A STRATEGIC APPROACH TO INFRA M&A

M&A IN THE PROJECTS AND INFRASTRUCTURE SECTOR IS VERY ACTIVE AS DEVELOPERS, OPERATORS AND INVESTORS SEEK TO RESTRUCTURE THEIR PORTFOLIOS TO POSITION THEMSELVES FOR PREVAILING GLOBAL MEGATRENDS, SUCH AS ALIGNING WITH ENERGY TRANSITION OBJECTIVES AND TAKING ADVANTAGE OF TECHNOLOGICAL SHIFTS. FOR EXAMPLE, THERE HAVE BEEN A NUMBER OF RECENT DIVESTMENTS BY OIL AND GAS MAJORS TO SMALLER INDEPENDENT COMPANIES, AND INFRASTRUCTURE ASSETS AS A GENERAL CATEGORY REMAIN VERY ATTRACTIVE TO PENSION FUNDS AND INSTITUTIONAL INVESTORS WITH FUNDS TO DEPLOY IN SEARCH OF YIELD. BY JONATHON HANNAH, SPECIAL COUNSEL, SULLIVAN & CROMWELL.

The rise in infrastructure M&A has brought with it increasingly sophisticated financing structures. Buyers of infrastructure assets may seek to utilise leverage for a variety of reasons, including maximising returns on equity, particularly for financial investors, freeing-up offshore currency reserves for Chinese SOEs or simply raising capital, in the case of independents. Financing of these acquisitions requires melding of traditional leveraged buyout (LBO) acquisition finance with elements drawn from project finance structures, and brings with it a number of unique features. We examine the opportunities and challenges in this evolving market.

Two distinct markets

LBO finance and project finance each have well-established frameworks that have developed over decades. Those frameworks involve norms that are well understood by their respective market participants and form the starting point for a given transaction, but must be tailored to the unique features of the financing and the sponsors' and lenders' commercial objectives. For prospective purchasers looking to finance a project acquisition, financings often draw characteristics from both paradigms. Blending these two approaches into a hybrid structure can present opportunities and challenges.

Determining how best to blend these characteristics requires a firm grasp of both approaches. The nature of the project being acquired will, of course, go some way towards informing the approach taken: an infrastructure project in Western Europe, where construction has been completed and a successful operating history demonstrated, will have a financing package bearing many features of an LBO financing of an equivalent credit in other sectors. In contrast, a mining or energy project in an emerging market that remains under construction will likely bear many more of the hallmarks of a traditional project financing, with sponsors and lenders needing to grapple with issues including political risk, completion risk, technical risk, market risk and environmental and social risk.

Other factors can also play a significant role in the direction that a financing takes. For example, are the teams structuring the financing at the banks and advisory firms primarily acquisition or project finance practitioners, or do they have the flexibility to operate in both spaces? It is imperative that purchasers and their advisers encourage flexibility from finance sources or the financing may get held-up or derailed by an off-market approach in either space. Will the loan be syndicated and, if so, will it be sold in the leveraged finance market or the project finance market? Savvy and well advised purchasers may strategically target their debt offerings to ensure they benefit from maximum available liquidity, beneficial pricing or other favourable terms that a particular market or markets might offer at that time. Borrowers are also increasingly targeting separate debt tranches at specific classes of non-bank investors who can offer bespoke financing solutions, albeit often at a higher cost and in limited amounts.

The two markets have distinct advantages and disadvantages. Acquisition financiers will be accustomed to moving quickly in line with the acquisition timetable, will expect lighter operational covenants and can perhaps access greater liquidity for some assets (at least in the commercial bank market). Project financiers will generally be better versed in understanding and accepting technical risk, market risk and political risk, and will often be able to offer longer tenors. A careful balancing exercise will need to be conducted and a clear picture of the purchaser's objectives and the fundamentals of the asset being acquired should be used to determine the optimal approach or blend of approaches to take.

