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M6 Birmingham Expressway refinancing

06/09/2006

Running the UK's first real toll road was always likely to require a delicate balance of private commercial nous and public tact - and so it has proved - write **Simon Ellis** and **Vander Caceres**.

Indeed public goodwill has proved so crucial that Midland Expressway - the Macquarie European Infrastructure Fund (MEIF) owned consortium - has already shared £114 million (US$215.5m) from its first refinancing with the public sector to fund a link road to the M54.

Macquarie's unlikely generosity might raise some eyebrows but after several PFI hospital refinancings provoked angry headlines and startled Treasury officials - the move seems like good politics.

More importantly, it betrays the success of a refinancing which has released an estimated £392 million for Macquarie and seen another European portfolio asset raised to investment grade.

The project

The 42km Expressway was launched to relieve a stretch between junctions 4 and 12 of the M6 which drew 144,000 vehicles per day and on which peak journey times estimated at up to 71 minutes for a 23 minute journey by November 2003.

The then 'Birmingham northern relief road' was awarded to Midland Expressway - a consortium of MEIF and Transurban - in September 1992.

In the mould of early 1990s infrastructure projects the Conservative government allocated both the lion's share of project risk and potential upside gains to the private sector.

Most significantly the terms of the DBFO concession allowed Midland Expressway increase tolls, according to Macquarie Infrastructure Group managing director Anthony Kahn, 'entirely at its discretion'.

After an elongated consultation exercise and a hard fought process of securing land acquisition along the extension the project reached financial close in September 2000.

After a mixed first six months, in which the Midland Expressway was challenged by heavy goods operators unwilling to pay the £10 (US$19.3) charge - the HGV toll was reduced to £6 (US$11.2) in June 2004 with a resultant increase in traffic flow.

In June 2006 traffic figures had risen to 45,325 - more than three times the volume required for the road to break even.

With the project on a firm financial footing, Midland Expressway looked to take advantage of its favourable position.

The immediate impetus for refinancing was a cash flow sweep due under the original terms due in 2007.

In addition precedents had been set for similarly long-term concessions by the Chicago Skyway and Indiana toll road deals in the USA based on short term accreting structures.

Refinancing also offered an opportunity to have the deal re-rated investment grade. This was achieved when S&P duly upgraded the transaction to 'BBB' last month.

The Refinancing

Macquarie's refinancing of the M6 demonstrates that the UK PPP market is adopting new financing techniques in its never-ending quest for leverage.

The original deal reached financial close in September 2000 with a £685 million (US$1.3 bn) senior debt package split into

- £638 million term loan
- £37 million equity bridge
- £8 million bond
- £2.5 million working capital facility.

Abbey National and Bank of America acted as the mandated lead arrangers
(MLAs) and launched syndication for the 10-year £638 million term loan in November 2000.

The deal was hailed as one of the most innovative financings in the UK infrastructure market at the time. It featured a step-down pricing structure ranging from LIBOR + 120bp during construction to LIBOR + 110bp post-construction.

Investors pointed out that the project had two distinctive advantages over exiting PPP deals at the time - and indeed to the present day - that appealed to them: a long term concession period of 53 years and the concessionaire's total control over toll rates.

The project company Midland Expressway Ltd was owned 75 and 25 per cent by Macquarie Infrastructure Group and Italy's Autostrade respectively and together injected £147 million (US$280m) in equity.

Investments can only be recouped through toll revenues and the government does not provide subsidies although the Department for Environment, Transport and the Regions (DETR) co-funded a Public Inquiry conducted in the mid-1990s and ultimately provided £20 million (US$38m).

In the end, 26 banks signed in to syndication in May 2001, while the bond and working capital facility were retained by the MLAs.

The Midland Expressway was the UK's first ever toll road and the largest motorway project in the country, while syndication of the term loan was the largest project finance syndication in the world for a toll road.

M6 opened in December 2003 and toll rates were increased for the first time in 2005 to a standard day tariff of £3.50 (US$6.60) for cars and motorbikes and £7 (US$13) for larger vehicles.

Although the M6 was seen as a benchmark project it was always widely regarded as a 'one off'. Indeed the government has discarded plans for the concession to build a 50-mile toll road between Birmingham and Manchester.

