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Restructuring  
infrastructure  
Bridging the gap



# Preface

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When infrastructure deals go wrong, restructuring them can become spectacularly complex, particularly when resolution processes put in place at deal inception are largely theoretical rather than based on prior restructuring experience.

So, how can infrastructure investors bridge this gap between theory and practice to enable successful restructuring of infrastructure assets? Where are the risks and what are the key components to a successful resolution?



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“Might this be a good time to increase public infrastructure investment? In advanced economies an increase in infrastructure investment could provide a much-needed fillip to demand, and it is one of the few remaining policy levers available to support growth, given already accommodative monetary policy. In developing economies it could help address existing and nascent infrastructure bottlenecks. And in all economies it would help boost medium-term output, as higher infrastructure capital stocks expand productive capacity.”

IMF, *World Economic Outlook October 2014: Legacies, Clouds, Uncertainties*, pp.75-76

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“Why does the IMF reach these conclusions [that now is a good time to increase infrastructure investment]? Consider a hypothetical investment in a new highway financed entirely with debt. Assume – counterfactually and conservatively – that the process of building the highway provides no stimulative benefit. Further assume that the investment earns only a 6 per cent real return, also a very conservative assumption given widely accepted estimates of the benefits of public investment. Then, annual tax collections adjusted for inflation would increase by 1.5 per cent of the amount invested, since the government claims about 25 cents out of every additional dollar of income. Real interest costs, that is interest costs less inflation, are below 1 per cent in the US and much of the industrialised world over horizons of up to 30 years. So infrastructure investment actually makes it possible to reduce burdens on future generations [...] Deferring infrastructure renewal places a burden on future generations just as surely as does government borrowing.”

Lawrence Summers, ‘*Why public investment really is a free lunch*’, *Financial Times*, 7 October 2014

# Introduction

## As more and more capital flows into infrastructure, why worry about restructuring?

Most governments understand the long-term social, economic and political benefits of encouraging infrastructure investment. Many investors are attracted to the sector, too: Prequin has recently estimated that fund managers globally have allocated 5.7% of their assets under management to infrastructure.<sup>1</sup> Given that private equity funds are currently targeting \$775bn of fundraisings, and there is also a great deal of interest in direct investment into infrastructure from pension funds and sovereign wealth funds, as much as \$100bn could flow into this asset class globally over the next 2-3 years. These sums are huge, reflecting the fact that increasingly diverse sources of capital are being attracted to an asset class which offers direct exposure to the most profound changes in our modern world, including population growth, urbanisation and rising energy demand.

However, some infrastructure deals do go wrong and require company or creditor-led restructuring. Key characteristics of projects which may be at risk include projects with:

- Revenue or demand risk – e.g. toll roads and rail franchises;
- Significant life-cycle or mid-term investment costs, particularly where there is risk exposure to factors such as high construction inflation (e.g. energy and low carbon investment); or
- Ambiguity on the basis of payment or performance where the grantor may be able to exercise material judgement surrounding performance or, in the extreme, potential termination issues.

As an asset class, the profile of infrastructure assets is generally compelling for investors. In many deals, revenue streams are protected by contract, a natural monopoly and/or a captive customer base, whilst heavy upfront costs create high barriers to entry. For the biggest 'real money' investors with long-term horizons such as pension funds, sovereign wealth funds, life assurers and family offices, the returns profile from infrastructure investing offers stable, reliable cash yields correlated to GDP growth and sometimes linked to inflation – well suited for liability and duration matching.

Furthermore, in recent years an increasing body of research has shown that in a world where the performance of financial assets has become increasingly correlated, holding the right pool of infrastructure assets can provide genuine portfolio diversification.<sup>2</sup>

Broadly speaking, "core" infrastructure is a sector in robust health. The latest triennial Deloitte survey of infrastructure investors found that approximately 70% stated that their portfolios were achieving or exceeding their target IRRs.<sup>3</sup> Infrastructure projects rarely go wrong: historical default rates have been encouragingly low for this asset class. But when deals do go wrong, restructuring them can become spectacularly complex. The very qualities that make infrastructure assets so attractive to investors – the essential nature of the service to the wider public, strong regulatory oversight and watertight contractual frameworks – tend to magnify the difficulties of a workout. And financial problems which spill over into operational performance can create issues which rise rapidly up the political agenda: recall the public outrage over US energy blackouts a few years ago.

In social infrastructure deals and many in the PFI-PPP space, public authorities retain the ability to step in and retake strategic control of the asset in the event of operational or financial failure. Such control – whether via a Golden Share arrangement, step-in rights within a concession framework, or a 'direct agreement' between the public authority and the secured creditors to an infrastructure project – typically creates a complex contractual matrix where the normal dynamics of a financial restructuring (new money requirements, valuation considerations, creditor priority waterfalls) need to be supplemented by a more nuanced understanding of what the real options are for each stakeholder following an event of default.