Sponsors may also wish to consider bifurcated project company and holdco level financings, with the acquisition consideration financed

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TABLE 1 - COMPARING PF AND LBO

	Traditional Project Finance	LBO Acquisition Finance	Typical Hybrid
Recourse to sponsors	Recourse until completion if there are sponsor completion guarantees, otherwise non-recourse	Non-recourse	Generally non-recourse (post-completion)
Time to implement	Relatively slower	Relatively faster (based on acquisition timetable)	Needs to meet acquisition timetable
Security	All asset security package (including structured project accounts), with few negotiated exceptions	Security over specified material assets based on agreed security principles. Security granted at or before closing may be limited to acquisition vehicle	Security package limited to actions within the control of the purchaser as a condition to first drawdown, with reasonable efforts obligation to grant perfect customary project finance security package post-closing
Operational covenants	Detailed operational and reporting covenants	Relatively fewer operational and reporting covenants	Based on a project finance covenant package, but can usually be adjusted to meet purchasers' reasonable commercial objectives
Financial covenants	Varies, but key covenant is Debt Service Coverage Ratio (often on an incurrence-only basis) and sometimes Loan Life Coverage Ratio	Varies, but rarely any financial covenants, other than a springing leverage ratio on a revolver	Varies, but key covenant is generally Debt Service Coverage Ratio (if any)
Tenor	Long term debt: often 10-15 years	Short to medium term debt: up to 7 years	Varies depending on how financing is positioned
Conditions to drawdown at closing/commitments	Extensive, including all asset security and project/business-related conditions	Certain funds; conditions limited to those that are within the control of the purchaser at closing, without reference to project company	Certain funds with limited conditionality
Due diligence	Detailed due diligence process, with independent lenders' consultant reports for certain key areas	More limited due diligence, primarily based on sell-side reports and (where applicable) buy-side reports. Well established process of disclosure and reliance	More limited due diligence, primarily based on seller and purchaser reports (although some lenders may seek independent reports)

separately from the project level debt in the LBO and project finance markets respectively. For example, when an MMG-led Chinese consortium acquired the Las Bambas copper project in Peru from Glencore, the financing involved a US$969m acquisition facility with a seven-year tenor for the purpose of funding part of the acquisition consideration and a US$5,988m project facility with an 18-year tenor for the purpose of funding on-going project costs. Both facilities were provided by a group of Chinese banks.

Other highly structured financing arrangements are becoming increasingly common, often involving multiple tranches of debt with different terms aimed at specific investor classes.

Existing project debt

Before even considering the nature of the new financing in connection with an acquisition, a threshold question will be whether there is existing project-level debt in place and, if so, whether the purchaser would like to maintain that debt following completion of the acquisition or intends to refinance it. A number of factors will play into this decision, including:

- Whether better economic terms might be available in the market;
- Whether the terms of the existing financing afford sufficient operational flexibility given the purchaser's intentions for the project;
- The tenor of the debt, repayment profile and whether the purchaser wishes to push out the loan life; and
- The costs involved in prepaying such debt.

While prepayment fees, other than break fees, are unusual in bank loan facilities, certain export credit agency (ECA) lenders, commonly the financiers of greenfield development projects, require these. In addition, some ECAs require a proportion of the margin to be paid upfront as a premium, which may not be refundable upon prepayment. Bond financings usually have a no-call period during which the redemption of the bonds would require payment of a make-whole amount, derived from a formula based on the net present value of scheduled interest and principal payments. In any of these circumstances it may be prohibitively expensive to refinance the existing debt, unless an alternative arrangement can be negotiated.

Many project financings, in common with many leveraged financings, include change of control provisions or transfer restrictions, particularly prior to the satisfaction of the completion tests, and the lenders will often have a right to require prepayment unless either a waiver can be agreed with the banks or they opt not to exercise their prepayment right. Early engagement with the existing lenders will be essential to understand the approach they will take. Where ECAs are part of the syndicate they may have less appetite for continued involvement following completion of the acquisition than commercial banks given their different objectives, especially where financing was originally provided on an export-tied basis – ie, financing of goods or services from their home country, typically procurement of the plant and construction services – and construction has been completed, or where an equity participant from their home country is exiting the project, but their approach can vary.

Where existing debt is being refinanced, care should be taken to ensure that the process of refinancing is smooth, particularly where indemnities benefiting the existing lenders will survive completion. Again, additional considerations will apply where ECAs are involved – as governmental or quasi-governmental entities these lenders control public funds and so often exercise a greater degree of conservatism than commercial banks might. ECAs will also generally require a lengthier internal approval process, meaning that they may not be able to respond as quickly as the purchaser and seller would like. Experience of dealing with these entities is a significant advantage, allowing purchasers to anticipate and address potential concerns and requirements that might otherwise cause delays. If consent to maintain an existing project financing in place cannot be obtained prior to closing, purchasers might consider arranging a backstop financing, perhaps as a bridge facility, that can be used to refinance the existing project debt should that be required.

