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For **Keri Smith** at Mayer Brown

Mezzanine financing looks for home in infrastructure

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Some of the largest infrastructure fund managers have raised debt funds targeting mezzanine financing, yet little is known about the types of transactions these funds close. *InfraAmericas'* Associate Editor Jinjoo Lee tries to lift the veil.

Mezzanine financing does not play as large a role in infrastructure as it might in other sectors like real estate or corporate finance. But over the last few years, some of the largest infrastructure fund managers have raised funds targeting mezzanine capital and say they are starting to educate the industry.

Hadley Peer Marshall, Brookfield's Head of Infrastructure Debt Americas, said infrastructure sponsors are increasingly considering how to apply mezzanine financing. "Five years ago, they rarely thought about it," she said.

AMP Capital, Brookfield Infrastructure Partners, Global Infrastructure Partners, IFM Investors and Carlyle, for example, have raised funds targeting this part of the capital stack.

Infrastructure debt fund managers said flexibility of capital, fast execution and the inherent value proposition should make mezzanine capital an important part of infrastructure financing.

Still, industry players remain divided over whether mezzanine financing is really necessary in most project financing structures. And in a market flush with senior debt capital and equity, mezzanine debt providers must be nimble to find opportunities.

Opportunities

Marshall said more opportunities have opened up because of increased regulation on banks. Their resulting reduced leverage appetite has created a "hole" in the capital structure, she said.

Patrick Trears, head of infrastructure debt in the Americas for AMP Capital, said that for many banks, it has become "punitive" to hold onto higher risk weighted capital after Basel III regulations.

Additionally, the spread compression experienced by sponsors, resulting from competitive dynamics, has led some infrastructure funds to consider mezzanine financing as a way to accrete returns, Marshall added.

Sample of infrastructure debt funds targeting mezzanine financing

Name	Location	Fund Vintage	Fund Length (years)	Investment Status	Current Status	Current Size USD	Target Size USD	Target Net IRR	Asset Location
AMP Capital Infrastructure Debt Fund I (IDF I)	AUSTRALIA	2011	10	Fully-Invested	Final Close	USD 424.75m	USD 530.94m	6	North America,Europe,Asia
AMP Capital Infrastructure Debt Fund II (IDF II)	AUSTRALIA	2013	10	Investing	Final Close	USD 1100.00m	USD 1000.00m	6	North America,Europe,Asia
AMP Capital Infrastructure Debt Fund III (IDF III)	AUSTRALIA	2016	10	Fund Raising	Fourth Close	USD 1000.00m	USD 2000.00m	-	North America,Europe,Asia
Brookfield Infrastructure Debt Fund	CANADA	2016	-	Fund Raising	-	-	USD 1000.00m	-	North America,Latin America,Europe,Asia
Global Infrastructure Partners Capital Solutions Fund (GIP CAPS)	USA	2014	10	Investing	Final Close	USD 1123.00m	USD 2500.00m	9-11	North America,Middle East,Latin America,Europe,Asia
International Infrastructure Finance Company Fund II	USA	2016	-	Fund Raising	-	-	USD 500.00m	11-14	North America,Europe,Asia
North American Infrastructure Debt Fund	USA	N/A	-	Pre-Launch,Fund Raising	First Announced	-	USD 500.00m	-	North America

Source: *InfraDeals*

Where infrastructure debt funds find opportunities

Mezzanine financing commonly makes sense when sponsors – especially developers and strategics – want to avoid selling assets to raise liquidity or fund a development pipeline, Marshall said.

“We tend to be transition capital,” said Daniel East, managing director for Carlyle’s Energy Mezzanine funds. For example, a sponsor may use mezzanine financing to keep its equity stake during construction. Then, when the project is operational and de-risked, the sponsor can keep a larger piece of the upside or sell the equity at a much higher valuation, according to East.

In 2015, Freeport LNG Development followed this model, funding 100% of its equity for its third liquefaction train through mezzanine capital arranged by IFM Investors. After selling equity for its first and second liquefaction projects to third-party investors, the developer decided it wanted to keep the upside on the third train.

Renewable developers and greenfield power and midstream projects often use mezzanine capital, even though these deals rarely become publicly known, fund managers said.

