Infrastructure finance: Risk management and the search for new models

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Introduction

Sumitomo Mitsui Banking Corporation (SMBC) is one of the largest Japanese banks and a renowned leader in infrastructure and public-private partnership (PPP) financing worldwide, in a wide variety of sectors. Arranging PPP financing in the Commonwealth countries, particularly the emerging ones, presents a series of particular challenges. These challenges can be overcome through the concerted efforts of governments, financial institutions and the private sector, and the application of lessons learned in the more developed PPP markets.

Hospitals, schools, fire stations, sports stadiums, waste treatment centres and incinerators, ports, airports, roads, bridges and tunnels: these assets are examples of what SMBC has helped its customers design, build and operate through successfully financing PPP projects throughout the world for more than ten years.

Benefiting from the primacy of the United Kingdom as the PPP market forerunner (and, today, as the most mature PPP country), SMBC Europe (SMBCE) has earned and consolidated a reputation as top lead arranger in infrastructure and PPP and has contributed to the remarkable development of PPP as a funding model in the UK and throughout EMEA. The same reputation is shared by SMBC’s divisions in the Americas and in Asia, making SMBC a true centre of excellence in all infrastructure and PPP sectors. As of August 2013, in EMEA alone and without considering transport PPPs, SMBC has financed 140 infrastructure and PPP projects, acting as lead arranger on 82 such projects and committing around £3 billion in project finance debt facilities.

SMBC is familiar with all PPP models used in the delivery of public infrastructure. These models are a function of: the legal environment in the country where the infrastructure is conceived, designed, implemented and then operated; the type of players involved in the project in the public and private sectors; and market forces (regulators, central banks, competitors, customers) which influence the allocation of risk between the many players involved in a PPP financing as well as its parameters of the financing (e.g. debt tenor, pricing, security).

Examples of projects with Commonwealth countries

SMBC has closed PPP projects in United Kingdom, Australia, Singapore and Canada. The salient details of a few examples of these projects follow:

- Greater Manchester Waste, United Kingdom
  - £575 million debt facilities
  - Closed in April 2009, sponsored by John Laing, Viridor and Ineos
  - 23.5 years’ debt tenor
  - Refurbishment, maintenance and operation of the Greater Manchester Waste Disposal Authority’s existing plant as well as the design, build, finance maintenance and operation of new facilities including a 375,000-tonne capacity Thermal Power Station
• **Victoria Desalination Project, Australia**
  - A$3.7 billion debt facilities
  - Closed in September 2009, sponsored by Suez Environment, Degremont, Thies and Macquarie
  - Seven years’ debt tenor
  - Construction and operation of a 150 billion litres/year water desalination plant

• **Sports Hub, Singapore**
  - US$1.1 billion debt facilities
  - Closed in August 2010, sponsored by Bouygues, HSBC, United Premas and Global Spectrum
  - Ten years’ debt tenor
  - Design, build, finance and operation of a 55,000-seat stadium with retractable roof, indoor sports arena, aquatic centre and athletes’ residence

• **McGill University Health Centre, Quebec, Canada**
  - C$392.5 million bank debt facilities and C$764.1 million bonds
  - Closed in July 2010, sponsored by SNC Lavalin and Innisfree
  - Four years’ bank debt tenor, 34 years’ bond tenor
  - Design, build, finance maintenance and operation of the McGill University Health Centre

SMBC has worked and is working on projects at various bidding stages in several other Commonwealth countries, for example South Africa, Ghana and Malta.

