

# Project Finance Crunched but still Funding!

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- I Overview of the Global PF market
- II The Credit Crunch
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# The Classic PF Model:

- **Financing of essential infrastructure in strategic sectors**
- **Industrial sponsors with proven track record & resources**
- **Construction period followed by...**
- **Commercial operation**
- **Strong contractual structure**
- **High Gearing (60-90% debt)**
- **Long tenor matching life of assets (up to 20-30 years)**
- **Stable cash flows**
- **Dominated by European & Japanese banks**

# Strategic sectors:

- **Power**

- Conventional thermal plant
- Renewable energy

- **Oil & gas**

- Reserve based lending
- LNG
- Petrochemicals-refineries etc.

- **Infrastructure**

- PPP/PFI
- Transportation: toll roads, bridges, ports, airports etc.

- **Mining**

- **Industrial projects**

- Aluminium smelters

- **Telecoms**

- Fixed networks
- Mobile networks

## An attractive asset class:

- **Historic high yields (50-150bps) relative to corporate loans (10-30bps)**
- **Good credit risk (A - BB)**
- **Secured lending**
- **Strong recovery prospects (75-100%)**
- **Steady and predictable deal flow**
- **Refinancing prospects post completion**
- **Cross-selling opportunities**
- **Downsides:**
  - **Complex & resource intensive**
  - **Non-recourse or limited recourse to project sponsors**
  - **Long lead time**
  - **Long tenor**
  - **Vulnerable to sector problems**
- **215 banks active at MLA level** (Source PFI League tables 2007)

# New developments: the hybrid transaction

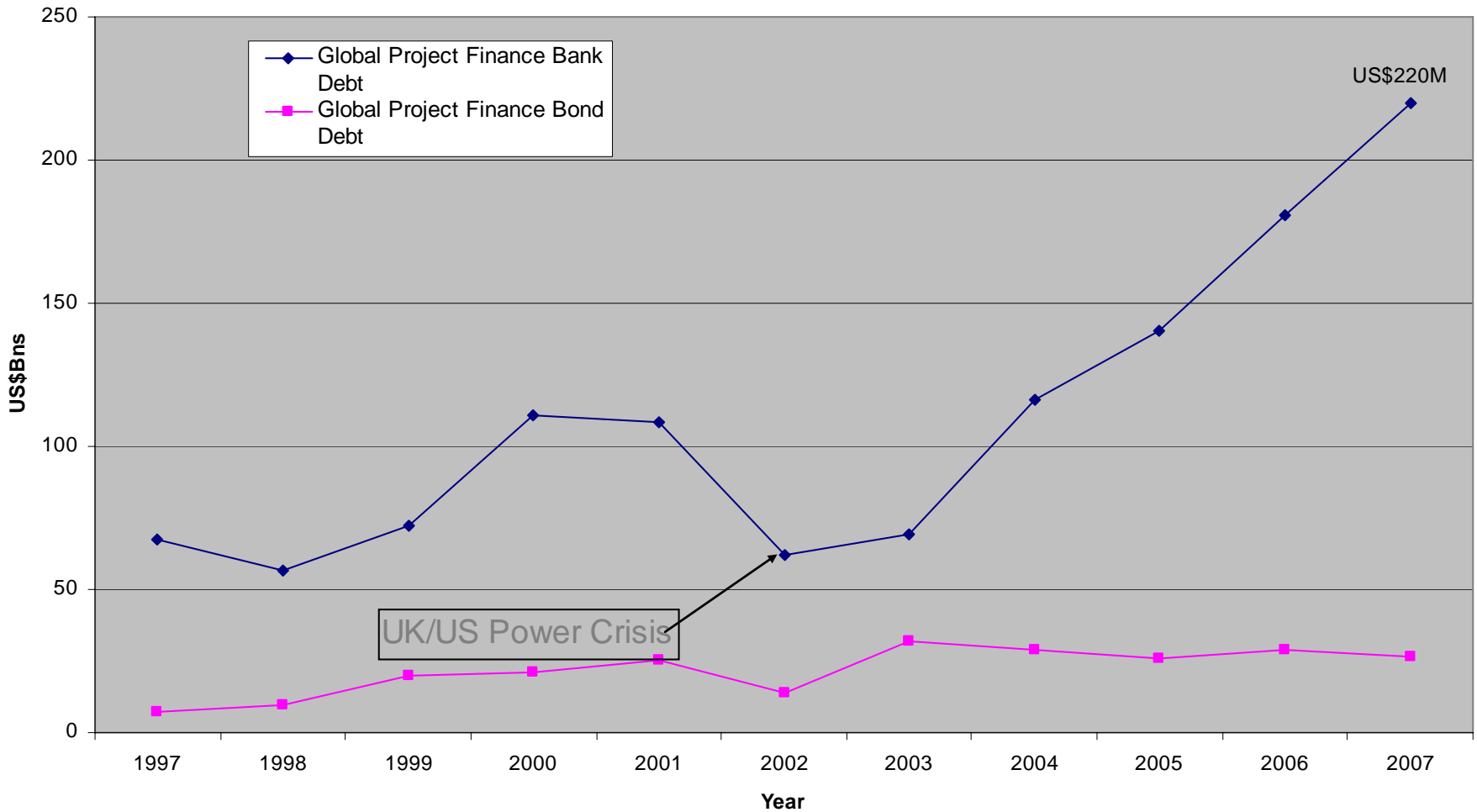
- Private equity and specialised infrastructure funds have recently become active investors in infrastructure
- Significant amounts raised in recent years:
  - 2005: \$4Bn
  - 2006: \$17Bn
  - 2007: \$45Bn
  - 2008: \$95bn? (source: Financial News)
- Infrastructure assets represent an attractive investment class for pension funds investors:
  - Long life
  - Stable & predictable cash flows with low risk of interruption in dividends
  - Revenues tend to be inflation linked
  - Capital growth in an environment of falling long-term rates
  - Fund managers/private equity have followed lead of Macquarie