“For example, if you’re a project sponsor with a small or stretched balance sheet, but a good project… And you don’t want to sell the company or the assets, you may not have a home,” said

Reiner Boehning, partner for GIP Capital Solutions. "Commercial banks, the syndicated loan market and the public equity market will be difficult or impossible to access."

Mezzanine capital is also sought when there is an added risk element in the project. Complexity during construction is one example. "A project may have an aggressive construction schedule or lack a turn-key, wrapped EPC contract, Boehning said. "We understand that risk because we have significant in-house construction expertise and have the ability to step in, if necessary."

Projects lacking full offtake or tolling agreements also tend to use mezzanine capital. "To the extent that the industry continues to build large power projects that are very capital intensive, without full power purchase agreements, there's going to be continuing need for mezzanine or structured capital," said Vince Hahn, principal for Carlyle Mezzanine Opportunity Fund.

AMP's debt fund, for example, is understood to be the mezzanine debt provider for Alterra Power's 200MW wind project in Texas, which relies on a financial hedge in lieu of a full power purchase agreement. In 2015, the fund provided mezzanine financing for the same developer's 204MW Shannon wind project.

While infrastructure debt funds compete with capital from the high yield bond, term loan B and leveraged loan markets, they are not vulnerable to market volatility, Boehning said.

"These markets are subject to periodic dislocations due to any number of exogenous factors. When that happens, people tend to head for the exits and suddenly liquidity shuts down. That's when we come in," Boehning said. "We capitalize on this stratosphere that doesn't have a home, either structurally or temporarily, and we have to be very opportunistic about it."

Speed is another advantage. AMP's Trears said mezzanine debt providers can move more quickly compared to banks. Banks tend to take longer to draft term sheets and pass credit committees, whereas debt funds have more streamlined processes, he noted.

Slow adoption

Fund managers said the infrastructure finance world is slower to adapt than the corporate finance and real estate sectors, where mezzanine debt is a much more active and larger component of deals. Paul Forrester, partner for the corporate finance practice at Mayer Brown, pointed out that money raised for mezzanine debt in infrastructure is a "trivial amount" compared to that raised in corporate finance, for example.

An obvious reason for fewer mezzanine financings is the abundance of available capital for equity and senior debt.

In Europe, mezzanine debt providers are the primary lenders for holding company level debt. However, in the US senior debt has filled that risk profile, said Jean-Pierre Boudrias, managing director and head of project finance at Goldman Sachs.

Another barrier for the sponsor could be the added negotiation, time and fees associated with another stack of capital, Forrester said.

Furthermore, mezzanine structures are so flexible that there are no easy-to-follow templates.

Nevertheless, fund managers said this flexibility is a strength. "In structuring a deal, we have complete flexibility on how we are repaid. We're focused on outright yield," East said.

Market efficiency

"If you hold the economic efficiency view of the world, we should really be using more mezzanine debt than we do," said Mayer Brown's Forrester.

By only using senior debt and equity, infrastructure transactions leave out the risk-reward offerings of investment tranches between the two types of capital, Forrester said. Either senior debt providers are over-leveraging, or the equity investors are injecting too much equity, the argument goes.

Not all industry participants agree. A New York-based project finance banker said that while mezzanine financing has advantages for sponsors looking to maximize the size of their investments, it will not fit those who have limited tolerance for burdensome financial risk.

Jim Guidera, managing director of project finance at Crédit Agricole, said mezzanine capital makes sense as an equity substitute but not as a senior debt substitute for most infrastructure projects. High senior debt leverage on infrastructure projects is justified considering the assets' risk profile and historical credit performance, he said.

Terms and target returns

Infrastructure debt fund managers said target IRRs for mezzanine financing range from 6-8% on the lower end to mid-teens on the higher end. Loans can generally be assigned on a floating rate or fixed rate basis, with tenors ranging from short-term to the full life of the fund. Flexibility is the key selling point, fund managers said.

Repayment methods are also wide-ranging. They include cash interest, payment in kind (PIK) interest, upfront fees, exit fees and equity participation through warrants, convertible participation, equity and preferred equity. Borrowers can also repay funds through a debt recapitalization after addressing transitional risks, through an IPO or by selling equity to a lower-risk yield purchaser.