WINSTON & STRAWN LLP

PODCAST

Let's Talk Sports: L.A. Dodgers, Edmonton Oilers, Indiana Pacers, University of Texas, U.S. Tennis Center, and Seattle Kraken

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In part two of this Let's Talk Lending episode, Winston & Strawn Partner Alan Hoffman is joined again by guest speaker Zach Effron, an Executive Director at JPMorgan focused on global stadium and arena financings.

Part two of the episode focuses on the following topics:

- Breakdown of the common denominators between the U.S. and European stadium financings.
- How JPMorgan steps in to bridge the risk until the arena is fully completed.
- How colleges and universities structure their stadium and arena financings.
- How clubs and bankers predict revenues that extend for a long period of time.
- The future opportunity for stadium and arena financing, specifically for the entertainment aspect, rather than just sports.

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Audio Transcript

Alan Hoffman: Welcome back to the second installment of Winston & Strawn's Let's Talk Lending, Let's Talk Sports podcast, the show that is gripping the nation. My name is Alan Hoffman and I Co-Chair the Project Finance group at Winston & Strawn and I head the firm's arena and stadium finance practice. My special guest back here again is Zach Effron, Executive Director in JP Morgan's investment bank where Zach is responsible for the firm's global stadium and arena finance practice.

When we last left off, Zach, you and I were discussing how we have taken the technology of a stadium or arena financing that is popular in the United States, the architecture so to speak, and looked to adapt it to sports clubs and arenas all across the world. One common denominator between the U.S. and Europe is the idea that the financing is vulnerable to the team moving away from the stadium and to protect against that risk we always require a non-relocation agreement whether it's for the Los Angeles Dodgers, Edmonton Oilers, Indiana Pacers, wherever it is, agrees for the life of the financing not to leave the stadium. If it wants to leave or move to a different city, different county, or a different state, it has to first effectively pay off the debt associated with the existing stadium. That's one of the mainstays of this type of financing, Zach, right? I don't think you've seen a deal where there's been an absence of a non-relocation agreement.

Zach Effron: Yeah. You know, it really is one of those features that's more than belts and suspenders. It's essentially a requirement for a transaction because people who are around the space, have done a lot of these deals, know that the threat of relocating is leverage for a team when their lease is expiring and we've seen teams successfully do it and others threaten it to get what they want. But from a financing perspective, I think lenders and investors know how much of the revenues they're relying on. Naming rights, sponsorships, and premium seating are subsequently reliant on the club being there. We look at these contracts, right? And they'll even say, if the team were to leave, the contract goes from X to Y and that's even if it stays in place.

When we're structuring a transaction as non-recourse to the team and ownership secured solely by the revenues generated in the building, it only works that the team is there, because these revenues are only being generated with the team being there. The conversation usually is an easy one where we have owners saying, well, if I'm going to spend this amount of money on the stadium, I'm not planning on leaving anytime soon. But it is a box that we have to check in order to really get all the parties comfortable from the banks to the long-term investors, to the rating agencies. If ever there's public subsidy on the table, they're going to require it as well. So, it's something now that's pretty much non-controversial, but certainly a requirement to get these deals done.

Alan Hoffman: Right. So, when the deals start, typically, not always but typically, if it's a new stadium or arena, there's a construction phase, couple years to build a new SoFi stadium, for example, and sometimes the long-term investor market is a little reluctant to take construction risk, not always. In those situations, how does a JP Morgan step in to kind of bridge the risk until the arena is fully completed?

Zach Effron: It's been interesting how that market's evolved just as demand for paper increases. We have seen some of the long-term private placement buyers, the insurance companies, coming into deals with construction risk. It's certainly not the norm. You know, the normal way we typically set up a completely new stadium or arena is a two-phase approach where we'll start with a construction loan that is typically five years, and then look to refinance that construction loan once we can achieve an investment grade rating for the takeout financing.

The benefits of the construction loan are that it's a more flexible piece of capital. You're dealing with relationship banks, typically a small group of relationship banks. As you're dealing with construction, we do spend a lot of time during the underwriting phase looking at the construction contract, the budget, the contingencies, and the strength of the contractor to make sure that there won't be any cost overruns or delays, but inevitably these things might happen.

If there are things like that you need to deal with, it's just typically easier dealing with a lender group than a large syndicate of bond investors. We typically would start in the bank market to deal with the construction risk, but also the proforma revenue risk. So, when the deals are originally put in place, we have projections and feasibility reports for what these revenue categories should be able to generate in terms of what we expect for the naming rights contract and the sponsorship and the premium seating.

