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Barts and the Royal London hospitals PFI

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The £1bn (US$1.86bn) new hospitals programme to redevelop the flagship St Bartholomew's and The Royal London hospitals in London reached financial close after over eight years in the making

The largest health PFI project in the UK to-date, Barts closed accordingly in style with not one but two monoline insurers plus EIB backing.

Following one of the largest UK PFI bond issues, a Skanska-led consortium achieved financial close on 27 April 2006 with the Barts and The London NHS Trust. The milestone came almost five months after the agreement of commercial terms on 9 December 2005, as the project looked likely to become the highest profile casualty of the Department of Health's review of PFI schemes at the turn of the year.

The scheme was finally re-approved by the health ministry in March 2006 after some degree of downscaling, but the cut in number of hospital beds from 1,248 down to 990 on the grounds of affordability and long-term flexibility did not change its status as a scheme full of superlatives.

The two-site Barts redevelopment is the UK's largest and most complex hospital project under the PFI as well as Skanska's largest construction contract ever - at around £1bn (US$1.86bn). The project company - Capital Hospitals - comprises Skanska, Innisfree and Equion.

Both projects will be funded through a combination of £745.4m (US$1.38bn) index-linked bonds - excluding variation bonds - and two £125m (US$233m) loan facilities provided by the European Investment Bank (EIB). Sold by Deutsche Bank and Morgan Stanley, the bonds are split in two equal tranches guaranteed by monoline insurers FSA and Ambac.

Background

The Barts and The Royal scheme was originally proposed in 1993 on the back of a 'Save Barts' campaign and ended with a similar campaign in the wake of the Department of Health's review in 2005/06.

The closure of the teaching hospital founded in the 12th century was formally announced in 1995 and a PFI project moved ahead to exclusively redevelop The Royal London hospital. But in 1998 the government decided that Barts should be saved as a cancer and cardiac centre of excellence and the two hospitals' NHS trusts started work on a new Outline Business Case (OBC) for a dual site solution.

In February 2001, the government approved OBC for single Barts and The Royal London PFI and a year later the procurement process was started. The deal, perhaps due to the very high bidding costs of £10-20m (US$18.6-37.2m) and a PFI field saturated by other contracts, attracted few bids and only Skanska and Bouygues-led consortia submitted definitive bids - less than the minimum three set in government guidelines.

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Skanska was nevertheless appointed preferred bidder in December 2003, in a consortium then including:

- Innisfree, as PPP/PFI investor
- Mowlem Aqumen - now as Carillion's Sovereign Hospital Services, as soft facilities management provider (catering and cleaning)
- Siemens, as manager of equipment and technology services
- Synergy Healthcare, as responsible for laundry and sterile services

Just after the Trust and the preferred bidder agreed on the commercial terms on 9 December 2005, a Department of Health review on large PFIs left the Barts scheme in a sort of limbo. The review's specific aim was - on the grounds of affordability - see if cancer and cardiac services at Barts could be scaled down or relocated to other hospitals in central London.

A media frenzy was sparked amid fears that Barts could fall off the drawing board - including a 1,000-doctor support statement and media reports on £100m (US$186.3m) cancellation compensation for Skanska.

After much expectation, on 9 March 2006 UK Health Secretary Patricia Hewitt finally gave the go-ahead to a scaled down deal which cut the number of hospital beds by 258 to 990. The new agreement would save the trust nearly £650m (US$1.2bn) over the 32-year contract, while leaving an open door to additional beds in the future.

The most significant aspect of the revamped project was the decision to set aside three floors of empty space - two floors at the Royal London and one at St Barts - which will be furnished with the remaining 258 beds as and when it is required.

These measures, combined with a recent reduction in the cost of borrowing money to finance construction, reduced the Trust's full unitary charge from a projected £116.9m (US$208m) to around £96.6m (US$172.4m).

A spokesman for the DoH says that the decision wasn't part of a wider government move to scale down all health PFIs: 'This is a unique case - a very large-scheme that we had to look at very closely - but what we've got now is a project with the right balance between what is needed locally and what is affordable.'

The project

The largest PFI health project undertaken in the UK to-date will provide a total of 990 beds in two hospital sites, which cover a built area of 270,000 square metres. It includes:

- The Royal London Hospital in East London - Britain's biggest new hospital - which will bring together London's leading trauma centre, the capital's second biggest children's hospital and one of Europe's largest renal units in a new landmark 18-storey building
- St. Bartholomew's Hospital in the City of London - the oldest in the capital - which will become a Cancer and Cardiac Centre of Excellence with the majority of care provided in a new eight-storey building, incorporating services from The London Chest Hospital in Bethnal Green.

