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Out Of The Shadows: The Rise Of Alternative Financing In Infrastructure

Primary Credit Analyst:
Michael Wilkins, London (44) 20-7176-3528; mike_wilkins@standardandpoors.com

Secondary Contacts:
Michela Bariletti, London (44) 20-7176-3804; michela_bariletti@standardandpoors.com
Robin M Burnett, London (44) 20-7176-7019; robin_burnett@standardandpoors.com

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Out Of The Shadows: The Rise Of Alternative Financing In Infrastructure

Infrastructure projects are increasingly attracting financing from the shadow banking sector--that is, non-bank financial intermediaries providing similar services to commercial banks. While this could provide project sponsors with access to much needed credit, Standard & Poor's Ratings Services sees a number of challenges facing the sector. The risks involved in infrastructure projects, especially construction risk, are unfamiliar to the majority of institutional investors, and will in our view require careful analysis and management to make the most of the opportunities available.

The landscape of infrastructure financing is changing. With traditional lenders such as banks and governments under severe economic pressure, infrastructure projects worldwide are increasingly turning to the shadow banking sector to finance the continued demand for growth. In the past few months, new investors to the sector such as BlackRock have entered the marketplace, or publicised their intention to do so, while experienced participants such as MetLife and Macquarie have set more ambitious targets for fundraising in the future. Last week Allianz Global Investors announced that it was looking to raise £1 billion for an infrastructure debt fund to invest in U.K. greenfield projects in the schools, hospitals, and roads sectors. According to Project Finance International, an industry intelligence provider, just under $200 billion was raised in the global project finance loan market in 2012. In the U.S., about one-quarter of all project lending last year came directly from alternative sources and institutional investors--nearly as much as from the public bond markets--with Europe, Middle East, and Africa, along with Asia Pacific, following a similar pattern. Should this trend continue, we anticipate that up to $25 billion of project finance debt will sourced from the shadow banking sector in 2013.

Overview

- The shadow banking sector is becoming an increasingly important source of finance for infrastructure projects worldwide.
- However, potential investors are cautious about such transactions because of the lack of historical performance data and their limited understanding of construction risk.
- The opaque nature of shadow banking means there is a danger that a credit bubble may appear.
- Despite a recent burst of activity from the shadow banking sector, we believe bank lending will remain the predominant source of financing for infrastructure projects.

By providing a potential source of long-term committed capital, shadow banking could in our view be of great benefit to the infrastructure sector. The existence of alternative sources of finance may also help to reduce the cost of borrowing for projects and introduce financial innovation into the marketplace. On the downside, our view is that the somewhat opaque nature of the shadow banking system could lead to a build-up of systemic risks within the infrastructure sector, as occurred prior to the global financial crisis of 2007-2009. To date, though, this has not been a major cause for concern.

However, in our opinion the relative levels of infrastructure risk, especially when compared to sovereign bonds

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(institutional investors' staple long-term yield investments); a lack of established and tested funding mechanisms; and a dearth of performance data for new and growing industry sectors (such as renewable energy) are all acting as potential barriers to growth. Investors' wariness about taking on construction risk in particular could in our view prevent them from making the most of the opportunities available, while denying funding for the large-scale, complex infrastructure projects that are likely to be most in need of attracting financing.

Shadow Banking Brings Risks And Rewards

We define shadow banking as the system of finance that exists outside regulated depositories, commercial banks, and publicly traded bonds. Shadow banking participants include pension funds, insurers, sovereign wealth funds, and export credit agencies, alongside finance companies, private investment funds, business development corporations, asset managers, hedge funds, and sponsored intermediaries such as money-market funds. Typically, shadow banking participants differ from traditional banks in three important ways:

- They do not usually operate under bank regulatory supervision;
- They do not normally benefit from capital support; and
- They do not benefit from the liquidity support available to regulated banks, such as the ability to borrow from central banks.

The differences between the capital, leverage, liquidity, and transparency regulations governing shadow banking intermediaries and the stricter regime governing traditional banks effectively creates a two-tier system of regulation. This arrangement can in our view create opportunities for borrowers and lenders to pursue the cheapest, least transparent sources of capital. Furthermore, we believe that it may result in creating incentives to maximise debt leverage, a process that has led, and may lead again, to systemic defaults and downgrades. For example, because loans and private placements from institutions do not trade through a central exchange, there is no place to observe the activity. This leaves the potential for a build-up of debt to be largely overlooked, as occurred with the overleveraging of the infrastructure sector prior to the global financial crisis of 2007-2009.

