SMIF/GSL investment partnership

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The close of the £115 million investment partnership between the Secondary Market Infrastructure Fund (SMIF) and Global Solutions (GSL) is a transaction that bodes well for the maturity of the secondary equity market in 2006.

The deal, which included both the £70 million sale of GSL's PPP assets to SMIF and the establishment of a £35 million investment partnership was the first of its type to be put to a competitive tender - a move that shows confidence in market liquidity.

Also in a secondary market more accustomed to sporadic activity, fire sales and piecemeal asset transfers, the strategic sale of a whole portfolio stands as a landmark transaction.

But nothing in PFI is ever that straightforward. GSL runs a number of high-risk and potentially controversial assets, could SMIF have bitten off more than it can chew?

Global Solutions

Security firm Group 4 Falck established Global Solutions as a bidding vehicle for private and PPP security projects in the early 1990s.

The operating division quickly made a mark - winning Europe's first private prison, HMP (Her Majesty's Prisons) Wolds in East Yorkshire and in 1995, also won the first DBFO private prison in the UK, HMP Altcourse near Liverpool.

The highpoint of GSL's PFI strategy was capturing the Foreign Office's £425 million prestige GCHQ PFI - to build and maintain the government's new military listening post in Cheltenham, Kent.

A controversial low came soon afterwards when the Yarl's Wood detention centre - a concession outside the PPP portfolio - burned down in February 2002.

But red tape would soon break up the group. When Group 4 Falck merged with Securicor in 2004, the EC's competition commissioner ruled that Group 4 must dispose of GSL.

Private equity firms Englefield Capital and Electra Partners bought the majority of the group for a cut price total of £208m.

Englefield and Electra took a 40 per cent stake each while the remaining 20 per cent was retained by management.

Under the new ownership, GSL has largely pursued healthcare projects culminating in the mid-sized Churchill hospital last year.

By the end of 2005 the new GSL had a substantial stake in a portfolio worth £850m in capital value and held a share in contracts valued at £3 billion.

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GSL portfolio

Project	Capital cost	Equity participation (per cent)	Equity partners	Financial close	Operational	Period (years)
GCHQ	£452m	N/A	Carillion, BT	June 2000	September 2003	20
HMP Altcourse	£88m	50	Carillion	December 1995	December 1997	25
HMP Rye Hill	£35m	50	Carillion	July 1999	January 2001	25
Medway STC and expansion	£14m	50	Carillion	March 1997	January 2002 (exp.)	15
Rainsbrook STC and expansion	£14m	50	Carillion	July 1998	August 2001	15
Manchester Magistrates Court	£30m	50	Carillion	March 2001	April 2004	25
Cheshire Custody Suites	£20m	50	Carillion	November 2004	December 2005	29
North Wiltshire Schools PFI	£39m	50	Bilfinger Berger	October 2000	March 2002	N/A
Nuffield Orthopaedic Centre	£37m	N/A	Barclays, AWG, UME	April 2002	March 2006	30
Oxford Churchill Hospital	£140m	20	Impregilo, Barclays	December 2005	March 2008	33
East London LIFT	£29m	50	Babcock & Brown	N/A	Sept 2004	25
Wolverhampton LIFT	£8m	50	Babcock & Brown	N/A	Jan 2006	25
Bexley, Bromley and Greenwich LIFT	£25m	50	Babcock & Brown	N/A	N/A	25
Brent, Harrow and Hillingdon LIFT	£17m	50	Babcock & Brown	TBA	TBA	25

Rationale and tender

GSL's status after 2004 as a PFI minnow made it ripe for the UK's growing league of secondary funds. After a series of approaches by the secondary funds, the GSL board made a strategic decision to release capital in order to meet their expansion plans, but aimed to keep a handle on the running of its assets - many of which were highly sensitive.

Chris Elliot, finance director of GSL explains: 'We are a service provider at the end of the day and what is key to us is delivering excellent service to our customers and maintaining that relationship.

'We deliberately did not seek to sell the equity but rather the economic interest, so we would remain as members of the company boards and provide day-to-day management.'

To meet this unique challenge GSL contracted PwC to arrange a restricted competitive tender.

PwC approached eight equity investors and secondary funds - believed to have included Babcock & Brown, I2 and Hendersons - to put together an offer including flexibility for future investments.

Another natural contender was SMIF which was established by Babcock & Brown and Abbey National in 2001as an equity fund specifically targetting the growing PFI secondary equity market.

SMIF - now majority owned by Star Capital, HBOS and AMP - had invested £300m in more than 40 PFI asset stakes by the end of 2005 and was hungry to reach its target of a £500m portfolio.