# A new approach to PF:

- **Definition of PF widened to cover new sectors:**
  - Car parks
  - Motorway service stations
  - Oil & gas storage
  - Portfolios of infrastructure equity investments
  - Utilities
  - Waste management/waste to energy
- **Financing terms blend between PF & LBO:**
  - Mini-perm <8yrs
  - High level of equity : c40%
  - Higher margins: 150-250bps
- **Important expansion of market**
  - Focused on operational assets
  - With incremental capital expenditure
  - Has accounted for perhaps c25% of the market

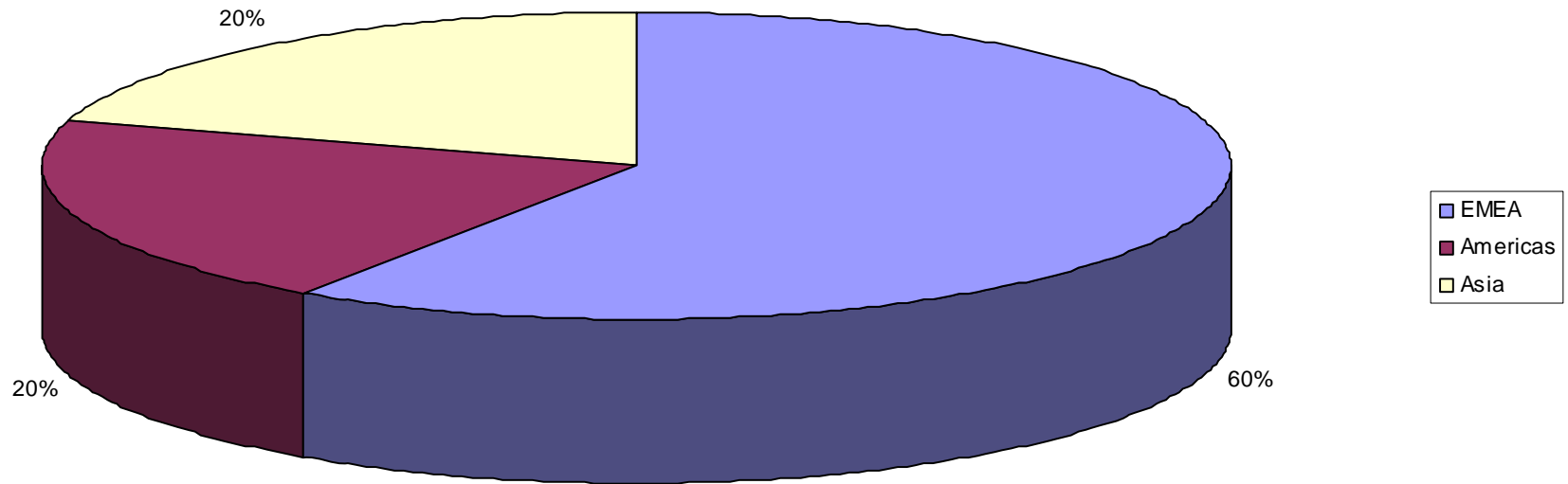
# The PF market has grown rapidly in last 3 years, c\$40bn per annum:

GLOBAL PROJECT FINANCE VOLUMES (Source PFI)



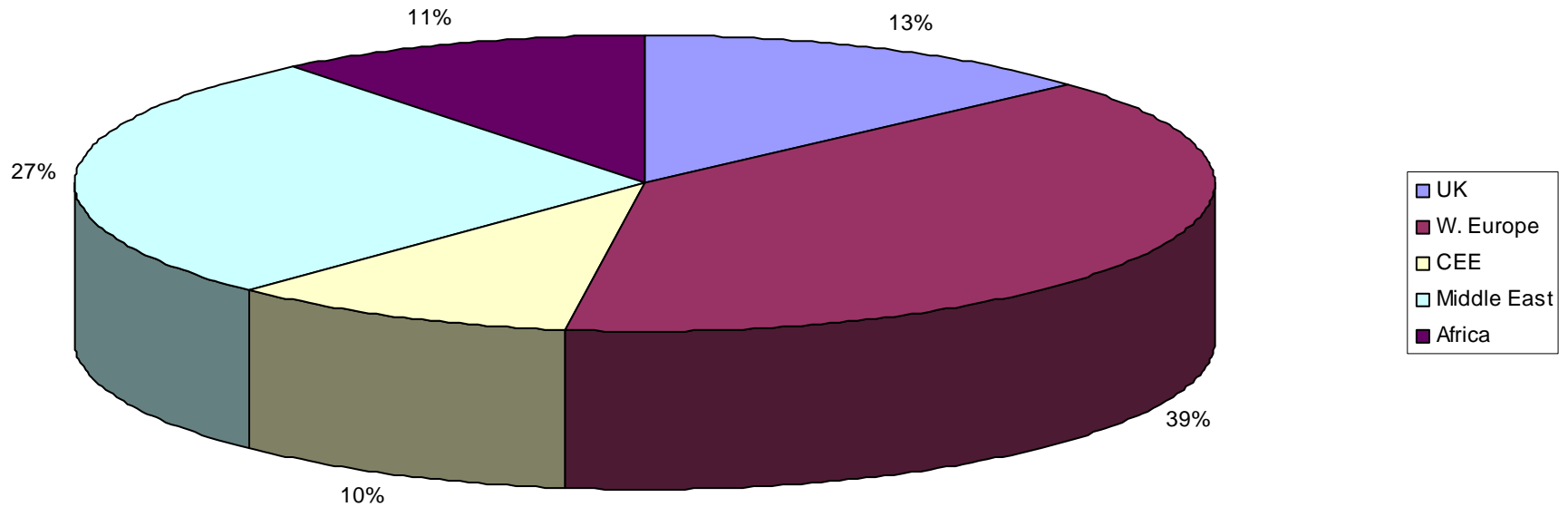
# Where is the activity in PF?

REGIONAL ANALYSIS OF PROJECT FINANCE VOLUMES IN 2007 (source: PFI)



