

Leveraged Loan and Refinancing Risk in Infrastructure Financings

Refinancing Assumptions Heavily Influence Credit View

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Fitch's analytical approach assumes Term Loan B instruments will likely refinance into another Term Loan B, aligning our analysis with the typical dynamics of the market.

Terry Pratt, Director, Fitch Ratings

Leveraged loans continue to be an important funding source for project financings in certain North American infrastructure segments. Funding structures that involve balloon payments at loan maturity remain a sizable part of the market. They also extend into new segments where cash flow exposure to market volatility has increased as borrowers search for lenders willing to accommodate those risks.

The Term Loan B (TLB) market, in particular, is an important segment of the overall leveraged loan market that supplies funding to project finance transactions, primarily in the U.S. Borrowers in the U.S. power and energy sectors often use the TLB structure for projects with short- to medium-term contracted or hedged revenues and a large degree of long-term margin volatility dependent on market conditions.

TLB transactions are designed to only repay a nominal portion of the principal over the loan term, resulting in a large balloon at maturity. During the loan term, the project's ability to pay annual debt service and manage leverage are key credit considerations.

At maturity, the analytical focus shifts to the ability to refinance the balloon based on projected cash flow over the project's remaining useful life. The analytic approach to evaluating refinancing risk and the underlying assumptions are important factors in deriving the rating.

Focus on Refinance Profile

Lending markets typically assess refinance risk by either comparing the balloon amount to some value of future cash flow or assessing financial performance with new debt that has some assumed amortization profile. Fitch Ratings thinks both approaches are useful for evaluating TLB refinance risk.

In the case of a refinance profile, Fitch thinks the uncertain market conditions that drove the use of a TLB in the first place will most likely result in new debt being refinanced in a TLB structure with similar features. This shifts the financial analysis' focus to include leverage metrics and the time needed to achieve full payoff under cash flow sweep assumptions.

A central part of the analysis includes assumptions about the cost of debt capital and the project's post-maturity financial profile.

Fitch's approach provides multiple avenues to evaluate credit quality and allows for refinancing analysis that is appropriate for an asset class and overall risk exposure. This report focuses on the U.S. TLB market, but the analytical tools described are also utilized across other leveraged loan asset classes and geographic regions, where relevant.

Examples of how these analytic tools may be used to evaluate TLB and refinance risk are provided in the *Appendix*.

Related Research

[Fitch Ratings 2021 Outlook: North American Energy Infrastructure \(December 2020\)](#)

[Fitch Affirms BCP Renaissance Parent's Sr. Secured Debt at 'B+'/'RR3'; Outlook Remains Negative \(November 2020\)](#)

[Thermal Power Project Rating Criteria \(May 2020\)](#)

[Infrastructure and Project Finance Rating Criteria \(March 2020\)](#)

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TLB Financial Risks

A TLB Transaction Has Two Distinct Phases with Different Financial Risks

- TLB Phase: Assessment of TLB focuses on the ability to:
 - Pay annual debt service; and
 - Manage leverage.
- Refi Phase: Assessment of Refinance and Post TLB focuses on:
 - Ability to refinance the balloon payment upon maturity; and
 - Credit metrics post refinancing.

Given the TLB structure is intended to mitigate default risk during the TLB phase, many market participants think the refinance phase risk drives the overall credit profile. However, defaults occur during the TLB phase for many transactions. Fitch typically assesses the credit quality of each phase and constrains the overall credit rating based on the phase that demonstrates weaker overall credit quality.

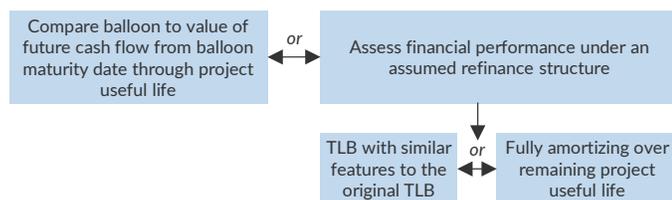
Typical Balloon Refinancing Structure

There are many financial attributes commonly used by the market to assess refinance risk. Some market participants compare the value of future cash flows to the balloon amount at maturity. This approach does not require an assumption about how the new debt raised to repay the balloon would be structured.