**Factors affecting the choice of PPP structure used and lenders’ expectations**

While all PPPs have in common a core project finance, limited (or no) recourse structure, and feature one or more special purpose companies as a borrower, the particular type of PPP used is a function of many different factors, such as:

• The legal environment of the country where the infrastructure is planned, designed, constructed and operated

• The type of players involved in the project in the public and private sectors (e.g. central and/or local governments; quangos; contractors or financial investors as project promoters, subcontractors of various tiers)

• Market forces: regulators, central banks, competitors, customers

Such factors influence the allocation of risk between the many players involved in PPP financing as well as its parameters of the financing (e.g. debt tenor, pricing, security, gearing). However, what does not change regardless of the specific PPP structure used is the set of lenders’ expectations vis-à-vis a PPP, which we summarise below:

• Satisfactory information must be available for a proper bankability analysis to be performed

• Rigour of analysis and relationship vs return considerations must be satisfactory

• Ring fencing of project cash flows; clarity of interface responsibilities between the project parties must be accepted by all project parties

• Banks must be able to perform a comprehensive and compliant review of each stakeholder in the project

• KYC (‘know your customer’) requirements must be present in the loan agreement as a condition precedent, representation and covenant, and must also be linked to events of default

• Lenders will select their advisors and manage their engagement throughout the life of the project

• Lenders will analyse each element, and the whole, of the structure and seek not to be held to follow precedent

• Main clauses of the financing must be present in the term sheet early on in the procurement process; detailed terms can follow once the credit agreement is laid out

• The presence of local banks as co-lenders is key in club financing in emerging countries

• Constant flow of financial, business and project information, especially during construction, must be ensured

• Site visits will be arranged regularly; access to key project parties and public clients must be granted

• Contracts can be charged/assigned; enforcement of the lenders’ rights will not lead to project termination because direct agreements with the relevant project parties will be entered into

• Best practice must be imported from more mature PPP markets

• Mitigation of project risk will take place through the project documentation, not just pricing

• Lenders will ascertain the structure robustness and perform many model sensitivities, appointing their own model auditor

• Lenders will formulate a viable exit strategy before signing the loan documents

**Financing PPPs: Challenges for emerging Commonwealth countries**

The 53 Commonwealth nations include mature or well-developed PPP markets, such as the UK (mature) and Australia and Canada (well developed), but also a few relatively new PPP markets (e.g. India, South Africa) and a multitude of untapped PPP markets in countries which feature huge infrastructure development potential, generating an opportunity for PPPs to be deployed to address the infrastructure needs. Africa, for example, hosts 18 of the Commonwealth nations and features a vast infrastructure gap estimated at US$93 billion a year.¹

However, the possibilities for attracting private sector finance will be limited by a wide range of variables such as the strength of the project in question, the capacity of governments to raise their own funding, foreign currency availability, the risk appetite of debt providers and the availability of equity, amongst others. The result of this is that, while PPP is often discussed as though it were a fixed and static financing tool, its availability and practicability responds constantly to exogenous influences and subjective factors.

In particular, following the global financial crisis and the introduction of a revised and stricter regulatory environment for banks, the conventional PPP finance model which typically
### Table 1

