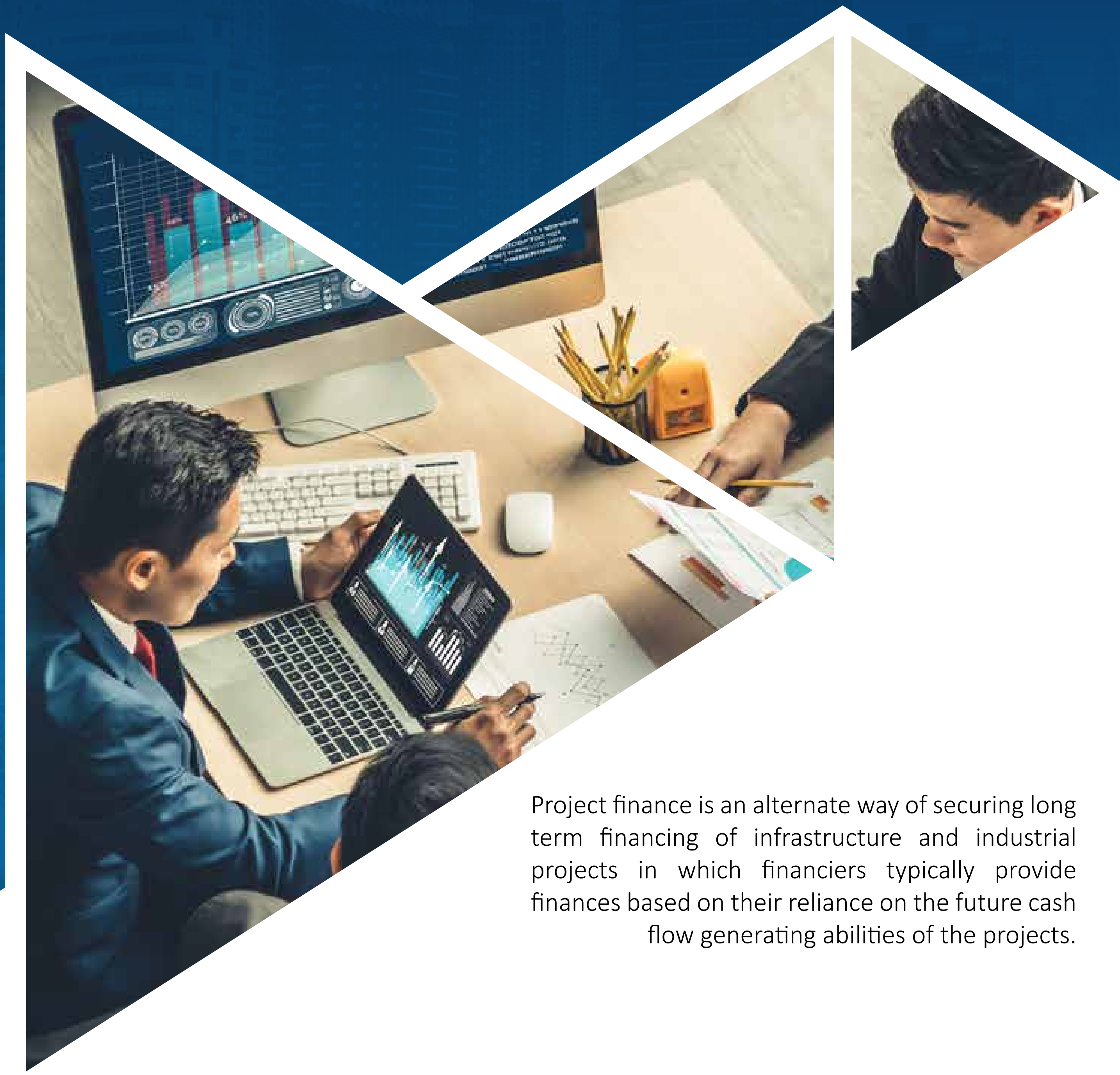
insights

Project Finance



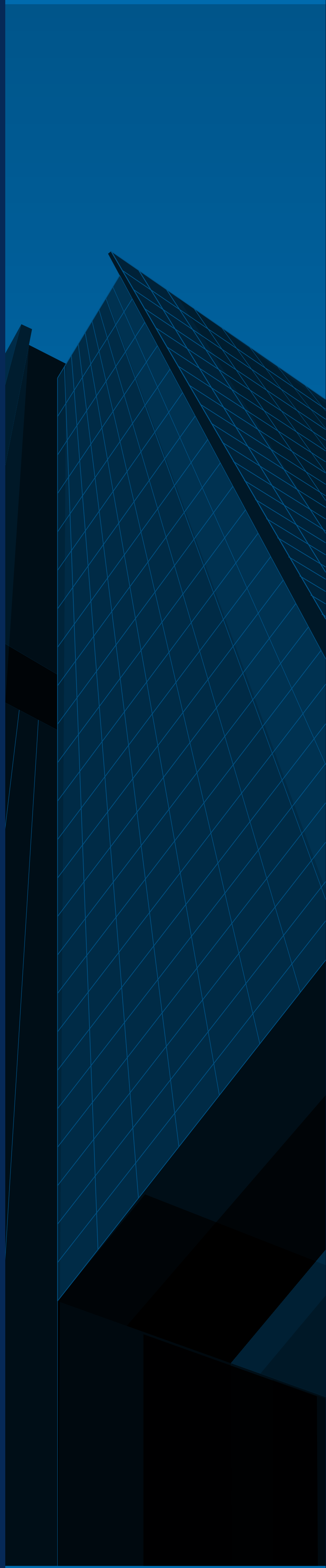
Project finance is an alternate way of securing long term financing of infrastructure and industrial projects in which financiers typically provide finances based on their reliance on the future cash flow generating abilities of the projects.

we have recently seen that many greenfield infrastructure projects (for example, power projects) funded their costs through project financing. Greenfield infrastructure projects are built from scratch starting from planning, designing, bidding, construction and finally operations and maintenance. Project finance is an alternate way of securing long term financing of infrastructure and industrial projects in which financiers typically provide finances based on their reliance on the future cash flow generating abilities of the projects. Under conventional financing, the loan is backed by a balance sheet of the sponsors, whereas in the project finance, the repayment of loan relies on cash flow and assets of the project itself. Therefore, in order to attract project financing, the project must provide security to its financiers/investors that it is financially and technically feasible and it is capable of servicing the debt through its operating cash flows over the life of the project

There are two basic types of project finances:

01 non-recourse project finance and

02 limited recourse project finance. Under the non-recourse project finance arrangement, the financiers do not have any direct recourse over the sponsors and thus rely on the repayment of loan through operating cash flow generated by the assets of the project. Under limited recourse project finance arrangement, apart from relying on operating cash flow of the project, the financiers have some recourse over the sponsors. For example, the financiers typically ask from the sponsors for pre-operational phase guarantees that there will be no cost overruns in the project during its construction phase. The sponsors commitment is usually captured under the Sponsors Support Agreement which lists down all the sponsors obligations and commitments towards the project.



Steps to Secure Project Finance

The main sponsors of the project first conceive an idea of setting up a new project. They initially conduct all requisite legal, technical and financial due diligence and secure any governmental consents required to develop the project. An outcome of an initial due diligence is captured under the project Information Memorandum (IM). The main purpose of IM is to acquaint prospective lenders with the project company, the project and the financing required for the project. IM summarises information about the sponsors and shareholding structure, the description of the project, project cost and funding requirements, project key strengths, project's technology/design, market trends, status of the key milestones in the development/construction of the project and the initial financial projections.

IM is initially submitted by the sponsors/company to the financiers, mainly development finance institutions. Once the financiers show their interest in the project, they sign a Mandate Letter (ML) with the sponsors and the company. The ML describes the scope of work that the financier will perform relating to the financing of the project.

After signing of ML, the financiers, with an assistance from their legal and technical advisors, mainly appraise the company, the sponsors and the project and review the project's commercial, financial, economic, technical, environmental, corporate governance and legal aspects. After successful completion of the appraisal, the financier submits the company and the sponsors a draft Term Sheet outlining the proposed financing structure and conditions of the investment. The draft Term Sheet is then negotiated with the sponsors and the company (in consultation with their respective legal counsels).

