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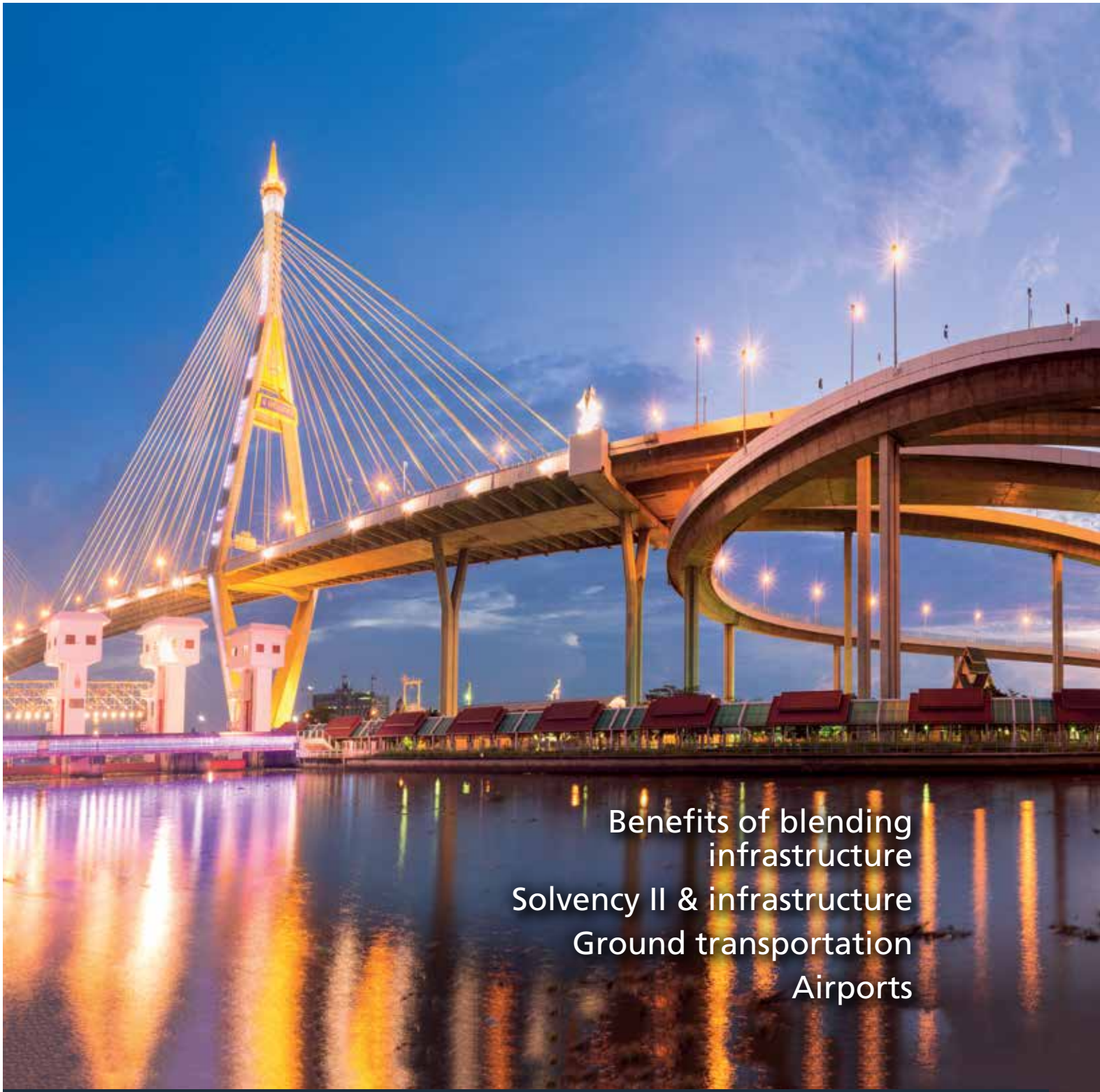

Benefits of blending infrastructure

Solvency II & infrastructure

Ground transportation

Airports

Infrastructure transaction trends

By Ian **MacFarlane**

With infrastructure assets offering investors a solid long-dated yield, and in particular compared to other asset classes, it seems unlikely that investor demand will abate any time soon. This despite a few upsets in 2016.