Other participants may assess refinance risk by assuming the balloon would be taken out with new debt that has some defined principal repayment structure. In most infrastructure transactions that have reasonable certainty of revenues and expenses, a stable repayment structure over a project's useful life is a common assumption. The useful life could be the physical, economic or contract life.

However, TLB transactions typically involve revenue and expense uncertainty. New lenders for these types of transactions with more cash flow volatility are likely to limit their exposure to a period that is shorter than the project's useful life. The uncertain market profile that drove the use of the TLB in the first place will, in normal market conditions, most likely result in a refinancing of the balloon into a new TLB structure rather than a fully amortizing structure over the project's useful life.

Refinance Phase Analytic Options



TLB - Term loan B.
Source: Fitch Ratings.

Fitch will focus on the refinancing analysis appropriate for the asset class and overall risk exposure, but may use more than one approach to gain better insights into resilience against refinance risk.

Types of TLB Transactions Rated by Fitch

Fitch Rates a Variety of Projects with TLB Debt Structures Within the Infrastructure Sector

TLB-eligible transactions tend to be long lived or evergreen assets rather than shorter term market plays with clear prospects for obsolescence.

Types of infrastructure TLB-funded projects Fitch rated include:

- Power: Generating assets that sell energy and/or capacity into North American wholesale power markets;
- Midstream Energy: Large interstate pipelines that earn revenue based on potentially variable utilization and tariff rates; and
- Industrial and Alternative Infrastructure: Assets that produce and sell commodities under short-term sales agreements with exposure to price and volume risk.

Key Financial Metrics in TLB

Fitch's analysis may consider several metrics to gauge various financial risks, as noted in the *Infrastructure and Project Finance Rating Criteria* (master) and sector-specific criteria, using them selectively as appropriate for the sector or transaction structure.

Metrics associated with a given rating category can vary widely depending on the nature of the transaction and the potential volatility of cash flow. In general, projects with more stable cash flows can support weaker metrics for a given rating category compared with projects with more volatile cash flows.

Analysis can include the annual debt service coverage ratio (DSCR), leverage (typically measured as debt to EBITDA) and the project life coverage ratio (PLCR), as stated under the master criteria. Fitch assesses metrics resulting from base and rating case assumptions, stress conditions and break-even scenarios. Fitch may utilize one or more metrics to assess financial risk for TLB transactions, depending on the phase.

TLB Phase

The key risk considerations are the ability of the project to pay scheduled annual debt service and to manage leverage. There is no refinance risk in this phase, so Fitch would typically focus on the average and minimum annual DSCRs to help gauge the project's financial resilience in this phase.

DSCR thresholds for specific rating categories typically vary depending on the likely volatility of cash flow. Threshold metrics are lower when revenues are more certain and higher when revenues are more volatile. For example, a thermal power project with DSCRs of around 1.4x would typically fall in the low 'BBB' category if revenue is fully contracted, but in the low 'BB' category if revenue is fully exposed to merchant market sales. In the power project examples described later in this report, in which all revenue is

earned from merchant sales, TLB phase DSCRs are above 1.5x, indicating a credit profile in the mid-‘BB’ category.

Fitch’s DSCR thresholds are quantitative guidance on credit strength. However, because a rating includes both qualitative and quantitative analysis, stronger or weaker financial metrics will be viewed in the context of the qualitative analysis of risk attributes described in the master criteria. For example, a merchant project operating in the PJM Interconnection region, where revenues are earned in energy and capacity markets, might be viewed differently than the same exact merchant project operating within the Electric Reliability Council of Texas’ (ERCOT) service territory, where revenues are earned only from energy markets where pricing is assumed to include a scarcity component.

Fitch may also consider leverage as a factor during the TLB tenor. Some sector-specific criteria do not provide indicative guidance on leverage thresholds for specific rating categories. In such cases, Fitch may look to other rated peers or historical transactions in the market to assess relative risk. For example, the leverage on a natural gas pipeline project could be comparable to leverage on similarly rated corporate-style assets in the midstream energy sector.