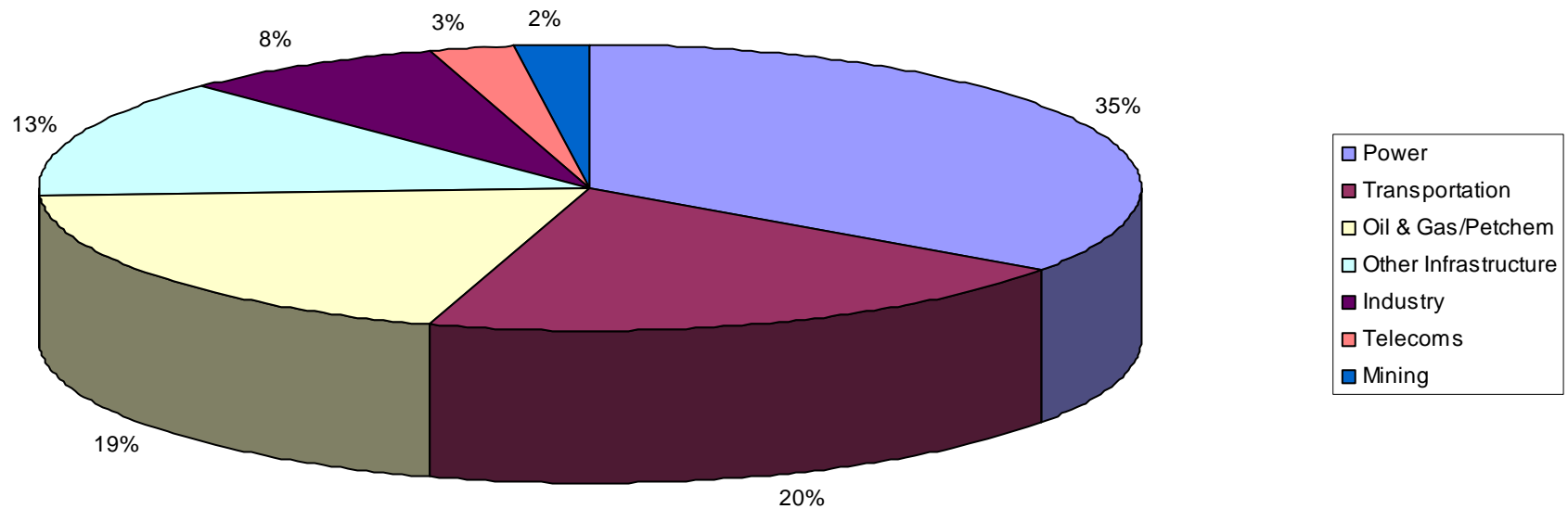
# W.Europe & Middle East are the key markets in EMEA:

ANALYSIS OF EMEA REGION IN 2007 (Source PFI)



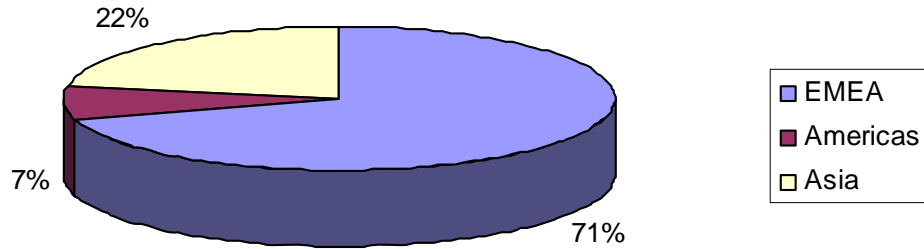
# Power, transportation and oil & gas are most active sectors:

SECTORIAL ANALYSIS OF GLOBAL VOLUMES (Source: PFI)



# PF is a product dominated by MLAs from EMEA

GEOGRAPHIC LOCATION OF MLAs (Source: PFI)