The USA is paving the way for a tightening of monetary policy and ultimately increased interest rates.

The value of infrastructure transactions globally in 2016 was high, albeit physical deal numbers declined slightly. Debt funding is readily available from institutions, funds and commercial banks, all with good appetite for large-scale transactions. Loan margins have crept up over the course of past 12 months, from the very low levels marked at the end of 2015.

2016 did of course deliver more than a few material events that impacted the markets; the Brexit vote in the UK in June and the US election result in November. The Brexit result was completely unexpected and the biggest impact was felt across the foreign exchange markets with USD strengthening significantly against the GBP and EUR; triggering a precautionary cut in UK interest rates later that summer. However, the Republican victory in November, and Pres. Trump's pledge to spend up to $1tn on national infrastructure, sent interest (swap) rates back up.

The US is therefore paving the way for a tightening of monetary policy and ultimately increased interest rates. Interest rate hedging for long-dated project finance transactions costs more now – see Chart 2. This is not to say that interest rates are 'expensive', far from it. The current combined cost of funds (fixed rate plus margin) is still considerably lower than pre financial crisis.

For new projects, the ultra-low interest rate environment has enhanced returns as the cost of debt can be kept very low. However, the downside of these low swap rates is the significant negative mark-to-market (MTM) on historical transactions which fixed their long-term rate of interest at much higher levels. In theory, this should not be an issue, unless there is a desire to refinance (due to lower margin availability, or where specific lenders are looking to step out).

Chart 1: Historic Spot Rates - 2016 and 2017 Year to Date

Chart 2: Historic Swap Rates - 2016 and 2017 Year to Date

Where projects have been in a position to successfully refinance, we have seen a mixture of appetite from existing lenders to remain in the transaction. Where funders have stepped out, the existing hedging can be 'novated' to new lenders. These new lenders will then apply a funding and credit charge to the novated swap rate to compensate for existing hedge MTM (therefore pushing the swap rate even higher). These charges used to differ significantly from one bank to the next, but we now find negotiations to align these costs are becoming easier, making refinancing with larger syndicates less onerous.

In our experience, this has been driven by more competition and the increase in the number of alternative funders looking to lend to this asset class. It is for these situations that the turn in the interest rate cycle could be a positive, and there may be more opportunity to refinance these legacy projects in the future without the obstacle of an extremely negative swap MTM.

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Swap and FX Movements

We have noted graphs showing the 10-year swap rate for USD, GBP & EUR for 2016 and then 2017 year-to-date. The EUR-USD, EUR-GBP and GBP-USD FX movements over the same period. We have also shown the current implied forward curve for these currencies over the next c. 20 years in Chart 2.

10-year swap rates in the USA have increased substantially over the last six months; by more than 100bps compared to only 30bps and 40bps in GBP and swap rates respectively. The USD curve has been driven by two rates rises since December last year, and an anticipation of more to come. The UK and the Eurozone are somewhat further behind in their cycle, although we would expect to see a rate rise in the UK well in advance of anything in the EU.

As can be seen, Sterling fell significantly immediately following the outcome of the European referendum vote, sending the USD rocketing to new highs that it has largely maintained over the last six months. EUR-GBP has been relatively steady, although it is likely to experience further volatility as the trade negotiations get underway in earnest.

