



## **The Current State of Credit, the Economy, and Privatization**

Association of American Port Authorities

Port Finance Seminar

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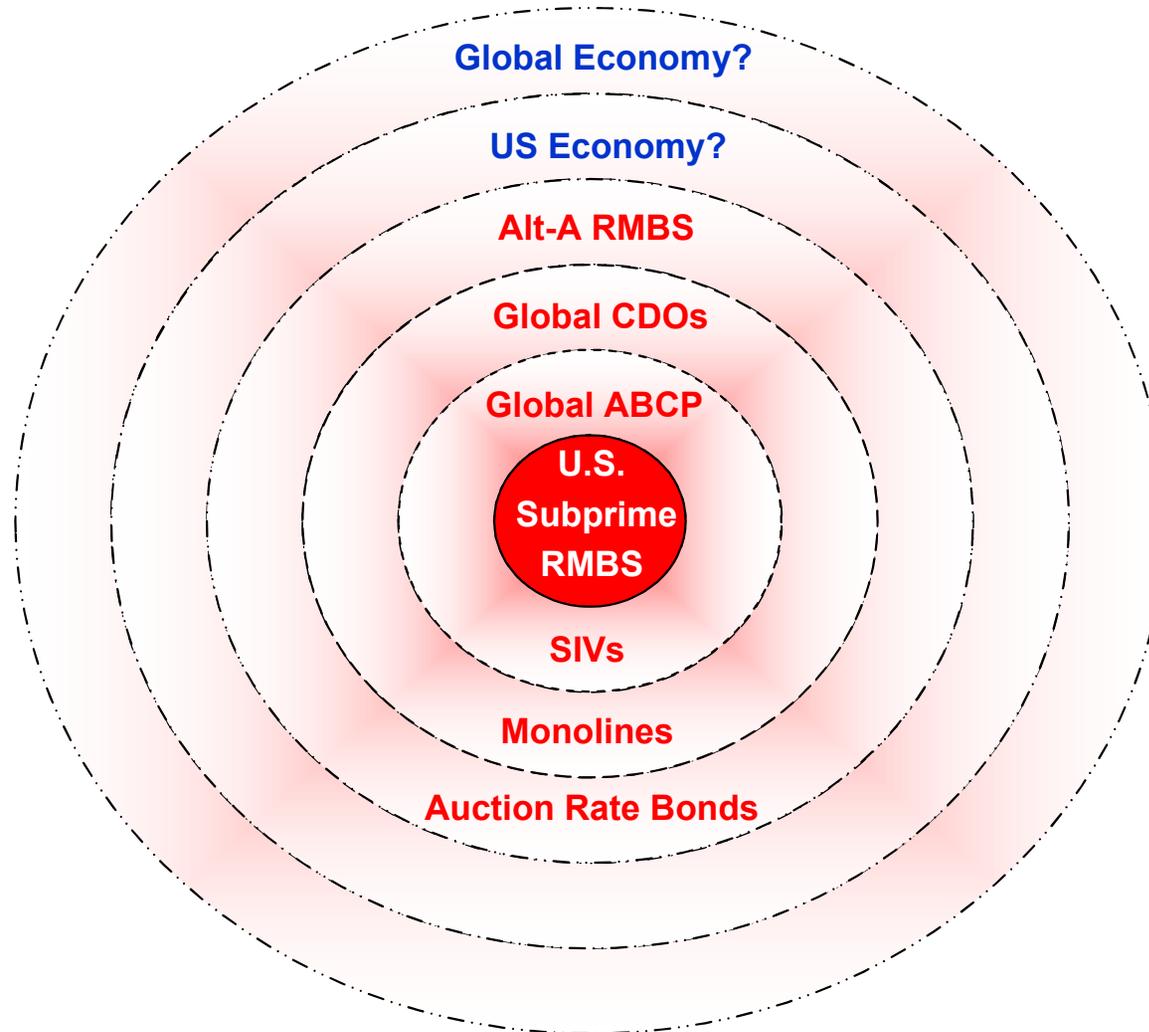


## Agenda

- > Credit
- > Economy
- > Privatization



# Subprime Shock Waves





## U.S. Subprime RMBS – The Epicenter

- > Increased competition amongst lenders led to riskier loans
  - High LTV ratios/piggyback seconds; loans with limited/no documentation; greater percentage of affordability products resulting in payment shock
- > Declining national home prices in combination with affordability products
- > The magnitude of fraud and/or misinformation
- > Borrowers willing to give up their home
- > Effects
  - Resulted in expected losses that far exceeded original loss expectations
  - Led to a lack of confidence and liquidity squeeze aftershocks



