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The credit crunch and PFI in Italy

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The credit crunch and project financing: a lesson from the renewable energy market in Italy

Despite recent instability in the world's financial markets that has affected the rest of Europe, the project financing market in Italy has shown no signs of slowing down.

The global financial instability has affected the sector in some ways, complicating negotiations relating to loan agreements and related security packages, not to mention escalating inherent risks, thus creating "new rules of engagement."

Nevertheless, the project finance sector in Italy has remained relatively stable, due in no small part to the support the banks have shown their clients in high-profile transactions in economically appealing sectors, such as renewable energy.

The energy sector is one of the few that has kept its pace in the market both in terms of:

- project financing (although banks are taking an increasingly cautious approach to evaluating prospective projects), and
- M&A (over a hundred M&A transactions have been completed in Europe in the renewable energy sector with overall investments estimated to be around Euro 40 billion and numerous other investments are envisaged within 2020 arising out of compliance with EU regulations).

Italy's growing potential is ensuring its appeal with international banks, venture capitalists and private equity funds investing in transactions in the energy sector.

"Thanks to the 2008/2009 Budget, Italy may consider itself together with Great Britain, as one of the most potentially profitable European countries in the renewable energy market. Indeed, our renewable energy certificates (which allow us to exceed traditional production levels) have almost doubled in value compared to the rest of Europe," comment Rodolfo Errore and Ariel Nachman, both lawyers with the firm Simmons & Simmons specialising in the energy-environment sector. They are referring to the section of the 2008/2009 Budget that established the unit value of the so-called green certificates, which are tradable commodities, at 1 Mwh, almost double the French.

The public debate of Italy re-embracing nuclear power has imploded only a handful of months after experts had defined the issue as a political turning point for the country in renewable energy. Nuclear energy remains a long-term objective for Italy, above all in terms of satisfying energy requirements, however in the meantime renewable energy continues to thrive (wind, solar, biomass).

Another interesting segment in Italy is gas: after the liberalisation of the market, we are now witnessing mergers between smaller-scale sellers seeking to expand their client base. Furthermore, larger organisations are looking towards nuclear energy and are forming alliances for the purpose of liaising with the Public Authorities and the legislators.

Another sector which is benefitting from incentives and is experiencing significant investments is regasification terminals, which are viewed as a valid alternative for reducing Italy's dependence on other countries for importing gas.

There has been a lot of interest in Italy by foreign investors, for whom the Italian market is appealing due to both regulatory factors and incentives for creating renewable energy sources.

As underlined by Rodolfo Errore, head of Simmons & Simmons' Italian project financing practice: "We believe that the positive trend in the renewable energy market will continue in the next 3 to 5 years and we will see a boom in the wind farm business from 2010-2011, which will probably come to an end around 2012 when the incentives system in Italy will be subject to changes. Investments in the wind and biomass sectors will remain constant and the nuclear sector will also take off. In view of this positive trend, several foreign companies, especially German, Austrian, Swiss, Israeli and US funds, have decided to invest in Italy. Finally, in view of the absence of a crisis in this sector, the banks will likely continue, albeit under slightly different terms, to fund renewable energy projects."

Italian companies operating in the energy sector vary and make for a diversified panorama.

According to Ariel Nachman, who heads the firm's Israeli Desk, "In Italy, the sector is fragmented and is seeing and will continue to see, strong consolidation, namely through acquisitions, with the view of creating major players in the sector. Not counting Eni and Enel, which are important operators with significant investments abroad as well, the remainder are relatively small-scale companies especially compared to countries like Germany, France and the UK. Moreover, the system is uneven and not prone to an international outlook or changes, which is due in part to the fact that local municipalities often control or have a significant stake in the companies and are therefore understandably focused on more local issues.

The aim of the legislator is to encourage competition and create new players. In general, efforts are made to ensure a greater consolidation at both sales and distribution levels. Moreover, companies involved in the manufacturing, transportation and sales side have all but disappeared with the entry of the private equity funds, interested in investing in the renewable energy sector (especially wind and solar projects), while specialised operating companies have sprung into life (such as companies dedicated to transportation or distribution)."