Pursuant to a five-year call option agreement signed between the sponsors in 2000, Macquarie bought Autostrade's stake in the project for £49m (US$93m) in June 2005.

Fast forward to August 2006 and this time the combination of lower borrowing costs in relation to 2000 and the project's track record meant that the project was due for a refinancing.

Midland Expressway mandated Calyon, Banco Santander, DrKW and Espirito Santo Investment to lead arranged the refinancing with:

- £1 billion (US$1.9bn) mini-perm

- £37 million (US$70m) construction reserve
- £17 million (US$32m) debt service reserve

Similarly to the financing of Indiana Toll Road in the US, the re-financing has a tenor of nine years and features a step-up swap.

The step-up swap is an interest rate hedging tool that covers the face value of the debt and allows the interest rate to start low and increase over time to match the project's cash flows which will naturally inflate.

A banker closed to the deal says that the step-up swap is like an index-linked swap in a PFI deal but instead of fixing the interest rate through the life of the financing the rate is fixed for a certain number of years so we can have a flat level of debt service during that period.

We understand that the interest rate is fixed at 100bp over the credit margin for the first five year and that the debt service coverage ratio during this period is 2.8 times.

The same banker says that step-up swaps must go for tenors beyond the term of the debt in order to give lenders confidence in the financing. We understand that the swap is for 30 years but includes a call option exercisable upon the maturity of the nine-year mini-perm.

The M6's project fundamentals are strong - a 52 per cent gearing and a project life coverage ratio of 3.2 times - and its future revenues are highly stable and predictable, a fact that supported S&P's BBB ratings for the refinancing.

Conclusion

The step-up swap has allowed Macquarie to boost gearing and manage liquidity by reducing interest payments during the first five years, when cash flows are relatively low, and increasing them later in the concession.

Overall, the refinancing mini-perm is helping Macquarie to improve the project's financial performance and therefore the value of the concession will increase in a few years and Macquarie may want to sell the toll road by then.

It is also significant to see an innovative structure based on accreting swaps - similar structure to those employed in the Indiana Toll Road or Chicago Skyway - move into the UK.

Richard Ginks, who led the Linklaters team advising the lenders says:

'This was an innovative and complex transaction, bringing elements of the financing technology seen on some recent US road deals to the UK infrastructure market, that was closed within a challenging timescale which required a commercial, pragmatic and cooperative approach to be adopted on all sides.'

As for the progres M6 toll structure itself, the prognosis is less rosy.

It looks likely that if the UK does expand its private-financed road portfolio it will be through a shadow tolls backed by a PFI-style unitary charge - which despite the extra risk involved to the public, tend to stay out of the media spotlight.

The M6 Expressway looks increasingly like a product of its time - with the consortium expected to sink or swim and 'risk sharing' a term yet to be coined.

In February 2005 the House of Commons Committee met with representatives the M6 Expressway in a session entitled 'Should All Roads be Toll Roads?'

From the disappearance from the radar a second M6 toll scheme and the absence of commercial element from the M25 deal, the answer for now appears to be 'No'.

The project at a glance

Project Name	M6 Expressway
Location	north of Birmingham, central England
Description	42km 6-lane real toll road aimed at relieving traffic along the M6 motorway
Sponsors	Midland Expressway ltd (Macquarie Infrastructure Group)
Operator	Midland Expressway
EPC Contractor	Alfred McAlpine, AMEC, Balfour Beatty, Carillion (£486 million design-build contract)
Concession term	2000 to 2055
Operational date	December 2003
Total value pre-refinancing	£835 million
Total value after refinancing	£1.05 billion
Original Equity	£147 million
Refinanced equity	N/A
Original senior debt	£685 million
Refinanced senior debt	£1 billion
Refinanced Senior debt breakdown	£250 million each from Calyon, Grupo Santander, DrKW, Espirito Santo Investments
Original senior debt pricing	LIBOR + 120bp stepping up over time
Refinanced senior debt pricing	LIBOR + 100bp stepping up at set intervals
Mandated lead arrangers	Calyon, Grupo Santander, DrKW, Espirito Santo Investments
Legal Adviser to sponsor	Clifford Chance
Financial Adviser to sponsor	Macquarie Bank
Legal adviser to banks	Linklaters
Date of financial close	23 August 2006