## Affects on Infrastructure Credits

- > Widening of credit spreads
- > Compression/Volatility of SIFMA/LIBOR rates
- > Adverse credit environment of monoline bond insurers
- > Lack of understanding of underlying credits by some investors
- > Auction rate market meltdown
- > High demand for bank liquidity – higher premiums
- > Negative mark-to-market on swaps
- > Generally high investment grade credit quality of munis has been a plus
- > Potentially adverse economic environment ahead (fuel, inflation, employment)

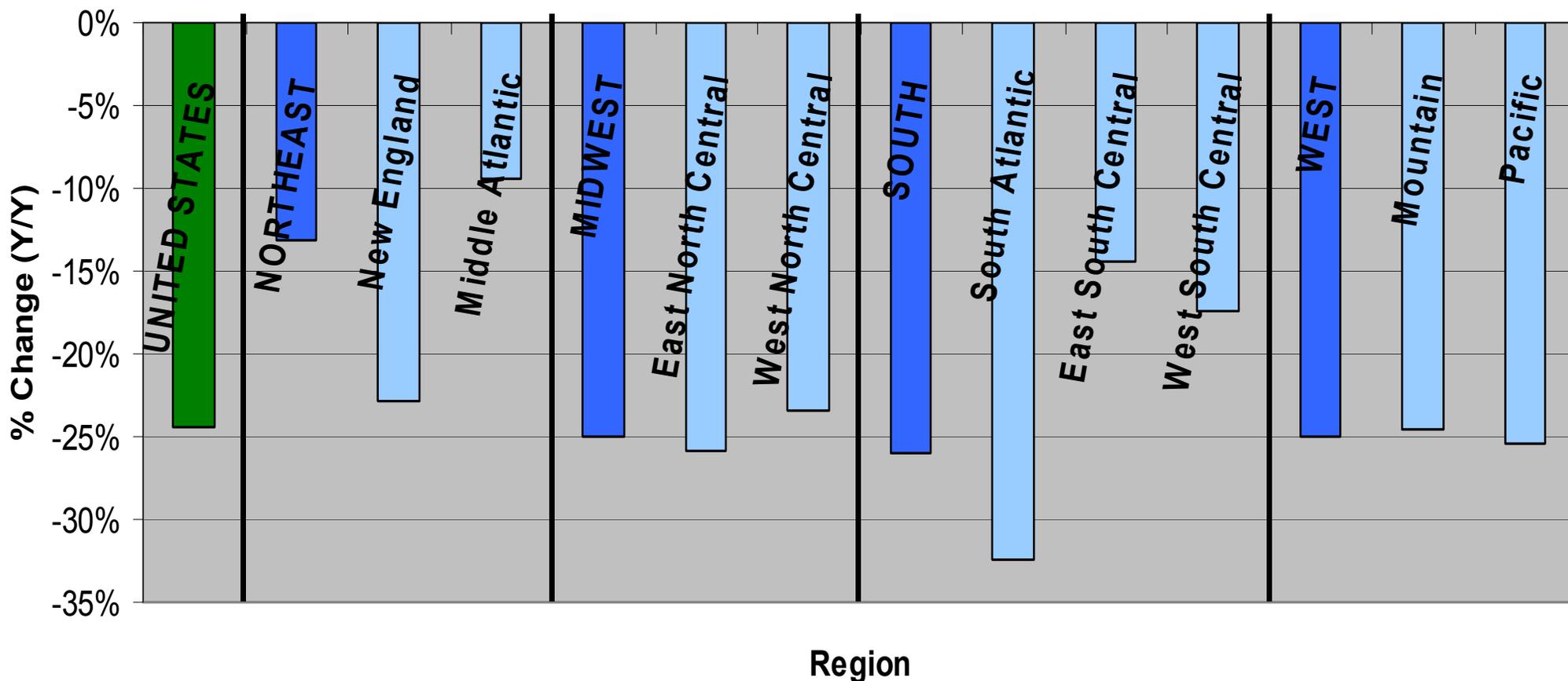


## Housing Price Appreciation

- > Nationally, prices increased an average of 56% between 2003 Q3 and 2005 Q2 (designated as the pricing peak)
- > Many MSAs saw much higher increases during this period, which Fitch viewed as unsustainable
- > Factors driving the increases included low interest rates, availability of non-traditional financing vehicles, rapid appreciation potential fueling speculation, population growth, population aging and changing demographics