This paper introduces some of the components contributing to that complexity and sets out a tried and tested approach to resolve distressed situations in the infrastructure sector.

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1 *Prequin Investor Outlook: Alternative Assets H1 2015*, available at [www.prequin.com](http://www.prequin.com)

2 e.g. Credit Suisse Asset Management, 'Can Infrastructure Investing Enhance Portfolio Efficiency?' by David Russ, Yogi Thambiah and Nicolo Foscari, May 2010.

3 *Where next on the Road Ahead?* Deloitte Infrastructure Investors Survey 2013.

# Assessing the risks

## Which deals are most exposed?

Logically, an asset which bears significant volume risk or cost risk will be more exposed to distress than a regulated utility, and should therefore be financed more prudently.

Infrastructure is a highly diverse asset class which is treated in different ways by different countries and can therefore be segmented in various ways. From a risk perspective, we find it helpful to think about the market broadly in terms of three segments:

### 1. Project infrastructure

Typically characterised by:

- Project-based structures, often via a thinly-capitalised special purpose vehicle funded with long-term project finance
- Contracted revenue base
- Availability-based revenue streams.

*Examples include PPP/PFI deals, infrastructure services, schools, hospitals, prisons, shadow toll roads and telecoms towers.*

### 2. “Infra-plus”

Typically characterised by:

- ‘Real’ businesses operating in competitive markets
- Likely to bear volume risk.

*Examples include airports, ports, ferries, passenger and freight rail concessions, waste collection/processing and user-pays toll roads.*

### 3. Regulated infrastructure

Typically characterised by:

- Regulated asset base
- Quasi-monopolistic utilities
- Strong regulatory oversight and influence over capex and distribution policy.

*Examples include water, gas, electricity, renewables and rail track and signalling.*

In principle, the risk-reward balance is the same in infrastructure as in any other sphere of investing: situations which offer investors the greatest possible upside are usually those which contain the highest risk. Logically, therefore, it is more likely that an asset which bears significant volume risk, cost risk or ‘merchant risk exposure’ (as in parts of the energy industry) will be more exposed to distress than a regulated utility with a stable pricing environment and a pre-approved capital expenditure programme, and should therefore be financed more prudently.

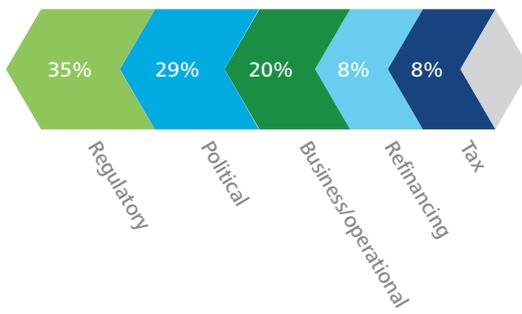
In our experience, **the risks in project infrastructure deals tend to emerge from the long-term nature of the projects and the need to make long-range forecasts on imperfect information.** Under-estimating future capex and maintenance costs is not uncommon, and finely-balanced operating models with RPI-linked revenue streams can fall apart simply because construction inflation can materially exceed RPI (and indeed has done so for the past three to four years in many countries). A similar issue arises in concession-based projects – where an operator is paid revenue by a public authority on an availability basis – due to inaccurate forecasting and poor understanding of the relevant availability metrics or mid-term lifecycle costs when the deal was originally structured.

**We have seen a number of older infra-plus deals bearing volume risk which show evidence of a “winner’s curse”** – i.e. where bidders have over-estimated future demand and therefore over-valued and over-leveraged their assets. “Winner’s curse” is less prevalent now, but it is easy to overlook the fact that, even where an asset benefits from decades of stable demand, circumstances do change: rapid changes in technology, commodity prices and consumer preferences can undermine seemingly robust business plans with startling speed. Environmental and regulatory risk is also hard to predict: the impact of public policy on the waste sector (notably increases in landfill tax) has crushed the profitability of a number of substantial companies across Europe in the past three to four years.

# How safe is regulated infrastructure?

Regulated infrastructure ought to be the most resilient part of the market. The risks on the delivery side arise primarily due to poor cost management or an operator’s inability to deliver the agreed investment programme within the relevant Control Period. But interestingly, Deloitte’s latest survey of infrastructure investors<sup>4</sup> showed that regulatory risk was of increasing concern when compared with the previous survey undertaken in 2010.

**Figure 1. When considering whether to invest, what are the key risks which concern you?<sup>5</sup>**



This reflects the fact that the regulated space has recently created some unpleasant surprises for investors. High-profile examples of why the perception of regulatory risk has increased include the Norwegian government’s decision to reduce tariffs on the Gassled system, the uncertainty created by the UK water regulator around the commercial terms of the latest price review, and the French government’s decision in early 2015 to freeze toll road tariffs.

