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Secondary markets: A natural progression of the PPP market in Australia or simply a UK phenomenon?

SECONDARY MARKETS – A NATURAL PROGRESSION OF THE PPP MARKET IN AUSTRALIA OR SIMPLY A UK PHENOMENON?

As the UK PFI market matures and more projects reach their operational phase, much has been said about the development of a secondary market for equity[1] stakes in operational PFI projects. What are the drivers of an equity secondary market and is it a natural progression of PFI? If there is to be considerable movement within equity ownership of PFI projects, can one expect a similar development in Australia once its PPP primary market is sufficiently mature?

Although market participants are enthusiastic about the growth prospects of a secondary market within the UK, there still seems to be some uncertainty as to whether such enthusiasm will translate into action and, if so, at what pace and with what prospects of success. However, with the value of equity in operational PFI schemes recently estimated at £2-3 billion, with more and more projects reaching operational phase and a strong pipeline of projects still to be released into the market, one would expect to see a strong level of secondary market activity within the UK in the future.

1. WHY A SECONDARY MARKET? – THE DRIVERS

The drivers for a secondary market differ depending on whether you are the buyer, the seller or the government. Government, although in theory one step removed from the sale, is directly impacted by the development of such a market.

1.1 The seller

(a) Return on investment and flexibility to re-enter the market

On completion of the construction phase the risk profile of a PFI project changes, and in material respects, risk reduces. This in turn potentially improves the return capacity of the original equity investment. Divestment at that time (ie, during the operational phase) becomes an attractive option for traditional equity investors (mainly construction companies in the UK context) as it gives them the opportunity to:

(a) recycle capital which they can then use as seed capital to re-enter the market by investing in new deals (thereby allowing construction companies, for example, to concentrate on their core-business) or to offset losses from unsuccessful bids (such as bid costs); and

(b) realise potential gains from taking the original risk.

However, other PFI equity investors such as operators, financier equity investors and other institutional investors may not necessarily be constrained or driven by the above factors or, if they are, may not be driven in the same direction. For example, it may be thought that operators would be more likely to hold on to their investment in the long term given that the delivery of the on-going facilities services is their core business. Alternatively, financier equity investors who are able to package the debt and equity components (and effectively underwrite equity) arguably have more flexibility as to whether and when they choose to divest their equity investment (as compared with the more traditional construction companies).

The distinction between the imperatives driving operators as opposed to traditional construction companies to divest their interests has been blurred recently by the trend in both the UK and Australia of traditional construction companies reinventing themselves into 'support services providers'[2]. Further, some of these traditional contractors have started to diversifying into development and equity investments with the intention of holding such investments for the medium and long terms.

An important consideration in the issue of divestment is, of course, the level of return the existing investors can expect to achieve from a sale. Although the experience to date in the UK is reportedly favourable in this respect[3], it is questionable whether the UK market or an Australian secondary market (to the extent one develops) can sustain the levels of return achieved to date in the UK. The point at which the level of return in a project is maximised for any investor will depend on the project itself and the commercial drivers of the investor (ie, is it a purely construction company, an operator or an institutional investor). One would expect that the extent of these returns (and therefore the likely success of a secondary market) will depend on how close the project was to the 'bottom line' at the bidding stage. The flip-side is that funds or investors buying into these projects need

to see an opportunity to buy PFI assets at realistic prices.

(b) The refinancing element

The potential for gains arising from divestment may be further heightened by the possibility of refinancing. Primary equity investors can sell before or after refinancing as it is possible to price in the refinancing benefit. Although whether, and if so, how, the refinancing benefit is priced will depend on the extent of any sharing required with government.

The desirability of a refinancing (and its benefit on the return on any secondary market sale) will depend on:

(a) how aggressively the original funding was structured (to enable the investor to win the project) and how much room exists for renegotiating key elements such as the coverage ratios and reserve fund requirements;

(b) the government's position on sharing any refinancing benefit[4]; and

(c) the risk profile as at the time of refinancing.

Of course, primary investors seeking to refinance prior to selling need to be careful that their desire to maximise the refinancing gain is balanced with the need to maintain an attractive debt/equity structure for an incoming purchaser. Potential buyers may consider the asset as a dividend stream. Changing the debt/equity ratio will effectively change the dividends paid to the investor. This, in turn, will be reflected in the price the buyer is will to pay for the asset.

