WHITE & CASE

Virtuous cycle: Creativity and innovation in infrastructure finance

Regional differences and market maturities are forging a dynamic finance landscape with ever-more resourceful and innovative methods of meeting the global infrastructure funding challenge.

Virtuous cycle: Creativity and innovation in infrastructure finance

Infrastructure assets require financing for different reasons at various points in their lifecycle. Transactions are increasingly incorporating finance options that are suitable throughout the lifecycle of the asset, rather than just during the construction phase. This has opened the door to a wider variety of players. Partners **Carina Radford**, **Simon Caridia**, **Richard Pogrel**, counsel **Catherine Andrews** and associate **Kamran Ahmad** of global law firm White & Case discuss.

The infrastructure finance market has roots in project financing for greenfield asset developments. Yet deal flow in recent years (in Europe at least) has witnessed a surge of infrastructure M&A. In an evolving market, where regional differences and market maturities have forged a dynamic finance landscape, traditional perspectives on the financing of infrastructure projects—focused solely on the period between procurement and completion of the initial financing—are continually evolving.

Participants want to future-proof the initial financing arrangements and create scope for innovation and creativity in the structuring of financing arrangements throughout the life of the asset through the use of multiple funding options, mobilized through specially designed documentation platforms.

So what are the different financing techniques available to address financing issues arising at key points in the asset lifecycle?

The lifecycle of an infrastructure asset can be broken down into several key phases. At each point, parties need to consider the financing needs of the asset or the investors. This may take the form of a requirement for additional finance, a refinancing, preparation of the asset for sale or methods for monetizing operations.

The trend is not globally uniform. Outside Europe, traditional methodologies will continue to figure, factoring in the maturity of the market and external issues such as political risk and availability of ratings.

Yet the direction of travel is clear. Investors are seeking more diverse and flexible approaches to infrastructure financing.

Phase 1: The initial financing

Project finance is still the "go-to" financing structure for greenfield projects and is an appropriate starting point. Most greenfield projects continue to use either bank debt, project bonds or a combination of the two. It's a tried and tested model, in which the structure is moulded by the political, geographic and market constraints affecting the project in question.

Greenfield deals with significant capital needs often require a multi-source finance solution. Over the last few years, an increasingly diverse range of players have entered the greenfield finance market. Alongside commercial banks, mezzanine and junior debt providers have taken a more active role, coupled with a reinvigorated ECA financing product slate. New entrants are responding to the different structural and liquidity needs of the greenfield market.