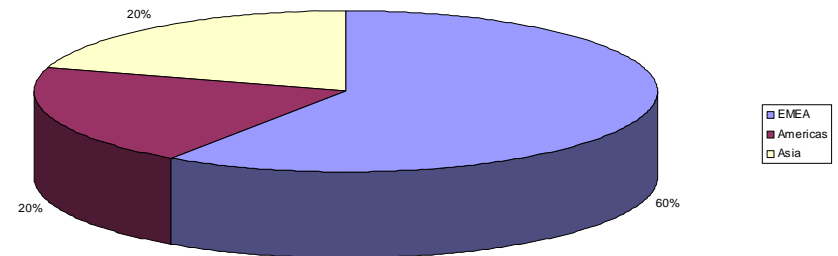
Japanese banks: 7.9%

Indian banks: 4.3%

Chinese banks: 3.5%

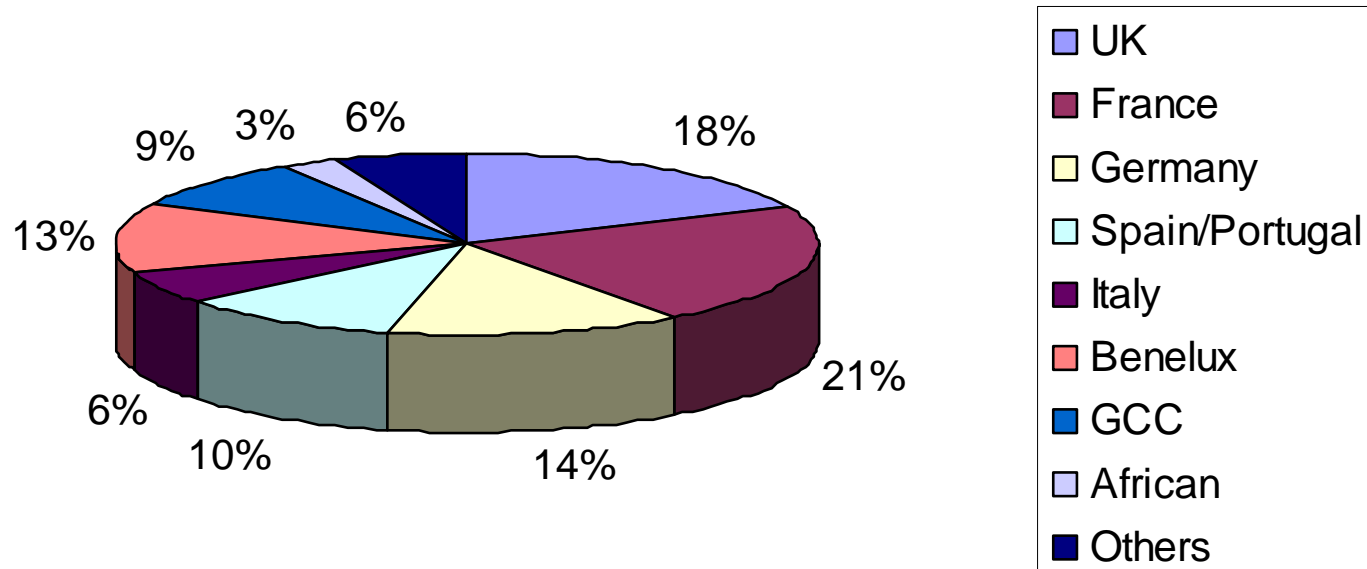
US banks: 4.9%

REGIONAL ANALYSIS OF PROJECT FINANCE VOLUMES IN 2007 (source: PFI)



# The EMEA market is dominated by W. European banks:

**GOGRAPHIC LOCATION OF MLAS** (Source: PFI)



Japanese banks arranged more than \$17Bn of PF making them the fifth largest arrangers after Benelux

## The PF Market in early 2007:

- **Growth market**
- **Hybrid transactions providing significant boost to the market**
- **Highly liquid with large number of banks active**
- **Dominated by Banks from Western Europe and Japan**
- **Since power sector problems in US & UK, low level of defaults & losses**
- **A very profitable product for commercial banks**
- **But competition & liquidity had brought problems:**
  - **Margins falling**
  - **Structures weakening but not yet “covenant lite”**
  - **Greater risk of failure in syndication**
  - **A market adjustment was inevitable!**
- **However, PF better placed to ride out credit crunch than other parts of the banking market.**

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# Key Events in 2007:

## • H1 2007

- US sub-prime mortgage market
- Securitisation of sub-prime mortgages-c\$1trn
- Contamination into wider market (CLOs/CDOs/SIVs/Banks)
- Fall in liquidity of financial markets

## • August/September 2007

- Northern Rock
- Major re-evaluation of risk/pricing in loan markets
- Major corporate/acquisition/LBOs badly affected
- Over \$300Bn of syndicated loans stuck with (mainly US) underwriters
- Knock-on affect to hybrid market/PF market-\$30Bn of unsold loans

## • Year end 2007

- Capital markets badly disrupted
- Monoline insurers under pressure
- Banks still underwriting but growing nervousness
- Nevertheless best year ever in PF

# Key Events in 2008:

## • H1 2008

- Markets very volatile
- PF relatively unaffected with over \$110Bn of loans arranged matching 2007
- PF Pricing increased by 25bps per qtr
- Impact of IAS39 eroding banks balance sheets through continued “mark to market” of unsold loans
- Short sellers beginning to target banks flowed through to CDS pricing

## • September/October 2008

- Lehman Bros. fails - \$275Bn of assets
- Fear of contagion
- Inter-bank markets grind to a halt
- Impossible to raise USD for a brief time in Europe
- Government rescue of banks

## • 4<sup>th</sup> Quarter 2008

- Loan syndication market now very slow
- PF has not escaped
- Banks focus on year end balance sheets & “de-leveraging”

# Why?

- **Banks borrow short, lend long:**

- Rely on interbank markets/CP markets
- Assets held for trade caught in falling market: "mark to market"
- Shifted to long term book

- **Bank balance sheets are very highly leveraged:**

- Corporates: 20-30%
- LBOs: 40-60%
- PF transactions: 50-90%
- Banks : 92-96%
- Losses are amplified by leverage.