Refinance Phase

Fitch may evaluate TLB refinance risk by comparing the balloon amount to a projected value of future cash flow over the remaining project’s useful life. Fitch may also assess the project’s financial performance with new debt issued to repay the balloon that is structured as a TLB, provided the useful life is beyond the likely tenor of the new TLB structure. Fitch may evaluate different metrics for these two approaches to gauge refinance risk.

Comparing the Balloon Amount to the Value of Future Cash Flows

The PLCR at TLB maturity provides a standard quantitative picture of refinance risk. Key assumptions for the PLCR calculation may include:

- Time frame for future cash flow generation. Fitch would typically develop a useful life expectation over which cash flow can be generated based on the inputs from technical experts, market conditions and its experience with similar projects;
- Discount rate. The discount rate used to calculate the net present value of cash available for debt service will typically be the coupon on the debt, but can incorporate varying assumptions about the cost of capital, depending upon transaction-specific circumstance; and
- Leverage at TLB maturity.

The PLCR is one measure of a project’s ability to repay a balloon based on an assessment of consolidate future cash flow from the time the balloon is due through its useful life. The PLCR does not indicate how a project might perform financially on an annual basis under an assumed balloon refinance structure, which may present a limitation to this approach. A project may demonstrate a high PLCR over a long useful life but weak annual DSCRs in the early years in a refinance structure, especially when leverage is high at balloon maturity.

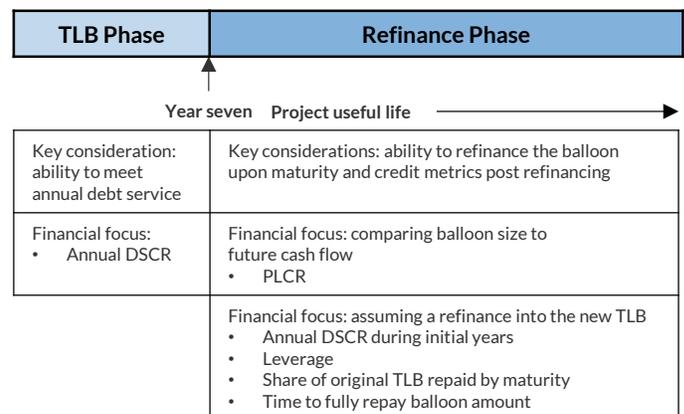
An Assumed Refinancing into a New TLB Structure

Key TLB structure assumptions may include:

- Annual amortization requirement. Fitch will typically assume 1% per year, which is the standard amount for most TLBs;
- Cash flow sweep structure. Fitch will typically assume a structure that is similar to the original TLB. Fitch may also evaluate a stress scenario for peer analysis that uses a standardized cash flow sweep structure;
- Tenor. Fitch will typically assume a seven-year tenor for the new debt; and
- Interest rate.

Metrics may include:

- The annual DSCR. This may be useful to gauge default risk, typically in the initial years of the refinancing. This metric may become a less useful measure of credit risk over time, as annual debt service declines, often resulting in very high annual DSCRs;
- Leverage trends over time;
- Share of initial debt repaid by maturity; and
- Time for full debt repayment. The number of years to amortize the new TLB debt to zero based on a standardized cash flow sweep assumption. The scenario assumes no maturity date. This measure may be most useful in evaluating credit risk relative to peers.
- An Assumed Refinancing into a Traditional Fully Amortizing Structure



TLB – Term loan B. DSCR – Debt service coverage ratio.
 PLCR – Project life coverage ratio.
 Source: Fitch Ratings.

While Fitch will typically assume a TLB balloon is refinanced into a new TLB structure, there may be situations when the balloon might be refinanced into a fully amortizing structure over the remaining useful life. This could occur when the useful life is equal to or less than the tenor of the new TLB structure and there is sufficient confidence that the debt could be repaid with remaining cash flow.

The key risk considerations in such a situation would typically be the ability of the project to pay annual debt service. Fitch would typically assess the average and minimum annual DSCR over the synthetic fully amortizing period to gauge financial strength.