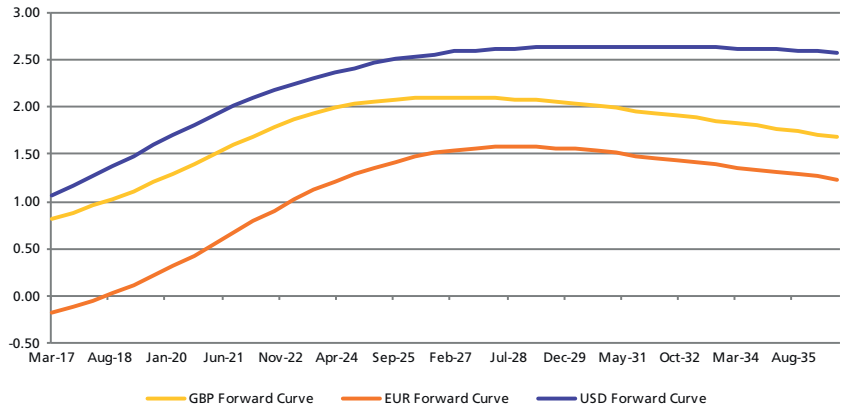
The forward 3-month LIBOR/EURIBOR curves all show a positive trend, and is reflective of the tightening monetary policy expectations. Interestingly, none indicate material increases over the next 20 years, so even although rates will be higher, they remain at long-term historic lows.

The Year Ahead

So how will recent events affect infrastructure in 2017? We suspect the answer is 'not very much', reflecting a similar attitude to the majority of last year. We do not see investor demand changing in 2017. Irrespective of a steady increase in interest rates, we still see a material appetite for solid investment opportunities with attractive yields and cash-flow visibility; infrastructure currently ticks all the boxes.

With regard to the debt markets, we see this remaining very liquid for the foreseeable future. In Europe there is renewed interest this year in institutional and fund lending to projects. While there is still a willingness from commercial banks to lend to these typical long-dated infrastructure schemes projects, this is normally from a group of 'usual suspects' who will tend to be selective in their appetite. >

Chart 3: Market Forward curves as of March 31, 2017



We are aware of how banks' balance-sheet constraints and capital requirements are impacting their returns, but infrastructure offers an attractive proposition compared to other asset classes, and banks cannot simply sit on their capital. We have seen some traditional bank names completely exit this asset class, but there is still capacity from other commercial banks that do not have the same capital constraints, at least for now.

Pre-Hedging and Deal-Contingent Hedging

In a rising interest rate environment, and given the size and tenor of typical infrastructure transactions, we are seeing more projects consider pre-hedging strategies. Whether FX and/or IR risk, there are a number of ways to address a pre-hedge. Optionality is flexible and easy to execute, whether vanilla options or swaptions, as it does not encompass the same credit constraints that a physical forward start hedge would face.

Deal-contingent hedging (DCH) on the other hand is becoming much more popular and is a way of entering into a forward-starting hedge without the constraints of having to post collateral or face dead deal costs if the transaction does not complete. Traditionally, these types of hedge have focused on the contingency around the regulatory risk.

However, bank providers will now look at a host of additional milestones that can govern the successful outcome of a project, making this type of hedge more attractive. There are a fairly large number of counterparties willing to enter deal-contingent hedging, meaning that the pricing of the 'contingent' risk element is reducing. At financial close, for IR hedging in particular, these DCHs are often cash settled so as to avoid issues around novating 'off market swaps' making the process even more straight-forward.

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Hedging Through the Politics

Infrastructure investing seems set to continue to be a favorable asset – both from an equity and debt investment perspective. Lower interest rates are beneficial for new projects, keeping total funding costs very low.

Projects looking to take advantage of refinancing opportunities are facing large negative MTM on legacy swap positions, but there are ways to manage this without crystallising a cash requirement. FX risk is being addressed more frequently, with 'event' risk in these markets being higher than ever, mainly driven by political outcomes. Pre-hedging and DCH is being explored by many and is a way to pin down hedging costs in advance of deal completions, and so providing more certainty in the financial model and likelihood of financial close success.

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Ian MacFarlane is a Board Director at JCRA and responsible for Project Finance and Infrastructure for EMEA. Ian and his team focus on providing advice, structuring and negotiating long-term hedging solutions for major transactions in this sector.

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