US$71tn

Estimated global infrastructure spending need by 2030

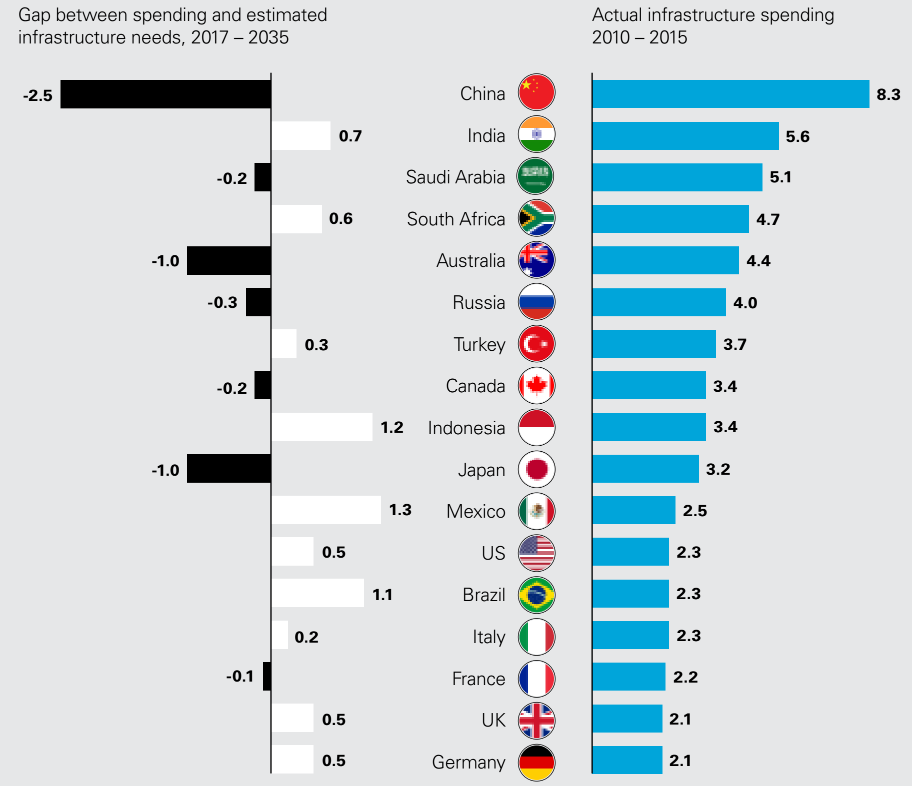
Source: OECD

In addition to the usual debt providers, institutional funders are getting more involved at the greenfield stage, and not just through a refinancing. Institutional participants are no longer typecast as being either "bank" or "bond" but represent a pool of highly sophisticated investors, ambivalent as to whether their investment takes the form of a loan or alternative debt obligation.

In practice, this means that a term sheet for a facility with an institutional component can often be flipped at the last minute into one for a privately placed bond or a US private placement (USPP), with additional requirements for a certain type of investor (such as clearing, or rating) bolted on. This highlights a distinct advantage to involving institutional investors. Some of the inherent refinancing risk that exists in the traditional structure can be eliminated by locking in a long-term price of debt and ensuring that debt terms are bankable by these long-term investors.

With a need for flexibility in mind, professionals structuring projects

Economic infrastructure, % of GDP



Source: McKinsey Global Institute

are increasingly opting for a capital markets product at the outset or as part of the financing mix. Project bonds offer tenors that are able to match underlying offtake agreements, fixed pricing, potentially quick-to-market execution and a deep investment market.

Viable solutions are on hand to overcome transactional roadblocks that stymie the successful marketing and execution of project bond transactions. For example, an issuer's ability to obtain the required rating for the project can be strengthened by innovative deal structures deploying different types of credit enhancement. Concerns arising where bondholders' waivers/consents may be required on an ongoing basis can be assuaged by the use of project/monitoring agents.

US$3.7tn

Estimated annual infrastructure funding gap globally, 2017 – 2035

Source: *Global Infrastructure Outlook: Infrastructure Investment Needs,* Global Infrastructure Hub, July 2017

The recent growth of privately placed infrastructure bonds reveals capital markets as both a valuable and viable source of financing for infrastructure and energy projects. In the past, a project bond had to be rated and publicly listed to attract a deep pool of investors. Now the European market affords increased use of private placements, enabling expedited execution and avoiding public disclosure obligations—indeed sometimes influenced by and a desire by project companies, and their sponsors to keep commercial information, such as tariffs and provisions in offtake agreements out of the public domain.

Similarly, US private placement market is an attractive source of capital for those looking to issue long-term, fixed-rate debt. European issuers are choosing USPPs for the ability to keep company data confidential, negotiate flexible terms, access capital markets without undertaking securities registration or obtaining a credit rating and provide access to a new investor base. This is a compelling proposition as USPP investors take the time to deeply understand credit risk and are often referred to as "bank-like," because of their long-term buy and hold approach, the amount of credit work they do and the amount of capital they deploy—further blurring the traditional separation between "bank" and "bond" investors. With European institutional investors taking a similar approach and/or investing alongside, the market is deeper and more dynamic than ever before.

Phase 2: Looking ahead and anticipating future finance needs

Although getting the deal done is always top priority, managing potential future funding requirements during the lifecycle of the project is still a keen focus for project financing solutions. Multilayered financing brings added complexity to any future finance requirements. Time is well spent setting up contractual flexibility for future leverage and/or refinancing

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Where does your project/asset/corporate sit on the risk spectrum?

Higher risk

- Lower sovereign credit/higher political risk
- Contracted revenues with shorter tenor than debt or "merchant" revenues
- High regulatory risk
- Potential for competition
- Construction risks perceived as high

- PPP structures with some traffic or toll risk
- Long-term contracted revenues from non-sovereign
- Perception of higher regulatory risk
- Less well-understood construction risk (as to latent defects, etc.)