(c) Change in strategy following financial difficulties

A number of so-called secondary market deals in the UK have been prompted by corporate restructuring brought about by financial difficulties[5]. It is too early to tell whether we will see similar 'rescue' sales in Australia by companies needing to exit the market regardless of the rate of return achieved. However, it will be important to ensure that depressed secondary prices do not become the norm thereby affecting the long term viability of other equity investors who rely on the sale of their equity stakes to re-invest in the PFI/PPP market.

1.2 THE INVESTOR

The secondary PFI/PPP market provides institutional investors with the opportunity to invest in schemes that offer long term stable government-backed cashflows which are high-yielding and substantially insulated from economic cycles. It is a risk profile that traditional fixed income investors find attractive, particularly pension funds.

If the secondary market is to attract potential investors there must exist (at a minimum):

(a) an appropriately balanced risk profile in the primary projects;

(b) the depth in the primary market to ensure investors can establish significant portfolios; and

(c) sufficient diversity within the fund to minimise the exposure to one particular project or sector risk.

Of particular importance are paragraphs (a) and (b) above given the low levels of equity traditionally invested in PPP/PFI/PV type projects. Confidence in the pipeline of projects will be critical in order for institutional investors to raise the funds necessary to establish the infrastructure/PPP funds to invest in the secondary market.

In addition to the above issues, the cost of capital to the investor (compared to the risk adjusted project IRR) will be an important factor influencing the investor's decision to invest in a PPP. Investors will not invest if their cost of capital is below the risk adjusted project IRR.

Institutional investors are not homogeneous and the drivers influencing their mandate for investing in PPP type projects differs. This, in turn, influences how a secondary market will develop in any given jurisdiction. In the Australian context for example, recent sell downs of equity interests in projects appear to reflect an appetite amongst certain institutional investors (superannuation funds at least) to buy into PPP type projects during the construction phase. Of course this is on the proviso that they are comfortable with, and have confidence in, the security of the revenue stream and the risk profile (particularly, whether the construction risk is being underwritten)[6].

1.3 DEVELOPMENT OF THE PRIMARY MARKET

The secondary market allows for the further development of the primary market by allowing equity providers to re-enter the primary market (thereby providing seed capital for new projects). In the UK, there is a strong feeling that the success of upcoming PFI projects will be at risk if the secondary market does not develop to give investors that flexibility to exit and re-enter the market. Although, it is argued by some industry participants that in the absence of a secondary market, investors can instead look at the option of packaging and listing their interests.

If investors can be confident that there will be a secondary market which will enable them to exit their position after a reasonable time, this may justify a lower rate of return being sought in the original deal[7] and, in turn, better value for money for the government. From the government's perspective, this would appear to be a strong incentive for it wanting to ensure the successful development of a secondary market.

2. A PPP SECONDARY MARKET IN AUSTRALIA - ISSUES TO CONSIDER

2.1 Generally

Although the Australian PPP market differs in a number of ways to the UK PFI market (not the least in terms of scale), the drivers outlined above will be critical to whether such a market can, and will, flourish in Australia. Of particular importance will be the factors set out below.

- The depth and diversity of the primary market and the confidence investors have in both the pipeline of projects and risk profile of the projects.

- Understanding the economic drivers (including tax profiles) of the incumbent investors and any prospective equity players joining the PPP market (both the primary and secondary markets) to divest or acquire such interests.

- How aggressively were deals that have already been closed (and are currently in operation or will be coming into operation over the next few years) negotiated at the bidder stage? How much risk did the investor companies originally take which they would seek to recover through any secondary market sale? How much benefit can be derived from a re-financing? Will those returns be sustainable?

- Whether market conditions give rise to an adequate level of demand from institutional investors to sustain a secondary market. Whether there are opportunities for capital gains elsewhere in the infrastructure equity market that would diminish the appeal of stable, long-term cashflows offered by PPP projects[8].

- Governments' stance on any changes in control of the project company. Governments have traditionally favoured sponsors with long term equity interests in the project to try and ensure continued monitoring and supervision of the project by an incentivised sponsor. This is particularly critical where the seller is a strategic investor whose role is crucial to the on-going success of the project. A related consideration for government is ensuring continued alignment of interests among the key project stakeholders, which will be critical for the project's on-going success.