After reducing the tender down to a shortlist of three - GSL and PwC selected SMIF at the beginning of 2006. In a hitherto unique partnership, GSL would maintain a degree of control over the assets and future business decisions (see below), while SMIF would gain a key foothold in the secured services market.

According to director Barry Williams, SMIF also benefitted in winning the tender from a business model unique in the

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sector:

'We have set ourselves up as a very flexible fund, one would describe us perhaps more as a business in that we can take on construction risk in our portfolio,' he says.

'Also we don't run any other funds which focus on primary equity, unlike some of our competition, who have involvement with two sets of investors one in the primary fund, one in the secondary fund, we do not have that sort of investor conflict.'

The SMIF/GSL investment partnership model

The two key elements of the deal were the transfer of 'economic interest' rather than equity stakes in the purchase and GSL's maintenance of significant management influence.

In short, GSL will keep its place on the board of SPVs, share decisions and continue its project management role.

SMIF will also fund the majority of bidding for new projects while GSL's shareholders will concentrate on funding existing service delivery.

According to Williams, the breakdown for SMIF is: 'In terms of an economic ownership, we have taken the vast majority of that equity income stream, in terms of a legal ownership, GSL and ourselves are still legally partners.'
The partnership will target Building Schools for the Future, hospital projects and its traditional core markets of secured services in the UK and Europe.

For SMIF the deal was also intended to give them privileged access over their rivals to the secured services market, as Williams adds: 'It gives us an entrée into the secure accommodation arena which is dominated by secure facility and prisons operators which compared to other operators is a different sort of skillset.

'That is relatively unique and also relatively limited into a couple of firms so I think that that was a consideration about the relationship.'

Secondary market outlook

The secondary market has yet to take off in the manner predicted five years ago. While there was significant activity on the market last year, much of it came in the form of manouevring within the major funds themselves to secure more debt and equity backing.

The lack of major deals was due to reticence of the sellers' market, which secondary funds splice into three major categories:

" equity investors such as Laing and larger combined construction and services groups such as Balfour Beatty. Both business models tend to divest assets at their own pace to demonstrate portfolio value (and influence quarterly results) although this may change if the market price for assets rises in 2006

" smaller construction companies which tend to dispose of equity stakes after individual projects pass their defect liability period. Construction firms thus largely dispose of assets piecemeal

facilities management companies. These are not seen as natural holders of long term PFI equity, and yet need to be seen to maintain a relationship with the asset. They have been historically reluctant to release equity

According to Williams, the new model will appeal mostly to the latter class by assuaging fears over sales jeopardising their future relationships with the public sector.

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'Service operators were always concerned about complete disposals because of the signals that would send. Now models such as the GSL model offer them an opportunity not to sell while still meeting their key concerns,' he says.

Conclusion

As SMIF is the first to admit, the secured services PPP sector is a niche. An Irish prison tender next year, a handful of court and custody PFIs and the prospect of a European market are not grounds for great excitement.
Also - as seen in the table above - several of the contracts have mileage on the clock and GSL's equity interests are only partial.

Of course the trade-offs for these is that SMIF will have a privileged advantage in secured services and the majority of the assets - including the flagship GCHQ - have already passed construction risk.

According to SMIF, the deal will be economical in the long run even if the investment partnership fails to make a single acquisition.

For GSL's shareholders - and especially Electra and Englefield which took a gamble on the firm in 2004 - the £70m windfall is a more than ample reward.

Although the issue of who takes ultimate responsibility for the assets still remains oblique. Owning secure assets is by no means a risk-free process as the incident at Yarl's Wood showed, and neither party will want to get their fingers burned.

Caveats aside, the GSL partnership is a good natural fit for both SMIF and GSL - and SMIF has done well to create a model that must appeal to FM providers looking to release capital over the coming year.

Such new financial tools are a sign of a maturing market and that is highly encouraging for future trades.
But tempting FM providers is only part of the equation, the secondary funds must now find a key to unlock the stakes of big construction and equity players who are happy to play a waiting game.

The tranasaction at a glance

Project Name	SMIF-GSL Investment partnership
Location	Various UK
Description	SMIF paid £70m for the economic interest in GSL's 14 UK PPP assets SMIF also contributed £35m to an investment partnership that will allow GSL to expand its future portfolio
Sponsors	SMIF, Global Solutions
Total Project Value	£115m
Purchase price	£70m
Value of future patrnership	£35m
Mandated lead arrangers	Banco Espirito Santo
Legal Adviser to SMIF	Denton Wilde Sapte CMS Cameron McKenna
Financial Adviser to SMIF	SMIF
Financial adviser to GSL	PwC
Date of financial close	January 2006

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