Scotland's Largest Schools PFI

South Lanarkshire's PFI Scheme Breaks all Records

Marc Roca

The UK's largest schools PFI for Scotland's South Lanarkshire council closed on 29 June 2006 with a record-breaking education bond issue worth up to £352.2 million (US$650m).

The scheme is also the third Scottish schools bond deal and the largest by far, more than doubling the size of its two predecessors – the Highland Schools II PFI project and North Lanarkshire's pathfinder scheme.

South Lanarkshire's 'Secondary Schools Modernisation Programme' PPP in central Scotland followed the path of North Lanarkshire's £158m (US$285.7m) ground-breaking scheme – awarded last year by Balfour Beatty and Equion – but unlike its twin deal it reached BSF-like scope.

Accordingly, the Scottish scheme will fully modernise all of South Lanarkshire's secondary schools for a total capital investment of £319m (US$585m). A total of 17 new secondary schools will be built and two will be refurbished.

A JV between construction group AMEC, PPP/PFI investor Innisfree and Equion – a division of John Laing – was awarded the 30-year concession on February last year and financial close was reached on 29 June 2006.

The consortium – InspirED Education (South Lanarkshire) – released the largest education PFI bond issue to-date to fund the project, involving £320.2m (US$587.4m) index-linked bonds due 2038 and £32m (US$58.7m) in variation bonds.

As in North Lanarkshire, monoline insurer XLCA-UK wrapped the bonds, but this time there was no European Investment Bank (EIB) involvement. Even with the spate of recent PFI bond issues, the current ultra-competitive market more than assured a successful bond sale for the ultimately quite standard schools scheme.

The Project

The scheme came to market with an OJEU notice in early 2003 and only two bidders remained by autumn 2004:

- South Lanarkshire Schools Partnership (SLSP) – led by Amey and Carillion
- InspirED Education – with Amec, Innisfree and Equion

On 2 February 2005, South Lanarkshire Council agreed the scope of its Secondary Schools Modernisation Programme and appointed InspirED as preferred bidder.

The consortium will deliver 17 new and two refurbished secondary schools in the Lanarkshire region of Scotland over a four year period. The facilities will be operated under a 33-year concession – ending on 31 August 2039 – with only hard FM services provided.

The scheme's capital value amounts to £319m (US$585m) and variation bonds worth an additional – standard – 10 per cent are available to provide some flexibility.

AMEC is the lead partner in the consortium and will design, construct and refurbish the schools, redevelop surplus land around 12 of the sites and provide estate management services over the concession period.

The annual unitary payment by South Lanarkshire Council to the sponsors will be around £26m (US$47.7m).

The construction period has three phases, which are scheduled for completion in the second half of 2007, 2008, and 2009, respectively.

Phase one includes:

- Calderglen High School
- Calderside Academy
- Carluke High School
- Duncanrig Secondary School
- Holy Cross High School
- Lesmahagow High School
- Sanderson High School
- St Andrew's & St Bride's High School

Phase two will see the construction of:

- Cathkin High School
- John Ogilvie High School
- Rutherglen High School
- Uddingston Grammar School

Schools in the last phase are:

- Biggar High School
- Hamilton Grammar School
- Lanark Grammar School
- Larkhall Academy
- Stonelaw High Schoo
- Strathaven Academy
- Trinity High School

Calderglen High School and Sanderson High School will share the same campus on the site of the existing Claremont High School. Cathkin High School and Rutherglen High School will be built on a site near to the current Cathkin High School building.

The two schools to undergo major refurbishment are Hamilton Grammar School, which was extensively refurbished in 1996 and Stonelaw High School, the newest of South Lanarkshire's secondary schools, which was built in 1998.

The first school is due to be delivered by August 2007 and final completion is scheduled for mid-2009.

Construction is well underway, with completed works at about £44m (US$80.7m) as of 31 May 2006.

According to S & P, the construction design and methodology for the project is straightforward and conventional. Each of the project schools is independent of the others, diversifying the project risk somewhat.

Except for two of the project schools, a delay to works on one or more schools will not affect the remaining program. Furthermore, the phasing of school commissioning should help to balance the construction program, and mitigate the risks relating to transition to operations.

Both the structure of the deal and the underlying project are based on North Lanarkshire's experience. The main differences were size and a limited number of soft services provided in last year's deal, as well as that the bonds to finance South Lanarkshire were RPI-linked, while North Lanarkshire's were LPI-linked – or limited to five per cent.

XLCA's Global Infrastructure head Alberto Ramos says that the project is a standard schools PFI scheme, with the usual risks on the back of very strong sponsors. As main hurdles he notes a longer construction period, as well as the large number of parties involved.

As in similar projects, the revenue stream is based on availability, with no volume or market exposure and the payment mechanism provides for a low likelihood of significant deductions.

The project's basis in the Standard Form Scottish Project Agreement provides for reasonable risk sharing in the construction and operations phases.

Financing

Financial close was reached well over a year after the award in early 2005, on 29 June 2006. The same date corresponds to the £320m (US$587m) bond issue payment day, while pricing day was 22 June 2006.

According to XLCA, which was involved with the InspirED consortium since autumn 2004, the monoline solution was decided on March 2005.

The consortium and its financial advisers Canadian Imperial Bank of Commerce (CIBC) also opted for the bond route because it was 'simply cheaper' and in June 2006 Barclays Capital – the investment banking division of Barclays Bank – started the sale of bonds as sole lead arranger.

