

A CHANCE TO SPREAD THE RISKS

IF YOU ARE LOOKING FOR AN ALTERNATIVE WAY TO RAISE CASH, PROJECT FINANCING MAY BE THE ANSWER. **DANNY DANIELS** OF HSBC TAKES A LOOK AT THE FACTORS INVOLVED AND PROVIDES A STEP-BY-STEP GUIDE TO HOW PROJECTS ARE STRUCTURED.

Essentially, project financing is used to raise funds to finance an economically separable project where the providers of funds look primarily to the cashflow from the project as the source of debt service and dividend flow. This brief guide is produced for finance professionals that are not otherwise practitioners of project finance.

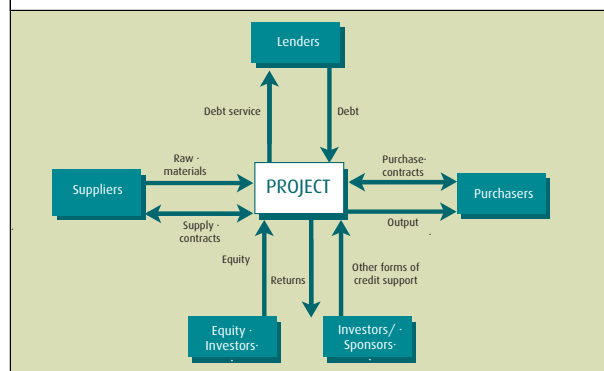
Project financing is commonly used in capital-intensive industries for projects requiring large investments of funds, such as the construction of industrial facilities, heavy manufacturing plants, mines and infrastructure, such as power plants, pipelines, roads, bridges and railways. Infrastructure projects will often involve government letting a franchise to exploit the provision of an asset for a limited time period, 'a concession', during which time the project must repay its obligations. While a bank's credit analysis of a company measures the businesses's overall capacity to repay, in project financing the lenders look only to the discrete project for repayment of the loan. The project will be a separate and distinct legal entity; project assets, project-related contracts and project cashflow are all segregated from the sponsors.

PROJECT STRUCTURE. Through contractual and risk structuring, a project company is typically capable of being highly geared, often between 60% and 90% debt funded. Therefore, it is important the project does not face a degree of risk greater than its capacity to bear it. Because of the high level of gearing, it is important the project has predictable cash inflows and outflows, and committed contracts between the various parties for the supply of raw materials, offtake arrangements and the initial construction are an important element in this.

Normally, the lenders to the project undertake due diligence to satisfy themselves that the contracts adequately secure the revenue and costs of the project. Often the outcome of this analysis is that lenders require long-term price certain contracts for raw material supply, offtake and construction. A simplified generic project structure is shown in *Figure 1*.

CHARACTERISTICS. The generic components of project financing can be characterised as:

FIGURE 1
GENERIC PROJECT STRUCTURE.



- the funder has limited recourse to the sponsor's balance sheet;
- the financing is for a specialised asset, with little or no residual value and limited alternative use;
- the sole repayment source for the lending is the project's cashflow;
- lending maturities are longer term to match asset life;
- lending is fully secured against the projects assets; and
- risks are identified and allocated among project participants.

The greater the recourse to the sponsor, the lower the risk transfer but the lower the cost of debt. At one end of this spectrum is fully guaranteed corporate recourse, while at the other extreme is non-recourse finance. The sponsor determines the amount of recourse they wish to provide to the lender. The decision as to where the balance of recourse is struck will depend upon the sponsors' appetite for risk, their borrowing capacity, the risk appetite of the available funding sources and the need to secure low-cost funding in a potential bidding situation. *Figure 2* demonstrates this relationship.

