FUNDAMENTALS OF PROJECT FINANCING

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In this article we look at all important features of project financing. In a project financing,, lenders initially look to the cash flow from the project being financed rather than the corporation or corporations seeking funding. The moving party in a project is its promoter or sponsor. The ultimate goal in project financing is to arrange a borrowing for a project which will benefit the sponsor and, at the same time, be completely non-recourse to the sponsor, in no way affecting its credit standing or balance sheet. This can be accomplished by using the credit of a third party to support the transaction. Different guarantees and undertakings of different partners may be used in each time frame to provide the credit support necessary for structuring a project financing. Most large projects employ different lenders or groups of lenders because of the different risks involved as the project facility progresses through construction to operation, and the different ability of lenders to cope with and accept such risks.

Key words: project financing, SPV, sponsor, credit, lender.

WHAT IS PROJECT FINANCING?

Structured financing is a debt obligation that is backed by the value of an asset or credit support provided by a third party. The special purpose vehicle (SPV) or special purpose entity (SPE) is the entity that acquires the asset and sells the securities to purchase the assets. Structured finance is used by corporations to fund major projects so that the lenders look to the cash flow from the project being financed rather than corporation or corporations seeking funding. This financing technique is called ***project financing*** and uses the SPV to accomplish its financing objectives. Discussions associated with project financing tend to focus on large complex projects. This might lead one to the conclusion that the project financing principles discussed in this article have little application to smaller, more ordinary financings.

Although the term "project financing" has been used to describe all types of financing of projects, both with and without recourse, the term has evolved and a more precise definition is: *A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.* A key word in the definition is "initially." While a lender may be willing to look initially to the cash flows of a project as the source of funds for repayment of the loan, the lender must also feel comfortable that the loan will in fact be paid on a worst case basis. This may involve undertakings or direct or indirect guarantees by third parties who are motivated in some way to provide such guarantees. Project financing has great appeal when it does not have a substantial impact on the balance sheet or the creditworthiness of the sponsoring entity. Boards of directors are receptive to proceeding with projects which can be very highly leveraged or financed entirely or substantially on their own merits. The moving party in a project is its *promoter* or *sponsor*. A project may have one or several sponsors. The motivation of construction companies acting as sponsors is to profit in some way from the construction or operation of the project. The motivation of operating companies for sponsoring a project may be simply to make a profit from selling the product produced by the project. In many instances the motivation for the project is to provide processing or distribution of a basic product of the sponsor or to ensure a source of supply vital to the sponsor's business. The ultimate goal in project financing is to arrange a borrowing for a project which will benefit the sponsor and at the same time be completely non-recourse to the sponsor, in no way affecting its credit standing or balance sheet. One way this can be accomplished is by using the credit of a third party to support the transaction. Such a third party then becomes a sponsor. However, projects are rarely financed independently on their own merits without credit support from sponsors who are interested as third parties and who will benefit in some way from the project. There is considerable room for disagreement between lenders and borrowers as to what constitutes

a feasible project financing. Borrowers prefer their projects to be financed independently off-balance sheet with appropriate disclosures in financial reports indicating the exposure of the borrower to a project financing. Lenders, on the other hand, are not in the venture capital business. They are not equity risk takers. Lenders want to feel secure that they are going to be repaid either by the project, the sponsor, or an interested third party. Therein lies the challenge of most project financings. The key to a successful project financing is structuring the financing of a project with as little recourse as possible to the sponsor while at the same time providing sufficient credit support through guarantees or undertakings of a sponsor or third party, so that lenders will be satisfied with the credit risk. There is a popular misconception that project financing means off balance sheet financing to the point that the project is completely self-supporting without guarantees or undertakings by financially responsible parties. This leads to misunderstandings by prospective borrowers who are under the impression that certain kinds of projects may be financed as stand-alone, self-supporting project financings and, therefore, proceed on the assumption that similar projects in which they are interested can be financed without recourse to the sponsor, be off-balance sheet to the sponsor, and be without any additional credit support from a financially responsible third party. It would be a content circumstance if it were possible simply to arrange a 100% loan for a project (non-recourse to sponsors) which looked as though it would surely be successful on the basis of optimistic financial projections. Unfortunately, this is not the case. There is no magic about project financing. Such a financing can be accomplished by financial engineering which combines the undertakings and various kinds of guarantees by parties interested in a project being built in such a way that none of the parties alone has to assume the full credit responsibility for the project, yet when all the undertakings are combined and reviewed together, the equivalent of a satisfactory credit risk for lenders has resulted.