Lower risk

- Stable, regulated, "brownfield" assets
- Availability payments/diversified payment risk/high barriers to entry
- Long-term contractual revenues from sovereign
- Construction risk well understood/track record of being on time and on budget

US$644bn

Total value of the 2018 *Global Strategic 100 Infrastructure Projects* list

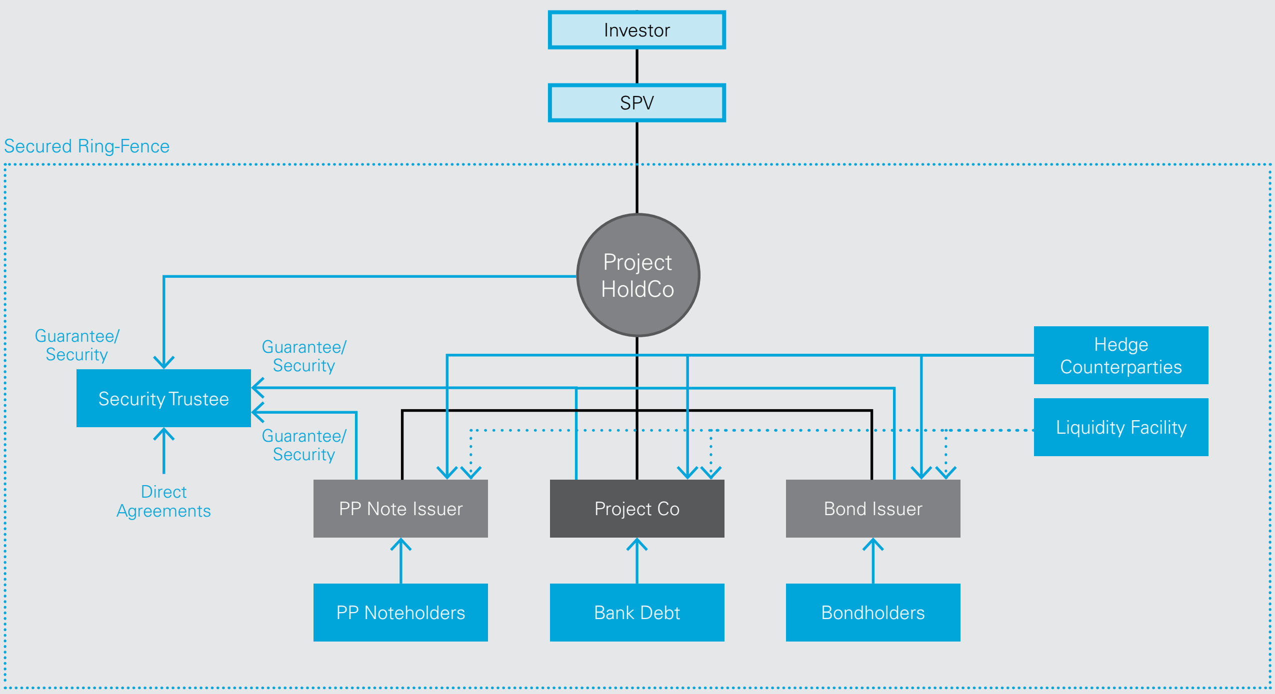
Source: *Strategic 100 Global Infrastructure Report*

options, given the desire to be able to expand the underlying asset and/or maximize returns once the asset is operational. Having the foresight to build in flexibility, agreed procedures and optionality at the outset is key to avoiding subjective lender consent requirements.

In this context, additional future debt facilities might include some or all of the following:

- Replacement debt, to refinance all or part of the existing senior debt on terms that do not affect the base case financial ratios
- Supplemental debt, to additionally leverage an asset up to an agreed debt-to-equity ratio
- Expansion debt, to finance expansions to the project where required by law or otherwise meeting certain base criteria

Example of a common terms platform



Source: White & Case

- Additional debt, to increase leverage if cash flows can support new incremental debt within the base case financial ratios

The rise in institutional investment in infrastructure projects, through a blend of bank and bond debt, has led to a paradigm shift in the legal documentation. Optionality is being built in. As a consequence, traditional project financing documentation has evolved to include sophisticated intercreditor agreements and common terms platforms, tailored to offer maximum flexibility to a project company, including the ability to access capital markets.

