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4TH CONSTRUCTION FINANCING COURSE

**Financing Challenges for P3s
After the Credit Crisis**

By Tim Murphy

The P3 Model

- The overriding importance of value for money
- The P3 debate and the cost of money
- The importance of lender oversight to risk transfer
- The standard players
 - Bidders
 - Financial advisors
 - The lending group(s)
 - Lender legal advisors

The P3 Model

- The standard process
 - The RFP, Proposal Validity and Credit Spread Lock-in
- The standard documents
 - The Debt Term Sheet, Mandate letter and Commitment Letter
 - Credit Agreement
 - Security Documents
 - Direct Agreements

Pre-Credit Crunch Financing

- Widely available credit
- Large single source debt financing
- Low spreads
- Lighter fees
- Light covenants
- Rare 'market out' or MAC clauses
- Underwritten debt
- Wrapped bonds

Summary

- 1. Changes to the form of P3 Financing**
 - bank-bond financing dynamics
 - emergence of mini-perms

- 2. Changes to the P3 Process**
 - Reduced risk tolerance at the bid phase
 - The rise of the club deal

- 3. Changes to the Legal Documentation**
 - default provisions
 - market-flex provisions
 - market-out provisions
 - increased security requirements

- 4. Tighter Credit-Approval Practices**
 - Credit committees find their conservatism

Summary – Part 2

5. The increased cost of borrowing

- Increased spreads
- Higher fees
 - Agency fee (administrative agent functions)
 - Upfront fee
 - Standby fee
 - Underwriting fee

6. Solutions

1. Changes to the form of P3 Financing – *Bank/Bond Dynamics*

– **Prior to Global Financial Crisis**

- PPP financing consisted of
 - Bonds (often with monoline wraps (AAA ratings))
 - Bank loans

– **After the credit crunch**

- Bond market closed (AAA rating lost)
- Underwrite and syndicate bank lending weakened
- Club deals are now common
- Some banks and life insurance companies still finance small projects single-handedly

1 . Changes to the form of P3 Financing – *Emergence of Mini-Perms*

– **Mini-perms (generally)**

- extending project financing on short-term basis (i.e., 3-5 yrs), which corresponds with construction and immediate post-construction phase of project

– **Two types of mini-perms**

– **Hard mini-perms:**

- project finance structure where legal maturity set at 3-5 yrs, compelling project company to refinance before maturity, or face default

– **Soft mini-perms:**

- project finance structure where legal maturity remains long-term (e.g., 25 years for a 30-year concession), but there is aggressive margin step-up & cash sweep to encourage refinancing

1 . Changes to the form of P3 Financing – *Emergence of Mini-Perms*

- Mini-perms not widely reported as being used in Canada
- Soft mini-perms used in three UK projects
- Hard mini-perms used in some Mid-East projects (e.g., Zayed University PPP project in Abu Dhabi, UAE)
- Major concern with their use: who assumes refinancing risks & costs?

2 . Changes to the P3 Process

- **The Rise of the Club Deal**
 - Selling the deal
 - Gearing ratio
 - Lowest common denominator
- **Reduced tolerance for risk at the bid phase**
 - Credit spreads held for only 30 days
 - Market flex/market disruption
 - Market out
 - Tougher conditions in debt term sheets

3. Changes to Legal Documentation Framework - *Increased Focus on Default Provisions*

- Default provisions in P3 financing agreements contain default events usually found in other loan agreements (e.g., non-payment of principal interest etc); plus default events specifically tailored to the project (e.g., project completion within fixed period)
- Bond financing focused on ratings downgrade
- Banks and Lifeco's are reviewing defaults with greater scrutiny: tightening loan agreement provisions and requiring earlier triggers
- In some cases, banks will re-examine default provisions contained in agreements executed prior to the credit crunch (e.g., Catalyst Healthcare's Romford Hospital PPP project in the UK)

3. Changes to Legal Documentation Framework - *Increased Focus on Market-Flex Provisions*

- **Market-Flex**: allows arranger bank to alter key financial terms in the proposed loan agreement but bank still provides funding
- Before the credit crunch, market-flex rarely used and if used, only applied to price changes
- Use is now more frequent and they are broader in scope (allow bank to change terms related to various matters, not just price)
- Concern that these developments make PPP financing less certain

