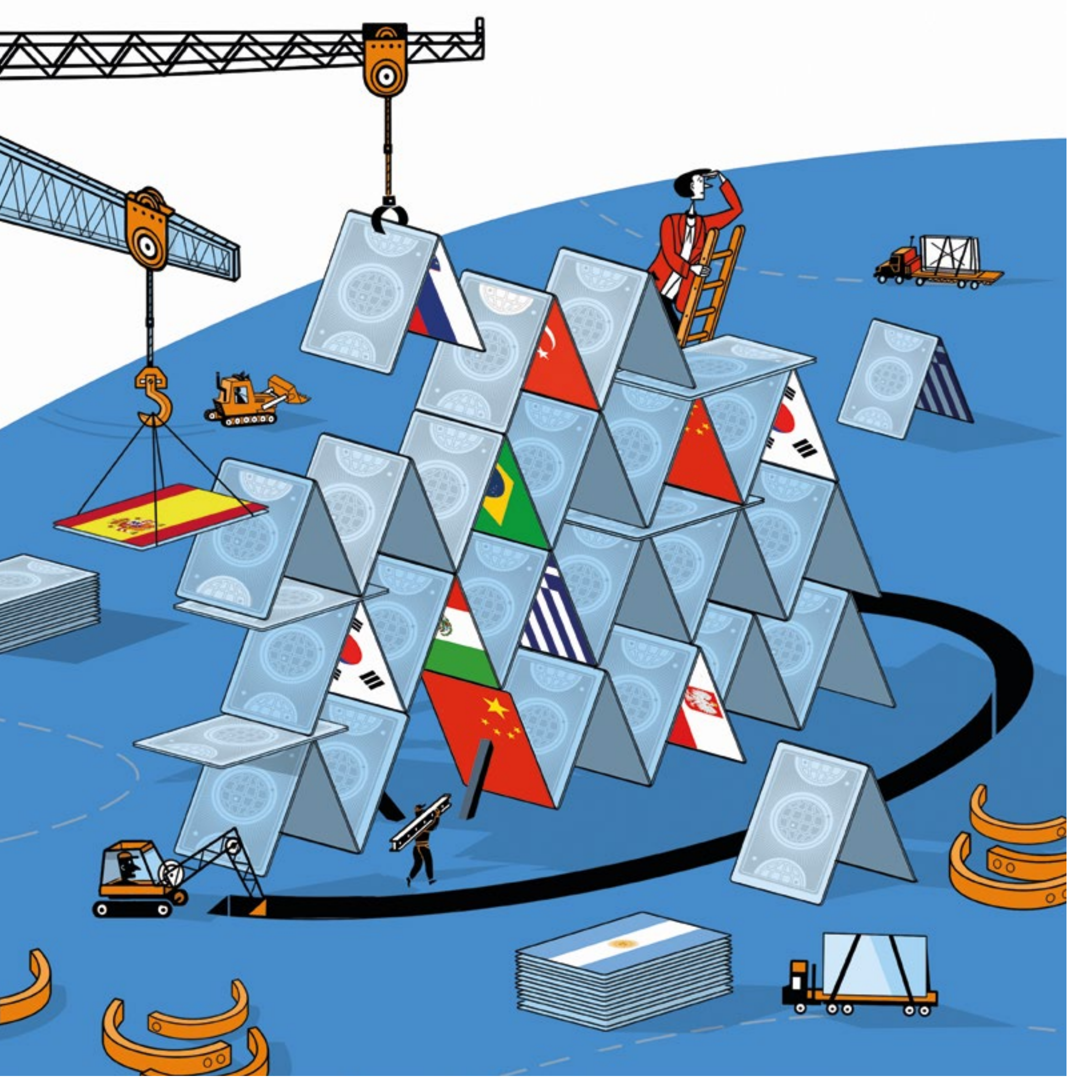
Competition and diversity

Doug Segars, associate MD of Moody's EMEA project and infrastructure finance team, suggests that funding sources are becoming more diverse. "Bank lending is highly competitive and public bond issues are making a comeback," he says, "particularly where large amounts of long-dated finance is needed, but the real story is private debt, both for new projects and as a source of refinancing for existing bank loans."

According to Segars, demand-risk projects are once again financeable, as long as sponsors are realistic about leverage and demand forecasts. "We see evidence of this in the number of European toll roads that have been financed or refinanced over the past several months."

Investors will need to be very comfortable about the sponsor's revenue projections, observes TC Treasury Services consultant Tony Chitty, director of international trade finance at engineering firm Mabey Bridge.

"Sponsors would be well advised to have a plan B in the event that the projected revenue was not forthcoming for whatever reason," he explains. "In most cases, lenders would be looking



BIG IN INFRASTRUCTURE – MAIN PLAYERS

The European Bank for Reconstruction and Development is owned by 65 stakeholder governments, as well as the EU and the European Investment Bank (EIB). Uniquely for a development bank, it has a political mandate – it will only assist projects in democratic countries. Projects of note include the construction of an arch to enclose reactor 4 at Chernobyl and seal its radioactive content from the surroundings.

The EIB is owned by EU member states and was formed to represent EU policy interests. It finances environmental and climate change initiatives, as well as providing infrastructure finance and funds projects mainly through loans. Its lending reached €77.5bn last year. In March this year, the EIB signed its biggest loan to date for India. This will go towards the construction of a new metro in Lucknow, and comprises financing of €450m. In 2014, the EIB extended a €900m loan to help finance expansion at the port of Rotterdam that will increase the port's capacity by 20%.