## Number of Building Permits Single and Multi Family Homes (YTD: Nov. 2007)

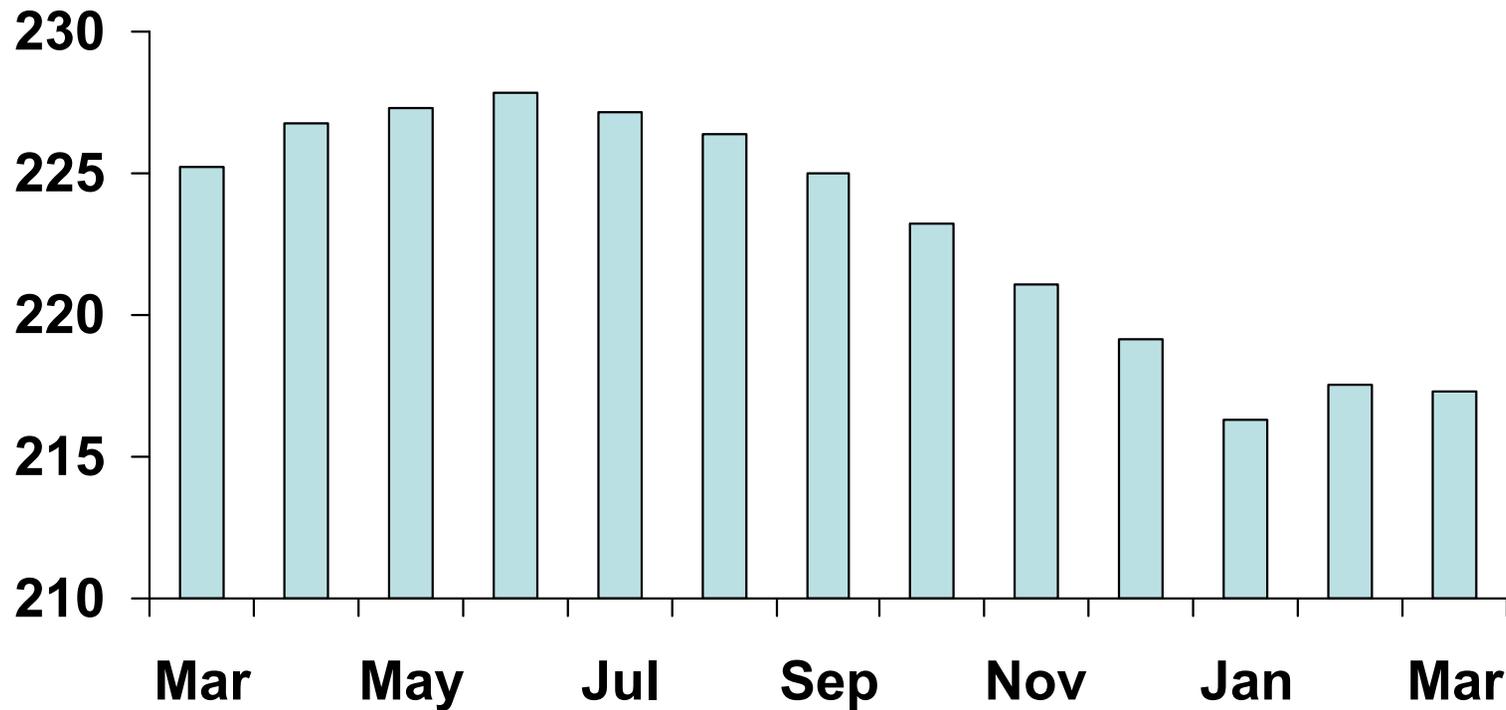


Source: National Association of Homebuilders  
Courtesy of: HousingEconomics.com



# Housing Prices

## March 2007 - March 2008

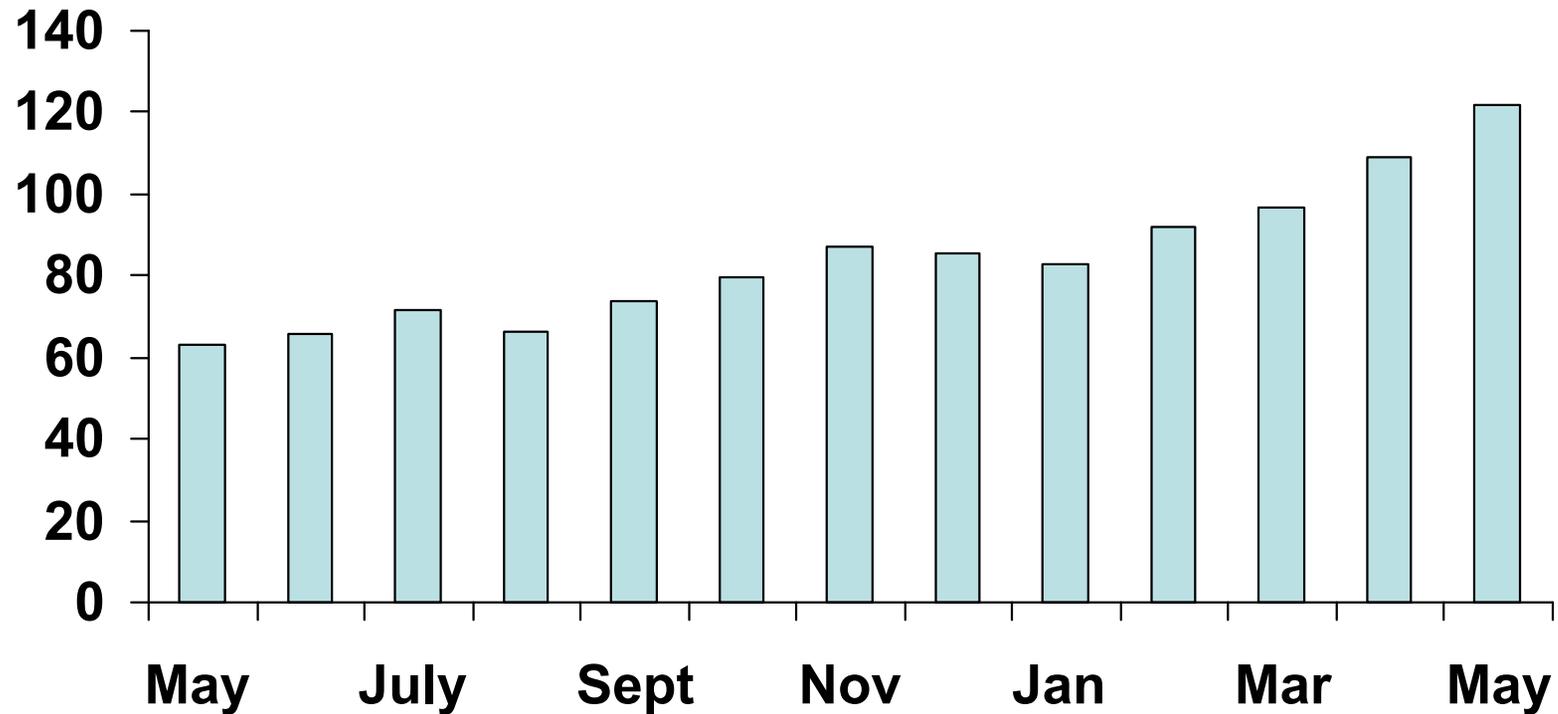