These documentation platforms seek to "future-proof" a project's long-term debt requirements, by incorporating an ability to refinance with bank or bond debt. Such flexibility facilitates future access to a broad spectrum of institutional investors and eases entry into different financing arrangements, targeting capital markets when it makes sense to do so, but retaining the ability to access the bank or institutional investor market when required.

Phase 3: Monetizing the asset and other operational finance options

The operational phase of a project opens up another realm of financing options to participants. So-called "hybrid finance" solutions can be used during the operational phase of a project to suit a variety of needs, ranging from the generation of working capital, dividend recapitalization, and additional investment at the project company level to increasing gearing at the holding company level in order to refinance the project company's indebtedness. Hybrid finance can be deployed on a standalone basis or alongside or "above" existing project finance debt. Infrastructure debt funds and alternative capital providers are drawn to this capital class primarily by the higher yields available, compared to senior debt.

Depending on the creditworthiness of the ultimate owner(s) and the status of the project company asset(s), typical hybrid products might include: structurally subordinated loans or notes at the holding company level; contractually subordinated junior or mezzanine debt at the project company level; bespoke solutions, including preference share structures; or bespoke highly structured debt packages with elements of high-yield and non-recourse project finance covenants.

A holding company loan hybrid finance transaction may include the following traits:

- **Corporate due diligence**: a need for a thorough understanding of corporate governance requirements, including the ability to direct actions at the project company level, as well as any conditions affecting upstream payments

- **Cash control/sweep**: incorporation of a project finance-style cash waterfall, ensuring control of cash by the holding company and a cash sweep at project company level following any suspension of cash distributions to the sponsor

- **Security**: provision of robust share security above the holding company level as well as assurance that no intervening security may be granted in the corporate structure

US$231.2bn

North America topped the list of global strategic projects in 2018 with US$231.2bn in project opportunities

Source: *Strategic 100 Global Infrastructure Report*

> **"The competitive nature of the M&A infrastructure debt market has made parties more aggressive on terms: Project companies are increasingly pushing for improved positions**

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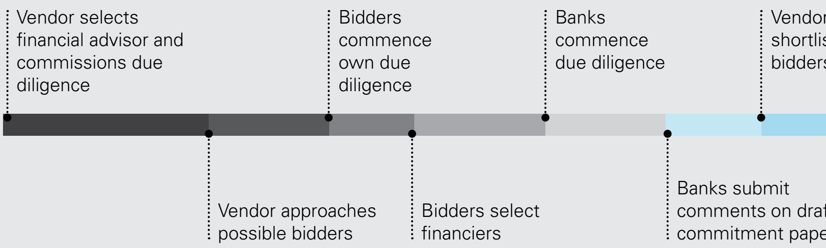
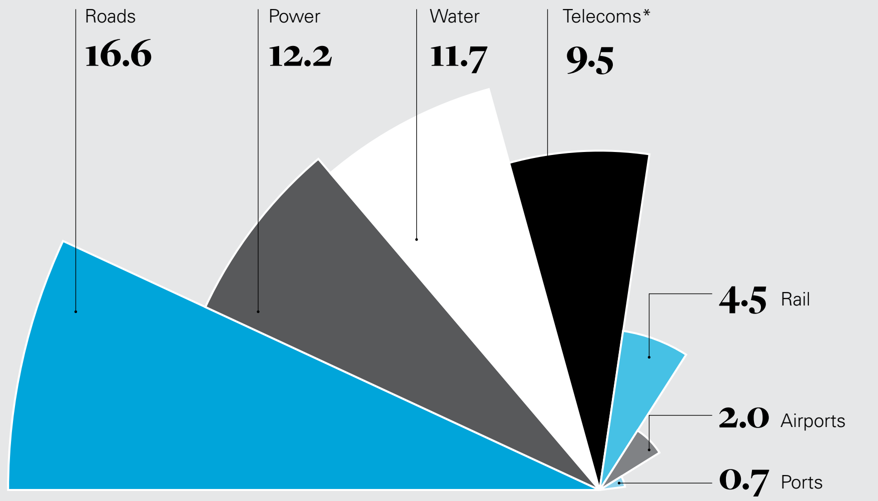
M&A transaction stages



