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Infrastructure Funds – Key Features for NAV Facilities

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This article looks at the distinguishing features of infrastructure funds from a credit perspective, their typical funding requirements, and the potential lessons for NAV facilities to private equity funds.

While there remains some debate on the precise limits on infrastructure as an asset class, for the purpose of this article we will use infrastructure funds to refer to any fund established for the purpose of investing in a portfolio of assets comprising investments in PPP, energy (including renewables) and/or infrastructure projects that are characterised by their long-term revenues. Infrastructure funds commonly take the form of a limited partnership, but also include a number of publicly listed companies that have been spun-off by the major multinational construction companies over the last 10-15 years to hold their operational projects.

Distinguishing features of infrastructure funds

Historically, the larger European infrastructure fund structures were deliberately designed to mirror the structure of a private equity fund to attract investors familiar with this structure. However, infrastructure funds typically differ from their private equity counterparts in the following key respects:

- **Long-term/open-ended funds.** In line with the long-term nature of the revenues from the underlying assets, infrastructure funds are typically established as either long-term (10-12 years) private funds or open-ended private/public funds.
- **Predictable revenues.** The key feature of infrastructure funds from both an investor and a lender perspective is the stable and often inflation-linked nature of the revenues from the underlying assets. These revenues may be subject to deductions through underperformance or default under an underlying project agreement, but (at least for "availability based projects," *e.g.*, projects whose revenues are not dependent on demand) will otherwise usually be fixed under the relevant project agreement or underpinned by a government guarantee/contract for difference.

- **Back-dated funding obligations.** While the bulk of the funds' investment in a given project will be made at the start of the investment cycle (either in payment of the purchase price when acquiring an existing project or in funding the construction costs), the underlying project agreements will frequently involve contingent or back-dated liabilities (such as decommissioning obligations), which the infrastructure funds may look to satisfy through the provision of Letters of Credit or keepwell agreements supported by a long-dated revolving credit facility.
- **Embedded leverage.** As with private equity funds, the underlying investments will typically be highly geared at the level of the actual projects. The low interest rates available in recent years have seen a large number of refinancings of this underlying project debt. While the majority of these have been carried out at the project level, the last 2-3 years have seen a number of the European infrastructure funds use aggregators/portfolio facilities to consolidate the debt of multiple projects under a single common facility, relying on the diversified pool of revenues to obtain lower pricing.

Funding requirements

As with their private equity counterparts, private infrastructure funds will typically enter into subscription line facilities to bridge their investors' capital commitments. The underlying credit analysis for subscription line facilities is largely identical for infrastructure and private equity funds, but pricing in the UK market at least is often slightly lower in light of the reliability of the underlying revenues (although lenders' primary recourse is to the uncalled capital commitments of the investors).

Where infrastructure funds have historically differed from their private equity counterparts is the widespread adoption of NAV facilities. As we have previously discussed here, here, here and here, the last two years have seen a significant increase in private equity funds seeking NAV facilities. While this widespread adoption is relatively new in the context of "primary" private equity funds, NAV facilities have been a common feature of the debt structuring of infrastructure funds for the last 5 to 10 years due to their long-term ongoing debt requirements and the relatively stable nature of their valuations.

Infrastructure funds will typically use these NAV facilities to finance the acquisition of new assets, refinance existing equity or subordinated debt obligations of the funds within their existing portfolio, fund new equity or subordinated debt subscription obligations in connection with investments and to provide letters of credit in support of these obligations and the back-dated funding obligations referred to above. While historically, European infrastructure funds have typically put in place three-year NAV facilities, we have increasingly seen funds placing a premium on the flexibility to extend this period either by extending the term of the facility to five years at the outset or incorporating extension and accordion options.

Given the relatively predictable revenues, the margins on NAV facilities for infrastructure funds are often considerably lower than their private equity counterparts in the European market, and there has been less appetite for preferred equity solutions.

Valuation methodology

As discussed here in relation to private equity funds, an infrastructure fund will also likely have no real time public market price available in relation to its assets, and the lenders will therefore be reliant on the fund's valuation of its assets. As with private equity funds, the controls and checks on these internal valuations are central to the integrity of the financial covenants and are often the focus of negotiations on NAV deals.

Infrastructure funds' NAV is calculated on a discounted cash flow basis by reference to the projected cash flows for the individual projects. As these are relatively fixed contractual cash flows, these projections should be less subjective than the forecasts that feed into the calculation of the enterprise value in the context of a private equity NAV facility. However, the valuations remain subject to a number of operative assumptions relating to economic factors such as interest rates, inflation and tax rates, forecast events and cost savings relating to the individual projects (including cost savings that are anticipated from insurance or spares pooling, the refinancing of the project debt and the implementation of any variations to the projects), all of which will affect the overall NAV. To the extent the investments include either (i) projects with demand-based revenues (such as toll roads) or (ii) projects that are forecast to retain a residual value after the expiry of the guaranteed revenue period (such as renewable energy projects and train rolling stock projects in the UK), lenders will need to pay particularly close attention to the assumptions that feed into their valuation.