The bank market provides a bridge to get through construction and to get your major revenue contracts in hand. It's not to say that a long-term investor wouldn't come in earlier, but in order to give our clients as much leverage as possible because really for a project like this, the long term rate of 25 or 30 year is from a financing perspective, the most important part of the business model and making sure that the performance work and the equity returns are hit.

We advise to access that market when you're at your strongest position, which would be once you're through construction and once you have your contracts in place. It's very hard to throw rocks at the project or to really question, is this going to work, are there going to be problems? Which from a dev perspective is often how things might be approached for better or worse?

So, those are just two very different projects to sell to a 30-year investor, right? I need to build the thing and I need to go execute these contracts, and then I'm going to generate a bunch of revenue. Here are renderings and a feasibility study versus let's go to the stadium because it's brand new or let's go to a game because it's sold out, and I'll hand you all the contracts. Here are the naming rights contracts and the sponsorship contracts. You can underwrite them and see exactly how much revenue this is going to generate over the long term. That enables us to get the investment grade rating, which is a requirement for the long-term buyers, and has served a lot of our clients very well, that sort of two phased approach.

Alan Hoffman: You mentioned the rating agencies a little bit. Just to clarify, the rating from the rating agency would be for the long-term debt. You wouldn't typically need that for your JP Morgan bridge loan during construction, right?

Zach Effron: That's right. The insurance companies need the rating. The NIC designation, which maps to the investment grade rating, whereas the banks do not. So, you don't need a rating to access the bank market. That said, while we do keep projects on our balance sheet, if our clients prefer to stay in the bank market, when we're initially taking them onto our balance sheet, we do have the takeout in mind when we're sizing the transactions. While the bank transactions are not rated, they're sized pursuant to rating agency criteria so that we know, should the project go as we expect, we will be able to get that rating and refinance it into the long term market.

Alan Hoffman: Right. Now, we've talked a lot about new construction and a new stadium or a new arena, but you and I have worked on some really exciting projects whereby the objective was not to build something new, but to enhance or improve an existing structure. For example, we funded finance stadium improvements for teams like the Dodgers and the Pacers and countless others. You want to just touch on that for a moment?

Zach Effron: Yes, absolutely. I think what's different about those deals is that we have more historical data to point to versus just proformas, which is typically the case in a new transaction. In either instance, investors seem to want to get invested just in the space of sports for the right name.

Giving people the opportunity to invest in Dodger stadium was a lot of fun and people were really excited to do it. There was new ownership and the club was entering a new phase in its history and saying to people, "Here's what this place has been able to generate from a revenue perspective and it's strong and attractive. Here's the vision that new ownership has, and here's what they want to do with the money in terms of enhancements and improvements to the stadium, which makes the investment just that more attractive."

Those are transactions that work very well, to be honest, because there is more certainty with them than on the new build. It's not to say that the new build transactions aren't very well received, kind of given the track record and the approach taken to structuring. But I think the takeaway is if you have an unlevered stadium or arena, there would be strong demand to put financing against it.

Alan Hoffman: Right, and we've talked a lot about professional sports. This technology in my mind, and I've seen it work equally well for college sports. I recently did a transaction for a University of Texas basketball arena, a new arena, which is scheduled to open this year. Zach, any reason you couldn't apply what we've talked about to college facilities?

Zach Effron: There have been successful examples in the college space, and I think others may have had different experiences. My experience has been if the facility is on campus and is integral to the university, the rating agencies might put it on the university's balance sheet anyway. So, structuring it as non-recourse to the university doesn't really achieve maybe the desired effect from the university's perspective.

There are certainly college organizations out there that are strong enough to raise non-recourse investment grade financing, where maybe more of a public private partnership model would be put in place like the University of Texas basketball arena in Austin through their partnership with OBG is unique enough.

But in general, I continue to see most university stadium and arenas financed either by the university or the athletic department on their balance sheet. It's really because they see non-recourse financing as a higher cost of capital when they're never going to let the project go anyway. They typically just say that they will just keep this on balance sheet and finance it at a double A rate or triple A rate, right? A lot of these institutions have such large endowments and they're so highly rated, the cost that comes with non-recourse just isn't attractive to them for something that they view as core of their mission.

Alan Hoffman: Right. When you do a stadium financing, one of the important things is to provide the club and the team the flexibility it needs to conduct its business over what could be a 30-year or 40-year financing period. One of the attributes I've noticed through this structure is flexibility. For example, if a club wants to purchase a new scoreboard, the latest technology in 10 years and that could be a $30 million investment, we allow for additional debt to be raised under the current structure, as long as certain conditions in that. But we don't preclude the club from going out or the stadium company from raising additional debt if they need to.