Holdco financings

Most LBOs involve debt being raised through a special purpose vehicle established to enter into the acquisition agreement (Bidco) or, less frequently, by the target or project company itself – subject to prohibitions on using the assets of a target company to finance the purchase of its shares – financial assistance – in some jurisdictions.

Holdco loans, also known as mezzanine loans or back-leverage, involve finance being raised by an entity that sits above the project company in the corporate structure and that will be structurally subordinated to debt at project company level. In the US, Holdco loans are frequently used in structures designed to take advantage of tax-equity financing that is available for certain infrastructure investments but they have become increasingly common for other reasons. Bifurcation of the financing in this way may be attractive where there is a desire to maximise leverage, benefit from optimal terms or to finance acquisition consideration separately from the project level debt.

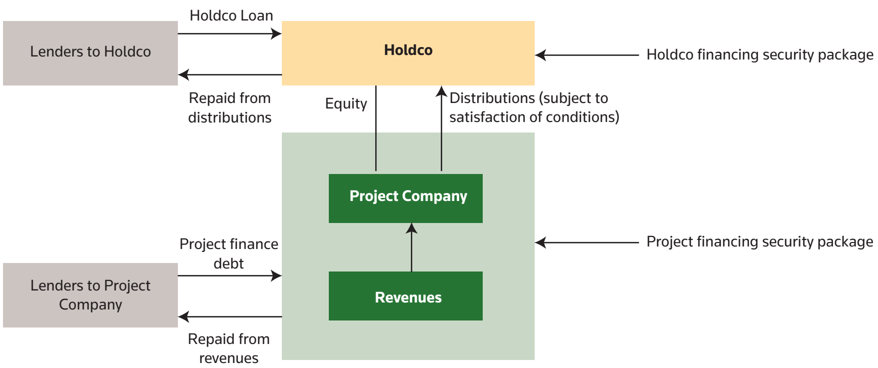
Holdco financing models have also been used in offshore wind projects in Europe and Asia, for example in asset rotation models where the developers may finance their share of capex on their balance sheet, while institutional investors acquiring an interest in the project raise non-recourse project finance on their equity share.

Holdco financings can be utilised whether the purchaser plans to maintain existing project level debt or to refinance it. However, existing project finance debt, particularly outside the traditional infrastructure space, can present challenges and will need to be carefully analysed to determine whether a Holdco financing can be layered on.

In a Holdco financing, the financiers are repaid primarily from cash distributions that are made by the project company. Most project financings will include conditions to making distributions with a full lock-up where these are not met. For some assets, cash sweeps are common and require all or a large proportion of distributable cash to be applied to repay the project finance debt on an accelerated basis in certain circumstances. This can lead to insufficient cash being distributed to service the Holdco debt.

If a Holdco loan is put in place as part of a coordinated financing effort at both project and Holdco levels, there will generally be scope to reach agreement regarding minimum distributions and cash-sharing arrangements for the benefit of the Holdco financiers. However, where an existing financing is being retained it is unlikely to be possible to renegotiate the terms to achieve this prior to closing (and the sponsor will have limited leverage in negotiations with existing lenders). In the absence of an arrangement that makes a Holdco financing bankable, it is likely that some form of limited

FIGURE 1 - HOLDCO AND PROJECT COMPANY MODELS



sponsor support would be required, at least as a bridge through to a refinancing of the project level debt on satisfactory terms.

Holdco financings where there is a separate financing at project level do not typically benefit from security over the shares in the project company or its rights and assets, which would be part of the collateral package granted to the project financiers, but would instead have security over the borrower of such financing (holdco) and its bank accounts. The ability to enforce this security following a default without giving the project financiers the ability to enforce their security at the project level – which could cut off the distributions that are the sole means of servicing the holdco loan (absent sponsor support) – will be critical.

The terms of most project financings include transfer restrictions that could trigger an event of default or mandatory prepayment if they are breached. The holdco financiers would typically want any enforcement action that they take to be expressly permitted under the project finance terms, but that will be a matter for negotiation and may be contentious where significant value is attributed to the expertise of the sponsor as the manager or operator of the project. Where there is no project level debt there will be much more flexibility and an investor buying an interest in a project would be able to pledge its shareholding in the project company in favour of its lenders.

Notwithstanding the potential challenges where there is an existing project financing (and certain other issues that are beyond the scope of this article), Holdco financings are a valuable tool in the toolkit of sponsors.