Source: White & Case

Global infrastructure investment required 2013 – 2030 $trn, 2010 prices



Source: McKinsey Global Institute

*Brazil, China, India and OECD countries only

- **Construction risk**: if construction risk exists at the project company level, the inclusion of project finance controls such as enhanced reporting, monitoring by a technical adviser and cash reserves within any holding company facility

- **Additional leverage**: controls on the amount of debt to which the holding company loan is structurally subordinated may be required over and above any controls already imposed on the project company

US$115bn

Total value of strategic projects in the transit sector globally in 2018

Source: *Strategic 100 Global Infrastructure Report*

- **Change of control:** lenders to the holding company will typically require assurances and protections against change of control within the group with consent rights and/or prepayment rights accordingly

Phase 4: Looking further ahead and entering the infrastructure M&A market

Raising external finance for the acquisition of an infrastructure asset is a different proposition to a debt raise for a greenfield project. While target assets often have project-like revenue streams, these assets have a proper balance sheet and a track record of trading/operations. Financing terms and structures in this context are a hybrid between leveraged finance terms and project finance discipline of ensuring sufficient oversight of the performance of the underlying asset(s).

For a vendor of an infrastructure asset, deliverability of a deal is key—and often a binary requirement in an auction process regardless of the apparent competitiveness of a bidder's price. Bidders need to assess the extent, and timing, of the commitment that they will obtain from funders. It is increasingly common for bidders to secure a fully documented financing solution at bid stage so that they can demonstrate to the vendor they can complete

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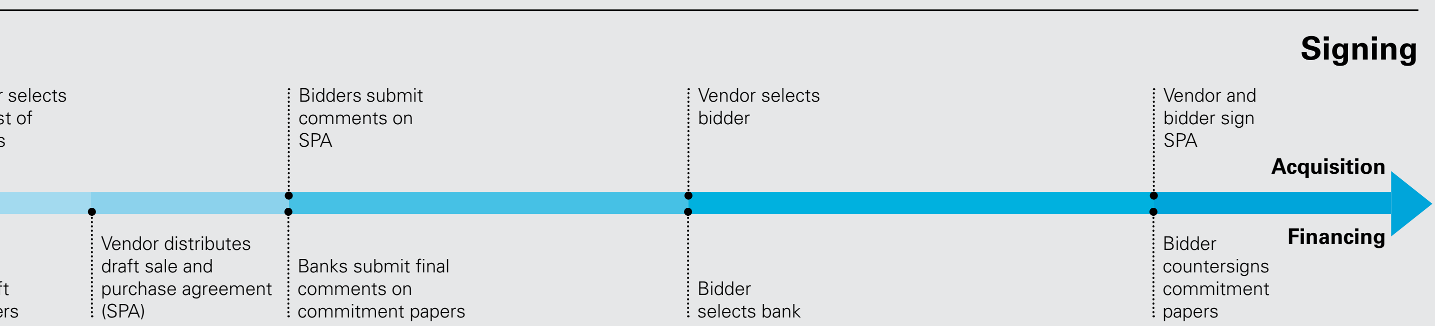

