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PFI Projects Reshape the Credit Profile of Europe's Construction Companies

Credit Analysts: Tommy Trask, London (44) 20-7176-3616; Craig Jamieson, London (44) 20-7176-3584; Jan Willem Plantagie, Frankfurt (49) 69-3 39 99-132; Peter Tuving, Stockholm (46) 8-440-5913; Michael Wilkins, London (44) 20-7826-3528

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Commonly referred to under a host of acronyms--private finance initiative (PFI) or public private partnerships (PPP)--private infrastructure financing is the fastest-growing method of financing the construction of assets needed for public services.

This growth has prompted Standard & Poor's to revise its assessment of the creditworthiness of construction companies in Europe. The differing levels of risk, degree of capital investment required, timing, and quality of cash flows mean that construction companies with exposure to PFI contracts cannot be evaluated using the same measures as those without such exposure. In the short term, PFI projects shift more risk onto construction firms, but over the longer term PFI funding can help to reduce the impact of economic cycles by providing more stable cash flows. Consequently, greater exposure to PFI contracts might improve credit strength in the long term and ultimately enhance the ratings on large construction firms. On the contrary, smaller firms, with less capability to assess risks inherent in PFI projects, might see their credit quality suffer.

Rating construction companies involved in PFI contracts is a two-stage process. Firstly, the conventional aspects of the company's business as a prime contractor for design, build, and management are evaluated. Secondly, the assessment looks at the issuer as an investor in the project's holding company, which usually owns the project and is referred to as the special-purpose vehicle (SPV).

The following negative factors need to be considered.

- Construction companies need to raise and maintain capital tied up in PFI projects, which can lead to significant debt levels. (Historically, construction firms have not had to raise long-term debt because they received cash prepayments or progress payments as the stages of a contract were completed.) Servicing such debt means that companies are vulnerable to liquidity problems in the event of a cyclical downturn.
- Pricing projects is an extremely sensitive process and outside a construction company's traditional skill set. Failure to accurately model inflation, costs, cash flow, and economic activity over the long term can easily result in losses for the project manager or the sponsors, as demonstrated by Amey PLC's loss on the Croydon Tramlink, which contributed to its takeover by Spanish construction company Grupo Ferrovial S.A.
- Smaller construction firms, that is, those that previously contracted directly with local and central government, now find themselves dealing with consortia that could prove to be a harder bargain in terms of prepayments and margins.
- Project dividends are subject to the underlying performance of the project, which could limit their payment.
- There is a steep learning curve, as with any new product or industry.

Nevertheless, given the rapid growth of PFI in the U.K., it is seen as an absolute necessity for all major construction firms to be active players in this market. There is, however, a shortage of qualified staff and companies risk overextending themselves in the quest to gain a foothold in the industry. For example, U.K.-based Jarvis PLC has been criticised for delays and dissatisfaction on a number of large school projects.

On the upside, PFI provides a number of positive rating factors, namely:

- The predictability, stability, and long-term nature of construction and services revenues and income for equity and subordinated debt providers, which help to reduce the impact the economic cycle has on the volume of traditional construction activity.
- The counterparty risk is greatly reduced, as the lead contractor or contract manager is paid for the work directly from the concession company. In addition, government usually pays services and maintenance costs, although they are subject to deductions for unavailability, poor performance, and sometimes volume risk.
- Larger construction firms can manage risks better by taking responsibility for the whole life of a contract from design and construction through to the end of the services contract.
- High barriers to entry due to the expertise and capital required to engage in tenders for PFI projects.

Changing Industry Structure

The increasing use of PFI as a procurement method for infrastructure projects has the potential to change the structure of Europe's construction industry. Traditionally, the construction sector has been characterized by low barriers to entry and intense competition among contractors. It is also an industry where the bargaining power of the customer is high relative to that of the supplier. This results in low margins on contracts and the potential for contractual disputes that can easily lead to a loss for the contractor.