Source: Office of Federal Housing Enterprise Oversight, Monthly House price index (purchase only) for U.S. Not seasonally adjusted



# Oil Prices

## May 2007 - May 2008



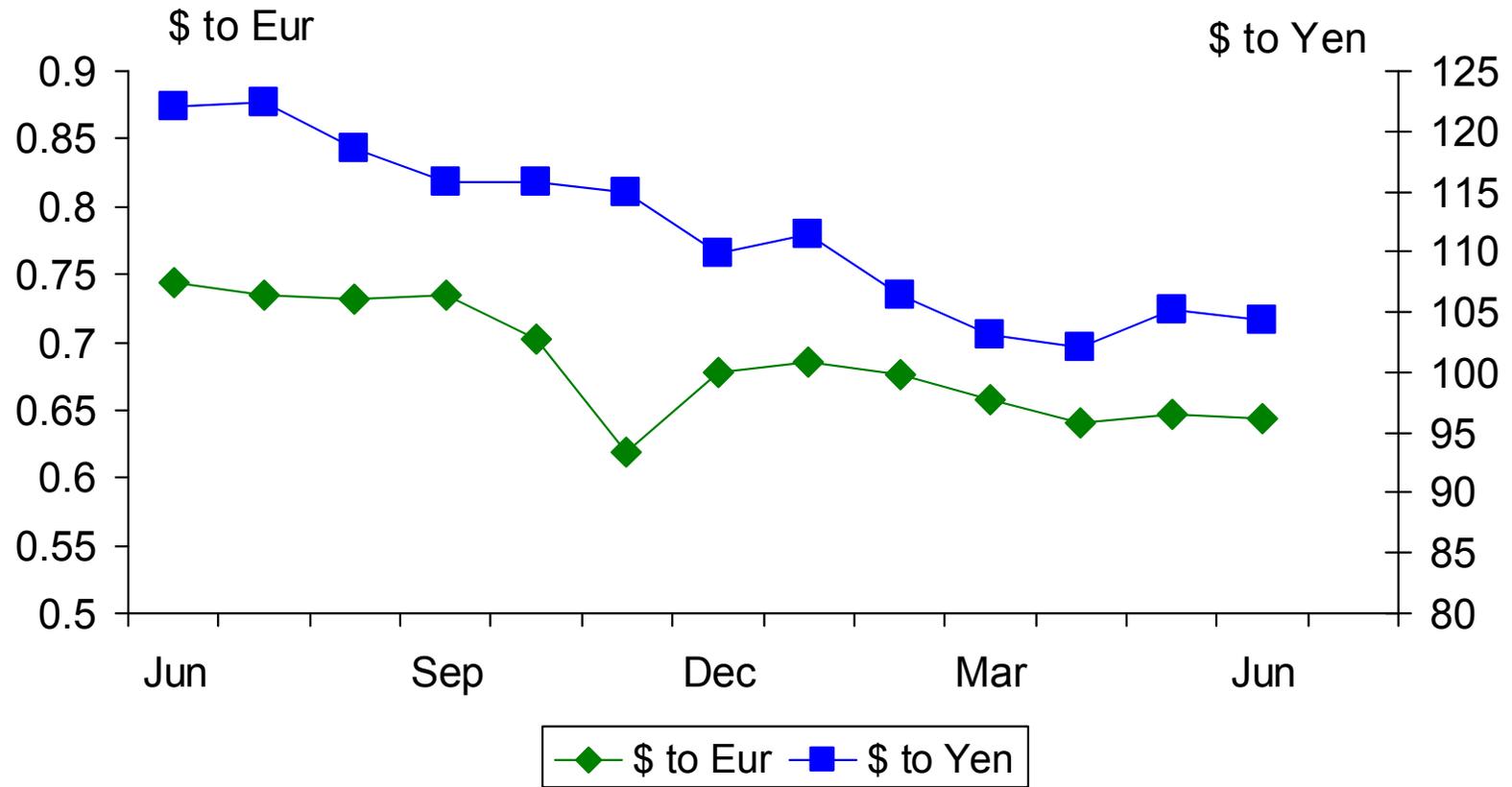
Source: Energy Information Administration, monthly ending prices, spot prices FOB weighted by estimated import volume