Skanska will carry out the design, construction, commissioning and facilities management of the works for the project company. Skanska Major Projects received a construction contract amounting to around £1bn (US$1.86bn), while Skanska Rashleigh Weatherfoil received a Hard FM contract for around £7.5m (US$14m).

Carillion's Sovereign Hospital Services secured a soft facilities management contract worth £30m (US$56m) per year for an initial term of 11 years.

The concession period is for 42 years, with a construction period of nine years and nine months. Non-clinical services will start during the construction period and run for 32 years and three months after construction completion.

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The FM services, which will start in mid-2006, will comprise:

- Hard Services, including estates maintenance, energy and waste disposal
- Soft services, including car park management, catering, cleaning, facilities management and helpdesk, ward housekeeping, laundry and textile, portering, receipt and distribution, reception, security, telecommunications and transport
- Equipment services, including medical equipment supply, installation, replacement and maintenance
- Supply of sterile services

Skanska will support its obligations as design and build sub-contractor by a performance bond provided by Svenska Handelsbanken, Danske Bank, Skandinaviska Enskilda Banken AB ('SEB') and Deutsche Bank AG up to an agreed maximum liability. The initial amount of the Performance Bond will be around £163.2m (US$304m) and will reduce upon completion of works milestones until it reaches zero by the expected global completion date of 31 December 2015.

Preliminary building work is already underway and the first phase, the Cancer Centre at Barts, is scheduled to be completed in 2010. Most new facilities at The Royal London should be operational early in 2012 and the redevelopment of both hospitals is expected to be completed in 2015.

Once all phases are complete, Barts and The London NHS Trust will pay about £96.6m (US$172.4m) a year - adjustable based on the Retail Price Index - to the project company until 2048.

The scheme's contractual structure is based on version 3 of the NHS Standard Form Project Agreement dated August 2003, as further amended in July 2004.

Ashurst is acting as legal adviser for the lead managers, Deutsche Bank and Morgan Stanley, as well as for the two monoline insurers. Allen & Overy is advising the St Bartholomew's and the London NHS Trust, while Capital Hospitals instructed Clifford Chance.

'Technically it was very complex - there hasn't been a PFI hospital scheme on this scale before.' comments Allen & Overy's John Scriven. 'We've been working on this project since the end of 2000 and during the past year the work has been particularly intensive.'

He adds: 'The legal documentation has a number of novel features and the range of creative solutions agreed upon shows that all parties involved were willing to work proactively to make this project a reality.'

In respect of the due diligence, the funders note how the complexity of the project was not a problem for bond investors as the strength of the monoline wraps makes it not very different from any PFI deal.

The financing

Financing for a health scheme of such a size, and one which had been going on for such a long time, was certainly challenging. There were lots of parties involved plus changes to the remit which had a substantial impact - mainly the last-minute downsizing.

Those who had to deal with the challenge were Deutsche Bank and Morgan Stanley - which were mandated in June 2005 - while Investec structured the deal as financial adviser.

The scheme was financed by a combination of bonds and a European Investment Bank (EIB) loan. Robert Taylor, the managing director of Deutsche Bank's debt capital markets group, says: 'The bond route was chosen as a way to assure the best pricing, and the deal just ended up coming back to the banks after all'.

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The two hospitals will be funded through a combination of £745.4m (US$1.38bn) index-linked bonds - excluding variation bonds - and two £125m (US$233m) loan facilities provided by the EIB. The bonds are split in two equal tranches guaranteed by monoline insurers FSA and Ambac, which provide the AAA rating.

'It was a challenge to raise index-linked bonds with this size, it represented untested ground.' says Deutsche Bank's Robert Taylor. 'There was uncertainty on the pricing and the capacity of the market.'

The project company and bond issuer, Capital Hospitals, released on early April 2006 £1.02bn (US$1.9) senior secured index-linked bonds if the £275m (US$513m) in aggregate variation bonds are included.

The bonds were split into Series A and B of £372.7m (US$695.5m) each, guaranteed by FSA and Ambac respectively. They were accordingly rated AAA by Moody's and Standard & Poor's.

In addition, £115m (US$214.6m) and £37.5m (US$70m) in Series A Authority and Rescue Variation bonds respectively were issued, with the same amounts for Series B. The variation bonds were retained by the issuer and will be sold from time to time in the future to provide additional finance.

As in the recent Allenby Connaught military accomodation deal, the bonds were split into two equal tranches that rank pari passu and so have the same exact characteristics. Robert adds: ''The double issue was due to the capacity constraints of the monolines and also of the market. It seemed that such a deal size might stretch the bank market and we didn't want to jeopardize the deal.'