Commitments

The majority of disposals of project assets are the result of a competitive auction process. Participants competing to be the winning bidder are usually compelled to accept an obligation to complete that is not conditional upon obtaining financing. Sellers now generally expect a debt commitment letter to form part of the bid package and will analyse the conditions to the commitment in detail. The debt commitment is critical to deal certainty (for both seller and purchaser), will affect the final selection of the successful bidder, and failure to ensure that financing is available at closing can be catastrophic.

For this reason, purchasers typically insist that their banks provide a commitment to lend where all the conditions are within the purchaser's control. This is known as a certain funds commitment, sometimes referred to as SunGard provisions in the US. Where this approach is taken, the commitment letter will provide for a comprehensive list of fundamental conditions to funding and will not restrict the borrower from drawing if these conditions are met.

This requires a major shift in mind-set for project financiers accustomed to lengthy lists of conditions precedent that are verified and refined during the detailed due diligence process, although much will depend on the nature of the asset and its stage of development. The state of unease at "certain funds" provisions felt by project financiers is often compounded by the more limited and expedited due diligence associated with an auction process. Where lenders might ordinarily benefit from detailed reports from their own advisers and several months to consider and discuss the issues, they are often being asked to provide a commitment letter quickly and at an early stage in the process.

What is more, the SPA will usually restrict the borrower's ability to add additional conditions later if issues are discovered by the lenders. The difficulty in obtaining firm commitments from project financiers might steer purchasers toward the LBO market, although this can sometimes be more expensive or only be available for insufficient tenors. Those banks that can offer a hybrid product will be sought after and benefit from opportunities in the space. It is interesting to note that these challenges can affect the price that is offered by purchasers in an auction and so reduce the consideration received by sellers that place a premium on maximising deal certainty.

While there is no easy answer, purchasers can smooth the process by engaging with the lender group as early as possible in the process, ensuring that consultant reports can be shared with the lender group in good time before the final commitment is made and that consultants are available to answer questions and resolve issues as early as possible in the process. While purchasers may understandably be reticent to spend time and money on this process before winning the bid, this may be necessary where a strong commitment letter is perceived as important to the strength of the bid.

Due diligence

The due diligence process is required to give the purchaser and its lenders a thorough understanding of the project and its risks, so that they can be evaluated, allocated and priced effectively. While the scope of due diligence for an LBO financing varies considerably depending on the nature of the business and transaction, it is safe to say that it is more limited than for a typical project financing. Sell-side reports often form the bulk of the due diligence with limited buy-side due diligence and even more limited lender due diligence.

In contrast, it is customary in the project finance market for reports to be prepared by consultants engaged for the benefit of the lenders. Such reports can be time-consuming and expensive to obtain and, in the case of at least

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the technical report, usually require a site visit. In an acquisition where the purchaser has obtained its own report on the project, engaging a second consultant to carry out what will effectively be the same due diligence on behalf of the lenders will usually be unattractive. It would likely also be difficult to secure full seller cooperation to engage with a second consultant given the disruption and drain on time and resources for the seller's management this can cause.

In the context of project acquisitions, in our experience most lenders are ultimately able to take a pragmatic view and accept the sell-side and buy-side reports as the basis of their own diligence, providing their coverage is sufficiently broad and they are given reliance upon it. We have seen some lenders insist on separate reports prepared for their benefit, particularly in the case of the technical report for projects where the perceived technical risk is high. Purchasers should consider agreeing the scope of reports at the initial pre-qualification stage in the process to avoid these issues arising later in the process. When engaging consultants to provide any buy-side reports, it will also be important to ensure that these can be relied upon by the financing sources.

Much will depend on the timetable for the acquisition and the competitiveness of the sale process. A tight timetable and a highly competitive process will require purchasers and their lenders to accept more limited diligence if they are to be successful. Every project will fall somewhere on the spectrum for complexity and stage of development that will dictate the level of due diligence that is necessary and appropriate, and all parties will need to be pragmatic.

Security

Both LBO finance and project finance typically involve the taking of security over the target's shares, assets and cashflows. In the case of project finance this tends to be quite rigidly applied, with "all-asset" security the paradigm and exclusions from the security package specifically negotiated. For LBO financing, the security package is generally based on a set of agreed security principles that reflect an overriding cost/benefit analysis and as a result is much more limited – although similar limitations can also apply on certain project finance deals with strong sponsors and a good credit story. Strong sponsors will often try to limit the security package to share security and security over bank accounts and intercompany loans.

