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AUSTRALIA'S HYBRID APPROACH TO PROJECT FINANCE

Pierre Tapper and Michael Regan*

Project finance generally refers to long-term, limited recourse debt structured to meet the specific requirements of capital-intensive resource and infrastructure projects. Project finance is designed to the strength of future cash flow and there is less reliance on more traditional credit benchmarks such as the credit standing of the borrower and the security value of the asset being financed. The market for project and structured finance has expanded in recent years in line with increased spending on capital-intensive assets and resources projects in industrialised and transition economies throughout the world. In June 2007, loans outstanding were estimated at US\$254 billion although this does not include private off-market lending (World Bank 2007). Australia accounts for around 15% of project finance loans mainly in the mining industry including mineral processing, storage, and port and rail transport facilities. In recent years, the fastest growing market has been in economic infrastructure (ports, energy, water, airports, roads, urban transport systems and railways). A significant proportion of this is used for public private partnerships (PPPs) for the private delivery of public and quasi-public goods such as toll ways and public buildings. More recently, the growth has been in PPPs delivering non-core services in health, justice and education.

The financing of infrastructure and PPP projects in Australia appears to be moving away from traditional project finance principles. The finance alternatives include short-term, limited recourse bank finance (ConnectEast, RiverCity Motorway), medium-term bonds (Southern Cross Station Project) and others have selected long-term annuities with maturities

matched to the PPP concession term (Casey Hospital). A large number of PPP projects are listed on the Australian Stock Exchange (ASX) and several have done so through the high-risk construction and commissioning stages of the project (Hills Motorway, ConnectEast). Assets are actively traded on the ASX by portfolio investors (Australian Infrastructure Fund, Macquarie Infrastructure Group) and acquisitions are made by sector-specific vehicles eager for diversification (the acquisition of Hills Motorway by the Transurban Group). Capital markets provide a convenient method of fragmenting risk and for the early stages of these long-term projects, a ready source of capital.

Since 1995, there has been extensive consolidation and re-birthing of listed infrastructure investment vehicles with only one of the 17 listed entities in the Infrastructure Index in 1995 carrying on the same business in 2007. The pattern is continuing with new market entrants building their portfolios with a combination of acquisition (Babcock and Brown and Alinta Limited) and portfolio trading (Australian Infrastructure Fund).

In listed form, infrastructure projects take the form of single assets vehicles (ConnectEast), multiple asset portfolios with a single industry focus (Macquarie Airports, Macquarie Infrastructure Group) or diversified portfolios (Australian Infrastructure Fund). However, as PPPs are wasting assets, managers of single asset investments move quickly to acquire other local assets or explore opportunities in international markets (Transurban; Macquarie Airports). A significant number of infrastructure

assets are held off-market by investors and fund managers (AMP Capital, Westpac, National Asset Management). Access to this asset class has been facilitated over the past decade by innovative intermediaries who recognised at an early stage the investment characteristics of this asset class and identified opportunities to profit from short-term de-risking and improvements in the valuation as assets mature.

Institutional investors account for a significantly higher proportion of shareholding in listed infrastructure than for other asset groups. The attraction is clear – institutional investors require assets with long term, stable and indexed revenue streams with which to match their long-term liabilities. Listed infrastructure in Australia has demonstrated a low correlation with other asset classes and markedly different response to many leading economic indicators than financial securities, equities, listed and direct property, suggesting that it is a good asset class to have in mixed-asset portfolios (Regan 2005).

The ready access to capital markets, strong investor appetite and rapid growth in national savings has created a strong Australian market for listed infrastructure projects in the land and air transport sectors. This has resulted in a two stage approach to investment economics. First, there is a preference for short-term financing during the construction and revenue ramping-up stages of projects. Revaluation and refinancing is planned at intervals during this period that permit significant returns to equity if the project meets revenue forecasts. Second, when the asset has matured, long-term investment finance is put in place.

For social infrastructure projects such as public buildings, public amenities, schools and hospitals, the projects are financed with medium term annuity bonds. These facilities may run for the duration of the concession (Casey Hospital) or they may have maturities of 8-13 years (Southern Cross Station).

Recent Australian experience suggests that the use of short-dated debt finance for long-term infrastructure finance is an alternative to traditional project finance. The difference is demonstrated by a comparison of two conventional build own operate transfer (BOOT) projects commissioned in recent years.