Once proposed financing structure and terms are agreed under the Term Sheet, then the financiers with assistance from its legal counsel, organise and co-ordinate the drafting, negotiation and execution of all the requisite legal documentation for financing. Once all the legal documentation is completed and agreed between the respective parties, the first disbursement is released by the financiers. This stage is usually termed as a financial closing. Financial closing is an execution of the financing documents that evidence sufficient financing for the construction and completion of the project and financiers are satisfied with all conditions precedent for the initial availability of funds.

Financial Projections

Project finance is only possible when the project is capable of producing enough cash flows to cover all operating and debt obligations over the whole tenure of the loan. The sponsors of the project typically provide a cash flow projection in the form of a financial model which is usually constructed on the spreadsheet and illustrates the cash flow projection over the life of the project. Since project finance is backed by the cash flow generating capacity of the project, therefore, the company is required to demonstrate a minimum Debt Service Coverage Ratio (DSCR) in its base case financial model. DSCR means, for any period, the ratio of (i) cash flow for such period, to (ii) debt service for such period. DSCR is a measure of the cash flow available to pay the debt obligation, for any specified period. Typically,financiers require the project to demonstrate a minimum DSCR of 1.2x-1.4x for a semiannual period, till the final maturity of the loan.

Project Finance Risks

Risks	Financier Risk Point of View	Mitigation
Project Documents	A bankable contract is a contract with risk allocation between the contractor and project company that satisfies the lenders	By managing all risks of the project. (The less comfortable the financiers are with provisions of the contract, the greater the amount of sponsor support will have to be provided.)
Construction Risk	Can the project be completed on sc hedule and according to the required specifications	By having a turnkey fixed price Engineering Procurement and Construction (EPC) contracts with single point of responsibility and fixed completion date. EPC contracts to include performance guarantees backed by performance liquidity damages.
Operational Risk	Once the project is constructed, it must be operated and maintained in a manner that the project company can comply with its obligations under the other project documents	Engage a competent operator and agree to an extensive reporting obligation and inspection. Procure insurances for operational property damage and business interruptions.
Repayment Risk	The financiers want to minimise the risk of non-payment by the project company.	Set up a Debt Service Reserve Account. Usually financiers require that 6 to 9 months of their debt payments are available at all time in this account. Ensure minimum DSCR ratios are met before any dividend distributions.
Currency Risk	If the project earnings are in local rupee and debt obligations are in foreign currency	Establish an offshore debt payment accounts where portion of loan proceeds is converted immediately into this account from the local earnings account. Indexation adjustments incorporated in revenue tariff.

Main Parties Involved in Project Finance

01 Sponsors

These are the main parties to the project who provide finance in the form of equity contributions. The sponsors initially conceive an idea of the project and conduct initial legal/financial/technical due diligence of their project.

02 Company/Project

Usually a separate legal entity (special purpose vehicle) is formed which owns the project assets and to which funding is provided by the sponsors/financiers.

03 Lender's legal counsel

Act as an independent engineer on behalf of the financier and provide comfort to the lenders on the technical feasibility of the project. They also oversee the construction and operational activities of the project.

04 Financiers

The main investors who provide project financing to the company. These are mostly development finance institutions that offer funding to encourage private sector evelopment in developing countries.

05 Security trustee

They hold various security interests, on behalf of the financiers, created over the project

06 Company's legal counsel

Act on behalf of the company/sponsors and provide legal services in negotiating key project documents with financiers

07 Lender's technical engineer

Act as an independent engineer on behalf of the financier and provide comfort to the lenders on the technical feasibility of the project. They also oversee the construction and operational activities of the project.

08 Financial model auditor

Act as an independent auditor on behalf of the financiers and provides its report after reviewing the financial model developed by the project company

09 Company's Technical Engineer

The company's technical engineer conducts all the technical feasibility of the project. They are also involved during the construction phase by overseeing different activities at project site during its development stage.

10 Insurance advisor

Act as an insurance/reinsurance broker and make placements of insurances