WHY USE PROJECT FINANCE? Projects are often costly, with long

development phases requiring multi-disciplinary skills. Consequently, sponsor(s) often choose project finance in circumstances where they are joint venturing with partners. The use of project finance is therefore driven by:

- the need for risk sharing with other companies and debt funders;
- restrictions on borrowing because the sponsor's funding lines are constrained or fully utilised for its general corporate activities;
- tax advantages of sheltering profits with debt service;
- advantageous accounting treatment because the project vehicle may be treated as an associate, not a subsidiary company by the sponsor; and
- funding efficiency from increasing gearing beyond that usually used by companies.

Project Phases. A project is dynamic. It changes from a relatively high-risk phase during construction and commissioning, to a relatively low-risk phase when stable-state operations have been achieved. This transition is often characterised by funders demanding security in the early years of the project that subsequently falls away in the later years when performance targets are achieved. It also leads to heavily structured transactions that are frequently refinanced by lower cost finance with less onerous covenant requirements when performance is proven and the future revenue stream can be more readily determined.

WHO BECOMES INVOLVED? The sponsor(s) of a project financing is the party that organises all the other parties and typically retains management control of the project entity. It is usual for the sponsor(s) to be the controlling shareholder, but third-party equity is becoming increasingly prevalent.

- **Institutional equity investors.** In addition to the sponsors, there are frequently additional equity investors in the project company. Participants in this market include private equity providers and institutional equity funds.
- **Suppliers.** The suppliers enter into a long-term agreement with the project company for the supply of feedstock (that is, energy, raw materials or other resources) to the project. Feedstock costs often make up the majority of the project's operating costs and possible cost variations are subjected to considerable scenario analysis.
- **Purchasers.** Sale of the end product is secured by offtake agreements. The extent to which these agreements match the length of the funding obligations and have fixed prices will reduce market risk for the project company. Generally, funders will be very cautious if exposed to market risk
- **Contractors and equipment suppliers.** Sponsors and funders will both take performance risk once the capital asset has been installed and proven to meet the required performance standard. Construction and delivery risk is usually retained by the contractor through fixed-price time-certain contracts with payment to the contractor being geared to performance milestones and liquidated damages payable by the contractor following a delay in commissioning. The contractor meets cost overruns unless there are specification changes made by the sponsors.

CAPITAL STRUCTURE. The appropriate capital structure varies as between projects. Generally, the capital structure will be affected by the lender's view of the:

- certainty of revenue streams;

FIGURE 2
CORPORATE RECOURSE

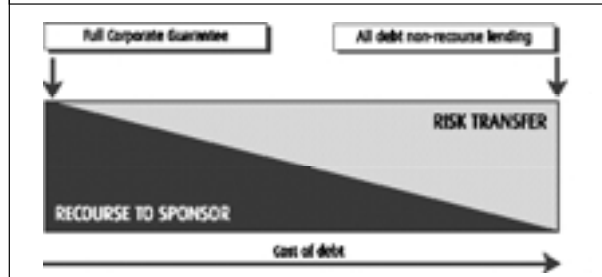
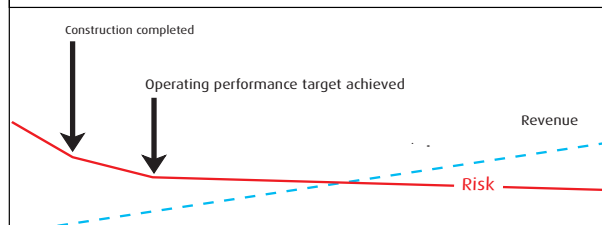


FIGURE 3
PROJECT PHASES



- certainty of capital expenditure programme;
- certainty of operating cost assumptions;
- clarity of contract rights and obligations; and
- the level of contingencies as a margin of comfort.

Generally, the greater the risk, the higher the amount of the risk capital that is required. At the primary level, the sponsor(s) equity provision evidences their commitment to the project, but gearing will also be affected by the debt service coverage ratios demanded by the funders. The two basic axioms are therefore:

- generally, debt capacity of a project is affected by risk structure and cash cover ratios; and
- risk is controlled by contract rather than exclusively gearing.