PHU MY 3 PROJECT, VIETNAM

Phu My 3 Power Company (PM3) is Vietnam's first privately owned energy producer commissioned in 2004. It project is a 717 MW combined-cycle power station and the most recent expansion of the Phu My power complex east of Ho Chi Minh City. The plant was built by a consortium that included British Petroleum, Sembcorp Utilities (Singapore) and a consortium of Japanese companies that included Sojitz Corporation and Kyushu Electric Power. The project was structured as a BOOT although the

documentation refers to it as a build own transfer (BOT) project. The post-construction franchise term is for 20 years. PM3 buys gas from the state-owned gas producer PVN under a 20 year power purchase agreement and sells its output to the state-owned transmission and distribution company, EVN. PM3 is estimated to be meeting 8-10% of Vietnam's energy demand.

Financing for the project was based on a traditional project finance structure that accounted for 75% of the USD390 million investment. The debt facility included loans from Asian Development Bank (ADB), JBIC and commercial bank loans. Construction took around 30 months and the project involved efficient but low-risk conventional gas-fired technology. As Vietnam's first privately financed infrastructure project, PM3 required political risk insurance and hedging of interest rate and currency risk exposures. These were provided by ADB, MIGA (World Bank) and Nippon Export and Investment Insurance. Standard and Poor's rated the country BB+/Stable at the time of this transaction.

The transaction took a long time to negotiate and was concluded after several failed attempts with other consortia. The project expedites the Vietnamese Government's plan to exploit its vast natural gas resources and develop a clean and dependable power generation sector to support the country's industrialisation.

Many critical undertakings in this transaction, including the supply and off-take agreements, are guaranteed by the Government of Vietnam and as the first privately-financed infrastructure project, enabling legislation was necessary to proceed as a BOOT arrangement.

THE EASTLINK PROJECT, VICTORIA, AUSTRALIA

The Eastlink (or Mitcham-Frankston Motorway) is a 39km toll-road located in the eastern suburbs of Melbourne and connecting the South-East Motorway and the city of Melbourne to the fast growing regional centres of Frankston and Dandenong. The project was a 39 year public private partnership and the first tollway commissioned under the Partnerships Victoria policy framework that was introduced in 2001. Eastlink was Australia's largest PPP project at the time it was commissioned, it involves a 4 year construction period and total project cost is estimated at AUD3,795 million. The winning consortium has a fixed time and price construction contract with Thiess Contractors and John Holland Group. The new motorway will be electronically tolled.

The winning consortium ConnectEast was listed on the Australian Stock Exchange (ASX) in November 2004 before significant construction activity had commenced. The ConnectEast listed group features two principal unit trusts, a common management company and a stapled security arrangement. The transaction is capitalised to provide investors with distributions during the 49 month construction



period. The AUD1,120 million of equity raised on the ASX was supplemented by a further AUD290 million in deferred stakeholder equity and AUD297 million to be raised via a dividend reinvestment plan. The entity initially borrowed AUD2,386 million in three senior facilities – an equity bridge (to cover the deferred equity component) of AUD290 million, a construction loan of AUD2,088 million (interest is capitalised during construction and it converts to a medium term investment loan when construction is completed) and, an AUD7.5 million bond facility. The construction facility may be increased to AUD2,200 million to meet changes in interest rates during construction. The capitalisation includes reserve accounts set up to meet unexpected shortfalls required for debt servicing obligations, operations, ramping-up revenue and contingencies.

The investment loan has three tranches with post-construction tenor of 2 years (40% of principal, expiring 2010), 4 years (40% of principal and expiring 2012) and 6 years (20% of principal and expiring 2014). Interest cost will be paid quarterly, fully hedged until 2010 and 80% hedged until 2014. Tranches 1 and 2 will be refinanced in 2010 and 2012 and all tranches will be refinanced in 2014 and 2019. It is also proposed to further refinance in 2024 (tranche 1), 2027 (tranche 2) and 2029 (tranche 3) with fully amortising loans maturing at the end of the concession period. The promoters believe they will pay an interest rate margin between 0.7-0.8% per annum for investment finance (ConnectEast Prospectus 2004).

The promoters plan to increase the level of debt capital at future re-financings (AUD780 million in 2014 and AUD665 million in 2019). This will be achieved against asset revaluation whilst maintaining a debt service coverage ratio of no less than 1.6. The financing strategy for ConnectEast revolves around short-term refinancing during the early years of the project. This will occur when the project experiences

a significant reduction in risk – construction is completed, revenue builds during the “ramping up” period, technology and management pass through a maturing process and the future patronage trend becomes clearer. This permits asset revaluation, increase in overall debt levels, strong returns to equity and the realignment and withdrawal of consortium equity interests.

