

# DBRS Canada Newsletter

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## HYBRID FINANCING OF PPPs: POTENTIAL ISSUES TO KEEP IN MIND

Hybrid financings that feature long-term bonds and a short-term loan facility have become common in Canadian public-private partnerships (PPPs). This form of financing presents cost advantages, but it also leads to the need for more extensive documentation and typically involves swaps to fix the floating rates payable on the loan facility, giving rise to several groups of creditors. Although generally well understood by the market, hybrid financings can create complexities that deserve particular attention when analyzing a PPP transaction, including the issues described below.

### Quality of Participants

For A-rated PPPs, DBRS would expect lenders and swap providers to be rated at least in the A-range. This requirement also applies to the creditworthiness of assignees in the case of assignment. These entities will generally be severally, but not jointly, liable for their respective funding or swap commitment. As such, DBRS takes a “weakest link” approach when incorporating the credit quality of the financing parties into its analysis. Factors such as the legal frameworks and financial systems of the lender’s and swap provider’s home countries are also considered. This is partly because the minimum rating thresholds set out in lending agreements are typically point-in-time requirements to be met at financial close or upon assignment, giving rise to the potential for subsequent credit migration. Even with a high credit rating, a lender or swap provider located in a country with an unstable financial system or opaque legal system could have adverse effects on the PPP rating. DBRS also takes the tenor of the loan facility into account when assessing the suitability of short-term financing, as shorter construction periods are likely to provide less opportunity for credit deterioration.

### Delayed versus Pro Rata

Hybrid financing is most often employed when short-term loan financing is used to bridge milestone or substantial completion payments. Under such a scenario, one option is to concurrently draw the bond proceeds and loan facility on a pro rata basis during the construction phase. Another option is the delayed loan-draw structure, whereby the bond proceeds are drawn first, followed by the loan facility. Although a delayed loan-draw structure will often result in lower financing costs than a pro rata draw structure, it may expose bondholders to potentially greater risks than lenders if the loan commitment is framed too loosely relative to the firm commitment of bondholders, whose funds are already fully tied to the project. In such a case, the two groups of creditors could have different motivations if the project were to experience serious difficulties.

For example, if a construction-related default occurs after the bond proceeds have been exhausted and a significant portion of the loan facility has been drawn, the interests of the lenders and bondholders will be fairly closely aligned, with both parties more likely to waive a default or facilitate the replacement of the defaulting contractor (if the project is still viewed as viable). However, a project with a delayed loan-draw structure that encounters difficulties when only bond proceeds have been drawn could give rise to more divisive dynamics among lenders and bondholders. With significant funds at risk, bondholders may have a large incentive to waive a default if presented with a credible remediation plan. With no funds in the project, lenders might be less supportive of a waiver or remedial plan, choosing instead to discontinue their funding commitment if permitted under the loan agreement. As such, when reviewing the financing documents of a PPP, DBRS generally expects to see terms that do not unduly compromise ProjectCo’s ability to replace a defaulting contractor in a timely fashion.

### **Severity Can Differ**

It is worth noting that the impact of a delayed loan-draw structure on the credit profile of a PPP can intensify as the differential between the rating of the project and the rating of the construction contractor and its guarantor widens. This is mainly because DBRS uses the construction contractor's rating as a starting point to derive the rating of a PPP for the construction phase, then adds to this rating based on the construction enhancements provided to the project on the logic that larger enhancements increase ProjectCo's flexibility to replace a defaulting contractor and complete the project. Therefore, a loan commitment that automatically terminates upon the default of the contractor would prevent DBRS from giving full credit to the construction enhancement package, as such a financing structure would compromise the contractor replacement mechanism and reduce the potential for the construction phase to achieve a rating better than that of the contractor, all else being equal.

### **Potential Mitigants**

Various approaches have been used or proposed to address potential hybrid-financing issues. The most obvious is a pro rata draw, which does not resolve all intercreditor issues but effectively aligns incentives among the lenders and bondholders by increasing their investment in the project at the same pace. The incorporation of a true-up mechanism in the financing platform – in which, after an event of default, lenders are required to advance funds to a collateral account for the benefit of the bondholders in order to bring their exposure in line with that of the bondholders – is also viewed as an effective means of aligning incentives between senior creditors. It should be noted, however, that other solutions could be developed to address the issue. Whatever other option is chosen by the project sponsors would likely be seen as an adequate mitigant by DBRS if it provides sufficient time and flexibility to ProjectCo to develop a remedial plan and, if needed, enact the contractor replacement mechanism embedded in the PPP contractual framework without undermining financing availability. If delayed loan-draw issues are left unaddressed, however, they could have a material adverse impact on the rating of a project during the construction phase.

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