According to Barclays Capital research (November 2012), in the first 10 months of last year, 168 companies borrowed directly from U.S. pension funds and insurance companies rather than going to banks. Roughly 40% of these borrowers were based in the U.S., 20% in the U.K., 8% in The Netherlands, and 6% in France. Consultancy Probitas Partners' latest figures show that debt funds accounted for 12% of the $23.5 billion raised by infrastructure funds last year. According to research from Prequin, a leading data provider, the majority of investors intend to continue utilizing unlisted funds to pursue investment opportunities. Preqin indicates that 20 such unlisted infrastructure debt funds were in operation in 2012, targeting $10 billion in investor capital--twice the amount raised in 2011. While, in practical terms, many investors have no option but to invest via funds, there is a growing preference among larger and more experienced investors for direct lending, largely in order to bypass management fees.

Currently, secondary debt markets for infrastructure projects remain relatively small. And in the absence of large volumes of liquid, investment-grade securities, institutional investors' involvement may be limited. However, as banks divest their loan books, there are increasing signs of activity in the secondary project finance bank debt market, spurred on by institutional interest. While most pension fund investment remains buy and hold rather than active trading, asset managers are looking to capitalize on the project finance sector's stable asset performance and favorable pricing spreads. However, we note that both the secondary debt and institutional private placement markets are not public, and are therefore not transparent in volume.

Investors' Interest In Infrastructure Accelerates...

Sustained activity through the end of 2012 suggests to us that institutional investors are now starting to look seriously at infrastructure investment. In May 2012, Topaz Solar Farms LLC (debt rated BBB-/Stable) became the first utility-scale solar project in the U.S. to be fully financed by private investors. Three months later, Europe followed step, with construction beginning on Meerwind, the first offshore wind project to be fully financed by private investors, located in the German Bight. Last September, Algemene Pensioen Groep N.V. (APG) became the first Dutch pension fund to provide debt financing for an infrastructure project, lending €80 million for the widening of a Dutch highway. In November, BlackRock, the world's largest asset manager, announced the establishment of its first infrastructure debt unit in London, while the Kuwait Investment Authority also signalled its intention to invest in the market in the future.

This momentum shows little sign of abating: German insurer Allianz recently became the latest asset manager to announce the launch of a new infrastructure debt fund in January 2013. From Australia, two leading institutions, Industry Funds Management and Infrastructure Capital Group, have also announced plans to set up debt funds in the sector.

In our view, the nature of certain infrastructure projects seems to complement the long-term liability needs of insurance companies and pension funds. Availability-based private finance initiative (PFI) schemes, for example, often combine stable fixed-rate and inflation-linked cash flows, relatively low credit risk (if not overleveraged), with high observed and projected recovery rates in case of default. In addition, infrastructure debt typically provides a higher yield than government bonds.

... But They're Looking For Low Risk And High Yield

Nevertheless, while the prospect of higher long-term yields is enticing, we see that potential institutional investors continue to be wary of being caught in a repeat of the asset bubble witnessed prior to the financial crisis. A perceived heightened level of risk, compared to the risk-free but lower-yield returns offered by sovereign bonds, remains a major obstacle to further investment in our view. This risk aversion by institutional investors and pension funds was recently identified as a major impediment to private sector infrastructure investment in the U.K. by the National Audit Office, a government spending watchdog, in a report published on Jan. 16, 2013, titled "HM Treasury: Planning For Economic Infrastructure" (see note).

As a result of this unwillingness to take on risk, there has been a shift away from the private-equity approach for capital return that was in evidence prior to the bursting of the infrastructure asset bubble in 2008. Under that approach, fund managers would make equity investments on behalf of their clients (such as pension funds and insurers) with the aim of generating returns from selling the asset at a profit within a short timeframe. Now, private investors are increasingly focused on low risk, low volatility debt-type investments that generate a more predictable cash yield over a longer timeframe, are potentially more liquid, and benefit from greater security post-default. In the public capital markets, a number of sovereigns and multilateral lending institutions have embarked on initiatives aimed at improving the credit quality of infrastructure projects, since this is the main focus of public debt investors. Examples include the European Commission's proposed Europe 2020 Project Bond Initiative, and the U.K. government's £40 billion UK Guarantees Scheme.