Under PFI, these dynamics are changing. The expertise and capital required to engage in the bidding process and to deliver a multitude of services under long-term contracts are new skill sets that raise barriers to entry. The importance in acquiring these competences has been demonstrated in a number of recent takeovers and acquisitions: U.K.-based Balfour Beatty PLC's acquisition of Mansell PLC in October 2003 and Spanish construction giant Grupo Ferrovial's takeover of Amey in April 2003, for example, were both driven by growth ambitions in PFI. Other large construction firms have been busy acquiring specialist facilities management and consulting firms to ensure they are able to offer a full range of expertise encompassing the lifecycle of a project.

More significantly, PFI funding reduces the vulnerability of the construction industry to the economic cycle. Construction firms typically have been classified as high beta stocks, as their earnings volatility was exacerbated by the 'boom and bust' of the economic cycle. The more predictable cash flows associated with support services and maintenance help to reduce earnings volatility. Furthermore, the longer lifecycle of PFI projects--often up to 30 years--outweighs the seven-year to 10-year duration of economic cycles, smoothing out macroeconomic influences.

With growth in PFI projects across Europe, a two-tier construction market is

emerging based on those firms that have resources and expertise to project manage large projects, and those that do not. Among the firms able to provide the full range of services are Amec PLC, Balfour Beatty, and Carillion PLC in the U.K.; Hochtief AG and Bilfinger Berger AG in Germany; Sweden-based Skanska AB; and Grupo Ferrovial and Grupo Dragados S.A. in Spain. Alongside these large players are the smaller construction companies, which act as subcontractors. Although the role of a subcontractor might appear to embody less risk than that of a project manager, it does bring a degree of vulnerability because of the lack of control over a project's cash flows while dealing with a concession company rather than the end customer.

How PFI/PPP Works

A PFI transaction is normally constructed using an SPV, which acts as the management and operating company for the project and is the legal owner of the concession that is granted by the public sector authority. The equity of the SPV is jointly owned by the prime contractor, service providers, public authority (in PPP only), and, possibly, the banks involved with the financing. In essence, risk is transferred from the public sector to the private sector via the concession contract.

Given the long-term nature of PFI projects, it will take several years for the contractors to fully appreciate the risks involved and for the benefits to be fully reflected in the ratings on European construction companies. As relatively few projects are completely into the operating phase of the concession, operating performance risk and lifecycle costing and scheduling have yet to be fully tested. Nevertheless, about £30 billion (\$55 billion) of PFI construction projects have already reached financial close since their introduction in the U.K. in 1992, providing a significant boost to overall activity in the construction sector.

The SPV acts as the prime conduit of financing. In addition to the initial share capital subscribed by the sponsors, the SPV is able to raise extra financing, either through subordinated debt from the project participants; or senior secured debt direct from the capital markets or from banks. In the U.K., the ratio between equity plus subordinated debt and long-term senior secured debt is 1:9. This emphasis on long-term debt financing reflects the relative cost of debt capital, which is significantly cheaper than equity financing.

Typically, the construction contractor's participation in PFI is two pronged. It provides capital through a small equity stake--up to 10% of the total financing--through pinpoint equity and subordinated debt. Operationally, it benefits from stand-alone construction and/or facilities management contracts that are generally profitable in their own right.