The renewables sector has been particularly hard-hit by regulatory action. Across Europe (and elsewhere, including Japan), governments have been looking at amending the generous subsidy schemes they put into place to encourage investment in renewable energy installations (see Figure 2 below). The objective of the amendments has been to reduce and control the significant cost of these subsidies to the public purse, but the changes have dramatically undermined the financial stability of many existing projects and have pushed some into default. Litigation has already started in Spain, and in some cases investor confidence has been dramatically undermined by governments’ apparent willingness to change the rules without consultation.

Regulated infrastructure ought to be the most resilient part of the market, but the regulated space has recently created some unpleasant surprises for infrastructure investors.

**Figure 2. Jurisdictional changes to renewable feed-in tariffs**

<p><b>UK</b> </p> <ul style="list-style-type: none"> <li>Changes to the FiT regime introduced in 2011 were struck down as unlawful by the High Court in July 2014</li> <li>Current threat is the proposed termination of the Renewables Obligation in 2015, 2 years ahead of schedule</li> <li>This is being challenged again in the courts on the grounds that it is a retrospective change</li> </ul>	<p><b>SPAIN</b> </p> <ul style="list-style-type: none"> <li>Changes to the ‘Special Regime’ consolidated by a revised law passed in June 2014 (RD 413/2014) which brings together a string of previous laws passed since 2010 to reduce subsidies and replace the FiT regime with a subsidy based on ‘reasonable’ operational and financial returns</li> <li>New law gives government the flexibility to make further changes in future</li> <li>Government actions are subject to increasing levels of litigation by investors</li> </ul>	<p><b>GERMANY</b> </p> <ul style="list-style-type: none"> <li>Subsidy cuts first made in 2013</li> <li>Further proposals have been made to change the financial support provided to renewables, but understood to be targeting new projects (2014 onwards)</li> <li>Germany faces broader energy policy challenges due to the decision to retrench from nuclear after the Fukushima reactor collapse in Japan – situation remains in flux and politically toxic.</li> </ul>	<p><b>AUSTRIA</b> </p> <ul style="list-style-type: none"> <li>2014: reduction in green feed-in tariffs</li> </ul>
			<p><b>ITALY</b> </p> <ul style="list-style-type: none"> <li>Proposed reform to reduce existing FiT for solar installations</li> <li>Impact remains uncertain and is suppressing new investment activity</li> <li>Early days – implementation of tariff reform is some months behind Spain</li> </ul>

4&5 Where next on the road ahead? Deloitte Infrastructure Investors Survey 2013

# Impact of financing arrangements on project risk

Problems have arisen where debt packages have been designed to facilitate early dividend repayments to sponsors.

In an ideal world, deals would be structured and financed appropriately for the level of underlying business risk. However, with excess capital chasing too few deals, this is not always the case. In addition, creditor enforcement mechanisms can be highly complex, whether or not this is contemplated in the underlying documentation. So care is needed in any contingency planning to protect creditors' interests and, potentially, allow for shareholder returns either through a creditor-led process or a consensual deal involving all investors. When appropriate, a process may also require regulatory intervention or agreement with the grantor of a concession, franchise or licence.

## Project finance

For deals funded with project finance, Moody's analysis has shown that historical default rates are broadly consistent with single-A credits within ten years of a project's financial close (Moody's memorably describes this improvement in credit quality over time as a "seasoning characteristic").<sup>6</sup> This does not detract from the fact that project finance deals are highly structured and small changes in costs can have a material impact on the financial performance of the project, determining whether creditors or investors can be kept whole or require a restructuring. The fact that relatively few project finance deals have required restructuring is attributed to the market practice of robustly stress-testing the original structures to withstand a wide range of potentially severe risks so as to minimise any post-default economic loss to creditors.

## Leveraged deals

Where we have seen more problems is in long-dated projects financed by shorter-term debt packages following the increased participation of financial sponsors in the infrastructure sector. This was a particular feature of the 2005-07 leveraged finance boom, where debt was available so cheaply (and with relatively high gearing levels) that private equity groups began to buy brownfield infrastructure assets backed by five to seven year LBO-style (leveraged buyout) debt facilities in the hope that regular refinancings could facilitate larger and more frequent dividend recapitalisations in the early years of a buyout. Recent examples in the European market have included regional airports, toll roads, waste collection and processing groups.