3. Changes to Legal Documentation Framework - *Increased Focus on Market-Out Provisions*

- **Market-Out:** more aggressive version of market-flex - allows arranger bank to cancel the agreement if market changes make loan syndication difficult
- Lenders started considering market-outs as the credit crunch crystallized.
- No strong consensus re what constitutes “market change” to trigger their exercise
- In equity underwriting, 20% drop in price within 45 days = “market change”
(See *Retrieve Resources Ltd. v. Canaccord Capital Corp.*, [1994] B.C.J. No. 1897, 8 C.C.L.S. 123 (S.C.).)
- Also suggestion that events comparable to market reaction on 9/11 = “market change” for equity underwriting
- Sample clause triggered by lender “opinion”
- Generally concern that their use compromises essence of loan underwriting

3. Changes to Legal Documentation Framework - *Increased Security Requirements*

- P3 financing centers on limited recourse
- Lenders' security interest usually limited to
 - Project Co's cash flows;
 - Project Co's contracts;
 - Project Co's shares; and
 - Step-in rights upon project default
- When fear that usual security interest is insufficient, lenders seek guarantees from sponsors, such as:
 - Contingent equity commitment
 - Cost-overrun guarantee
 - Completion guarantee
 - Shortfall guarantee
- Liquid Security requirements
 - Construction
 - Service phase

4. Tighter Credit-Approval Practices

- The new conservatism
- Stripping out risk
 - Tighter covenants
 - PCG and L/C's
 - Authority payment risk

5. The Increased Cost of Borrowing

- Increased cost of borrowing was a major challenge for P3 financing in most markets
 - *“In most economies, developed or emerging, spreads between corporate and sovereign rates have increased since mid 2008 to levels not seen since the Asian crisis, the dotcom bubble or the Argentine crisis, indicating an increase in risk premium”.-- International Monetary Fund (2009)*
 - *In Canada, as of November 2008, PPP deals were pricing “well in excess of the 200bps mark with a majority of projects pricing over 300bps, while only a year [before that] deals were able to close around 100bps”. -- Fengate Management Capital Group Ltd.*
- Suggestion that a contributing factor to spread hike in Canada was “bumpy flow” of P3 deals in years leading to the credit crunch
- Concern that margin increases put pressure on VFM that P3 procurement produces
- Concern that P3 critics unfairly capitalize on margin increases, distorting public perception re benefits of PPP procurement

6. Solutions to P3 Financing Constraints

– Government Co-Lending

- Gov't lends alongside private lenders, as a last-resort lender (implemented in UK, US, EU & France)
- In the UK model, gov't ranks *pari passu*, and has voting rights
- Not implemented yet in Canada, but CCPPP recommends that gov't should be a subordinate & passive lender
- Advantages: unlocks bank lending in short-term; and may create secondary market for gov't debt
- Disadvantages: puts public money at risk, and low chance of secondary market for gov't debt if gov't is a subordinate & passive lender

6. Solutions to P3 Financing Constraints

– Government Grants

- Gov't makes grants to private-sector sponsors during the construction period, at substantial completion and/or at a specified time after the commencement of operations (already implemented in some Canadian provinces)
- Advantages: decreases reliance on private lending, enabling large projects to close; also, it's easy to implement
- Disadvantages: may compromise essence of PPP procurement if grants are substantial as a % of total financing; also, may complicate PPP procurement process

6. Solutions to P3 Financing Constraints

- **Interim Payments**
 - Construction period risk
 - Short and long term lenders
 - Bond solutions
 - Innovation and competitiveness

6. Solutions to P3 Financing Constraints

– Government Credit Guarantees

- Gov't provides credit default guarantees to private-sector lenders (already implemented in the US, EU & France)
- France: max guarantee of 80% of loan; available until Dec 31/10
- US: loan guarantees and standby lines of credit to finance surface transportation projects of national and regional significance; any payment to 3d party lender must be repaid by borrower
- EU: guarantee against revenue risks in the early operational period of infrastructure projects
- Gov't credit guarantees not generally favoured in Canada b/c concern that they may create complexity, & may have little overall value on balance
- But, the EU approach may work in Canada, by guaranteeing only specific risks, such as revenue risks, leaving the rest to the private sector

6. Solutions to P3 Financing Constraints

– IO Responses

- Separate technical and financial submission dates (shorten the hold period)
- Provide for a Benchmarking Rate and a Benchmarking Date and Credit Spread Lock-in Dates
- Add a Revised Financial Submission Date
- Add a Financial Close Refinancing Gain
- No lender exclusivity arrangements
- Lender commitment letter –no MAC and waive market flex
- Add a Severe Market Disruption Event to the Project agreement
 - Extend to 10 days after Event
 - IO can terminate

Concluding Thoughts

- With the return of a more stable lending market, P3s remain value for money



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