Infrastructure – Risk Perspectives

Episode 5

Infrastructure M&A: Navigating known risks part two

Martin Bennett: Hello, I'm delighted to be joined again by Marsh colleagues Tom Burrell and Stefan Farahani for a further conversation of transactional risks in M&A and the utilisation of specific risks insurance to mitigate known situations that arise, reduce contingencies, or remove contingencies, that otherwise may impact valuation and bankability of transactions.

My name is Martin Bennett and I lead Marsh's activity with private capital investors both through M&A and their investment lifecycles. So Stefan, perhaps could you just share the background to the particular example that we want to have a conversation around today?

Stefan Farahani: Yes, of course. The background is, it's very common for subsidies and feed-in tariffs to have eligibility criteria in order to receive them and a recurring risk that we have seen is around plants being aggregated, such that they receive a lower rate of feed-in tariff. And in particular, the way these rules operate are that smaller projects have fewer economics of scale and so naturally, a regulator and regulatory systems will say that smaller projects should be benefiting from larger feed-in tariffs and the risk arises because smart contractors when they are building these projects will build multiple small projects next to each other that would each receive the higher rate of feed-in tariff. Now the risk is the regulator might not like that and might look to aggregate those projects together and give them the lower rate of feed-in tariff and equally claw back any feed-in tariff that has been received historically.

Tom Burrell: Excellent, and just thinking a little bit about this specific example Stefan, what was the ultimate insurance solution that we looked at here?

Stefan Farahani: So on this particular example we arranged insurance for €60 million against the risk that the historic feed-in tariff was clawed back by the regulator, the risk that the regulator stopped paying future feed-in tariff and subsidies at the preferred rate and also the risk of fines and penalties being imposed by the regulator. We placed a ten year policy so that covered all of the historic risk and the risk of its challenge in the subsequent ten years and the premium was a one-off premium at 4.5% of the policy limit.

Martin Bennett: And Stefan, that obviously sounds like a great solution that we put in place there – how did that solution actually positively impact the particular deal that you were working on for the benefit of the related parties?

Stefan Farahani: So this particular deal benefited both buyer and seller, this type of issue is fairly well known and we've seen it in various jurisdictions, the problem the parties have, or a seller in particular has, is that once this risk is identified it puts a lot of investors off because it speaks so significantly towards the value of the project and the future cash flows – often is can lead to broken processes. In this case the insurance solution gave the buyer sufficient comfort that the transaction could proceed but also from the buyer's perspective it gave them a competitive advantage because they could therefore acquire a project with certainty of the cash flows that other investors weren't willing to look at because it had this known issue associated with it.

Tom Burrell: Excellent and thinking, you're talking about buyers and sellers – where you've got debt in a project I guess there's a positive impact potentially for lenders and their interests too though?

Stefan Farahani: So lender reticence around these risks is often one of the main driving factors for seeking insurance. Lenders don't get the upside but they take the downside and so their focus is on stable cash flows and certainty of free cash flow to repay debt. And so having the risk of a large fine or reduced subsidies is deeply concerning to them. And our experience is taking the insurance in a collaborative process, potentially having the lender as a loss payee or a signee under the policy can be a way of getting them comfortable with some of these risks in a project because they know if the risk manifests they are going to be repaid through the insurance solution.

Martin Bennett: Stefan, that's great. Thank you very much for working us through the example for today's episode. I think we will conclude there and very much looking forward to talking to you and Tom again in the near future around another specific risks example.