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How the Infrastructure Debt Market is Evolving to Accommodate a Growing Institutional Appetite

There have been many seismic shifts in the infrastructure space since the global financial crisis started in 2007. One of the most game-changing has been the terminal decline in the availability of long-term bank debt. The reasons for this are well known – banks, especially those from Europe, are attempting to repair their damaged balance sheets, and Basel III actively discourages them from lending on a long-term basis to infrastructure deals. There are a few exceptions to this trend, however – Japanese banks and the occasional German bank still have some appetite for long-term infrastructure lending but they are very much the exception to the rule, and are by no means able to plug the gap left by their peers.

At the same time there is an increased emphasis on longer-term debt and a desire to spread maturities among investors. Fewer and fewer investors are seeking five- or seven-year debt maturities that they must refinance regularly.

The Need for New Sources of Debt

The retrenchment of banks from their previously pre-eminent role as long-term lenders to the infrastructure sector begs at least two questions: what are the alternatives and will they be able to replace the banks on the scale required? The answer is multifaceted and complex.

One aspect of that complexity is related to the different types of lending banks provide, or used to provide the sector. For example, bank lending has historically been critical for the PFI/PPP sector, and the vast majority of that has now dried-up. Banks have also almost totally disappeared from the provision of subordinated or mezzanine debt to the infrastructure sector. In terms of acquisition finance, the situation is not quite as drastic – there is still bank debt available for high quality assets. Nevertheless, bank appetite in that area is still much reduced.

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The severely restricted capacity of banks to provide long-term debt for infrastructure deals comes at a time when the need for infrastructure spending across the globe is soaring. Again the reasons for this are well known – aging infrastructure in the West, combined with constrained public sector budgets, as well as a huge refinancing need due to the maturing of debt arranged in the boom years, and a growing need for new infrastructure in the world's emerging economies.

"It may take a very long period but the bank market needs to be replaced by the institutional market," says Steve Rankine, Executive Director, Infrastructure Debt at Hastings Fund Management. "All of the expertise sits in the banks at the moment, except for a limited number of funds, such as ourselves."

"The market needs the expertise and capital that has historically been provided by these banks," adds Tim Cable, Director, Infrastructure Debt at Hastings Fund Management. "The market is actively engaging now with the institutional sector."

Bond markets

Over time, a great deal of debt will go to the bond markets. But they will not be the full solution by any means.

"The UK market is a particularly flexible one from a bond point of view, so a lot of assets are well suited," says James Wilson, Senior Managing Director and CEO of Macquarie Infrastructure Debt Investment Solutions (MIDIS). "In other markets, like the euro market there aren't the same sort of structures or terms available in the bond markets.

"There are also a relatively significant number of borrowers who do not suit the bond markets and are fundamentally better suited to the bank markets – particularly those who have smaller individual maturity tranches or higher ongoing monitoring requirements."

In the interim, in Europe, the EIB has been providing nearly half of the debt for greenfield projects. But that is unlikely to be a long-term solution.

Private Placement Markets and Private Loans

The EIB and bond markets, in Europe especially, do not have the capacity or expertise to immediately replace the

banks and so institutional investors through the US private placement market, private loans and debt funds are the obvious alternatives. Nor are the EIB and bond markets able to provide a solution to the huge refinancing need that is emerging.

Deals that were originally done in the 2005/06 period are likely to be refinanced by a combination of the bond markets, private institutional loans and the US private placement market. Companies are seeking to spread their maturity profiles, so they are not exposed to several refinancings on the same date. As such they will use different markets as a way to diversify their funding sources.

"The private, fixed rate, long-term debt market is a very logical source of capital and it's one that historically had been a large provider of capital to the sector," says William Pappas, Senior Vice President at Pricoa Capital Group, which provides private debt, mezzanine and equity financing to middle market companies and projects across the world.

"The private placement market, especially in the U.S., is very accustomed to executing these types of complex transactions. It has been reasonably active over the past few years in investing in European infrastructure, especially in the UK and is a really good fit. It's proven to have capacity of over USD1bn for a transaction, so it's a reasonably deep and attractive market.

"We expect a reasonably good pipeline of deals to finance over the next few years. Refinancing activity is significant, and the issuers are finding the U.S. private placement market is an efficient provider of capital and a good fit as far as positioning their capital structures appropriately, given the long-term nature of their asset profiles."

Private placement markets in Europe for infrastructure, to date, have been extremely limited. However, that state of affairs may be about to change. This was highlighted by the recent GBP100m senior loan raised by South East Water from the Universities Superannuation Scheme (USS) in November. It is expected that the UK water companies will seek similar deals, and the appetite among pension funds and insurers is growing.