Structural Features and Credit Enhancements

TLB-funded projects may generate revenue from merchant markets, contracts or hedges during the TLB phase. Fitch will give credit to those revenue streams as relevant and with consideration to counterparty creditworthiness. Contracts and hedges can be structured to better achieve deleveraging targets and thus lower refinance risk. Indicative DSCR metrics for a rating level decrease in periods when cash flow is more certain.

TLB transactions often have a working capital facility that provides for a debt service reserve and additional liquidity to deal with market volatility or timing of payments, among other things. Fitch would typically not include unrestricted and undrawn facility capacity as debt in its financial analysis.

TLBs have floating interest rates. Fitch would assume a forward interest rate profile based on market conditions relevant for the project's operational and financial profile. Many TLB transactions are required to hedge a certain share of interest rate exposure through the debt tenor. Fitch will give credit to any such hedge as appropriate.

In scenarios where the TLB balloon is assumed to be refinanced into another TLB or other amortizing structure, Fitch will make assumptions about the interest rate of the new debt. Fitch will

develop its assumption based on several factors, including market conditions, norms in the industry for the asset class, the operational strengths and weaknesses of the project in relation to peers, and the project's record in raising funds from debt markets.

Fitch will typically use the financial metrics resulting from rating case assumptions to determine the TLB debt rating. However, there may be situations where stress or break-even analysis results may provide a better gauge of credit quality and would therefore influence rating outcomes.

Recovery Ratings for TLB Debt Issuances

An issuer using TLB debt to fund a transaction may request a Recovery Rating in addition to a debt rating for the TLB. If Fitch assigns a Recovery Rating to rated TLB debt, Fitch follows the methodology defined in the master criteria.

Appendix – Examples

The *Appendix* provides three examples of how Fitch may apply the analytical tools discussed in this report along with its general rating methodology to evaluate the credit risk of hypothetical transactions that involve an initial TLB funding and significant refinance risk. These examples are meant to illustrate Fitch's analytic approach to determining a rating outcome range based primarily on quantitative financial metrics and without consideration of many other transaction attributes covered under the master and sector rating criteria that could improve or weaken the project's credit profile

Example 1 Merchant Power – Energy and Capacity Market

Asset Profile

Technology	Combined-cycle gas turbine
Capacity	1,000MW
Heat Rate	6,400Btu/MWh
Fixed O&M	\$31/kW-year
Variable O&M	\$2/MWh
Remaining Useful Life	25 years

Market Profile

Energy and Capacity Market

Natural Gas Price	\$2/mmBtu-\$3/mmBtu
Capacity Factor	65% declining 1% per year from 2030
Energy Prices	Approx. \$20/MWh-\$35/MWh
Capacity Prices	Year One: \$29/kW-year Year Two: \$38/kW-year Year Three: \$46/kW-year Year Four: \$46/kW-year, rising to approx. \$80/kW-year

Financial Profile

	Initial	Refinance
Debt (\$ Mil.)	600	451
Debt per kW	\$600	\$451
Structure	Term Loan B	Term Loan B
Annual Amortization (%)	1	1
Cash Sweep (%)	50	50
Tenor	Seven years	Seven years
Interest Rate	LIBOR + 350bp	LIBOR + 450bp
% Initial TLB Repaid at Maturity		25
PLCR at Maturity (x)		1.7
Leverage at Maturity (x)		5.9
Debt/kW at Maturity		\$451
Full Repayment of Refi Debt with a 100% Cash Sweep		Eight years
Indicative Rating – TLB Phase		BB/BB+
Indicative Rating – Refi Phase		BB-/BB

Summary

Assuming strong operating performance and low risk for natural gas supply interruption, the project would be among the lowest cost producers in the market initially, with a relatively high capacity factor during the TLB phase and well into the refinance phase. The high initial debt burden and refinance phase metrics reflect a rating in the low to mid 'BB' category. The indicative rating range for the TLB phase is near the mid to upper end of the 'BB' category based on DSCRs of 1.7x average and 1.5x minimum. However, the overall credit profile is driven by the financial performance of the refi phase. The 50% sweep results in only 25% paydown of the initial TLB debt by maturity. Leverage is significant at about 6.0x at maturity, but the competitive position of the asset may help to mitigate that risk. The debt/kW at maturity is somewhat less than half the typical capital cost for this type of plant. Mitigating some of this refinance performance is a PLCR well above 1.0x. Also, in a scenario in which the refinance TLB cash flow sweep is 100%, the debt would be repaid in a relatively modest eight years.