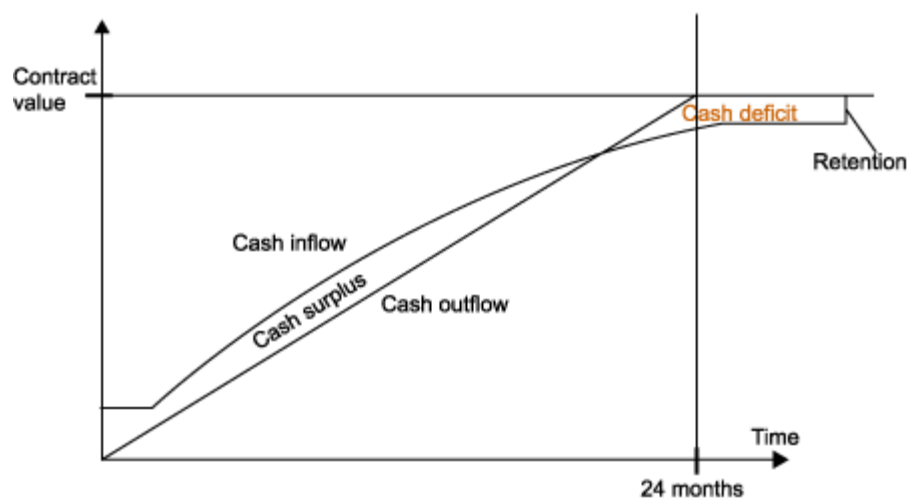
Consequently, construction companies look to recycle their investment after the construction phase is over in order to maximise the use of their capital. The desire to exit a project before the end of its working life is not seen as a negative factor, unless the company's participation is strategic to the project where such an exit weakens the project. For companies that have a long-term facilities management contract, Standard & Poor's expects to see congruence of the interests of the operators and the debt holders over the term of the project.

The ability to raise debt finance is essentially due to the stability and predictability of the future income stream, although the project company takes availability risk, performance risk, and/or an element of volume risk. Associated deductions are generally passed down to the relevant subcontractors; consequently, these risks ultimately lie with the service providers. Standard & Poor's considers all risks inherent in a project and the

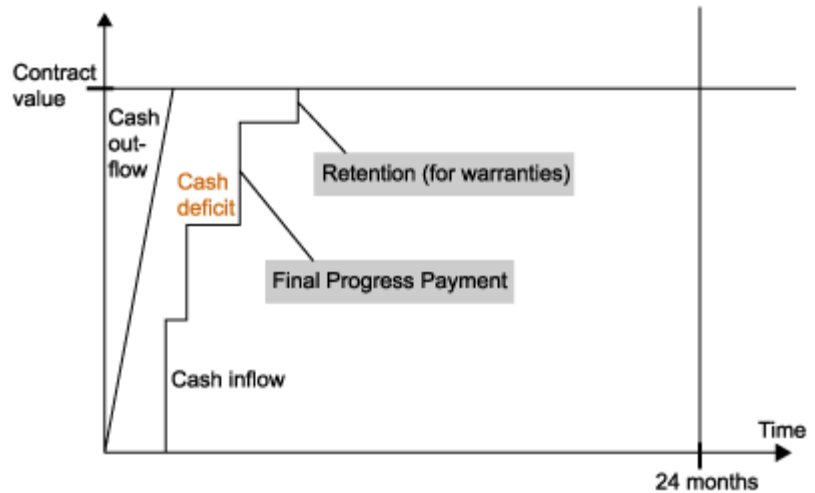
stability and predictability of the income stream and business profile is largely negated by the relatively weak financial profile of most projects. Although receivables come from sovereign or quasi-sovereign authorities, this does not imply that there is a notching off the sovereign rating. The average underlying rating of PFI projects is in the 'BBB' category, although monoline insurance guarantees enable the project rating to achieve 'AAA' levels with lower costs of funding. Longer maturities are also available for single-asset project financing than for corporate lenders. Often referred to as nonrecourse financing, it insulates SPV shareholders (sponsors, including the construction company and other equity providers) from any liability in the event that the debt is not serviced--although it would lose the capital invested, and, more importantly, any accrued receivables or work-in-progress from the concession company that may not be paid, as in the case of the Croydon Tramlink. If the SPV were unable to service the debt, the lenders would only have recourse to the assets and contracts of the SPV.

