Refinancing projects and pre-hedging financial market risks

By Rishin **PATEL**

While the amount of dry powder ready to invest in infrastructure assets piles up, putting money to work is proving to be somewhat of a challenge. The infrastructure investor community has seen some significant competition on all fronts.

Firstly, there is the re-emergence of significant fund-raising activity where even the 'big boys' are going head-to-head to secure long-term commitments from institutional investors. In some instances, placements are being allocated beyond 18 months in the future for both listed and unlisted funds. And then, when it comes to deploying capital, there is still a distinct lack of quality assets available which meet desired investment returns, resulting in an ever-increasing wall of money looking to be deployed.

As a result, over the course of 2018 we have witnessed a flurry of refinancing activity of existing assets in operational stages as well as development stages, and increasingly in non-traditional jurisdictions (which we refer to later) for many of these funds. Many of these refinancing deals require careful consideration by the bidder of existing hedging contracts and the expense of breaking or restructuring them.

Financing options

Alternative sources of financing available have been prominent in most of the recent refinancing scenarios. The implications that this has on the bid price to acquire the asset or pre-hedging the interest rate, inflation and FX risk upon acquisition of the asset are topics of discussion. Even though there has been a material shift lower in borrowing costs in the debt markets, initial equity financing seems to increasingly be the preferred choice. For example, traditional bank debt is replaced by innovative debt products such as infrastructure bonds in countries like India, where banks have a distinct lack appetite to lend.

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For instance, let's take an existing operational asset that was funded through commercial bank debt facilities. Inevitably, the long-dated financing will have legacy hedging contracts in place and depending when and at what level these contracts were struck, the costs to 'unwind' or break these contracts will be punitive. If the refinance of this existing operational asset is funded through a 100% equity contribution, historic liabilities can significantly influence the bid price. These costs can be materially adjusted in favor of the bidder with the ever-increasing transparency of xVA releases from bank hedge counterparties.

Far too often, these adjustments are overlooked in favor of the overall IRR,

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without looking specifically at enhancements. Without any equity contribution whatsoever, the legacy hedging contracts can often act as a partial pre-hedge to the refinancing.

Whether investors are buying or selling an asset, pre-hedging to financial close is increasingly becoming a prerequisite for infrastructure projects. The cost to pre-hedge the financial risks in the project really depends on the type of pre-hedging the project is looking for. Some may involve an upfront cash payment (buying options) and some may require collateral to be posted to the contract provider (forward swaps/contracts) for the duration of the pre-hedge. These are all suitable pre-hedging solutions, but often the upfront collateral requirements for such a pre-hedge may not be available.

The project could fund a pre-hedge through equity, but this will clearly erode the equity IRR and therefore be unfavorable. As a result, sponsors sometimes opt not to pre-hedge and instead build in a larger buffer to the financial model to compensate for fluctuations in underlying variable rates. So what is the solution? We suggest that the increasing popularity of deal-contingent hedging provides some significant benefits in today's financial environment

Deal-contingent hedging takes shape

Deal-contingent hedging has never before played such an instrumental role in pre-hedging a project as it does today. Unlike its vanilla derivative counterparts, there is no requirement for upfront cash payments or collateral. The transaction underwrite risk transfers from the project to the hedge provider. Wind the clock back a few years and there were only a handful of institutions in a positon to provide this type of pre-hedge solution at anything like competitive levels. Now, there are an increasing number of players in this space.

This situation has not only forced institutions to be innovative in how these deal-contingent contracts can be structured and delivered, but it has also driven significant price compression on deal-contingent premiums. The contingent risk is now more often on the project reaching financial close. This is a material change from the past, when a sanction or regulatory approval represented the specific contingent risk in a project.

The need to ensure projects deliver financial performance targets and investment returns has driven sponsors to look at portfolio diversification to capture enhanced yields. One notable shift is the significant uptick in activity in the Latin American and Asia Pacific regions for renewable energy projects. This jurisdictional diversification brings its own challenges when looking at project pre-hedging.

In the emerging markets, liquidity and tradeable contracts vary from country to country. Large-scale renewable projects may indeed have a requirement to pre-hedge in a size and tenor that is not provided by the relevant domestic market. Where a simple solution is available, it may be too costly and therefore erode the project IRR to an unsustainable level.

In summary, we expect to see a continuation of asset refinancing in 2019, where the 'wall of money' will be deployed into brownfield and new greenfield assets. With the inherent risk of global interest rates rising, project pre-hedging will undoubtedly become increasingly relevant. The characteristics and innovation of deal-contingent hedging as a pre-hedge solution, and the variety in the way it can be delivered, will most certainly take center stage.

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