The Current State of Credit, the Economy, and Privatization

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Agenda

> Credit

> Economy

> Privatization
Subprime Shock Waves

Global Economy?

US Economy?

Alt-A RMBS

Global CDOs

Global ABCP

U.S. Subprime RMBS

SIVs

Monolines

Auction Rate Bonds
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


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

June 2007 - June 2008

$ to Eur

$ to Yen

Source: Yahoo Finance, beginning month
Imports by Port – Rolling 12 Months

April 2006 - April 2008

Source: Port web sites
Exports by Port – Rolling 12 Months

April 2006 - April 2008

Mil TEU

Apr-06 Apr-07 Apr-08

NY / NJ GA Long Beach Los Angeles
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 – It's 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.