The Organisation for Economic Co-operation and Development export credit agencies, including UK Export Finance, ekn in Sweden and Exim in the US, also play a role in project finance, providing guarantees to banks. They have had significant involvement in power-generation projects, for instance.

for some measure of government support for public infrastructure projects, and if the project was of clear public benefit (for example, a bridge that significantly reduced journey times on a busy route, or a river crossing that negated a 20-mile diversion), the state may agree to provide such support, albeit only as a backstop."

Nedim Music, assistant director of corporate finance debt advisory at Deloitte UK, agrees that there is greater interest in infrastructure assets where there is an annual government contribution. "For example, investing in a toll road where future income depends on the number of vehicles that use the road is clearly less predictable."

Yield pick-up relative to comparable asset classes is one of the factors investors will take into account when considering whether to back a project, explains Wilkins. The average yield on a sovereign bond is around 1%, whereas infrastructure projects generate between 2.5% and 4%.

International Project Finance Association council member Darryl Murphy says a number of banks remain uncertain about their long-term financing appetite. "While there is interest in short-term acquisitions of infrastructure assets, many banks are trying to figure out what they can do in terms of long-term lending. In the meantime, private-placement investors, such as insurers and debt funds, are putting more capital into project finance."

Investment climate

Deal flow in Europe has been adversely affected by the economic climate, which has limited investment in new infrastructure projects. As a result, the ability of project sponsors to dictate terms has been strengthened.

"In terms of sectors, we have seen a move towards renewables as public-private partnerships have declined," explains Murphy. "However, there is still a strong focus on risk management and stability of revenue. Regulatory risk is also a concern for investors in light of retrospective

PROJECT FINANCE – A DEFINITION

The International Project Finance Association defines project finance as the financing of long-term infrastructure, industrial projects and public services based on a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project.

"Bank lending is highly competitive and public bond issues are making a comeback, particularly where large amounts of long-dated finance is needed" changes to renewables tariffs in a number of European countries."

"The project finance market is very liquid at the moment," says Music. "Insurance companies and pension funds are hungry for yields and looking to deploy capital, so there is a lot of appetite for infrastructure assets."

Most of the assets in the infrastructure space have behaved in a very predictable way, generating steady returns over a long-time horizon, says Giles Frost, chief executive of international infrastructure sponsor and manager Amber Infrastructure. One of the benefits of project finance is that the returns are largely (or in some cases completely) uncorrelated to wider economic factors.

Playing the long game?

Manish Gupta, head of infrastructure corporate finance at EY, also suggests that anyone looking to invest for a period shorter than seven to eight years should be looking for alternatives.

"There are many infrastructure debt instruments that are liquid, such as government-guaranteed bonds previously issued by Network Rail or high-credit-quality bonds issued by infrastructure companies, such as Heathrow Airport and regulated utilities," he says. "I am aware of many institutional investors who have invested in high-credit-rated bonds, in some cases as a replacement for gilts."

Matthew Cutts, financial institutions global sector head at built assets design and consultancy firm Arcadis, describes the availability of finance for private-sector projects in the UK as positive.

"The UK is becoming a mature market for insurers and pension funds to provide long-term debt and, despite the EU referendum, it is viewed as a long-term stable income market," he explains. "Transportation projects are probably still most favoured, although they are few and far between. Energy is probably more of a risk due to political uncertainty regarding tariffs and end-customer pressures."

A spokesperson for construction services company Carillion says project finance is generally available from financial institutions, such as Aviva and Legal & General.

When considering whether to back a project, investors take into account political certainty, availability of local partners (particularly operators) and certainty of long-term yield/revenues, adds Cutts. "Companies need to be able to deliver cost, operational and asset life cycle certainty."

Another important caveat, adds Segars, is that not all lenders have the same investment objectives. Sponsors may need to structure their projects to meet the needs of the particular investors from which they are seeking to raise debt. A recent example of this phenomenon is the financing of German wind-farm developer WindMW, which closed in December 2015 with eight tranches of debt offering different maturities and currencies.

It should also be noted that project finance remains subject to market cycles. In a report on project finance investment published last year by Clear Path Analysis, Viktor Kats, co-head of International Finance Corporation's global infrastructure fund, observed that, over time, the perceived risk profile of infrastructure projects will be adjusted, brownfield assets will no longer be viewed as risk-free and managed greenfield risk will be viewed as something that can be handled.

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INFRASTRUCTURE DEALS

In December 2014, life insurance company MetLife announced that a consortium of its affiliates and third-party investor clients had provided $200m in financing to railway leasing firm Angel Trains Group, bringing its total investment in UK rail infrastructure to more than $1bn.

Most of the lending MetLife does is on existing operating assets – the majority of its infrastructure portfolio comprises of first lien debt, explains John Tanyeri, MD and head of infrastructure investments in Europe.

"As with most insurance companies, we are an asset-liability management firm, and when we look at the assets that match up with those liabilities, infrastructure generally has stable cash flows over long periods and some form of direct or indirect government support," he says.

The challenge for major institutional investors is maintaining deal flow as competition for large infrastructure projects intensifies, adds Tanyeri. "We have seen a number of new debt funds emerge and insurance companies and pension funds becoming more interested in the debt aspect of the capital structure for a number of infrastructure companies. This had led to increased liquidity, which results in tighter spreads and looser covenants."

Valuations for existing infrastructure assets are high, which has led to concerns that the market might be overheating. Companies such as MetLife are hoping that economic growth in Europe will create new investment opportunities in this asset class.

Another factor influencing deal flow is pension funds with very long liabilities buying infrastructure assets and holding them for much longer than conventional investors, who might recirculate the asset after seven to 10 years.

"We are always looking at how the asset performs over multiple economic cycles," concludes Tanyeri. "When you look across our $10.5bn portfolio, it is pretty much comprised of airports, rail, transmission and telecommunications – essential assets."