2.2 Key contractual and commercial issues in a secondary market sale

The issues concerning an acquirer of an equity interest in a successfully constructed and commissioned, fully operational PFI/PV project will differ from those that arise for an equity investor in the original project. At a minimum, the focus will be on the provisions dealing specifically with the operation of the project (and associated risks) rather than necessarily its construction and commissioning. The following key issues would be of particular concern to an equity provider entering the secondary market[9].

- Whether there are, and if so to what extent, any restrictions on equity transfers or re-financings in the existing contracts. Even in circumstances where the existing contract is silent on refinancings (and the sharing of any gain), government may withhold consent to the transfer (to the extent such consent is required under the existing contractual framework) subject to receipt of a share of any refinancing gain made as part of such sale.

- The purchaser will need to be comfortable that adequate service levels can be maintained and that it has a clear understanding (and has adequately priced) the projected performance (and associated risks) of the project.

- Who takes the risk of any latent defects arising during the operational phase notwithstanding that the construction and commissioning phases have been completed? Whether there are any outstanding liquidated damages or other project company liabilities arising from the completion or commissioning of the project. Whether these have been priced. The impact of any such outstanding amounts or liabilities on the government's reaction to the proposed sale.

- What relief is given to the project company during the operational phase, whether through the abatement process, default regime or otherwise.

- Usual risk allocation issues which arise or are of particular importance during the operational phase of a project including refurbishment cost risk, end of term risk, uninsurability risk, the risk of insurance cost increases during operation, change of law risk during operation, design risk in respect of refurbishment obligations and price risk relating to inputs such as power and energy.

3. CONCLUSION

Time will tell whether a secondary market will develop in Australia and whether such a market will reflect the UK experience. Until more PPP deals are entered into and reach the operational phase, there is simply not the depth or breadth in the primary market to make the development of a secondary market viable. For secondary funds to achieve an appropriate level of diversification there needs to be an adequate number of operational projects across a variety of sectors. This is particularly important given the low levels of equity traditionally invested in PPP/PV projects and the associated costs and level of involvement required in delivering such projects.

Despite this, the future looks promising given the UK experience and the enthusiasm that appears to exist within the private and government sectors for the development of the primary PPP market in Australia.

Secondary Markets – a natural progression of the PPP market in Australia or simply a UK phenomenon? A question still very much open to debate. The next few years at least will certainly prove interesting.

Endnotes

1 Although a secondary market is emerging in PFI debt, this paper does not specifically address this area of development. Of course, the decision to sell PFI debt is driven by different imperatives to those driving the decision to sell PFI equity. PFI means the UK Private Finance Initiative. In Australia, similar transactions are described as Public Private Partnerships.

2 In Australia, companies such as Baulderstone, Leightons and Multiplex have established associated service companies.

3 It has been reported that both the Carillion and Mowlem deals achieved startlingly good returns with their resale values being multiples of 4 and 5.5 (respectively) times their book values.

4 In the UK, the government has agreed a voluntary code with the private sector to take a 30% share in any refinancing gain on any completed deals (unless the project agreement expressly provides otherwise). Any refinancing gain arising under new projects will be shared equally with the government on a 50:50 basis. In Australia, although there does not appear to be a consistent approach on this issue which is still being debated in the market, governments will generally seek to share in any windfall gain arising from a refinancing of a particular project on a basis to be agreed with the private sector. To date, this has generally been on a 50:50 basis.

5 The firesale by Amey of its portfolio of 8 PFI stakes to John Laing is a prime example of this. Amey was effectively forced to rethink its strategy of moving towards becoming a support services company because of the need to sell its existing PFI interests to overcome its financial difficulties.

6 In Australia, a number of infrastructure funds exist which invest in greenfield and mature infrastructure assets alike. What is not clear is whether this structure will be maintained in respect of PPPs or whether there will be a clear distinction between funds established for investing in the primary market as opposed to the secondary market.

7 Although, investors will want to ensure that any deal they enter into will be attractive to potential buyers in the future.

8 Indicators to date, show a demand for PPP's from institutional investors particularly superannuation funds that are looking for stable, long-term income yielding assets (rather than necessarily growth assets).

9 This is not intended to be an exhaustive list of all issues arising in the context of a secondary markets deal.