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<th>Challenges</th>
<th>Nature of risk</th>
<th>Steps to overcome the challenge and implement PPPs</th>
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| Political stability                 | Unpredictability of policies and reversals of budget strategies. Appropriation of funds           | • Structure PPPs as short-term construction-only financings, rather than long-term design, build, finance and operate (DBFO) financings. While not plagued by political unrest, Canada is the prime example of a Commonwealth country where short-term PPPs have been used successfully  
• Select projects that rely on a wide platform of political support, i.e. ‘critical’ infrastructure projects that are not confined to specific geographies within a country and create new jobs  
• Investigate the availability of political risk insurance                                                                 |
| Macro-economic indicators (e.g. inflation, currency devaluation) | Decreasing project cash flows and visibility on investor returns                                 | • Ensure that project payment mechanisms include adequate protection against inflation and currency devaluation, which are powerful deterrents for foreign investors, and drive up required coverage ratios  
• Consider providing a stream of revenue payments in hard currency (e.g. US$, GBP) and if necessary a debt tranche denominated in local currency to be provided by local banks                                                                 |
| Regulation and legislation          | Ineffective security arrangements, project progress stagnation                                    | • Approve ad hoc PPP procurement laws and ensure contracts are enforceable by both local and international banks  
• Adopt to the fullest extent possible the standard contracts used in more mature PPP markets in order for banks and equity investors to be familiar with the project risk allocation  
• As security may be held both onshore and offshore, and lenders’ security includes step-in rights in contracts governed by local (the emerging country’s) law, it is essential that the validity and enforceability of such security arrangements be proven for international investors and banks to increase confidence in the local legal systems                                                                 |
| Develop PPP expertise               | Loss of projects, lengthy negotiations and inefficient transfer of risks                          | • Public servants must embark on a ‘capacity building’ programme, both at decision-making, senior level and at deal-making, daily project management level, through close interaction with experienced advisors on live projects rather than through attending seminars or classroom-based learning sessions. PPPs are an advantageous financing solution but can be resource-intensive and very expensive if expertise is lacking. Lack of expertise may also lead to unnecessarily lengthy negotiations and stifle investor appetite  
• Tender few, well structured ‘pathfinder’ projects; avoid procuring ‘mega-projects’ (e.g. capex value above £1 billion) as the first PPPs in the country; very large, flagship PPPs are fraught with political risk and are less likely to attract sufficient lenders  
• Be ready to co-invest with foreign equity investors, and to contribute funds, e.g. in the form of (limited) one-off capital grants, to enhance project buy-in from the private sector                                                                 |
| Country rating and public sector covenant | Sub-investment grade sovereign ratings discourage investors despite higher headline returns | • Offer central government explicit guarantees of repayment where possible and engage early on with multilaterals and direct foreign investors (e.g. World Bank, IFC, AfDB, DFID, ADB), as well as providers of political risk insurance, to improve project risk  
• Be prepared to accept short-tenor financings with cash sweeps and mini-perm structures  
• Obtain buy-in from local banks early. Foreign banks will look to local ‘champions’ to promote the projects to the international lending community  
• Embrace the Canadian public-private partnership model for public monitoring of projects after financial close                                                                 |
comprises ten to 30 per cent equity and 70 to 90 per cent long-term senior debt provided by commercial banks may become increasingly difficult to implement. The crisis has drained capital out of the banking system as loans are written down and banks reduce their exposures. Scarce capital resources are being focused on banks’ central strategic goals – to support their core businesses and core clients. Banks are also looking for higher returns, lower consumption of risk capital and greater strategic rationale.

The challenge with regard to sourcing finance in sufficient volume to meet the needs of infrastructure investment in emerging markets may lie in developing a new PPP model that responds to lenders’ constraints while accommodating the priorities of host governments. In order to offset these constraints on the part of debt providers, the new PPP model needs to retain the rigour of the conventional PPP model to ensure that the infrastructure is built on time, on budget and up to specifications, while enabling the placement of these long-term and essential infrastructure assets with investors who have a matching long-term investment appetite. This will not only ensure that long-term liquidity is tapped but will also create a new asset class that will drive increased activity and interest in domestic capital markets.

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| Bankability             | Failure to attract and maintain financial institutions’ appetite | • Decrease lender risk by offering short-term debt maturities and construction period financings, with refinancing risk taken by the public sector. Due to the perceived impact of Basel III, international banks are keen to minimise long-term funding commitments and liquidity costs  
• Establish or identify a refinancing vehicle backstopped by a state guarantee, or, better, benefiting from an AAA guarantee issued by a multilateral investment bank such as WB or AfDB. The sole function of this vehicle would be to transfer assets from short-term investors to long-term investors, e.g. local/diaspora citizens or natural long-term investors such as life insurance companies and pension funds. The refinancing vehicle would raise finance from domestic and international capital markets, benefiting where possible from credit enhancement provided by governmental or multinational agencies (e.g. JBIC, AfDB)  
• Equity investment should be minimised because of high returns required by investors translating directly into a prohibitive cost for the end user. Instead, a subordinated stand-by tranche could be used to replace pure private sector risk capital. This subordinated debt tranche could also be provided on a concessional basis by development finance institutions (e.g. the African Development Fund) depending on the extent to which the public services being provided by the assets require to be subsidised. |
| Customer relations      | Lenders follow core customers in the countries/sectors of their choice | • Debt follows equity, so it is imperative that emerging countries attract reputable international contractors and equity investors in order to attract their lenders. This can be achieved through the establishment of a tangible pipeline of a few well-structured projects, with each project launched in key financial centres (e.g. London) after extensive market soundings. |
| Foreign relations       | Lack of integration, hostility between countries, psychological hurdles | • Secure the sponsoring of national infrastructure spend programmes by trusted ‘champions’ (e.g. the African Development Bank) and collaborate with these institutions to make projects eligible for initiative, such as the African Development Bank Infrastructure Bond  
• Incessant diplomatic liaison |