Equity for the 42-year concession amounts to an estimated £128m (US$228m) - including £20m (US$37.3m) in mezzanine finance - divided into the project company's three stakesholders:

- Skanska's UK unit, 37.5 per cent
- Innisfree - 37.5 per cent
- Equion - 25 per cent

Leverage stood at PFI's usual 90 per cent, while average and minimum annual debt-servie coverage ratios (ADSCRs) are 1.21x.

Road show ran until just before Easter and pricing day was reached on 20 April 2006. The spread over gilts was at 51.5bp to give a semi-annual coupon of 1.703 per cent and carry an expected average life of 27 years, with legal maturity in 2046.

The securities, which had an issue and re-offer price of 100, are linked to the retail price index - so both the bond's principal and interest are determined by reference to the UK All Items Retail Prices Index.

Prior to the issue of the securities - on 3 April 2006 - Deutsche Bank undertook a gilt settlement programme (GSP), which involved the purchase and sale of gilts in order to reduce the risk of the gilt market being distorted as a result of the launch and pricing of the bonds.

On such a tight pricing, Robert says: ''The pricing was driven down by financial institutions, as banks - which were the bulk of the buyers - were happy to 'warehouse' the bonds and lock in a profit by separately hedging all the components of risk - mainly interest rate, credit and inflation.' Effectively, instead of the usual banks buying the bonds to sell them on, they will hold them on balance sheet.

The sale was oversubscribed very heavily at the start, boosted by the high-profile status of the scheme and price talk suggesting around 55bp. But as the spread was cut back later, demand weakened and the oversubscription ended up around two times - similar to Allenby Connaught.

The payment day for the bond issue was 27 April 2006 and the secondary market trading started the day after on the London Stock Exchange. They were placed overwhelmingly in the UK domestic market, with only a 16 per cent overseas.

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Index-linked securities attract a different type of investors than fixed-rate bonds, so buyers were mainly banks and there were just a few of the traditional fund managers and insurance companies.

Deutsche Bank and Morgan Stanley were the underwriters and the combined managing, underwriting and selling commission was 0.03 per cent of the total issue excluding the variation bonds. The paying agent is BNP Paribas.

The conclusion

The financing of the massive Barts deal follows on the footsteps of the £1.46bn (US$2.72bn) Allenby Connaught - both in form and time. Its closing came only three weeks after the MoD defence PFI, and also involved two identical bond tranches wrapped by monoline insurers. But a main difference stands out: Aspire's bonds were fixed while Capital Hospital's are index-linked.

A curious aspect of the deal is also how being under a high-profile and often critical media spotlight seemed to ultimately create even more interest in its bond issue. But the same characteristic - coupled with its sheer size - also put it at risk just as it was about to close and forced tough last-minute changes.

In any case, the closing in the same month of two record-breaking bond-financed PFI deals shows the health of the UK's PFI market - even if huge health schemes have fallen out of favour right now in the Treasury.

The Barts and The Royal London hospitals redevelopment ultimately will save what is probably Britain's oldest hospital and bring modern centralised facilities for an area of London which is expected to boom due to its proximity to the Olympic site - a factor which helped tip the balance in favour of perhaps one of the UK's last super-hospital PFIs .

The project at a glance

Project Name	Barts and The London hospitals PFI
Location	London, UK
Description	PFI redevelopment of two hospitals with a combined capacity of over 1,000 beds in two sites in East London and the City of London
Sponsors	Skanska Innisfree Equion
Public partner	The Royal London Barts and The London NHS Trust
EPC Contractor	Skanska UK
Project Duration	42 years, including a 9-year and nine month construction period
Total Project Value	£1bn (US$1.86bn)
Total equity	£128m (US$228m)
Equity Breakdown	Skanska – £48m (US$89.6m) Innisfree – £48m (US$89.6m) Equion – £32m (US$59.7m)
Total senior debt	£995.4m (US$1.86bn) including: • £745.4m (US$1.38bn) index-linked bonds issued by Capital Hospitals • 250m (US$466m) EIB loan facilities And excluding: • £275m (US$513m) in variation bonds
Bond issue breakdown	Two equal tranches of £372.7m (US$695.5m) • Seriees A - ISIN: XS0252382063 • Series B - ISIN: XS0252384515
pricing	Gilts + 51.5bp
Debt:equity ratio	90:10
Mandated lead arrangers	Deutsche Bank Morgan Stanley
Monoline insurers	AMBC and FSA (one tranche each)

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Legal Adviser to sponsor	Clifford Chance
Financial Adviser to sponsor	Investec
Legal adviser to banks (and monolines)	Ashurst
Legal adviser to government	Allen & Overy
Financial adviser to government	PwC
Date of financial close	27 April 2006

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