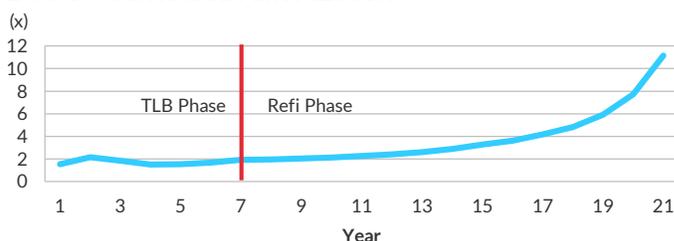
Btu – British thermal units. MmBtu – Million British thermal units.
TLB – Term Loan B. PLCR – Project life coverage ratio.
DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

Annual DSCR Performance

TLB Phase		Refi Phase		Total Period	
Min.	Avg.	Min.	Avg.	Min.	Avg.
1.52x	1.74x	1.96x	4.07x	1.52x	3.29x
Indicative DSCR Threshold for Rating – TLB Phase			BB-/1.40x	BB/1.55x	BB+/1.70x

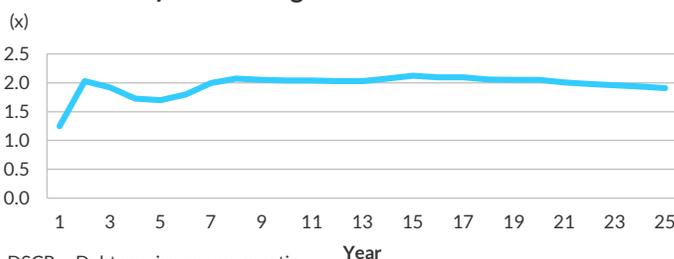
TLB – Term loan B. DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

DSCR – Scheduled Amortization



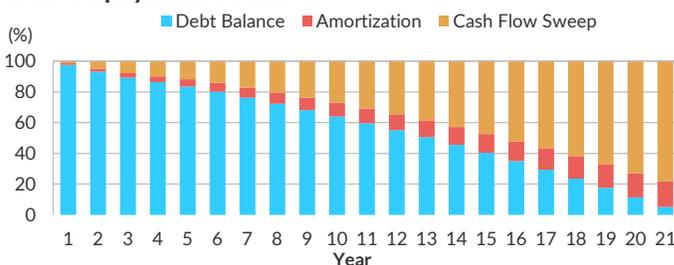
DSCR – Debt service coverage ratio. TLB – Term Loan B.
Source: Fitch Ratings.

DSCR – Fully Amortizing Debt Over Useful Life



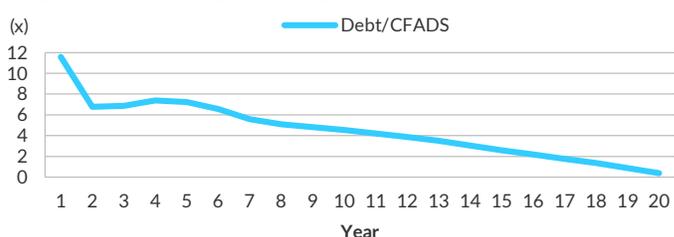
DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

Debt Repayment Profile



Source: Fitch Ratings.

High But Declining Leverage



CFADS – Cash flow available for debt service.
Source: Fitch Ratings.