As one of the shareholders in the SPV, the construction firm has some control over operating and financing decisions, and cash flow, which is considered a form of compensation for subscribing equity capital. Through the SPV, the project manager is awarded the construction contract, and possibly the facilities management contract for operating the completed installation. As a project manager and prime contractor it is able to draw down payments to fund work in progress. In contrast, the subcontractors are usually cash flow negative, receiving payment only after reaching certain milestones or completing their work (see charts 1 and 2). The subcontractors, therefore, help finance the working capital needs of the SPV. This will have a negative impact on the balance sheet and ratio analysis of the contractors in question. On the other hand, the prime contractor may benefit from positive working capital and will therefore have less need for loan capital and lower funding costs. This is all well, as long as business activity remains strong, otherwise it could lead to a liquidity cliff if volumes fall and advance payments diminish. The subcontractor with negative working capital generally has a higher cost of finance, but could in fact see liquidity improve as volumes fall.

**Chart 1
Cash Flow Profile:
Project Manager**



**Chart 2
Cash Flow Profile:
Subcontractor**

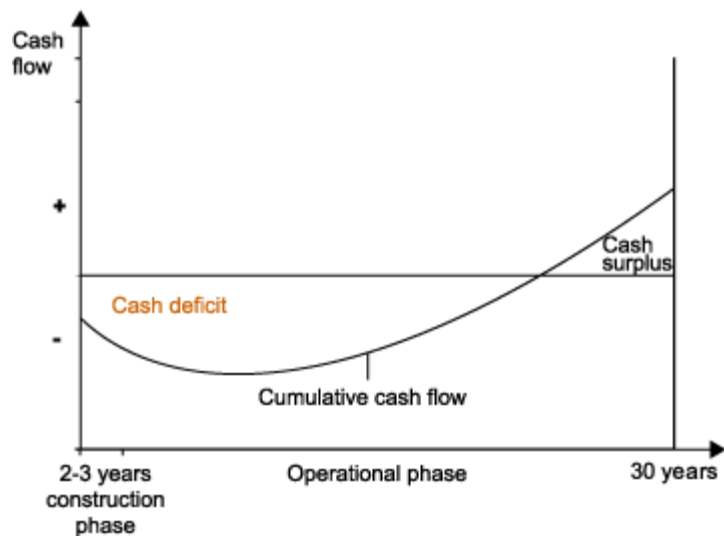


Following completion of the build phase of the PFI project, the SPV starts to receive operational payments for the use of the facility, which are generally subject to deductions for performance failing to meet preagreed levels; and sometimes are also subject to volume risk. From these payments, the SPV is able to pay its sponsors and provide project liquidity. Interest payments and amortization are the initial uses of the profit made on operational cash flows, followed by the funding of reserves such as debt service and lifecycle replacement reserves. Pinpoint equity providers are unlikely to receive any dividend income on their equity investment until quite late in the project's lifecycle, although subordinated debt holders, often the sponsors, can begin to receive interest payments almost immediately after construction completion and often have their investment amortized before senior debt fully amortizes. Distributions to subordinated debt and equity holders are subject to tests that are often based on the project achieving minimum debt service coverage ratios.

Payments from the SPV to the project management firm are made in sequence. Firstly, payments are provided for the design and build phase, together with any operational fees. Next, the lenders will receive interest on any debt they provided, and, eventually, equity sponsors receive dividends. Toward the end of the project lifecycle, as a shareholder in the SPV, the project manager is eligible for the distribution of any free cash held as cover for reserve accounts.

Given the bespoke nature of a PFI project, and the fact that construction companies are involved in many projects at different stages of evolution at any given time, this makes for a very complex financial ratio analysis. Consequently, the ratio analysis necessitates a detailed understanding of the nature and timing of PFI investments, and a separation of the investment activities from the traditional construction activities in the analysis. (See sidebar for an outline of the debt adjustments used in the ratio analysis.) Chart 3 shows the cash flow characteristics for a typical PFI contractor/investor over the life of a project.

Chart 3
Cash Flow Profile:
PFI Contractor/Investor



The extent of any profit a construction firm makes on a project depends on the structure of the transaction: often the terms of the deal state whether or not the SPV is able to operate at a profit so as to reward its shareholders. Even if for political reasons a contract may be designated 'not-for-profit,' construction and/or service contracts can be negotiated as stand-alone contracts, and can then be profitable in their own right.