In our opinion, another key reason behind institutional investors' failure to fully embrace infrastructure debt is the lack of information about more challenging projects. A good example is the demand for investment in offshore wind farms in Western Europe. These are large-scale, difficult projects that utilize new technology and have little proven track record of yield. Utility balance sheets and state lending organizations have been the dominant sources of funding for this relatively new asset class, but these are unlikely to be sufficient to fund the ambitious investment needed by 2020. We estimate that the amount needed to meet U.K. and German government investment targets alone by 2020 is between $117 billion and $133 billion, presenting a considerable opportunity for those investors able to successfully manage the risks involved.

Construction And Operations Risks Can Be Overcome

Market sentiment suggests that construction risk in particular remains a specific source of anxiety. This can make it difficult, for example, to market project finance debt to a long-term institutional investor seeking low risk through a long debt tenor. Some new market entrants seem to us to be wary of taking on the uncertainties associated with ensuring that a project is constructed and completed on time, to budget, and capable of operating as designed. Certainly, this can be a complicated process: Alongside the complexity of construction itself, there are numerous associated risks to be considered, including the project's delivery methods, design and technology, the capability of contractors, and the manner in which the project contracts distribute risk between contractors and suppliers. (For further details, see "Request For Comment: Global Project Finance Methodology--Construction Phase," published on Jan. 28, 2013, on RatingsDirect on the Global Credit Portal).

Typical problems encountered by projects during construction include the underestimation of costs, design changes, granting of permits, adverse weather, and force majeure events. More difficult construction tasks, such as those in heavy civil engineering works and industrial plants, are more likely to lead to delays and cost overruns than simple construction tasks such as in the accommodation sector. Estimating the required amount of credit support to complete a project is therefore a complex task in itself.

Banks experienced in project finance lending have historically been well equipped to address these risks by providing, for example, debt margin structures that recognize the higher risks during construction. However, margins that step down when a project completes construction are more difficult to implement in capital market funding structures.

Nevertheless, these issues are far from insurmountable. Many can be resolved by changing the project structure or covered via insurance, given sufficient expertise and experience on behalf of investors. Equally, operations contracts are not without risks of their own. Disputes in rated public-private partnership (PPP) transactions, for example, often arise due to differences in contract interpretation with respect to service quality, and can have serious implications for lenders and bondholders.

The Transition To Capital Market Funding Will Likely Be Gradual

Since they are typically funded pre-completion, economic infrastructure projects have traditionally been the most reliant on bank funding, especially in Europe and the Middle East. These include complex, large-scale, industrial, energy, and civil engineering projects, which often involve new technology--in other words, the kind of projects that institutional investors have typically been most cautious about.

By comparison, in the U.K. and Canada, for example, the bond markets have mainly been involved in funding social infrastructure such as schools, hospitals, and government accommodation projects since the late 1990s. As a result, both the mechanisms for funding and the market participants themselves are now generally well established. Yet, it's new and heavy industry--particularly the energy and transportation sectors--that currently have the greatest demand for funding.

Consequently, bank lending will in our view remain the main source of funding for infrastructure projects. And despite the recent burst of activity from the shadow banking sector, in our view, any transition will be relatively gradual. Nevertheless, as regulatory pressures require the banks to hold more capital for longer-term loans, lending for long-term infrastructure projects will continue to become less attractive to banks and more attractive to yield-hungry investors.

Note

More details on the National Audit Office report "HM Treasury: Planning For Economic Infrastructure" can be found at http://www.nao.org.uk/publications/1213/economic_infrastructure.aspx

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Request For Comment: Global Project Finance Methodology--Construction Phase, Jan. 28, 2013
- How Europe's New Credit Enhancements For Project Finance Bonds Could Affect Ratings, Nov. 13, 2012
- Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- The Changing Face Of Infrastructure Finance: Beware The Acquisition Hybrid, Sept. 7, 2007
- The Amazing Growth Of Global Infrastructure Funds: Too Good To Be True?, Nov. 30, 2006

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

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