Reasons for jointly owned or sponsored projects

There has been an increasing trend towards jointly owned or controlled projects. Although most corporations prefer sole ownership and control of a major project, particularly projects involving vital supplies and distribution channels, there are factors that encourage the formation of jointly owned or controlled projects that consist of partners with mutual goals, talents, and resources. These factors include: The undertaking is beyond a single corporation's financial and/or managerial resources; The partners have complementary skills; Economics of a large project lower the cost of the product or service substantially over the possible cost of a smaller project if the partners proceeded individually; The risks of the projects are shared; One or more of the partners can use the tax benefits. Greater debt leverage can be obtained. The joint sponsors also select the legal form of the SPV (corporation, partner, limited partnership, Limited Liability Company, contractual joint venture, or trust) that will be satisfying their tax and legal objectives.

Credit exposures in a project financing

To place a project financing into perspective, it is helpful to review the different credit exposures that occur at different times in the course of a typical project financing.

– Project financing risks can be divided into three time frames in which the elements of credit exposure assume different characteristics: - engineering and construction phase; - start-up phase; - operations according to planned specifications. Different guarantees and undertakings of different partners may be used in each time frame to provide the credit support necessary for structuring a project financing.

Projects generally begin with a long period of planning and engineering. Equipment is ordered, construction contracts are negotiated, and actual construction begins. After commencement of construction, the amount at risk begins to increase sharply as funds are advanced to purchase material, labor, and equipment. Interest charges on loans to finance construction also begin to accumulate.

Project lenders do not regard a project as completed on conclusion of the construction of the facility. They are concerned that the plant or facility will work at the costs and to the specifications which were planned when arranging the financing. Failure to produce the product or service in the amounts and at the costs originally planned means that the projections and the feasibility study are incorrect and that there may be insufficient cash to service debt and pay expenses. Project lenders regard a project as acceptable only after the plant or facility has been in operation for a sufficient period of time to ensure that the plant will in fact produce the product or service at the price, in the amounts, and to the standards assumed in the financial plan which formed the basis for the financing. This start-up risk period may run from a few months to several years.

Once the parties are satisfied that the plant is running to specification, the final operating phase begins. During this phase, the project begins to function as a regular operating company. If correct financial planning was done, revenues from the sale of the product produced or service performed should be sufficient to service debt—interest and principal— pay operating costs, and provide a return to sponsors and investor

Some projects are financed from beginning to end with a single lender or single group of lenders. However, most large projects employ different lenders or groups of lenders during different risk phases. This is because of the different risks involved as the project facility progresses through construction to operation, and the different ability of lenders to cope with and accept such risks. Some lenders like to lend for longer terms and some prefer short-term lending. Some lenders specialize in construction lending and are equipped to monitor engineering and construction of a project, some are not. Some lenders will accept and rely on guarantees of different sponsors during the construction, start-up or operation phases, and some will not. Some lenders will accept the credit risk of a turn-key operating project, but are not interested in the high-risk lending during construction and start-up. Interest rates will also vary during the different risk phases of project financing and with different credit support from sponsors during those time periods. Short-term construction lenders are very concerned about the availability of long-term "take out" financing by other lenders upon completion of the construction or start-up phase. Construction lenders live in fear of providing their own unplanned take out financing. Consequently, from the standpoint of the construction lender, take out financing should be in place at the outset of construction financing.