Building New Skills

Entering into a PFI contract involves a range of activities--pricing, planning, design, construction, maintenance, and operation--some of which can be outsourced if required. As the following section points out, the most important element of any PFI contract, and the one that entails the biggest potential risk, is the bidding process.

Managing the bidding process is crucial to the success of all PFI contracts, and is the critical area where firms are building knowledge and expertise. Bidding can take up to 12 months from formal announcement to the final stage of nominating a preferred bidder just prior to formally awarding the contract. Throughout this lengthy process, which encompasses design, costing, negotiation, and project planning, the construction firm is self-financing its bid team. Funding the bid process is a sunk cost, which can amount to £1 million per project for a typical U.K. PFI project. Guidelines on accounting for bid costs (Urgent Issues Task Force 34) were issued in May 2002 and require costs incurred prior to the preferred bidder stage to be written off as a sunk cost in the profit and loss statement. Only once selected as preferred bidder--so there is virtual certainty that financial close will be achieved--can post-preferred bidder costs be capitalized. In case project completion is deferred, this can force contractors to expense bid costs that otherwise could have been capitalized, as was recently the case for Jarvis. For construction-related costs, this generally covers the period of the construction contract and for costs related to the concession (such as legal costs), this covers the term of the concession.

Apart from the overall aim of securing the contract, the bidding process enables the bid company to assess the future viability and profitability of the

deal. The ability to accurately project costs, inflation, resource usage, and other economic variables for a period of up to 30 years and their impact on the different elements of the project is a core competence. Errors made in the initial forecasts and assumptions can mean the difference between positive cash flow or being locked into a loss-making contract for the rest of the project's life, although mechanisms such as benchmarking and/or market testing in the operating phase can mitigate long-term pricing risk by effectively re-setting the fee level for the relevant contract at regular intervals.

Ratings Evaluation

When evaluating a project, Standard & Poor's considers the ease of replacement of a contractor. Where the asset to be constructed requires relatively simple traditional facilities management services, subcontractors are generally easier to replace due to a wider pool of alternative contractors. This is not the case, however, for complex projects, where there is substantial reliance on a subcontractor with expertise and ability that is difficult to replace due to a small number of alternative suppliers.

The ability of a project (or project lender through step-in rights) to terminate and replace a failing subcontractor before the project is terminated is vital to ensure senior debt is insulated as far as possible from subcontractor defaults. When projects are terminated for reasons of project default, senior lenders can receive less than 100% of outstanding debt under the concession compensation arrangements.

The experience of problems at several high-profile British projects highlights the importance of a project SPV having a flexible replacement regime and range of alternative contractors who could replace the incumbent contractor/operator and execute the project with minimal disruption. Projects that have encountered difficulties and delays include, for example, Jarvis' schools PFIs in Huddersfield and West Yorkshire; Sir Robert McAlpine's Dudley NHS hospital, and Croydon Tramlink; and Ballast Wiltshire's collapse into administration while responsible for three school PFI projects in Tower Hamlets, Dudley, and East Lothian.

Standard & Poor's is aware of at least one construction contractor that has suffered financially from terminating a subcontractor, although the project itself has not been affected to date. The construction contractor is also often responsible for paying liquidated damages to the project SPV if it is responsible for delays to construction being completed. Any delay in construction has a significant impact on the project company, as it only begins to receive payments from the authority once the project is operational. This in turn has a knock-on effect for the subcontractor, as its payments are only received once the build is completed to the agreed specification--this can lead to a vicious circle, whereby delays in payments push a subcontractor into difficulty and cause it to be removed from the project. Penalties for delays between the subcontractor and construction contractor should be back-to-back with the construction contractor's obligations under the concession contract and should pass the full risk of delays to the parties responsible.