- **Bank must rebuild balance sheets:**

- By increasing equity and reserves through capital injections
- Reducing assets on balance sheet to improve ratios
- And increasing profitability to generate new reserves

# Response of banks:

- **Restrict new lending**

- New lending tightly controlled
- Focus on core products
- Credit committees very conservative

- **Risk appetite reduced**

- Reluctant to underwrite, due to volatile markets and risk of “mark to market” on unsold loans
- Flight to quality

- **Increase pricing**

- Long term liquidity costs  $> \text{LIBOR} + 100\text{bps}$  for many banks
- Margins & fees significantly increased

- **Tenor**

- Pricing very sensitive to tenor
- Preference to lend to corporates  $< 5$  years
- Concerns about long tenors  $> 10$  years

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# Response of the banks to current market conditions:

- **PF will remain a core product of main players**

- Limited fall out from banks leaving the PF market-eg Fortis & HBoS
- More significant is reduced appetite to hold large participations

- **Global market**

- Activity in H1 2008 was strong but more or less closed by Q4
- Expect volume of loans arranged to be c\$160-175Bn down 20-25%
- Global activity could shrink to pre-2005 levels in 2009 – i.e. c\$110bn

- **Underwriting**

- Banks reluctant to underwrite
- H1 2009 to be dominated by club deals, longer to arrange
- H2 2009 return to underwriting smaller deals

- **Risk appetite**

- Focus on core sponsors
- Fear of emerging markets
- Concentration on domestic markets
- Return must be attractive when compared to other products-eg corporate loans

# Priorities in PF:

- **Return to home markets**

- Prioritise EMEA: Western Europe & Middle East (GCC)
- Nevertheless some activity in North Africa & South Africa
- And also energy related transactions in Russia

- **Traditional sectors**

- Power with sovereign risk off-takes
- Renewable energy – strategic need
- PPP/PFI
- Petrochemicals – in spite of low oil price new investment is essential

- **Liquidity**

- Transactions > \$1,000-750M will stretch market
- Marginal banks will determine key terms & conditions

- **Pricing**

- Minimum margins currently 175bps and rising subject to risk and deal size

- **Tenors**

- Shorter tenors < 20 years will be the trend
- Many transactions will use a mini-perm structure (c7yrs) to stimulate additional liquidity

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## Some good news:

- A new President in US
- USD stabilised & remains reserve currency
- Very low interest rates partly offset higher cost of debt
- Falling steel and commodity prices reduce construction costs
- PF banks still active but with much reduced appetite
- Governments can stimulate economies by encouraging infrastructure investment
- EMEA to remain a priority for PF banks
- Infrastructure funds have raised c\$100M over last 5 years much of which still to be invested
- Essential investment in energy/infrastructure sectors in GCC required but may be vulnerable to falling oil prices.

# Where will new business come from?:

- **Traditional PF sponsors**
- **Infrastructure funds but likely to hold back until H2 2009 and then on an opportunistic basis**
- **Key sectors:**
  - Power
  - Renewable energy
  - PPP/PFI
  - Transportation: roads, airports etc.
  - Oil & gas in Middle East subject to oil price
- **In Western Europe & GCC:**
  - UK/France/Italy/Spain & Portugal
  - UAE
  - Saudi Arabia
  - Russia
- **Transaction size:**
  - In GCC, sufficient resources to facilitate larger transactions
  - Outside of GCC, deals larger than c€500M will be difficult

## Conclusions:

- **PF remains a core activity for most key players**
- **However, the credit crunch will reduce capacity**
- **The overall market is likely to shrink to pre-2005 levels**
- **Hybrid transactions will be particularly affected**
- **As banks return to classic PF model**
- **With much higher profitability**
- **New projects less affected**
- **Banks will retreat to domestic markets**
- **EMEA will suffer less than other regions**
- **And some markets such as GCC & Western Europe will be less affected.**