Example 2 Merchant Power – Energy and Capacity Market

Asset Profile

Technology	Combined-cycle gas turbine
Capacity	1,000MW
Heat Rate	6,400Btu/MWh
Fixed O&M	\$31/kW-year
Variable O&M	\$2/MWh
Remaining Useful Life	25 years

Market Profile

Energy and Capacity Market

Natural Gas Price	\$2/mmBtu to \$3/mmBtu
Capacity Factor	65% declining 1% per year from 2030
Energy Prices	Approx. \$20/MWh–\$35/MWh
Capacity Prices	Year One: \$29/kW-year Year Two: \$38/kW-year Year Three: \$46/kW-year Year Four: \$46/kW-year, rising to approx. \$80/kW-year

Financial Profile

	Initial	Refinance
Debt (\$ Mil.)	600	389
Debt per kW	\$600	\$389
Structure	Term Loan B	Term Loan B
Annual Amortization (%)	1	1
Cash Sweep (%)	75	75
Tenor	Seven years	Seven years
Interest Rate	LIBOR + 350bp	LIBOR + 450bp
% Initial TLB Repaid at Maturity		35
PLCR at Maturity (x)		1.9
Leverage at Maturity (x)		5.3
Debt/kW at Maturity		\$389
Full Repayment of Refi Debt with a 100% Cash Sweep		Six years
Indicative Rating – TLB Phase		BB/BB+
Indicative Rating – Refi Phase		BB

Summary

Assuming strong operating performance and low risk for natural gas supply interruption, the project would be among the lowest cost producers in the market initially, with a relatively high capacity factor during the TLB phase and well into the refinance phase. The high initial debt burden and refinance phase metrics reflect a rating in the mid 'BB' category. The indicative rating range for the TLB phase is strongly at the upper end of the 'BB' category based on DSCRs of 1.8x average and 1.5x minimum. However, the overall credit profile is driven by the financial performance of the refi phase, which is slightly weaker. The 75% sweep results in paydown of about one-third of the initial TLB debt by maturity. Leverage is significant at just above 5.0x at maturity, but reasonable at a mid-'BB' credit profile given the competitive position of the asset. The debt/kW at maturity is about one-third of the typical capital cost for this type of plant. Further mitigating refinance performance is a PLCR at maturity of nearly 2.0x. In a scenario in which the refinance TLB cash flow sweep is 100%, the debt would be repaid in just six years, a relatively brief time for the asset profile.

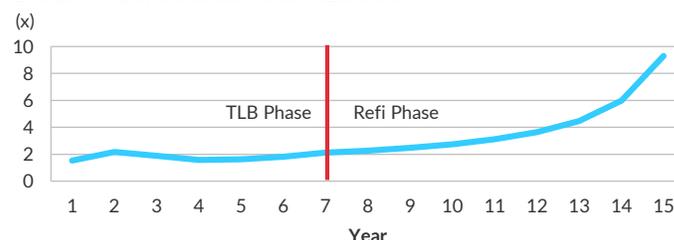
Btu – British thermal units. MmBtu – Million British thermal units.
TLB – Term Loan B. PLCR – Project life coverage ratio.
DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

Annual DSCR Performance

TLB Phase		Refi Phase		Total Period	
Min.	Avg.	Min.	Avg.	Min.	Avg.
1.53x	1.82x	2.27x	9.11x	1.53x	5.92x
Indicative DSCR Threshold for Rating – TLB Phase			BB–/ 1.4x	BB/ 1.55x	BB+/ 1.7x

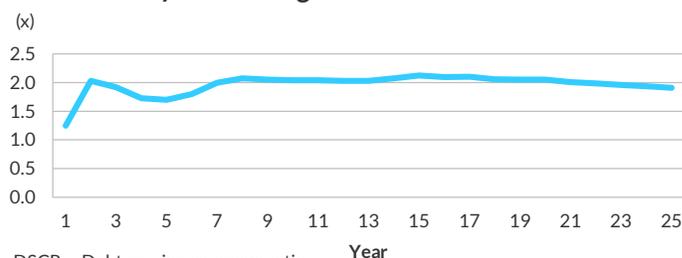
TLB – Term Loan B. DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

DSCR – Scheduled Amortization



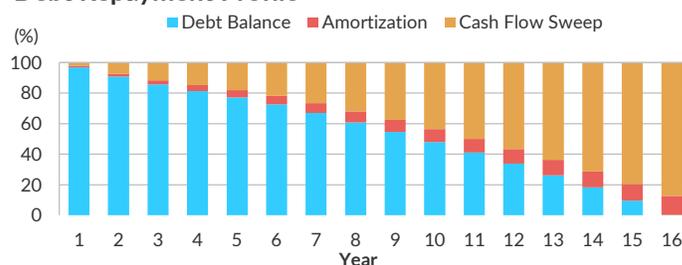
DSCR – Debt service coverage ratio. TLB – Term Loan B.
Source: Fitch Ratings.