The debt funding approaches are fundamentally different for these two projects but the assets possess similar characteristics. Both are capital-intensive, relatively low-tech, carry low fixed and variable costs and output pricing is regulated. The two investments possess low demand price elasticity, they form part of well-developed supply chains and both are examples of privately funded public infrastructure.

What are the reasons for the different approach to the financing of infrastructure and PPP projects in Australia? There are probably five reasons for this.

First, Australian based projects benefit from a strong institutional framework and a large and dynamic capital market. The market has demonstrated a strong appetite for listed infrastructure in both portfolio and single asset forms. Investors can choose from a variety of stocks, sectors and risk profiles. For example, investors may take indirect construction and commissioning risk, post-construction “ramping up” risk, long-term operational risk or they may take the arbitrage opportunities created by trading in different markets and different asset types. Investors in listed Australian PPPs assuming construction risk are paid a return during construction (ConnectEast 2004, RiverCity Motorway 2006) and public listing offers two important advantages with long-term assets – market pricing and liquidity.

Promoters may also take advantage of changes in the investment risk during the life of the asset and

increase leverage to improve return on equity and reduce borrowing costs (KPMG 2007). Many listed infrastructure securities exhibit low return volatility, revenues are stable and mostly indexed, fixed and variable costs are low and improvement in capital productivity translates to strong growth in long-term yield. Australian investors have demonstrated a clear preference for participating in the early-stage de-risking of projects with asset revaluations, equity withdrawals and debt refinancing. This process is also favoured by institutional investors who take a position after the asset has reached some level of maturity thereby avoiding early-stage project risks.

Second, capital market innovation created the stapled security as a method of capitalising capital-intensive projects without the need for high levels of long-term external debt. The stapled security enabled promoters to structure both debt and equity using a group structure and legal quarantining of the financing, ownership and operations components of the transaction. Although the stapled security is generally considered equity for investment purposes, investors can achieve subordinated status ahead of creditors in the event of administration.

Third, Australian infrastructure consortiums are generally financier-led which is a departure from the practice in North America and Europe where PPP bidders are often led by contractors and asset service providers. In Australian transactions, financial intermediaries such as ABN Amro and Macquarie Bank underwrite debt and equity capital which permits the constructor and other members to focus on asset delivery and lifecycle costing. As debt and equity is placed with third parties and frequently credit wrapped, the presence of a financier in the bid team doesn't come at an excessive premium. Equity contributions by consortium members may be deferred (although supported by appropriate bank security) permitting equity sell-down during and following completion. Financing arrangements replace the deferred equity component during construction and possibly the early post-commissioning periods. Australian infrastructure projects generally feature higher levels of financial innovation than is found in overseas markets.

Fourth, there is strong institutional support in Australia for local and international infrastructure investment in both listed and unlisted form. This is largely driven by a sound understanding of the operational and investment performance characteristics of this asset class. Listed infrastructure outperformed the ASX all industrials in the period 1995-2003 and has proven to be an attractive medium and long-term investment.

Fifth, the strong growth in managed funds in Australia over the past decade has created a pool of equity and debt capital searching for stable, long-term returns. Institutional investors may assume equity or debt positions with infrastructure and PPP projects in either listed or non-listed projects. Continued strong

growth in managed funds, the robust underlying credit ratings for many of these projects and the performance characteristics of this asset class suggest that traditional project finance will find strong competition in the Australian market.

CONCLUSION

A robust capital market in Australia stimulated by a high level of capital accumulation has created an alternative to traditional project finance for non-resource projects and public private partnerships. The projects that find their way to the ASX are generally the larger scale finite tenure PPPs that offer the prospect of capital growth during the early stages of the value cycle. Although external debt for these projects is short-term, interest rate and currency exposures are significantly hedged (Transurban Annual Report 2006, ConnectEast Prospectus 2004). The external bank debt used in these projects shares some of the characteristics of project finance including stringent debt service coverage ratio criteria, limited recourse security, debt service reserves and, sinking funds for lifecycle maintenance and asset rehabilitation.

Short-term debt financing is an attractive strategy in a stable and relatively low interest rate environment. However, it attracts refinancing risk at critical times during the early-stage maturity of these projects. A more volatile interest rate environment and an extended downturn in equity markets may well see a switch back to the traditional project finance approach for these projects.

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