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Private placement investors eye P3 pipeline

Private placements are a promising source of long term debt for US P3 deals. Market participants, investors and brokers believe the robust pipeline of P3 deals will meet the increasing demand for long term fixed debt. InfraAmericas' Hana Askren and Debtwire Municipals' Maria Amante investigate.

Institutional investors are a perfect match for private placements, and some are arguing that the P3 market is a perfect match for the longer tenor, covenant protection and higher yields which private placement deals typically offer. Last year's private placement market was strong with almost USD 60bn in global issuance, but investors continue to seek deals with terms and tenor amenable to their long-term outlook. And their gaze is increasingly falling on the P3 market.

"The investors feel that there is a lot of value in these transactions," says Greenberg Traurig shareholder David LaSota, who suggests that the competition for bread-and-butter corporate issuance may lead investors to "push agents to bring P3s to them".

The catalyst for this trend has been the development of an increasingly strong US P3 pipeline. Though the P3 market continues to have its risks, its more reliable procurement processes and sophisticated structures have not gone unnoticed among institutionals. OSU, Long Beach Courthouse and the Luis Munoz Marin Airport in Puerto Rico are all recent deals that used private placements, though private placement debt has yet to be used on a greenfield project.

Of particular interest are availability-based structures. Squire Sanders P3 lawyer Roddy Devlin sees these long-term, steady and relatively low-risk payment structures as similar to traditional municipal bonds and contracted power generation structures. Both areas where investors are well established, noted an industry advisor.

Private placement investors "get to weigh in on the structure, can make suggestions how to enhance it, and get to perform their own due diligence," explains Anita Molino, managing partner and president at Bostonia Partners and chair of the National Council for PPPs. Among Bostonia's institutional accounts, most have seen yearly increases in their allotment for private placements.

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Important source of funds

Meridiam investment director Jad Hreibe agrees private placement market is a funding source "that is largely untapped in P3 deals in the US." But he notes that in order for them to participate, bidders need to bring investors to the table months, not days, before a deal is set to close.

In the corporate private placement market investors generally receive transaction materials only a few weeks before pricing and can quickly determine the level of their participation and at which price. P3 teams need to ensure enough private investor interest and a good understanding of the pricing structure before bid submission - which requires more time than the corporate process.

Devlin also says the P3 procurement process has been a hindrance because it requires each bidding team to include evidence of committed finance as part of its bid. Such a commitment must be open for a specified period of time. Hreibe argues there is no reason why prevailing processes can't change, though this would require a change of mindset.

Another Greenberg Traurig shareholder, Charles Kolin, says at least one of the bid teams for the original CampusParc (OSU) concession did put together a small syndicate of private placement investors willing to provide financing at closing that would remain the permanent debt. In the end, QIC won the bid with a USD 265m 5-year mini-perm loan and a USD 20m capex facility, both of which it refinanced a year later with a 30-year bond priced at 190bps over US Treasuries in the US private placement market.

Numerous projects, including the USD 3.6bn renovation of the LaGuardia Terminal Building have significant capital needs and could benefit from private placement debt, says Kolin. The traditional private placement market offers long term debt - over 30 years as appropriate - at fixed rates which P3s can benefit from greatly, both in terms of fixing financing costs and taking refinancing risk off the table. The Port Authority has said it will select a preferred proposer for the LaGuardia project this June.

Devlin also cites a bidding team attempt to bring institutional investors to the table for the initial closing on a deal he declined to identify. As these investors become more comfortable with the P3 model and willing to accept construction and maintenance risks, P3 consortiums will consider private placement as a viable financing source and the US market will gain an important financing alternative. The availability of tax-exempt bonds and TIFIA funding present cheaper sources of financing, and P3 bidders are likely to look at these traditional financing sources first, Hreibe says.

P3s structured on an availability model could use private placements at closing or to refinance afterward. Tax-exempt bonds such as private activity bonds (PABs) and munis will preclude private placements where they are used, but not every deal will use them.