Key elements of a successful project financing

There are several elements that both sponsors and lenders to a project financing should review in order to increase the likelihood that a project financing will be successful. The key ones are: a satisfactory feasibility study and financial plan should be prepared with realistic assumptions regarding future inflation rates and interest rates; the cost of product or raw materials to be used by the project is assured; a supply of energy at reasonable cost has been assured; A market exists for the product, commodity, or service to be produced; transportation is available at a reasonable cost to move the product to the market; adequate communications are available; building materials are available at the costs contemplated; the contractor is experienced and reliable; the operator is experienced and reliable; management personnel are experienced and reliable; untested technology is not involved; the contractual agreement among joint venture partners, if any, is satisfactory; the key sponsors have made an adequate equity contribution; satisfactory appraisals of resources and assets have been obtained; adequate insurance coverage is contemplated; the risk of cost overruns has been addressed; the risk of delay has been considered; the project will have an adequate return for the equity investor; environmental risks are manageable. When the project involves a sovereign entity, the following critical elements are important to consider ensuring the success of a project: a stable and friendly political environment exists; licenses and permits are available; contracts can be enforced; legal remedies exist; there is no risk of expropriation; country risk is satisfactory; sovereign risk is satisfactory; currency and foreign exchange risks have been addressed; protection from criminal activities such as kidnapping and extortion; existence of a commercial legal system protecting property and contractual rights.

The best way to appreciate the concerns of lenders to a project is to review and consider some of the common causes for project failures, which include the following: Delay in completion, with consequential increase in the interest expense on construction financing and delay in the contemplated revenue flow; Capital cost overrun; Technical failure; Financial failure of the contractor; Uninsured casualty losses; Increased price or shortages of raw material; Technical obsolescence of the plant or equipment; Loss of competitive position in the marketplace; Poor management; Overly optimistic appraisals of the value of pledged security, such as oil and gas reserves. In addition, for projects in a foreign country, the following are causes for project failures: government interference; expropriation and financial insolvency of the host government. For a project financing to be successfully achieved, these risks must be properly considered, monitored, and avoided throughout the life of the project.

While the sponsor or sponsors of a project financing ideally would prefer that the project financing be a non-recourse borrowing which does not in any way affect its credit standing or balance sheet, many project financings are aimed at achieving some other particular credit impact objective, such as any one or several of the following: To avoid being shown on the face of the balance sheet; To avoid being shown as debt on the face of the balance sheet so as not to impact financial ratios; To avoid being shown in a particular

footnote to the balance sheet; To avoid being within the scope of restrictive covenants in an indenture or loan agreement which precludes direct debt financing or leases for the project; To avoid being considered as a cash obligation which would dilute interest coverage ratios, and affect the sponsor's credit standing with the rating services; To limit direct liability to a certain period of time such as during construction and/or the start-up period, so as to avoid a liability for the remaining life of the project; To keep the project off-balance sheet during construction and/or until the project generates revenues. Any one or a combination of these objectives maybe sufficient reason for a borrower to seek the structure of a project financing. Liability for project debt for a limited time period may be acceptable in situations in which liability for such debt is unacceptable for the life of the project. Where a sponsor cannot initially arrange long-term non-recourse debt for its project that will not impact its balance sheet, the project may still be feasible if the sponsor is willing to assume the credit risk during the construction and start-up phase, and provided lenders are willing to shift the credit risk to the project after the project facility is completed and operating. Under such an arrangement, most of the objectives of an off-balance sheet project financing and limited credit impact can be achieved after the initial risk period of construction and start-up. In some instances, the lenders may be satisfied to rely on revenue produced by unconditional take-or-pay contracts from users of the product or services to be provided by the project to repay debt. In other instances, the condition of the market for the product or service may be such that sufficient revenues are assured after completion of construction and start-up so as to convince lenders to rely on such revenues for repayment of their debts.