DSCR – Fully Amortizing Debt Over Useful Life



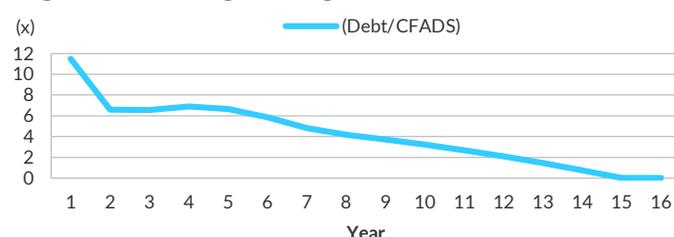
DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

Debt Repayment Profile



Source: Fitch Ratings.

High But Declining Leverage



CFADS – Cash flow available for debt service.
Source: Fitch Ratings.

Example 3

Contracted and Merchant Midstream

Asset Profile

Technology	Long-haul natural gas pipeline
Capacity	1.5 billion cubic feet/day
Competitiveness	Average
Remaining Useful Life	30 years

Market Profile

Long-Term Shipper Contracts Initially

Contract Tenor	10 years, 15 years, 20 years
Contract Rates	\$0.50 cents/dekatherm capacity, on average
Spot Rate	\$0.40 cents/dekatherm capacity, declining

Contracts Assumed Renewed at the Spot Rate

Capacity at	13% – years 1-10
Spot Rate	25% – years 11-15 60% – years 15-20 100% – years 20-30

Financial Profile

	Initial	Refinance
Debt (\$ Mil.)	1,750	1,258
Structure	Term Loan B	Term Loan B
Annual Amortization (%)	1	1
Cash Sweep (%)	75	75
Tenor	Seven years	Seven years
Interest Rate	LIBOR + 300bp	LIBOR + 400bp
% Initial TLB Repaid at Maturity		28
PLCR at Maturity (x)		1.14
Leverage at Maturity (x)		7.59
Full Repayment of Refi Debt with a 100% Cash Sweep		14 years
Indicative Rating – TLB Phase		BBB/BBB+
Indicative Rating – Refi Phase		BB-

Summary

Assuming strong expectations for pipeline operating performance and a favorable competitive position linking a strong producing basin to markets with favorable long-term growth prospects but some competition, credit profile is strong initially but erodes as contracts fall way and capacity is exposed to declining spot pricing. The indicative rating range for the TLB phase is investment grade based on DSCRs of 1.66x average and 1.46x minimum – assuming shipper counterparty ratings are also investment grade. However, the overall credit profile is non-investment grade based on the financial metrics of the refinance phase. Only 28% of the initial TLB is repaid by maturity, and the first falloff of shipper contracts occurs just eight years later. Leverage at maturity remains elevated at nearly 8.0x, which would typically be high for the asset's competitive and contract position. The PLCR of 1.14x at maturity indicates moderately elevated refinance risk. Under a scenario in which the refinance TLB cash flow sweep is 100%, the debt would be repaid in 14 years, a relatively long time for the asset profile. The credit profile under a scenario with fully amortizing fixed-rate debt would be very weak in the outer years.