Muni market shifts
Municipalities are putting increasing effort into analyzing taxable financing options, doing a thorough value-for-money and full lifecycle cost analysis rather than "simply defaulting to the tax exempt option," Molino said. The more favorable interest rates on PABs and tax-exempt muni bonds are only one piece of the value puzzle, and taxable financing will emerge as the better option for certain deals, she explained.

New regulations and disclosure requirements will continue to force increased diligence and analysis on the issuer side. Projects and financing structures will undergo a "much more detailed comparison", noted the advisor. Rising construction costs can make P3s more attractive, as cost overruns will be borne by the private partner rather than the procuring body.

The Long Beach Courthouse is a project that could potentially have issued municipal bonds, but chose a private placement instead. That deal closed its refinancing in the private placement market late last year, issuing USD 518.5m in asset-backed bonds paying a 6.88% coupon and maturing in 2047.

Risk mitigation
The private placement market has developed ways to mitigate risks in these deals, including construction risk, said Molino. Mitigating these risks at closing is a "critical component" for getting these investors in P3s. If the deal is financed at closing with shorter term bank debt and then refinanced with a private placement post-construction, the deal can become more complicated by the additional steps.

Construction risks can be attenuated by requiring the EPC to increase contingency, to add a three-month buffer to the construction period or put up special reserves to mitigate potential change orders. Investors typically hire a construction oversight firm for due diligence.

Institutional investors have some flexibility to invest at the construction stage via delayed draws, which allow for funds to be disbursed on a more efficient basis and enable the sponsor to avoid negative carry when the funds are not needed, explained LaSota. This is a unique feature of the traditional private placement market not found in other bond markets and offers a competitive alternative to the traditional bank project financing route.

While traditional private placements have always been around to finance the operation phase of a project, private placements have also been used to finance construction in private projects, including recent projects like REX Pipeline, Hudson River Cable project, Caithness Shepherds Flat Wind Farm and Brazos Sandy Creek coal-fired power plant, said Kolin. The five or six top insurance companies are the ones that "can get their hands dirty" and will participate at this stage, he noted. Many other mid- to smaller- insurance companies may also play in the deal based on the participation of the larger insurance companies.

Public procurement authorities and private sector sponsors could also make the P3 structure more inviting to institutional investors who “have come to expect certain representations, warranties, covenant and legal opinion support”, different from what is required by bank lenders, Devlin said. Procuring authorities and private sector players could encourage institutional investor participation, “both at the initial closing and in refinancing, by addressing such expectations upfront in the project and financing documents,” Devlin said.

Several investors in Long Beach had both their muni desks and their private desks take a look at the deal, since the muni side has more experience understanding appropriations risk and governmental issues. Pricing on the Long Beach deal may have been somewhat on the high side partly because of these risks, the slightly higher risk profile of the state of California compared to other states, and the fact that Long Beach was the first social infrastructure P3 in the private placement market, said Kolin. “Although there was a slight learning curve in Long Beach to get over, with Long Beach having cleared the private placement market, we think there’s a lot more potential” for other P3s to be financed with private placement debt.

Some Texas road projects have a refinancing on the horizon, and the private placement market is showing interest, the advisor noted. More activity on the refinancing side could open the door for participation in deal closings, which will provide a more reliable pipeline of deals, said Hreibe. “Simpler is better” at the beginning, meaning that inaugural deals will likely be road deals rather than airports or transit.

Canadian model

With the strong dealflow in the US, the market could follow the Canadian P3 market, in which many deals use private placements as the principal financing solution, said Hreibe. One example is last year’s Ottawa Light Rail Transit, which was funded at closing with a USD 225m private placement with National Bank of Canada as underwriter and Sun Life as lead manager, in addition to a revolving credit facility and a government grant. Canadian life insurance companies, at least one of which invested in Long Beach, could lead the way in select transactions where they don’t have to compete with tax-exempt forms of financing. Insurance companies want access to this asset class and they have big balance sheets, noted the advisor.

“We definitely are interested in developing this market to give ourselves more options for financing,” said Hreibe.