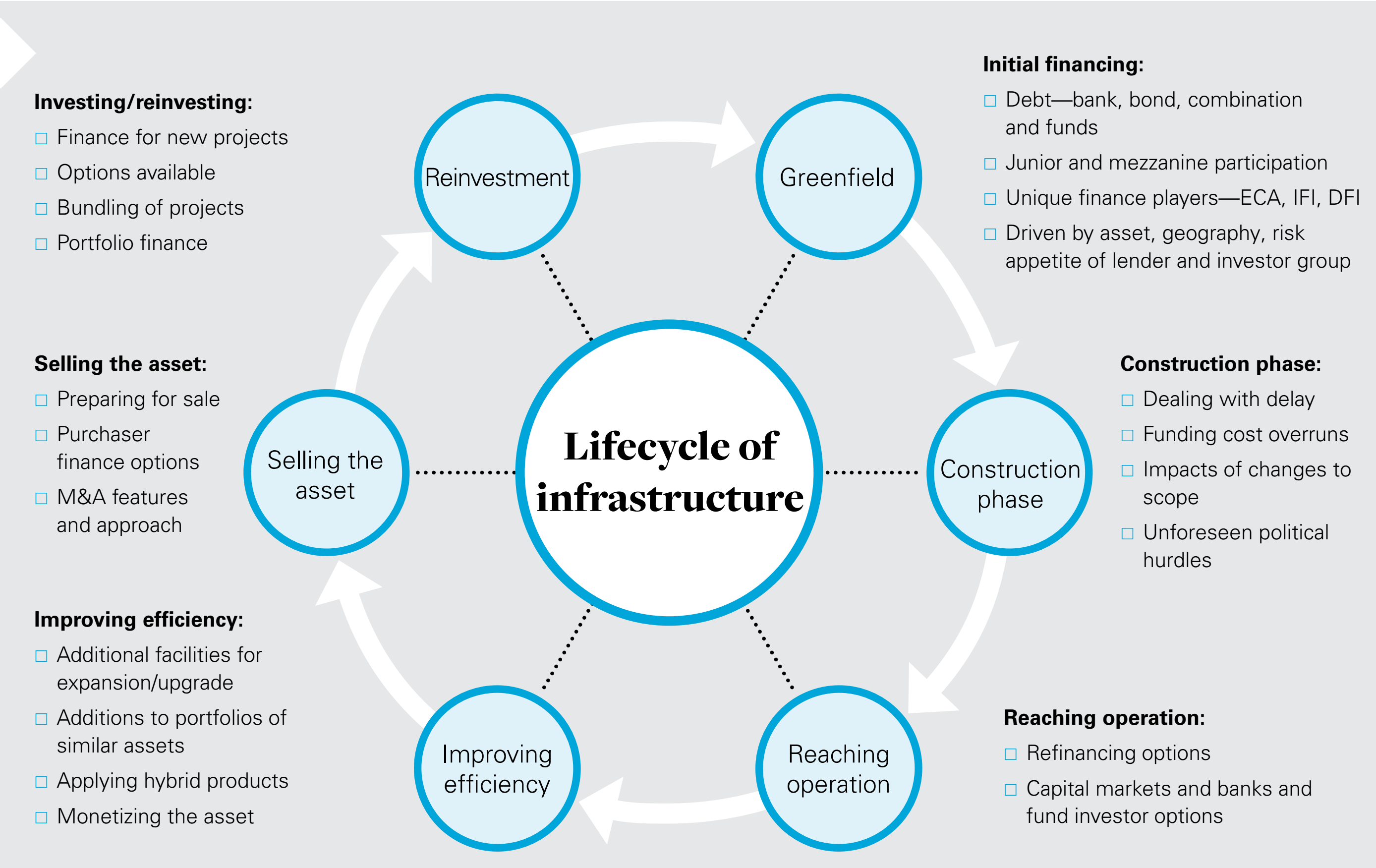

Source: White & Case

the acquisition quickly after being selected as preferred bidder.

The competitive nature of the M&A infrastructure debt market has made parties more aggressive on terms. Bidders are pushing for improved positions in certain covenant protections—such as in terms of the way in which (or the frequency) they can deploy an equity cure or relax certain reporting requirements or a less onerous material adverse change clause. This reflects the balance of bargaining power in a market that is currently tilted in favor of borrowers. The market is continually going through cycles of this nature.

Conventional wisdom—that financing for an infrastructure acquisition is the preserve of commercial banks lending on a short-medium basis, refinanced in the future on a longer-term basis by long-term bondholders, infrastructure debt funds and pension funds—is being overturned. Experience in the current market suggests that there are large institutional investors pushing for participation in the financing from the outset.

The way ahead

The pool of equity and debt investors interested in infrastructure continues to grow as the market itself continues to evolve. The competition to finance infrastructure assets at all points of their lifecycle seems unlikely to abate with ever-more resourceful and innovative structuring in debt products that deliver value throughout the asset life.

A more heterodox array of participants will fuel the creation of new methods of meeting the infrastructure funding challenge. Creativity and innovation will be the watchwords as they structure their future funding options.

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