This tends to be a heavily negotiated area and there is no one-size-fits-all approach, but in our experience purchasers are typically able to secure bank commitments that are conditional upon security within the control of the purchaser being put in place at closing with a reasonable efforts obligation to put other security including any direct agreements in place as soon as possible after completion of the acquisition. While the precise nature of the post-completion security package will be negotiated, the starting point tends to be the project finance blueprint (with the obvious exception of holdco financings).

In LBO financings, security over the acquisition vehicle is typically put in place on the closing date, with a period of up to three months post-closing in which to perfect security over the shares in material subsidiaries and other assets. This can be a challenge for the acquisition of projects. First, projects typically comprise a single main asset, eg a mine, LNG plant or wind farm, with all or the vast majority of the project's cashflow generated under a handful of key contracts. Lenders may be nervous about there being a lengthy gap in taking security over such key assets and contracts following closing.

Second, project finance lenders are accustomed to all or virtually all security being granted at closing and are therefore more troubled by having outstanding loans that do not benefit from full security than those versed in acquisition finance. To address this, on some occasions banks have sought second-ranking security that automatically steps up to become first-ranking security at closing. In our view, this approach could only survive a cost benefit analysis in very rare circumstances. Holdco financings would be much more straightforward with no project level security granted.

Alternative financing options

Limited recourse financing will not be the right tool in all circumstances and other options could be more appropriate. A corporate purchaser may wish to raise debt on its own balance sheet or fund the acquisition out of cash reserves. If the purchaser is a substantial entity with a strong credit, this debt may have lower fees and margins, be unsecured and have more limited covenants – although it would usually be full recourse to the purchaser's business and assets (in contrast to project level finance where post-completion recourse would be limited to the project).

Sponsors may also wish to consider bridge financing, with or without corporate guarantees, with a view to a later refinancing. One motive for this is that significantly faster deal execution can be achieved as a result of the more limited due diligence process and simpler negotiation of the covenant package based on the sponsor's credit.

It may also be possible to put in place a project bond, for example a Rule 144A/Reg S structure, to finance a project acquisition, perhaps with the back-up of a bank commitment to provide more certainty if the bond market is not available, at least on more attractive terms, at the time the acquisition closes. As an alternative, deals may also be structured with the intention of a prompt refinancing of bridging bank debt in the capital markets.

Although timing issues for issuing project bonds to finance acquisitions can potentially be dealt with through the use of closing escrow account structures, other issues to consider, and if possible build into SPA financing cooperation terms, will be driven by the high level of co-operation in diligence matters required from the seller/the target, particularly in order to achieve the required standard of financial disclosure.

The level of diligence required to meet the disclosure standards required in the bond markets, for both legal and marketing purposes, will most likely go beyond the level of diligence typical in an M&A process. Although the exact disclosure package will be developed as a part of an iterative and deal-specific process, it is likely, for example, that target management would need to be available to assist with the due diligence process, including preparing a description of the business, answering due diligence questions from underwriters and their counsel on the target's financials and operations, and potentially preparing pro forma financial statements. In addition to required financial statements (audited and management accounts), the target's auditors would need to consent to the disclosure of audit opinions and delivery of comfort letters in the required form, with bring-down at settlement of the project bond.

Conclusions

Financing the acquisition of projects and other infrastructure assets requires sponsors and lenders to adopt a flexible and pragmatic approach. Sponsors should consider how best to target their financing and be prepared to include features of both the project and acquisition finance markets as well as proactively anticipating the requirements of both existing and new lenders in order to achieve a timely and frictionless closing. Lenders and their advisers participating in this sector need to appreciate the requirements of a bid process and be prepared to move forward on an acquisition finance timetable.

While the timeline for an acquisition financing is generally shorter than that for a project financing, where banks agree to rely on the same due diligence reports as the purchaser there is really no reason why this process cannot be compressed to fit the typical acquisition finance timetable.

This is not a market that all lenders will be comfortable operating in. However, we continue to see the emergence of new players on the lender side that see good opportunities. More nimble private credit operators are becoming more experienced in assessing project risk and are able to provide bespoke products that can be tailored to meet the requirements of sponsors and investors in a way that the traditional bank market in both the project and LBO spaces cannot.

In our experience, where the sponsor and lender side parties approach deals with the right mind-set, lenders and sponsors working constructively together can reach pragmatic solutions to the issues that arise. As more and more deals are completed, each side's expectations are becoming better understood, leading to a more streamlined process.

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