Month end



# Currency Values

## June 2007 - June 2008

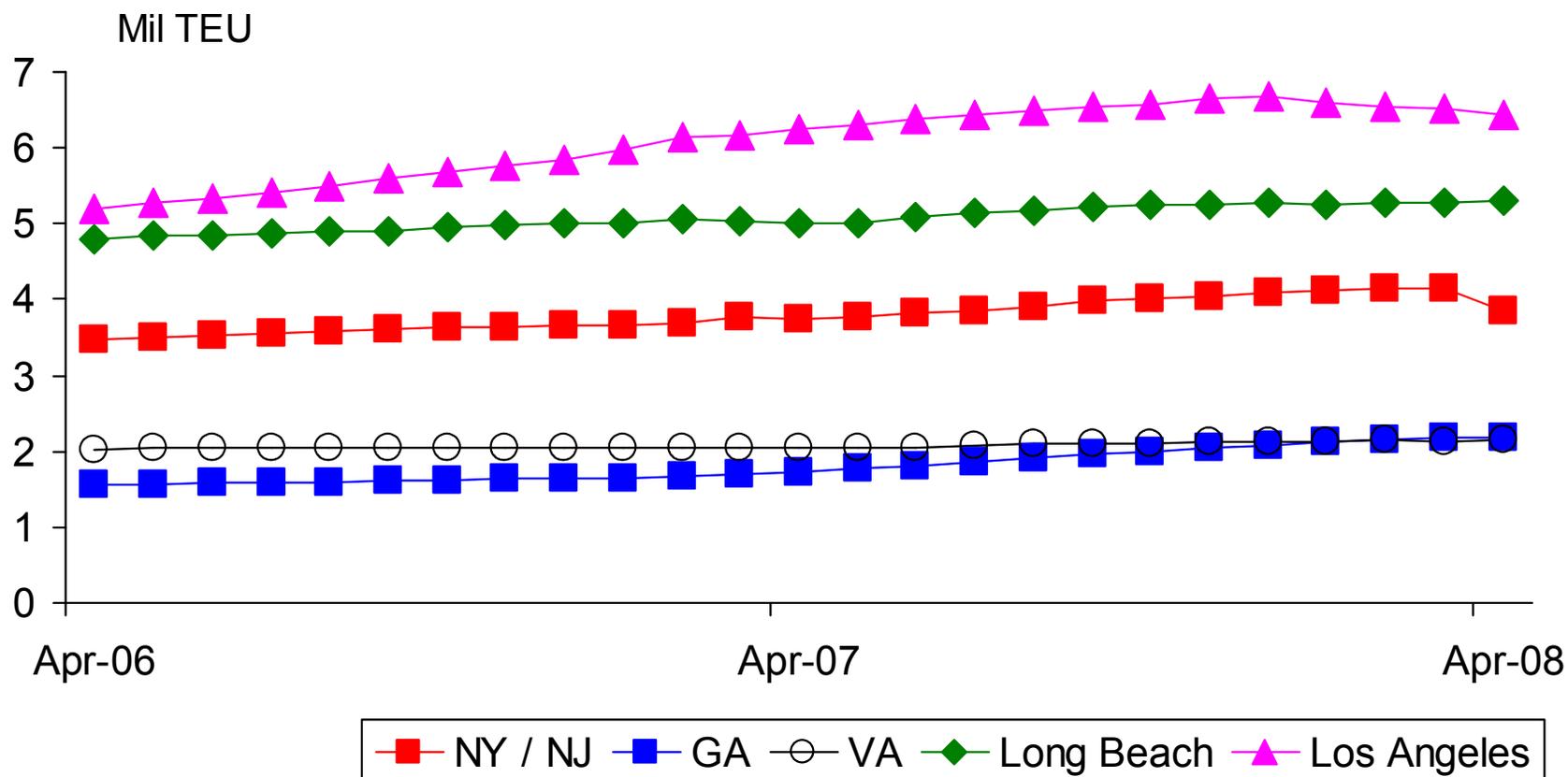


Source: Yahoo Finance, beginning month



# TEUs By Port – Rolling 12 Month Total

April 2006 - April 2008

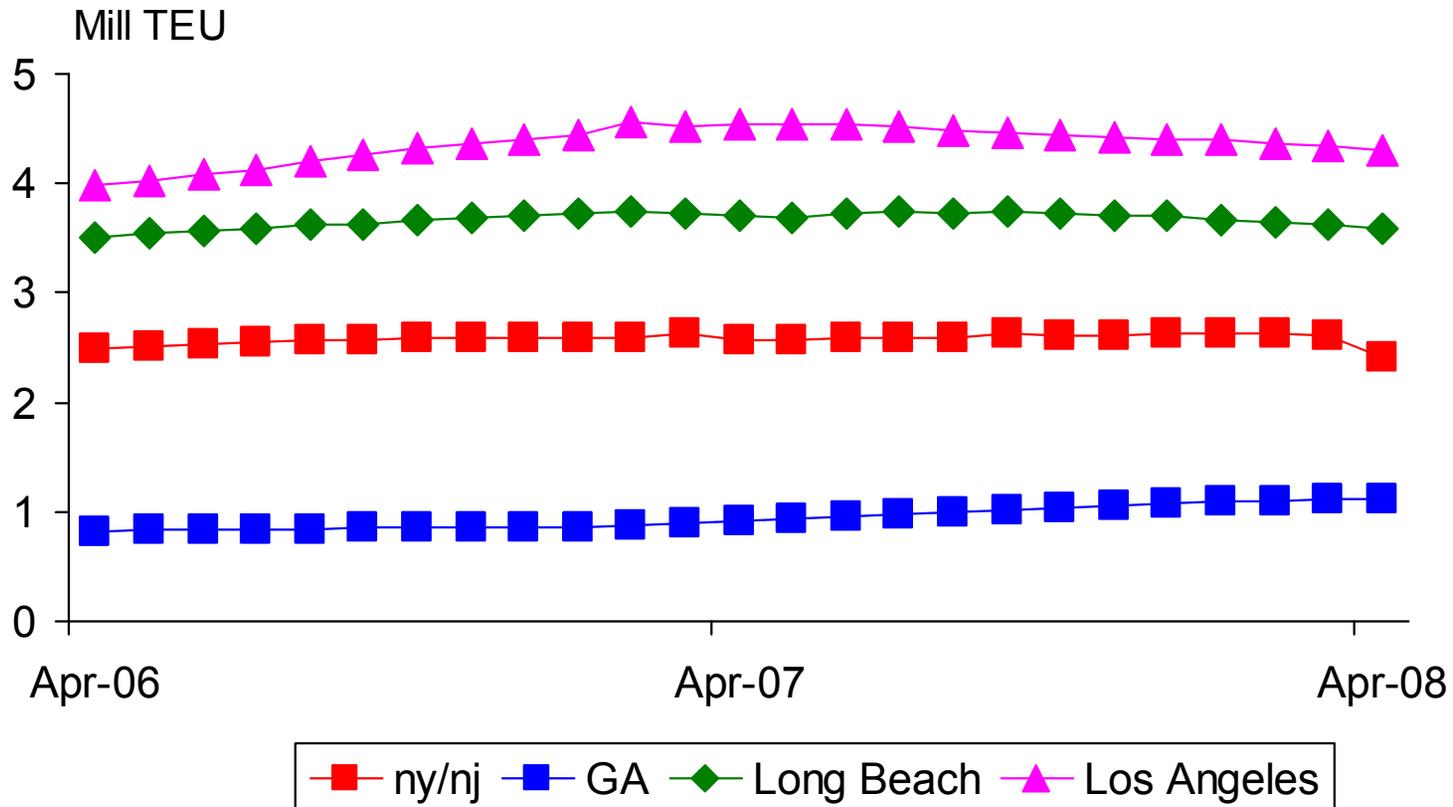


Source: Authority web sites



# Imports by Port – Rolling 12 Months

## April 2006 - April 2008

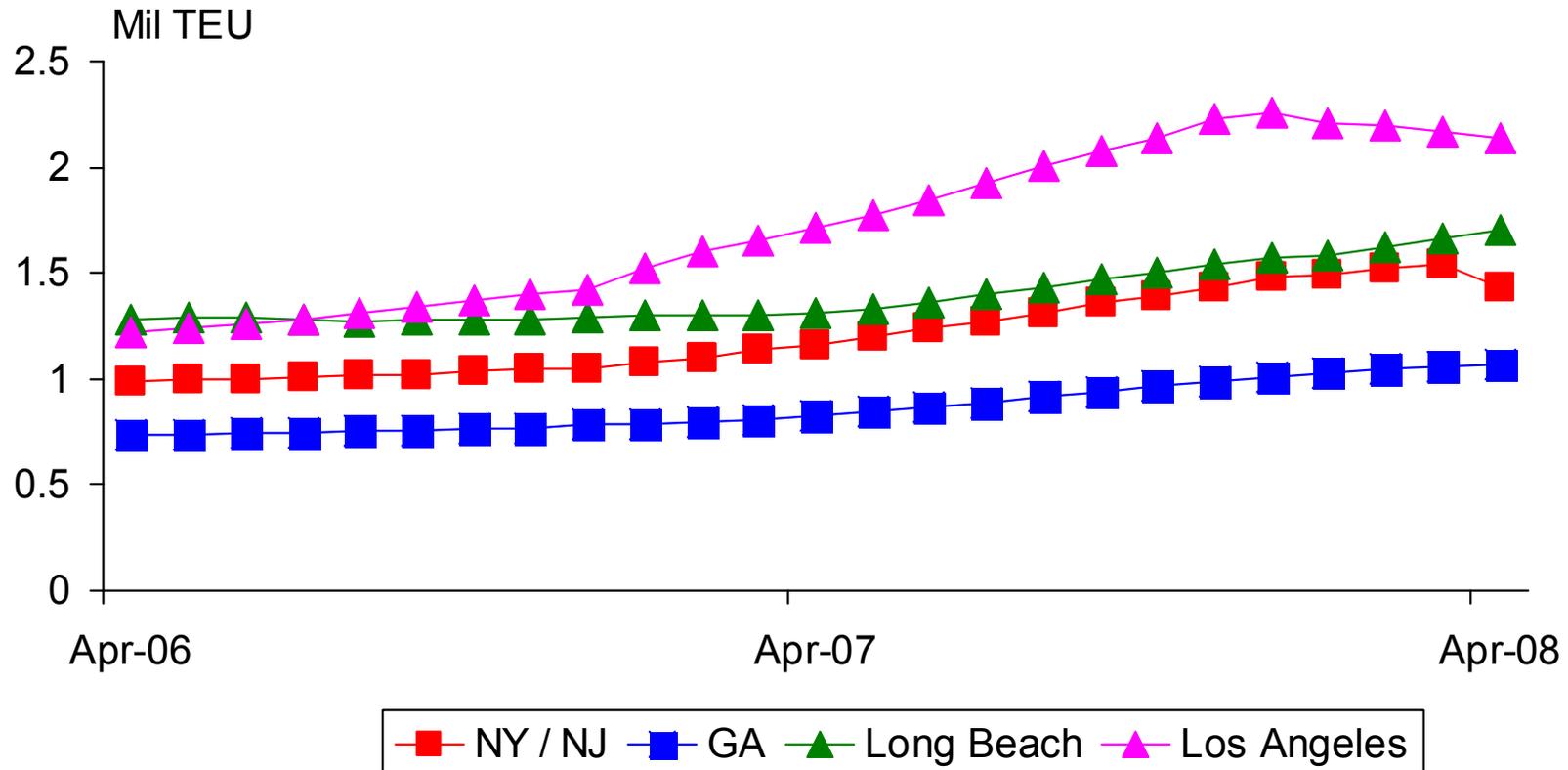


Source: Port web sites



# Exports by Port – Rolling 12 Months

April 2006 - April 2008





## Impact on Economy and Employment

- > Decline of “wealth effect” impacting major item purchases, all retail sales, business-to-business transactions as consumer actions impact business investment
- > Construction employment slows
  - 5.6% of employment nationally in 2005 (BLS data)
  - 5.4% as of the end of 2007
  - Commercial construction replacing residential in some areas
- > Real estate-related jobs impacted, including brokers, mortgage industry, interior design and home décor, etc.
- > Consumer-driven recession possible as home value loss (perceived or real) combines with high energy prices, weak dollar, etc.