Table 1: Institutional Participation in Infrastructure Debt

Project	**Sector**	**Investor**	**Debt**
Porterbrook	Rail	MetLife	GBP250m, 25-year amortising loan facility
Associated British Ports	Ports	MetLife	GBP200m private placement
South East Water	Water	Universities Superannuation Scheme	GBP100m private placement
N33 PPP	Roads	ABP	EUR78m loan to be provided in operational phase
Open Grid Europe	Energy Transmission	Prudential M&G	EUR175m Senior Debt
Jadraas 200MW Wind Farm	Wind	PensionDanmark	EUR124m Senior Debt
Alder Hey Hospital PFI	Healthcare	Prudential M&G	Senior Debt Facility (*Pending*)

Source: *Infra-Deals.com*

Debt funds
In addition, a number of different kinds of debt funds have been set up recently, which are also seeking to meet a part of the need at least.

"In Europe, infrastructure borrowers are diversifying funding sources by accessing debt funding in the UK and European bond markets, the US private placement market and the institutional loan market," says David Ridley managing director and founder of Westbourne Capital.

"There's a big gap to be filled, and the institutional loan market will play an important role in the provision of longer term funding for investment grade borrowers and also in the provision of sub-investment grade debt. Traditionally those infrastructure companies which have junior debt or holding company debt in the capital structure have primarily sourced this type of debt from banks, institutions are active and well placed to provide this type of debt in loan format going forward."

Debt Fund Structures
The private loan space has a number of new vehicles available to help facilitate it, including debt funds and platforms. For example, there are some vehicles set-up to for the PFI/PPP market to provide long-dated, senior-type loans,

priced at attractive spreads but low yields, with underlying investors being those with long-dated liabilities such as insurance companies and pension funds, such as Hastings Funds Management. There are also those funds that are seeking to credit enhance long-dated loans, so they can be distributed in the bond markets, such as Hadrian's Wall. Thirdly, there are those funds focused on more economic infrastructure that are seeking to lend for five-to-ten years plus either on a senior, junior or holding company basis such as Westbourne Capital. AMP Capital is focused on junior only.

Table 2: Selected Infrastructure Debt Funds

Fund	Target Size	Selected Assets
AMP Capital Infrastructure Debt Fund	EUR400m	Porterbrook, Southern Water, Invenergy, BAA
AMP Capital Infrastructure Debt Fund II	EUR700m	
Aviva Investors Hadrian Capital Fund 1	GBP1bn	
Harbourmaster Infrastructure Debt Fund	EUR2bn	
Hastings High Yield Fund		Arqiva, BAA, Cory Environmental, Maher Terminals
IFM		ConnectEast, Dampier to Bunbury Natural Gas Pipeline Victorian Comprehensive Cancer Centre
Westbourne Capital		

Source: *Infra-Deals.com*

Junior debt

Infrastructure debt funds tend to be either pooled funds or offer separate account-type arrangements. Often investors will co-invest alongside the funds.

"Our funds have invested in senior debt alongside banks, but typically in the longer dated tranches as there are constraints in the bank market for term," says Ridley. "For junior or holding company debt, there tends to be less capacity from the banking market. Borrowers are accessing the institutional private loan market or are in some cases tapping the high-yield bond markets ."

Infrastructure debt funds, are, as such, seeking to develop structures that will allow institutional investors access to infrastructure opportunities that by and large have proved somewhat elusive to them so far. Those new structures are only just beginning to emerge. Nevertheless, the industry at present resembles a kind of patchwork of different potential solutions.

"There's not a great deal of uniformity across the industry," says Andrew Jones, Global Head of Infrastructure Debt at AMP Capital Investors. At our end of the spectrum there are high-yielding, subordinated funds, which are typically ten-year closed end structures. They are a market norm.

Senior debt

"On the senior debt side a number of funds are trying to create entry and exit mechanisms, which in many ways mirrors the earlier development of equity funds. There are a number of benefits and challenges. For example, gaining geographical diversification requires some structuring work.

"As such, the costs of providing a multi-jurisdictional offering are high and relative to the returns on the senior ranches are in some cases prohibitively high."

The fact that most companies have much more debt in them than equity means that the potential opportunities are huge. However, as Jones points out, getting the economics right to make such investments at the senior level is not easy. Senior debt by nature is a safe investment but with that the returns are much lower than junior debt and equity. As such, the costs of running a pooled vehicle and employing managers can make it difficult to generate attractive net returns, which has been holding back the sector.

"Investors and managers are trying a number of ways to solve this problem," says Jones. Some investors are clubbing together and pooling their appetite to a point where the economics become viable.

"Managers are offering less resource intensive, directly originated loans with more of a secondary focus, so there are

lower upfront costs involved. Some managers are on very long-dated assets with less diversification, so larger amounts are invested per asset in an attempt to lower costs."