Zach Effron: Yeah, that's a really good point, Alan. We put these structures in place to be living and breathing financings because these are very long-term projects, where the stadium is going to be used for the next 20 to 30 years and to think that you might not need taxes or capital again, you wouldn't want that stringent of a financing over this long period of time. The additional bonds test provides for additional debt to be raised. Typically, as long as a certain annual debt service coverage ratio can be met and that the investment grade rating can be maintained.

The way to think about it is when we initially sell the deal, we sell it to investors with a certain financial profile, which could be categorized as on an annual basis and you'll have this much revenue covering your debt service, and we're selling it to you with this rating, triple B, triple B minus.

If in 10 years you need additional debt, presumably your revenues have increased so your coverage has gone up, and you should be able to maintain the investment grade rating. So that's typically how we think about it, which as long as we can't dilute the existing investors, they're okay with additional debt. They also know that it's going to be used to enhance their collateral. So, if you're investing in a 30-year stadium, those last 10 years could be a little rocky. I mean, you probably are wanting the owner at that point to invest in the building just to keep it competitive and to keep it generating revenue.

Alan Hoffman: Right, and the structures are very resilient. Through the years, when unusual issues have come up, it's tested the parameters of the structure and the structure has held up very strong. For example, if there's a labor strike in the respective sports leagues, like we just had with major league baseball for a couple months, we have protections built into the deal, such as a strike reserve fund to cover debt service if there's a labor disruption.

We've had some casualty events where there's been fire or damage to a facility, and we have insurance proceeds that are available to ensure that debt service is maintained. We've just been through a two-year pandemic that nobody could have ever envisioned. While our documents didn't necessarily take into account a COVID type situation with specificity, there were enough protections built in that the various deals could survive that kind of problem, including one where spectators were warned at the sites for long periods of time.

The point really is that a lot of thought has gone into this to make it almost default proof that we could deal with casualty, we could deal with labor strikes, and we could deal with pandemics. That's why it's held up so well.

Zach Effron: Absolutely. We spend a lot of time stress testing these structures before putting them out into the market, and we've done enough of them now where we kind of know these are the stresses that the agencies are going to put us through, or these are the kind of questions investors are going to ask. So, to head that off or to be prepared for that, these are things we suggest putting into the structure.

You mentioned the strike reserve fund or the debt service reserve fund, and there's been evolutions with the size of those funds through various market cycles. But also, one thing to take a look at is, again looking at the revenues and the contracts, is how is your naming rights contract going to pay, or how are your suite payers going to pay if there is a strike? Are they going to pay during the year of the strike and get a rebate to next year or at the end of the contract?

We really have to drill down into that level of diligence, and we'll model out these scenarios, because we know these are the questions we're going to get. And we do get the question, what's going to happen during the next pandemic, even though it feels like we're through it and not worried about it as much as perhaps another labor strike. But even labor strikes, we've got protections in the structure so that service can be paid, typically up to a two-year labor strike. The stadium company is still going to pay.

COVID was a great test case to see and to prove the value of sports as live content, where you had a lot of sponsors saying, a lot of deals had to be struck, but you had a lot of sponsors and JP Morgan out at USTA being one of them saying, we need to recut our deal for this year, because obviously I'm not getting the same amount of activation and the same value, but no sponsor wanted to walk. Everyone wanted to find a way to keep the relationship going, to stay invested, and to be there for the return that we're experiencing now, because they knew that was going to be even more than they had originally paid for in terms of just people wanting to get out and get back into live events.

Alan Hoffman: Right. These are long term deals often. I talked about 30, sometimes 40 years. How hard is it for the club and for the bankers to try to predict revenues that go out for such a long period of time? Is that one of the biggest challenges for the banker?

Zach Effron: Well, I mean, the way we deal with it is through structure. On the revenue side, we do have revenues that are contracted to go out sometimes 10 or 20 years, and that's not all of the revenues going into our issuer or stadium company, but a healthy amount actually is under contract for a long period of time, 10 or 20 years. I guess that's the naming rights contract and some of the larger sponsorship contracts. Then for some of the shorter ones that are still under contract, like premium seating, we're able to look at examples, either what the club has been able to do in its existing building or its peer clubs, when it comes to renewals on shorter contracts, like shorter sponsorships or premium seating, we stagger the renewals. If we have three-, five-, or seven-year contracts on our suites, we make sure that we don't have any big cliffs coming up at once.