## Impact of Slowdown on Tax Revenues

- > Property tax growth slows or declines as taxable value gains slow or decline
- > Transaction-related taxes and fees
  - Mortgage recording and transfer taxes
  - Impact fees
  - Building permit fees
- > Sales taxes
  - Distressed homeowners
  - Reduced access to home equity



## Privatization – What is it?

- > Shifting the production of a good or the provision of a service, in whole or in part, from the government to the private sector.
- > Can be accomplished through
  - Management contract
  - Long term concession / lease
  - Sale of asset



## Privatization – Pros and Cons

### > Reasons For Privatization

- Private sector viewed as operating more efficiently
- Reduce demand on public funds
- Adds to the tax base
- Allows public sector to focus on core functions
- Private firms may be able to secure more capital for development
- Taps hidden value of asset

### > Reasons against privatization

- Diminished, or loss, of control over major asset
- Monopoly characteristics of many public assets
- Potential bankruptcy of private entity
- Loss of future revenue stream



## Credit Evaluation of Privatization Transaction

- > Review associated risks
  - Environmental
  - Capital Improvement / Construction
  - Public Policy
  - Termination
  - Performance and Revenue
  - Debt and Equity
  
- > Concession agreement key document



## Environmental

- > Concession should indicate who is responsible for environmental risks
- > For standalone financings, optimal allocation is for public sponsor to bear risk of pre-existing conditions.
  - Rationale – costs and process can be open ended and ultimately require government involvement regardless of risk allocation
- > Sponsor assumes risks for post concession environmental conditions
- > Concession should be flexible to accommodate changes in environmental laws, and which entity bears responsibility for compliance



## Construction and Capital Investment

- > Concession should clearly delineate who is responsible for capital investment
- > Optimal allocation is for Private Sponsor to bear construction risk assuming appropriate protections.
- > Rationale – Public sponsor may have limited expertise and legal limitations on contracts.
  - Private sponsor can sufficiently mitigate construction risk with appropriate performance bonds, LCs and financing structure.
  - Public sponsor can enhance private sector performance with early completion incentives.
  - Public sponsor construction can entail legislative and other policy risks in addition to construction risk.



## Changing Public Policy

- > Optimal allocation is a shared approach.
  
- > Rationale - Changes in public policy are inevitable. Very long-term and inflexible agreements are much more exposed to political risk.
  - Public sponsor should be allowed to make public policy changes i.e. build competing facilities.
  - Public sponsor should have optional termination right.
  - Contract should include clear process for economic leveling upon adverse impacts.



## Changing Public Policy (cont.)

- Optimal contract should be 30-40 years with renewal rights.
- US practice thus far is for longer-term concessions although this is likely to evolve.
- World-wide, terms are much shorter and generally renegotiated.
- Up-front payments are not the norm.
- Non-compete clauses can ultimately tie public hands and lead to contract frustration or termination.



## Termination

- > Optimal allocation is a shared approach.
  
- > Rationale – Its in best interest of all parties to have asset remain operating and inappropriate terms could preclude IG rating.
  - Termination for cause should be based on clear and reasonable requirements.
  - Contract should include adequate cure periods.
  - Contract should require Lenders notification and include step in rights.



## Termination (cont.)

- Public sponsor should provide compensation for lost value and only be responsible for obligations incurred for initial financing and other permitted obligations (i.e. additional works).
- Public approval of eligible debt helps retain public control
- Public approval helps ensure longer-term commitment of private sponsor.



## Performance & Revenue Risk - Upside/Downside

- > Optimal allocation is a shared approach.
  
- > Rationale – Sharing of upside mitigates longer-term political risk while limiting the downside can help solidify long term commitment of Private sponsor.
  - Allow set rate of return on equity with sharing of upside.
  - Allow sharing of refinancing gain.
  - Allow some form of revenue raising flexibility/contract extension to provide some downside protection.
  - First two US transactions may be seen as unbalanced in favor of private sector.



## Debt and Equity

- > Optimal allocation is a shared approach.
  
- > Rationale – Investment grade ratings can be precluded to the extent debt is subordinated to equity.
  - For negative amortizing, and bullet structures, distributions and additional debt limits should be tied to LLCRs and PLCRs.
  - Structures assuming or requiring a refinance need covenants triggering refinance at least one year prior to maturity.
  - Equity should remain at 10%-25% of project depending upon state of maturity.



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