Nevertheless, typical infrastructure projects tend to have around 60%-80% of senior debt in them, which means the potential opportunities at that level are huge.

"Institutions and funds like ours are happy to look at senior debt in the same way the market has over the course of the last decade with respect to appropriately structuring it," says Cable. "We are happy to look at those opportunities as they stand."

"The need is such that lots of different solutions will have to come to market to achieve the outcomes required."

Our expectation is returns from senior debt in this space will sit somewhere from the low 200's bps up to the mid 300s bps over benchmark. This is very much a global issue and therefore a global opportunity. But at the moment we see the opportunity as being mainly in Europe

The issue of how to make the returns stack up from senior debt is still an issue however, and as has been mentioned this is the fundamental problem affecting this part of the market.

Macquarie's Wilson points out that the returns on senior debt ought to take account of the fact that banks are no longer lending long term.

"At the very least, investors are looking for a reflection of the fact that they are providing long-term funding," he says. "That in itself is likely to provide an increased yield over bank debt. As this is a private placement-style market, they'll also provide funding where there is not readily available liquidity in the bond markets, for instance. That is also likely to attract a premium.

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The opportunity to develop infrastructure debt funds and other forms of infrastructure debt has come about, as mentioned, partially as a result of the interest institutional investors are showing for the market, which in turn is being driven, in part, by a better understanding of what capital structures and solutions work best for specific infrastructure assets.

"We've gone through boom times and now we're going through different times, so investors are able to see which businesses are truly stable and resilient and then determine what the appropriate capital structure should be" says Wilson.

"Debt is looking at specific asset types. There is a better understanding of what will be the ideal capital structure for specific assets. Institutional investors are much more focused on assets that better match their long-term liabilities that give them a proper risk-adjusted return. That's why they are thinking about this sector now."

Banks as Short-Term Lenders and Arrangers

The interest and influx of institutional capital into the debt funding sphere of infrastructure would seem to suggest that banks' role in the asset class will in future be extremely limited. However, the picture is a little more complex and there is a lack of consensus in the market as to what exactly their roles will be.

"Almost all of the high quality assets we have invested in or are looking to invest in, have been able to find the senior bank debt packages that the sponsors were hoping for, albeit with a little less leverage," says Jones. "There are still a meaningful number of banks that have appetite for this space on a club basis.

"There is some room for institutional participation in those club-style deals but that will always be a fraction of the overall funding package, and the vast majority of senior debt will be provided by the banks. But we still see no participation from banks in junior tranches because it is so prohibitive from a capital usage point of view."

Banks can help mitigate construction risk. But the longer-term markets are best suited for take-out type financing and more permanent capital once a new project is up and

The fact that banks have built up a great deal of investing and transaction expertise in the sector suggest that they will continue to play a significant role in infrastructure finance, as, for example, such experience is essential to gain the confidence of equity investors.

"The banks will always have a role," says Pappas. "But given the constraints they'll have to work with under Basel III it will make it difficult for them to provide long-term take-out financing. But that's where the other long-term sources of debt come into play. There may be some innovative structures.

"Banks can help mitigate construction risk. But the longer-term markets are best suited for take-out type financing and more permanent capital once a new project is up and running. It's also very well suited for refinancing a lot of the maturing bank debt over

running

the next few years that's coming due."

The view that banks will be restricted to short-term lending is shared by others. In fact many banks are in the process of discussing where their future lies in the asset class, whether they will continue to have a role in arranging deals and keeping their project finance teams together and distributing the funds to investors rather than holding onto assets for several years.

"They will provide short-term capital –working capital lines and things like that with shorter tenors," says Rankine. "Anything sub-five years, they may still want to participate in. But capital usage beyond that point is too big for them.

"They have an additional problem in that Basel III also affects swaps, and the ancillary business they have always looked for. So, that's not going to be as attractive either."

Greenfield and Brownfield

The appetite for infrastructure debt is clearly there among institutional investors and the mechanisms are either already there or are being developed in order to help them access the market. However, that appetite varies as do the enabling structures depending on what kind of deals are on offer.

As most institutional investors are relatively new to the infrastructure space there tends to be more of a focus on refinancing existing assets, or financing acquisitions by infrastructure funds. However, there are a small number that have an appetite for greenfield and construction risk, and the associated higher returns.

"The market is much more focused on brownfield transactions and projects with a solid history, clear revenue visibility and availability-based structures," says Pappas. "In terms of greenfield, projects with availability-type structures are what's most attractive to investors.

"It's very hard to do greenfield projects with significant demand risk – that's very difficult to do."

The consensus among infrastructure debt investors, whether their focus is senior or junior debt, tends to follow Pappas' view – most opportunities are to fund brownfield transactions with fewer in the greenfield sphere.