As with private equity funds, there is a need to balance the lenders' requirement for appropriate controls to ensure that any valuation is reasonable and conservative with the fund's desire to minimise the operational burden and cost associated with the regular valuations. While the approach adopted varies from deal to deal, we have typically seen a slightly more lender-friendly approach to external valuations adopted (in part as there are fewer variables that feed into the valuation process for infrastructure assets and the costs of external valuations are potentially lower), and we set out below some of the key features that we would expect to see:

- **External valuer approval of amendments to underlying assumptions.** As an initial step, lenders will need to carry out a comprehensive due diligence exercise on the economic assumptions set out in the model to ensure that they are satisfied with these. To the extent that any amendment is proposed to these assumptions or to the underlying valuation methodology, which would have a material effect on the calculation of the LTV (either as a result of the magnitude of the change in NPV or because the change would trigger the LTV to be breached/complied with), the consent of an external valuer will typically be required. As part of the legal due diligence, it is important to identify the reporting obligations imposed on the fund in relation to the valuation and the related definitions and concepts in the limited partnership agreement. These will necessarily form the basis for the reporting requirements under the finance documents, as the fund will need to ensure that there is no disconnect between the valuations that it is required to provide to its lenders and its limited partners.
- **Additional/External Valuations**. The timing for External Valuations is often the subject of commercial negotiation, but the principle that external valuations will be obtained periodically is less contentious than for PE funds, and external valuations are typically provided either (i) semi-annually or (ii) annually with the option for the Agent to require additional reviews, either if certain value triggers are met (such as a breach of the LTV covenant or a 50% reduction in the NPV of the Investments from their original value) or at any time at lenders' cost unless a Default is identified by the additional valuation. If the External Valuer proposes

a different valuation for the Investments or does not approve of any of the proposed assumptions or calculations, the valuation methodology will be adjusted for subsequent calculations in order to conform with the External Valuer's proposals.

- **Frequency of valuations – desktop vs full valuations.** As the valuations are necessarily historic, lenders are keen to receive full valuations on as frequent a basis as possible, and will usually want to see a calculation of the NAV in each quarterly management report. Due to the fairly onerous process of obtaining external valuations and the limited scope for fluctuations in the valuation of infrastructure assets, quarterly valuations will usually be prepared internally by the Borrower on a desktop "roll forward" basis (*e.g.*, on the basis of the last semi-annual valuation, but adjusted to reflect any acquisitions or disposals and the elapse of time). These desktop valuations will not necessarily take into account any external event or circumstances that would potentially have a material effect on the performance of an investment (such as the material reductions in demand over the last two years due to lockdown, which have necessitated the restructuring of various transport projects across Europe). In order to address this risk, lenders will need to understand the composition of the investment portfolio and (as set out below) will typically seek to impose various caps/haircuts on the proportion of the portfolio that may be invested in certain asset classes.

Portfolio composition

Alongside the valuation methodology, the other main source of discussion in relation to the NAV calculation will typically be the criteria that will need to be satisfied for an investment to constitute a Qualifying Investment and count towards the Adjusted NAV calculation. It will need to be restrictive enough to satisfy the lenders that the portfolio is one that they are able to take a credit risk on (particularly in light of the lower margins commonly seen on these facilities), and it will need to be permissive enough to allow the fund to acquire what they perceive to be valuable assets. This will usually start from the investment policy/investment criteria of the fund and will depend on the existing investments the fund already holds and what the lenders are willing to take credit risk on.

We frequently see investments in certain jurisdictions carved out of the Adjusted NAV either as a consequence of concerns about the overall credit risk of the relevant state or due to political concerns. While the fund should be largely protected through the compensation on termination provisions in the underlying project agreements in the event the public authority elects to voluntarily terminate, there may be a slight shortfall between the compensation proceeds and the published valuation of the project. For example, in 2018 the manager of one UK-listed fund issued an RNS announcement stating that in the event the government elected to voluntarily terminate all of its UK projects, it would receive cash compensation in an amount equal to 86% of the current published valuation of its UK projects.

In addition to the usual geographical considerations and concentration limits for single investments and/or asset classes, lenders will typically look to restrict the proportion of investments in construction phase and/or that are subject to demand risk. Given the very different risk profile associated with these projects, we have typically seen lenders seeking to cap their exposure to demand risk projects at 20-30% of the overall portfolio by value, save where the fund has been established specifically for the purpose of investing in demand-based assets. As any asset level facility will typically restrict the payment of distributions at any time that an Event of Default is continuing under the underlying facility, defaulting investments will typically be carved out completely from the Adjusted NAV.