Funders will always require sponsors' risk capital to be committed ahead of debt. If the sponsor(s) procure letters of credit to guarantee their equity commitment, the actual equity infusion can be deferred. The use of standby or contingent equity is not particularly favoured by sponsors, especially those who account for 'at risk capital', whether it is subscribed or not, but it is a useful mechanism when uncertainties require that further sponsor(s) funds may be needed in certain downside scenarios. Typically, sponsors covenant to funders to maintain a minimum equity percentage throughout the project's life. Three generic areas of consideration determine the composition of the risk capital:

- the capacity and timing of projected distributions;
- the sponsor(s) wish to retain management and control of the project; and
- exit strategies.

SOURCES OF FINANCE. Commercial banks have demonstrated an ability to evaluate complex credits. Typically, the amount borrowed

peaks at completion. The debt has an amortisation schedule that is tailored to the cashflows of the project and typical maturities do not exceed 15 years. However, maturities in excess of 27 years have been achieved in the UK, particularly in PFI/PPP projects. There are essentially five types of facility that can be arranged for the bank portion of the financing requirement:

- revolving credit facilities;
- limited recourse term loans;
- standby finance;
- letters of credit; and
- equity-bridging loans.

CAPITAL MARKETS. The private and public bond markets have grown more receptive to project finance and sponsors have shown increasing interest in the capital markets as a source of funding for projects as the long maturities available and the fixed rate finance both suit the nature of projects. The project bond market is smaller than the bank market, but there are a number of advantages to project bonds:

- often, the underlying funding cost of a capital markets instrument is lower than the inter-bank rate;
- maturities in excess of 30 years are attractive to institutional investors such as UK pension funds;
- fixed rate finance complements the need for pre-determined costs;
- well-structured low-risk projects can be rated as investment-grade and, consequently, command lower pricing; and
- the alternative funding source leaves the capacity of the sponsor's bank lines undiminished.

Table 1 makes a brief summary of comparison of the various sources of finance.

PRIVATE FINANCE INITIATIVE. The Private Finance Initiative (PFI) is the corner stone of the UK government's widening involvement of private finance in funding public infrastructure and a natural development of the privatisation of state-owned companies in the 1980s and early 1990s. First launched in the UK in 1992, the PFI has grown into one of the government's most significant means to fund infrastructure development. The government has signed more than 400 PFI contracts worth in excess of £28billion which span a wide variety of sectors. Many countries have now passed legislation designed to encourage private sector participation in the

TABLE 1
DEBT FINANCE SUMMARY

Type	Commercial bank market	Private placement market	Public market (incl Rule 144a)
Maturity	Limited to 15yrs	Up to 20 years	More than 30 years
Market Size	Limited by Bank appetite	Limited market for large projects with long maturities	Large
Interest rate	Floating	Fixed/Floating	Fixed/Floating
Currency	Typically \$, £ & €	Typically \$, £ & €	Typically US \$ & €
Rating	Not required	Not required	Not required
Prepayment	Possible	Possible	Possible
Covenants	Extensive	Extensive	Extensive

development, financing, operation and ownership of public sector projects, the basic financing structure for which borrows heavily from project finance techniques.

The principle behind PFI is to bring private sector expertise to public sector projects, particularly with regard to the disciplines of project management and optimal risk transfer. Under PFI, an open competition is run to select a private consortium to contract with a public sector body to finance, design and construct a specific facility/asset within a time and cost specific contract. Once in operation the public sector pays the consortium for providing the service despite the fact that the service may be free to the user at the point of delivery. PFI has been used to finance the provision of hospitals, schools prisons and roads.

PUBLIC-PRIVATE PARTNERSHIPS. In recent years the UK government identified an alternative to PFI. This alternative was more inclusive of the role of government. The premise of Public-Private Partnerships (PPPs) is that the private and public sectors co-operate in joint venture to deliver infrastructure more efficiently than the government could otherwise accomplish in its own right. The degree of private sector involvement varies on a project-by-project basis but in the UK standard contract terms are developing with clear precedents set on the roles of each party.

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