The Project company – InspirED Education (South Lanarkshire) – issued:

- £352.2m (US$650m) guaranteed secured index-linked bonds due 2038 including £32.2m (US$62m) of variation bonds

> The South Lanarkshire schools PPP represented the coming of age for bond financed education PPP deals

The bonds priced with a spread of 55.44bp over Gilts – listed 2 ½ per cent due 2024 – a choice related to the bond's rated average life of 17 years. The coupon for the index-linked bonds due 30 September 2038 amounted to 2.08540.

The bonds were wrapped by monoline insurer XL Capital Assurance (UK) – XL CA – in what is its fourth PFI transaction guaranteed. In 2005, XLCA also provided a £143m (US$262.3m) triple-A financial guarantee to the first-ever bond-financed education deal in nearby North Lanarkshire.

The variation bonds, which can be used to fund future changes, are also guaranteed as to scheduled principal and interest by the monoline.

The bond issue was 1.8 times oversubscribed, with interest from both traditional and arbitrage investors. The latter has a larger stake in the final allocation, which was clearly domestic.

The project equity is split equally between the three partners – AMEC, Equion and Innisfree – which will each invest £8.4m (US$15.4m). The total equity amounts to £25.2m (US$46.2m) and the debt/equity ratio is roughly 92:8 per cent.

According to S & P – which provided a 'BBB-' long-term underlying debt rating – the base case annual senior debt-service coverage ratio (DSCR) is 1.190x minimum and 1.195x average. Moody's assigned a provisional Baa2 underlying rating.

Unlike in the North Lanarkshire deal – where it provided almost half the debt – the European Investment Bank (EIB) was not involved in South Lanarkshire. The non-involvement of the EIB was a choice of the customer – the council – and was never on the table.

Conclusion

The South Lanarkshire schools PPP represented the coming of age for bond-financed education PPP deals. While it closely followed the footsteps laid down by the pathfinding North Lanarkshire deal, its financing took place in a different environment with ever more competition and investor appetite.

XLCA managing director Miguel Peña comments 'Competition is even more intense in a schools scheme, as its risk profile is lower than hospitals or roads.' He adds that competition now is 'extraordinary' and that more of it or new players doesn't seem likely – or even possible.

By comparison, last year's North Lanarkshire schools PPP bond issue – even if the first in the UK and much smaller at £72.5m (US$133.1m) – priced at 73bp above gilts. In contrast, Highlands schools in April this year had a spread of 55bp and South Lanarkshire followed on with 55.44bp over gilts.

The pricing differences may not seem all that surprising, as after all a similar gap is expected in the first BSF closes – with

Bristol's pathfinder closing in the 80s range and the next ones expected around the 60s pricing range.

But increasing liquidity in the UK bond market is evident and since last year banks have greatly intensified arbitrage movements. South Lanarkshire's bonds, for instance, would have in the past attracted a 100 per cent institutional investors but now had a majority of arbitrage investors – banks.

For Peña, South Lanarkshire's pricing just reflects 'the current capital market flow'. 'If it had been launched last year instead of now, the pricing would have been close to North Lanarkshire's.' he concludes.

Linklaters structured finance partner James Dickson says, 'The bond issue for South Lanarkshire Schools was 1.8x oversubscribed which demonstrates the appetite for this type of investment, notwithstanding that there have been a number of wrapped bonds brought to market in the last few months.

'These kinds of deals will, I believe, only get more innovative as the market looks to apply similar financing techniques to a wider range of assets,' he adds.

Linklaters PFI partner Bruce White comments: 'Having also advised on the recent Sheffield University Accommodation Project bond financing, this project demonstrates further how this type of financing – previously dominated by the health sector – is now being used by other sectors bringing variety to the kinds of risk available to investors.'

The increased investor appetite for the UK's dynamic PPP market, with less uncertainties and level of cushion than before – or than any other country – is fuelling a bond market that is already squeezing the bank loan option out of PPP. Luckily for all, though, the number of deals in the country still comes in a top-notch variety of sizes and colours.

Marc Roca

The Project at a Glance	
Project name	South Lanarkshire Secondary Schools Modernisation Project
Location	South Lanarkshire, central Scotland, UK
Description	The construction and up to 33-year operation of 17 new secondary schools and the refurbishment of two - effectively renewing all the schools the area
Sponsors	InspirED Education - with Amec, Innisfree and Equion
Operator	Equion
EPC contractor	Amec Project Investments
Project duration (Including construction)	33 years
Construction stage	Three phases up to mid-2009
Total project value	£345.2m (US$m)
Total equity	£25.2m (US$46.2m)
Equity breakdown	£8.4m (US$15.4m) - 33 per cent - each sponsor
Bond value	£352.2m (US$650m) guaranteed secured index-linked bonds due 2038
Bond breakdown	£320m (US$587m) plus £32.2m (US$62m) of variation bonds
Bond pricing	55.44bp over Gilts - listed 2 _ per cent due 2024 - giving a coupon of 4.792
Bond arranger	Barclays Capital
Monoline insurer	XLCA - UK
Debt/equity ratio	92:8
Legal adviser to sponsor	Pinsent Masons
Financial adviser to sponsor	CIBC
Legal adviser to lead arranger and monoline	Linklaters
Legal adviser to council	Dundas and Wilson
Financial adviser to council	Grant Thornton
Technical and commercial adviser to government	Turner Townsend
Date of bond launch	22 June 2006
Date of financial close	29 June 2006