On the other hand, more day of game or revenues that aren't under contract, like food and beverage or merch or parking, we can have an estimate for growth in our base case model at CPI, but we also are going to run stress tests on it. Investors and rating agencies are going to look for stress tests, and that's why we have coverage in our deals of typically two times revenue over debt service so that these models can withstand a decent amount of fluctuation through an economic cycle. But it's been very interesting watching these assets perform where people continue to spend for sports. It's a very resilient asset class.

Alan Hoffman: One of the things we haven't really touched on, is entertainment beyond sports, right? Because these facilities are used for concerts, they're used for all kinds of different events that fill up the arena or the stadium and so it's not solely a sports play, it's a sports and entertainment play. But where do you see the most opportunity in the future for this type of stadium or arena financing?

Zach Effron: We're seeing it in the NFL right now, where it almost feels like a new cycle starting where you've got the Titans, the Chiefs, the Broncos, the Bills, the Admirals. It didn't feel like the NFL stadium stock was that old but all of a sudden you've got a large handful of teams coming up saying our buildings... It's economic useful life versus physical useful life, where the building itself may be in fine shape, but in order to stay competitive, they want a new building or want to renovate. I think you're just going to continue to see continued investment in new stadium and arenas in some of the more traditional spaces, NFL, and NBA.

But then spoke about these non-tenant buildings where there's certain developers out there who prefer not to have a sports team as an anchor tenant, but their thesis is that live content as music is as profitable as having a sports team, just given the cost of the content and the amount of revenue they're able to drive with that content.

I think it'll be interesting to see how it plays out. I think we'll continue to see continued investment where we would expect it, with the dominant major leagues here in the U.S. We'll continue to see non-tenant buildings, entertainment venues. And in Europe, no one's looking at a team in Europe without thinking, is there a stadium angle? Or how do I get the team, plus get the stadium done?

Alan Hoffman: Right. Well, one of the most thrilling aspects of this particular practice, at least for me and I'm sure you'd feel the same way, is when you complete one of these deals, there's a physical structure there. There's something you can drive by, you can point to, you can show your family. You've created something that's not only unique but that's going to last for a long time. There's a real special feeling to that. I know the Super Bowl this year out in Los Angeles, I remember when you and I had hard hats on and we were standing in an empty bowl starting off with a construction site. There was nothing there. And a few years later, they built the most magnificent structure probably that I've ever seen, at least in the sports and entertainment field. It is a thrill to see that final product when games are played and the ribbon cutting ceremony takes place, right?

Zach Effron: 100%. These projects change areas no matter where you are, and maybe some on a grander scale than others. SoFi being the biggest example of just how much you can completely change an area and just how much that whole Hollywood Park, but also what else is going on around it, is just going to completely change Inglewood. We saw it in Brooklyn with the Barclays Center. You even saw it on a smaller scale in downtown Louisville with the Yum Center. These buildings really have the opportunity to completely change areas. So it is very exciting to work on and yes, it is always a thrill and it was definitely great to see the Rams win the Super Bowl in their new home. It was a great combination to working on that transaction. Happy for them.

Alan Hoffman: Yes and I was out in Seattle with the Oak View Group who built the new hockey arena for the expansion team that is known as the Kraken. Oak View, or OVG as they are commonly known, is a leader in the industry of developing and operating arenas and stadiums across the world. They have Tim Nowicki, as everyone knows as not a legend but a leader in the industry, and they have some of the brightest minds working in finance and business development. OVG not only built a sports and entertainment venue for Seattle, but they built an energy and excitement and brought that to the city. You can see it and you can feel it and you know it's sustainable.

The whole community in Seattle rallied behind the Kraken and rallied behind the idea that they will have access to concerts, shows, and top-tier entertainment in their city all year long in addition to hockey. So, congratulations to Oak View Group and to the NHL for getting that project done because if you visit Seattle and walk around the city, you can feel the energy building. It's not only uplifting, it's very much a remarkable feeling when you're there and you see it firsthand.

Thanks, Zach. I really appreciate such insightful commentary and thank you to all of our listeners. I will remind you that you can subscribe to the podcast via Apple iTunes or Google or by visiting the Winston & Strawn website where we provide insights on various topics and the latest market updates and trends in all areas of finance. I am actually hoping this podcast leads to some motion picture roles for me and with Zach Effron as the lead, I think we could probably get a very large audience. So, as Chevy Chase used to say on Saturday Night Live, goodnight and have a pleasant tomorrow.

Speaker

Alan Hoffman

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