Project financing is sometimes called off-balance sheet financing. However, while the project debt may not be on the sponsor's balance sheet, the project debt will appear on the face of the project balance sheet. In any event, the purpose of a project financing is to segregate the credit risk of the project in order that the credit risk of lending to either the sponsor or the project can be clearly and fairly appraised on their respective merits. The purpose is not to hide or conceal a liability of the sponsor from creditors, rating agencies, or stockholders. Significant undertakings of sponsors and investors in projects subject to the Financial Accounting Standards Board must usually be shown in footnotes to their financial statements if not in the statements themselves. Because project financings are concerned with balance sheet accounting treatment, familiarity with accounting terms used to describe or rationalize balance sheet reporting is important. Terms such as contingent liability, indirect liability, deferred liability, deferred expense, fixed charges, equity accounting, and materiality are used to rationalize the appropriate positioning of entries in a sponsor's financial statements and footnotes. Accounting rules for reporting these types of liabilities are under continual review, as the accounting profession grapples with the problem of proper and fair disclosure and presentation of objective information to stockholders, lenders, rating agencies, guarantors, government agencies, and other concerned parties.

Corporations set target rates of return for new capital investments. If a proposed capital expenditure will not generate a return greater than a company's target rate, it is not regarded as a satisfactory use of capital resources. This is particularly true when a company can make alternative capital expenditures which will produce a return on capital in excess of the target rate.

Project financing can sometimes be used to improve the return on the capital invested in a project by leveraging the investment to a greater extent than would be possible in a straight commercial financing of the project. This can be accomplished by locating other parties interested in getting the project built, and shifting some of the debt coverage to such parties through direct or indirect guarantees. An example would be an oil company with a promising coal property which it did not wish to develop because of better alternative uses of its capital. By bringing in a company which required the coal, such as a public utility, an indirect guarantee might be available in the form of a long-term take-or-pay contract which would support long-term debt to finance the construction of the coal mine. This, in turn, would permit the oil company's investment to be highly leveraged and consequently to produce a much higher rate of retur

There are often other side benefits resulting from segregating a financing as a project financing which may have a bearing on the motives of the company seeking such a structure. These benefits include: credit sources may be available to the project that would not be available to the sponsor; guarantees may be available to the project that would not be available to the sponsor; a project financing may enjoy better credit terms and interest costs in situations in which a sponsor's credit is weak; higher leverage of debt to equity may be achieved; legal requirements applicable to certain investing institutions may be met by the project but not by the sponsor; regulatory problems affecting the sponsor may be avoided; for regulatory purposes, costs may be clearly segregated as a result of a project financing; construction financing costs may not be reflected in the sponsor's financial statements until such time as the project begins producing

revenue. In some instances, any one of the reasons stated above may be the primary motivation for structuring a new operation as a project financing.

Tax benefits from any applicable tax credits, depreciation deductions, interest deductions, depletion deductions, research and development tax deductions, dividends-received credits, foreign tax credits, capital gains, and non-capital start-up expenses are very significant considerations in the investment, debt service, and cash flow of most project financings. Care must be used in structuring a project financing to make sure that these tax benefits are used. Where a project financing is housed in a new entity that does not have taxes to shelter, it is important to structure the project financing so that any tax benefits can be transferred to parties in a position currently able to use such tax benefits.

Project financings are complex. The documentation tends to be complicated, and the cost of borrowing funds may be higher than conventional financing. If the undertakings of a number of parties are necessary to structure the project financing, or if a joint venture is involved, the negotiation of the original financing agreements and operating agreements will require patience, forbearing, and understanding. Decision making in partnerships and joint ventures is never easy, since the friendliest of partners may have diverse interests, problems, and objectives. However, the rewards and advantages of a project financing will often justify the special problems that may arise in structuring and operating the project.

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