## Swaps

Interest-rate swaps (or equivalent bond breakage costs) have also proved to be a headache on many deals due to the prolonged low interest rate environment creating large out-of-the-money (OTM) swap positions. Sometimes the hedging has been mismatched (e.g. short-term debt has been rate protected with long-dated swaps) which means that on a default, an OTM swap position crystallises which is very large compared to the term debt, which can create intense inter-creditor conflict – particularly where there are cross-holdings in the term debt and swaps.

In other situations, we have seen financial difficulties arise due to the aggressive structuring of the swap – for example, where floating rate debt is swapped into an accreting ratchet in order to conserve a project's cash flow (or to facilitate a dividend) in the early years of a deal, but the project's cash flows fail to grow as quickly as anticipated to meet the accreting swap payment obligations. In a small number of deals, we have also seen inflation swaps create large OTM positions, gaining their holders an unexpected – but influential – seat at the restructuring table.

<sup>6</sup> *Default and Recovery Rates for Project Finance Bank Loans, 1983-2012*, Moody's, 19 June 2014

# Bridging the gap

## How to approach a distressed infrastructure deal

It has been said that every restructuring turned on a fact or an event that was not foreseen at the start of the process. These facts are not typically recognised or understood simply because very few people look at performing assets through the eyes of a restructuring professional. This explains why infrastructure restructurings can become so complex: the resolution processes put in place at the inception of a deal are usually theoretical rather than based on prior experience. For example, it remains exceptionally rare to see a government authority deploy its step-in rights following a project default.

### How can this gap between theory and practice be bridged to enable infrastructure assets to be successfully restructured?

The reality of modern restructurings is that each stakeholder considers its own interests and options, and acts accordingly. Consequently, the possibilities for aggressive positioning by certain stakeholders who are prepared to take ransom positions are magnified by the fact that there are likely to have been few, if any, relevant precedents for others to assess whether the dissident stakeholder has real scope to hold out for a deal which meets their own requirements, or is simply grandstanding.

Having restructured a wide range of infrastructure assets across Europe, we recognise that, in seeking to resolve issues within infrastructure projects, the solution must be positioned to meet the specific needs of project stakeholders, recognising the significant creditor interest (potentially up to 90% of invested capital) and the role of the supply chain in maintaining and operating the infrastructure.

Understanding which of the stakeholders has the power in a restructuring negotiation is critical. Having stabilised the liquidity position of a project in crisis, therefore, one of the first pieces of analysis required is a 'stakeholder analysis' which builds on a review by a project's lawyers of the relevant concession agreements, key contracts and financing documents in order to form a tactical view on the relative commercial standing of the different stakeholders. The stakeholder analysis will look at, amongst other things, the group and security structure; key stakeholders and relative standings; contracts and commercial implications of default, termination, or insolvency; strategic options and associated benefits, risks and issues; and potential implementation routes, including government/regulatory approvals/blocking rights, inter-creditor dynamics and voting analysis.

Understanding which of the stakeholders has the power in a restructuring negotiation is critical.

Figure 3. Illustrative approach to restructuring infrastructure assets



# Implications for infrastructure investors

The key messages from this paper for infrastructure investors are:

- Infrastructure projects rarely go wrong: historical default rates have been encouragingly low for this asset class. But when deals do go wrong, restructuring them can become spectacularly complex.
- Investors need to be particularly cautious when acquiring and financing projects based on long-range forecasts formulated from imperfect information, particularly deals bearing demand or volume risk.
- It is always worth spending time at the outset of a deal thinking in some detail about the downside risk, and getting comfortable that the commercial and contractual mechanics in place to resolve any future issues are genuinely realistic and deliverable.
- If an existing project gets into trouble, one of the most important pieces of analysis to optimise an investor's negotiating leverage is to form a robust contractual and commercial understanding of the relative standing of each of the major stakeholders – and hence be able to optimise the investor's own negotiating strategy which reflects the reality of where the balance of power really sits.

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# Contacts

Contact the authors or our team at [infrastructure@deloitte.com](mailto:infrastructure@deloitte.com) to discuss what these insights could mean for your portfolio.



**Ben Davies**  
Director  
*Restructuring Services*  
+44 20 7303 5374  
[bedavies@deloitte.co.uk](mailto:bedavies@deloitte.co.uk)



**Christopher Blunt**  
Director  
*Government & Infrastructure, Financial Advisory*  
+44 131 535 7406  
[christopherblunt@deloitte.co.uk](mailto:christopherblunt@deloitte.co.uk)



**Nick Prior**  
Partner  
*Global Leader, Infrastructure & Capital Projects*  
+44 20 7007 9858  
[nprior@deloitte.co.uk](mailto:nprior@deloitte.co.uk)



**Jason Clatworthy**  
Partner  
*European Leader, Infrastructure M&A*  
+44 20 7007 6505  
[jclatworthy@deloitte.co.uk](mailto:jclatworthy@deloitte.co.uk)

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