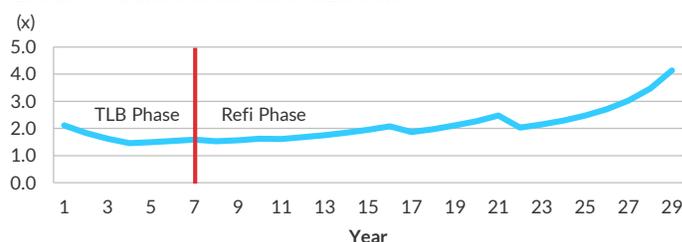
TLB – Term Loan B. PLCR – Project life coverage ratio.
DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

Annual DSCR Performance

TLB Phase		Refi Phase		Total Period	
Min.	Avg.	Min.	Avg.	Min.	Avg.
1.46x	1.66x	1.52x	2.21x	1.46x	2.08x
Indicative DSCR Threshold for Rating – TLB Phase				BBB/1.46x	BBB+/1.52x

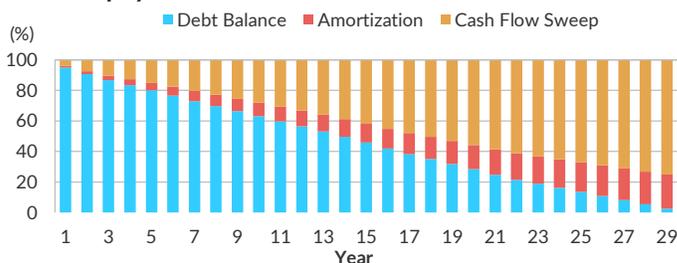
TLB – Term Loan B. DSCR – Debt service coverage ratio.
Source: Fitch Ratings.

DSCR – Scheduled Amortization



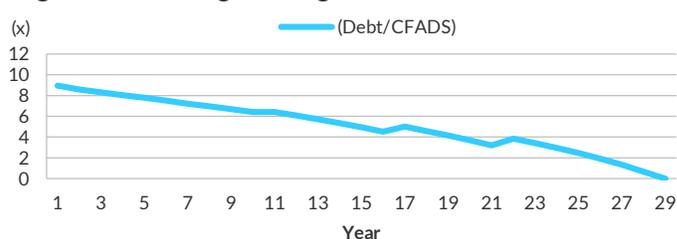
DSCR – Debt service coverage ratio. TLB – Term Loan B.
Source: Fitch Ratings.

Debt Repayment Profile



Source: Fitch Ratings.

High But Declining Leverage



CFADS – Cash flow available for debt service.
Source: Fitch Ratings.

Analytic Profile Summary for Example Projects

	CCGT Example 1	CCGT Example 2	Pipeline Example 3
Qualitative Summary			
Revenue Basis	Merchant energy and capacity	Merchant energy and capacity	Medium- and long-term shipping contracts
Competitive Basis	Top quartile initially, but declining over time	Top quartile initially, but declining over time	Strong initially, but declining over time
Debt Structure	TLB 50% cash flow sweep	TLB 75% cash flow sweep	TLB 50% cash flow sweep
Annual DSCR Performance (x)			
TLB Phase Average	1.74	1.82	1.66
TLB Phase Minimum	1.52	1.53	1.46
Refi Phase Average	4.07	9.11	2.21
Refi Phase Minimum	1.96	2.27	1.52
Other Financial Metrics			
% Initial TLB Repaid at Maturity	25	35	28
PLCR at Maturity (x)	1.66	1.93	1.14
Leverage at Maturity (x)	5.91	5.29	7.59
Debt/kW at Maturity	451	389	N.A.
Full Repayment of Refi Debt with a 100% Cash Sweep	Eight years	Six years	14 years
Indicative Rating			
TLB Phase	BB/BB+	BB/BB+	BBB/BBB+
Refi Phase	BB-/BB	BB	BB-
Factors That Could Lead to a Lower Indicative Rating	A modest decline in the PLCR or modest rise in leverage at maturity. Such a PLCR decline could occur if refi phase prices or capacity factors decline modestly from expectations.	A modest decline in the PLCR or modest rise in leverage at maturity. Such a PLCR decline could occur if refi phase prices or capacity factors decline modestly from expectations.	A slight decline in the PLCR or modest rise in leverage at maturity. This could occur if forecast spot rates decline from expectations.

CCGT – Combined-cycle gas turbine. TLB – Term Loan B. DSCR – Debt service coverage ratio. PLCR – Project life coverage ratio. N.A. – Not applicable.
Source: Fitch Ratings.

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