"We have capacity to do both greenfield and brownfield," say Ridley. "While we are able to invest in greenfield assets, we will only do so selectively and on the basis of pricing which reflects the additional risk. But across the board to date, we have been able to access better value in brownfield assets.

"Typically, with new-build type assets, the loan piece is priced as part of a package of collateral business including interest rate derivatives and potential bond mandates. As such, the loan piece can be underpriced when considered on its own. But pricing does move around, and so there may be opportunities."

Hastings has a similar perspective:

"Core PPP with some construction risk is OK for us, depending on how well it's wrapped up and how low the construction risk is," says Rankine. "But real greenfields, as in new technology is out of our spectrum."

"The market isn't comfortable with financing construction projects that don't ultimately have very solid dependable revenue, whether that's availability payments or something similar," adds Cable. "The market's moved and changed, and the demand for construction risk in an environment you don't know or understand upfront isn't there anymore."

Bank Loan Portfolios

As mentioned the appetite to invest in refinancings and acquisition debt is strong among institutions. Such demand leads to the assumption that there is parallel desire for the acquisition of banks' loan portfolios.

"We are seeing more examples of that," says Jones. "12 months ago there was a lot of excitement in the market. But through that period there were some pretty unrealistic price expectations from the potential acquirers, and the banks were finding that they just weren't in the position to take any upfront hits on their balance sheets.

"The assets they were holding at par were being bid at substantial discounts. Recently, we've seen more of a meeting of minds and people are beginning to get transactions done. We've seen a number of large institutional investors transferring assets off bank's balance sheets. A more normalised, less distressed market is emerging there."

Rankine agrees that the sale of banks' loan portfolios will develop into a less distressed market.

"A logical step would be where banks accumulate a portfolio of loans and then seek fund managers to help them put those portfolios away in a very rational basis at a fair price for everyone," he says. It's part of our role to bring a rational market position to this situation.

"The banks don't want to hold the assets long-term, and the institutions want to pay a reasonable price for the underlying investment."

Table 3: Selected Secondary Debt Trades

Seller	Acquirer	Loan Commitments	Purchase Price
Banco Espirito Santo	Sequoia Infrastructure Debt Fund		
Bank of Ireland	Aviva	EUR200m	EUR162m
Bank of Ireland	PensionDanmark	EUR270m	EUR225.5m
Barclays	Barclays Senior Debt Infrastructure Fund I		
Natixis	Ageas	EUR2bn (by 2015)	
Source: *Infra-Deals.com*			

Direct Lending
As the market matures further there is greater scope for institutional investors to lend directly to deals, as has been happening recently on the equity side. Nevertheless the same constraints to institutions remain.

“It’s early days,” says Ridley. “There aren’t nearly as many institutional investors in the infrastructure debts markets as there are in the equity markets. But if you consider the infrastructure equity markets the early investors were mainly funds rather than direct investors.

“Over time as the industry develops and there is more education then some institutions may decide they want to build up an internal team and invest directly or continue to use specialist managers or a combination of both.”

“You are seeing institutions going direct,” says Rankine. “They are the guerrillas and hopefully they have good in-house credit teams. The problem for institutions is that it doesn’t make a lot of sense to have their own project finance teams – it’s too expensive and the analysis in project finance is much more complex than corporate deals.

“We are providing a kind of credit bureau to a series of institutions, so economically it is hugely beneficial to use a manager than set up their own team. So there will be institutions that build their in-house teams in the same way the equity guys have done but the economics don’t always work.”

Outlook
Whether or not institutions decide to lend directly ought to be understood as part of a larger picture in which there are fundamental changes happening in the infrastructure sector.

“Banks are going to become providers of short-term capital,” says Rankine. “Institutions over the next five to ten years will completely replace the core debt capital for both project finance and corporate across the board. We’ll see a completely different environment.

“The US is much more used to that sort of environment where it’s got much deeper and accelerated capital markets. You’ll see that model across the globe."

Jones agrees that institutional participation in infrastructure lending is set to increase, albeit if certain conditions are met.

“If the intermediaries in the market, managers like ourselves, are able to find effective solutions to allow access to investors at rates of return that are attractive, then there is a very significant level of demand and interest for infrastructure debt from institutional investors.

“Subject to those structural questions being answered effectively, we will continue to see a dramatic increase in institutional demand in the market."

The growth in institutional debt funding for infrastructure must also be understood in relation to the burgeoning requirement, across the globe, for infrastructure finance. At the moment that need tends to be in the Western economies. Over the next five to ten years the need from the world’s other major economies is expected to increase dramatically, with geographies such as China, India, Brazil and Africa all thirsting for infrastructure debt and equity.

“We certainly see infrastructure investors participating in those markets on the debt side,” says Wilson. “This is very much a global phenomenon.”

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