Credit support in the form of parent guarantees and performance/surety bonds is often required by lenders due to the relatively weak credit profile of the contractor. This credit support can take a variety of forms from letters of credit to surety bonds--Standard & Poor's and lenders would almost never accept naked construction project risk without some form of risk mitigation. Surety bonds are a form of creditor support, but generally rely on a dispute resolution procedure and willingness of an insurer to pay in order to perfect a claim. Surety bonds generally are not relied on by Standard & Poor's as a form of timely credit support for debt service, although their absence or insufficiency

would be a significant credit weakness.

Risk Management

A risk that has emerged recently, but has generally been prevalent in project finance, is that contractors generally do not sign contracts with subcontractors at the time they themselves sign up to the project concession agreement with a fixed-price, date-specific deal--this is a typical feature of project finance in general. If proper planning and costing has not been carried out, this increases the risk of not being able to procure subcontracts on adequate terms and increases the risk of the contractor being paid a fixed sum under the concession contract, while exposed to potentially different terms and conditions under its subcontracts. Adequate planning, liquidity, delay float, and costing contingencies are therefore important for a contractor to consider when bidding for concession contracts. This was highlighted in the case of a project delay and legal wrangle between Sir Robert McAlpine and Drake & Scull--its mechanical and engineering (M&E) contractor--on Dudley NHS hospital, where it is understood Drake & Scull did not have a formal contract even after work had commenced, subsequently encountered difficulties with fulfilling its project obligations, and was terminated by Sir Robert McAlpine.

The significant use of debt financing also assists in matching the cash flows and financial risk management of the project. The bulk of the debt is fixed rate, achieved through conventional interest rate swaps or inflation/LIBOR swaps, or index-linked to match the indexed revenue flows from the authority counterparty. The actual level of income is dependent on the level of use or availability of the facilities, and is classified in two categories--availability and throughput. An availability measure is employed for accommodation facilities, based on the number of serviceable units (the number of hospital beds available to a set specification, for instance).

Throughput is applied to those projects based on volume (highways or sewage, for example). Both methods pay a current price, adjusted for inflation. Throughput payments are theoretically most at risk from fluctuating demand, although this risk could be mitigated by forecasting techniques, a financial profile that is robust enough to absorb the volatility of cash flows, and by ensuring that payment schedules have sufficient flexibility to compensate for various scenarios.

Maintenance risk or nonavailability is effectively transferred to the maintenance subcontractor through indemnities or penalties for nondelivery, while construction risk is passed down to the construction contractor, if the building is unavailable due to construction-related issues such as M&E--this risk is passed down further to the M&E subcontractor. The construction contractor is generally also responsible for latent defects arising in the facilities for 12 years after the completion of construction. Contracts are usually on a fixed-price basis, with indemnities on specific build phases provided by the respective subcontractors.

Sidebar: Debt Adjustment for European Construction Companies

Debt is adjusted according to the following:

- Cash; debt is net of excess cash and high quality short-term investments that are readily available for debt repayment at short notice. Cash held in joint ventures or in foreign jurisdictions subject to exchange control, cash needed for working capital purposes, and cash earmarked for acquisitions do not qualify.
- Seasonality; where seasonality is pronounced, leverage ratios are

calculated both at mid-year and year-end.

- Customer advances; generally no adjustment, although reliance on advances means exposure to a credit cliff in case volumes decline. The presence or absence of customer advances is factored in to the rating subjectively.
- Off-balance-sheet commitments; surety bonds are generally not included in debt, other than where repeatedly called upon. Ratios are adjusted for financial guarantees, operating lease commitments, and pension and medical obligations in the same way as for all other industrial companies.

As construction companies generally have significant trade creditors, unsecured debt is normally notched down from the corporate credit rating due to structural subordination. Structural subordination is mitigated by downstream loans and upstream guarantees in certain legal jurisdictions, diversification, and the disproportionate distribution of debt, for example.

Analyst E-Mail Addresses

tommy_trask@standardandpoors.com

craig_jamieson@standardandpoors.com

jan_plantagie@standardandpoors.com

peter_tuving@standardandpoors.com

mike_wilkins@standardandpoors.com

CorporateFinanceEurope@standardandpoors.com

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