**What might this new PPP model look like?**

One impact of the global financial crisis has been the introduction of a more demanding regulatory environment under Basel III, which requires commercial banks to rebuild their balance sheets and increase their capital adequacy ratios. These ratios can be improved either by increasing capital or decreasing the assets. Since capital is in short supply and expensive, lenders have been reducing their loan books. As a consequence, private sector commercial banks (as opposed to the so-called ‘private sector’ or development finance institutions) are no longer willing to finance the long tenors required for the total life cycle of an infrastructure concession, as such long-term loans, would be capital-consumptive and, consequently, offer low profitability.

However, commercial lenders may be more open to accepting the project risks during the construction period (plus a one or two-year bedding period). The new PPP model might, therefore, incorporate commercial debt during this period as this is when risks are deemed to be highest and where the project would most benefit
from the close monitoring and prompt remedial action that commercial banks are resourced to provide.

At the same time as the regulatory environment has been obliging banks to restrict the volume and tenor of their limited recourse lending, the appetite of institutional investors such as pension funds and insurance providers has been growing. The past year has also seen higher yielding sovereign bond issues by emerging markets being heavily oversubscribed. In addition, there has been a strong emphasis on the part of governments and multilateral and other agencies on the need to stimulate domestic capital markets.

The long term, utility-like character of essential domestic infrastructure is already being targeted in the mature and developed markets by institutional investors, and a similar focus should be incorporated within the model for emerging markets. Apart from tapping a growing source of liquidity, such a focus on mobilising domestic resources might also impose a new discipline on domestic public sector sponsors of infrastructure projects by making them accountable to domestic investors.

The principal features that the new financing model needs to offer are as follows:

- Replacing private sector equity wholly or in part by some form of concessional equity or subordinated debt, thus allowing for a cheaper cost for the end user. The returns expected by private investors, which include the conservative pricing of uncertain future risks, usually result in public sector services that, when priced with a fully cost reflective tariff, are unaffordable in emerging markets

- Creating a reliable refinancing process through which, as soon as possible after project completion, senior debt providers have the opportunity to reduce or remove their exposure to the project

- Enabling domestic or diaspora investors to invest into long-term, low risk and stable domestic infrastructure assets through properly structured ‘project bonds’

- The project bonds will be structured through a ‘re-financing vehicle’ (set-up, for example, by the African Development Bank’s newly established Africa 50 Fund) which will purchase the private bank debt outstanding upon the acceptance of the project following the construction of the infrastructure and the bedding in period

- The re-financing vehicle will raise the liquidity by issuing a project or infrastructure bond on a limited recourse basis (i.e. the bond holders will be remunerated from the project cash flow)

- The function of the re-financing vehicle will be to use the proceeds of the project bond to repurchase the senior debt

Recommendations

In conclusion, whatever model of public-private partnership is used, it is essential that the basic risks to investors are properly identified and mitigated. Many governments, including in emerging Commonwealth countries, have devoted considerable energy to developing their own PPP legislation. Table 1 summarises our recommend steps for overcoming the implementation challenges.

ENDNOTES

1 Infrastructure gap reported by Africa Infrastructure Country Diagnostic (World Bank, African Development Bank and others).

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The authors of this article are expressing their personal opinions, not those of their employer.