Although Italy is undoubtedly an appealing market, the new rules governing PFI transactions in the renewable energy sector still have to be taken into consideration and applied on other sectors financed by PFI transactions.

The conditions have changed above all in new projects for banks. "Currently, the renewable energy sector and second level infrastructure in Italy are not feeling the crisis. The limited impact does not necessarily mean there are no effects. Project financing transactions are and will be carried out differently from the past, at the request of the banks," comments Errore.

Second level transactions between Euro 20 and 100 million will continue in the renewable energy sector, but the terms put in place by the banks will be changing. First, we will see an increase in the costs for syndicated loans, to which increased interest rates will be added. At the same time, mid-term loans will be reduced from an average of 15-20 years to an average of 10-15 years. Finally, we are beginning to see greater selectivity on the part of banks regarding the transactions in which they invest, as they choose to opt for transactions offering increased revenue flows and higher profitability that ensure higher margins on returns. When identifying prospective investments, greater attention is placed on strong sponsors. "The banks," explains Errore, "are turning away from syndicated deals and moving towards club deals. Pools of banks are therefore taking the same risks".

A critical issue, however, lies with the transactions that the banks' credit committees have already approved. The real effect of the financial crisis on the project financing market is seen in the number of transactions that received approval from the credit committees, but are currently on hold until the transaction terms are more in line with market conditions. This means in effect that the leading banks with low fees and weak sponsors, are more likely to reconsider projects.

Banks are therefore looking to renegotiate with sponsors the fees and the timing of loans. This is objectively a challenging task, which could have significant effects on not just the financial models for project financing, but also on business plans. Putting a loan project on hold could trigger the breach of other loan agreements already entered into, subject to legal loopholes that can allow the banks to revise the terms.

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These issues then cascade down to the sponsors, that may already have started to pay the advance payments after receiving the go-ahead from the banks, or may not have significant margins for changing their business plans.

The crisis has reversed the burden of proof in the relationship between the banks and the companies. This is not limited to an increase in the limitations and guarantees of the company. More formal obligations are being requested by the banks. As ever, the time frame for financing projects is getting shorter. This calls for a new structure planning for project financing transactions, which will likely involve the growing presence of mezzanine loans. "This may well be the revolution of project financing in Italy." says Nachman.

"Clauses relating to contractors," explains Rodolfo Errore, "are putting more limits in place and the standard market guarantees are even being doubled in some cases. More often we are seeing contractors being requested to provide a Parent Company Guarantee, which are alternative corporate guarantees for typical project financing structures, whereby the risk for failed performance shifts to the parent company. In essence, we could be seeing non recourse loans under exam (secured by collateral) for certain project finance transactions entailing the introduction of guarantees usually used in corporate transactions. Moreover, banks tend to mitigate risks by asking the borrowers for fees, which in some cases have increased by 60-80%, switching the effects of the crisis onto the borrowers."

In general, the consensus on the market is that short-mid term transactions will be favoured over longer term transactions. Given the good opportunity arising from the link between the balance and the lack of envisaged refinancing, certain banks are currently refusing to finance over 15-20 years. In fact, the tendency seems to be for terms of 8-10 years without incurring any refinancing obligation.

This is where the mezzanine loan comes in again: this form has had great success in the UK, but is not frequently used in Italy given its short term. "If a company is involved in numerous projects, it may not be able to find the equity it requires to finance them all. As an alternative to the more traditional loan systems, financial institutions can be found that are willing to finance the equity for up to 95% of the amount normally required of the sponsor for the leverage, or to provide with a mezzanine structure (with or without a balloon payment at the end of the term)."

New legal challenges on the horizon? "We are definitely studying and researching new contracts and clauses. First, because the mezzanine structure is not used often in Italy, but, secondly, because the real challenge lays in finding a balance between the different interests and constructing finance structures and contracts that work for both types of creditors: senior lenders and possible equity or junior lenders."

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