As touched upon, we have recently seen an increase in the infrastructure funds introducing an additional layer of leverage between the fund level and the underlying investments. These portfolio financings typically entail the refinancing of a small sub-portfolio of investments (usually within a single asset class) that will be grouped together under a common holding company and will often benefit from lower pricing as the lenders at the portfolio level will benefit from greater diversification than the historic lenders to the individual investments. This does, however, present a challenge for the NAV lenders as any material issues affecting a single investment which forms part of a portfolio may result in a distribution block at the portfolio level. We have therefore seen lenders seeking either to treat all investments under a single portfolio financing as a single investment for the purpose of the concentration tests or having separate concentration limits for any portfolio financing.

Security considerations

Although it is more common for funds to have been structured from the outset in a manner that permits effective security to be taken in connection with any proposed NAV financing, given the multiple levels of debt within the structure, it is vital that thought is given to the interaction between the various funding requirements when setting up the fund structure in order to limit, as far as possible, the potential for overlap between the security made available to different lender groups.

It is very common for infrastructure funds to maintain subscription line and NAV facilities, but the holding company structures through which the funds held their investments were often developed without regard to the potential security requirements of NAV lenders. As a result (and given the difficulties of interposing new holding companies within an existing structure), a number of funds have elected to have the same entity act as borrower under both their NAV and subscription line facilities. The security available to the two lender groups are conceptually ring-fenced, with (i) the capital call lenders benefiting from a security assignment and power of attorney over the fund’s rights in respect of the commitments of the limited partners and the Investor Proceeds account and (ii) the NAV lenders taking security over all other accounts of the fund and all of its shares and other equity interests in the various holding companies that sit below the fund, but this remains a problematic approach from a legal and insolvency perspective and is not something that has typically been seen on the private equity NAV facilities. Following the *Abraaj* and *TCA Global Credit Fund* cases, the relatively relaxed approach that lenders have adopted to the intercreditor issues arising from the overlap between their respective facilities may fall away, and we may see either an increased push for formal intercreditor arrangements where lending to the same entity or (in line with the approach adopted by private equity funds) the NAV facility may need to be moved into an aggregator vehicle that sits immediately below the fund.

Due to the nature of the bidding process for infrastructure assets, the underlying investments will typically be highly geared, and each of the underlying project level facilities, the project agreement and any shareholders agreement relating to the underlying investment will often impose restrictions on change of control and the grant of security. In contrast to private equity investments, where the change of control restrictions will often look through to the ultimate fund manager, the drafting of these restrictions on infrastructure assets varies considerably. The restrictions will often only go as far as an intermediate holding company and will not extend to the Fund or its immediate subsidiaries from whom security is being sought, but this is not necessarily always the case.

In order to limit the level of due diligence required on the change of control provisions in the underlying documents, share security is typically therefore only taken at the level immediately below the fund (and crucially at a level that ensures that no direct share security has been granted by any holding company that is a party to the underlying finance documents for the investment). Where this isn't possible (*e.g.*, as a result of the holding company for an investment being a direct subsidiary of the fund), this can result in the investment having to be carved out of the security (and therefore the NAV), unless a comprehensive due diligence exercise is carried out on the underlying documents and, if necessary, any consents or waivers are obtained (it would be unusual for such consents to be sought, but it is occasionally necessary where an investment is crucial to the NAV and it is not possible to structure around the restrictions).

Conclusion

The key economic features of infrastructure funds and their underlying facilities naturally lend themselves to NAV facilities. The relatively fixed revenues give lenders a high degree of certainty that there will be spare cash flows and assets available to meet the borrower's ultimate repayment obligations, and this is reflected in the typical pricing for such NAV facilities.

Care must be taken (i) in relation to the assumptions that feed into the valuation to ensure that these are suitably robust and that there is appropriate oversight from an external valuer and (ii) to regulate the composition of the qualifying portfolio by excluding/limiting the value attributable to single investments (or which are to be treated as single investments by virtue of being subject to a common financing), investments within a single sector/country and (most importantly) investments that carry demand risk or that are in their construction phase and therefore have a very different risk profile.

The increasing complexity of the funds' financing strategies and the widespread use of gearing at different levels within the structure present significant challenges in structuring both the security package and the financial covenants. To the extent funds can be structured from the outset to anticipate these funding requirements (*e.g.*, through the inclusion of a single aggregator vehicle or even a layer of "clean" holding companies over which share security may be granted without tripping any change of control restrictions in the underlying documents), this can significantly ease the process of granting security and any related due diligence requirements. Much of this analysis will equally apply to private equity and secondary funds with highly geared underlying investments and demonstrates the value for funds in seeking input from a finance perspective at an early stage and looking to anticipate their funding requirements over the full lifecycle of the fund when deciding on how to structure the fund and its investments.

Please note: an abbreviated version of this article appears in Wildgen's new Fund Finance Magazine, available ***here****.*