

STATE BANK OF PAKISTAN TRAINING PROGRAM

INTRODUCTION TO PROJECT FINANCE AND LENDER'S PERSPECTIVE

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Focus

1. Definition
2. Different from Corporate finance
3. Constraints & Benefits
4. Key Steps
5. Credit Rationale & the 5Ps
6. Other Remarks

1. Project Finance Is:

- ❖ where revenue stream earned from the use of the project's asset is used as a basis for financing.***
- ❖ where the source of the repayment is the expected revenue from the project and does not rely on the credit of the sponsors or the underlying value of the project assets.***
- ❖ where repayment of debt from project's cash flows***

2. Financing Approaches

- *Corporate* Finance
- *Project* Finance, also known as,
“Non / Limited Recourse” Financing

Project vs. Corporate Finance

Project Finance	Corporate Finance
<ul style="list-style-type: none">• One Asset• Cash Flow Post-Construction• High leverage• Risk allocation• Project Technical/Financial Assessment	<ul style="list-style-type: none">• Many Assets• Existing Cash Flow• Less leverage• Corporate Credit• Assessment of Corporate Credit

3. Why Project Finance?

- ✓ Need for Infrastructure
- ✓ Large Investments
- ✓ Financing Constraints

Financing Constraints

- Country Creditworthiness
- Sector Regulatory Arrangements
- Regulatory Treatment of Bank Lending

Regulatory & Legal Frameworks

- Clear and codified regulation
 - Can start with strong government support
 - Can privatize outright . . . but rules must be clear
- Enforceable contracts
- Transparent pricing mechanisms
- Non-interference
- Lenders' rights

Benefits of Project Finance

- ✓ Leverage resources (debt : equity)
- ✓ Risk sharing (risk matrix)
- ✓ Attract financing (box the risk + security + support + transparency on inputs & outputs + projections and sensitivities to key variables)
- ✓ Off Balance Sheet (sponsors' perspective)

4. Key Steps

- ✓ Feasibility Analysis
- ✓ Structuring & Negotiating Project Agreements
- ✓ Prepare Financing Plan
- ✓ Prepare Information Memorandum
- ✓ Finalize Project Agreements
- ✓ Negotiate Financing Terms
- ✓ Syndication/Underwriting - Financial Closure

5. Developing a Credit Rationale

✓ 5 C's of Credit (Corporate financing)

The five key elements a borrower should have to obtain credit:

- Character (integrity),
- Capacity (sufficient cashflow to service the obligation),
- Capital (net worth)
- Collateral (assets to secure the debt), and
- Conditions (of the borrower and the overall economy).

✓ 5 P's of Credit (Project financing)

- Political (country, sector, regulation)
- Participants (credibility)
- Project (risk parameters)
- Package (security, credit enhancement)
- Profitability (cash flow, ROE, IRR)

Political Risks

- ✓ Country / Sub-Sovereign Credit
- ✓ Investment Climate
- ✓ Sector risks

Specific Political Risks

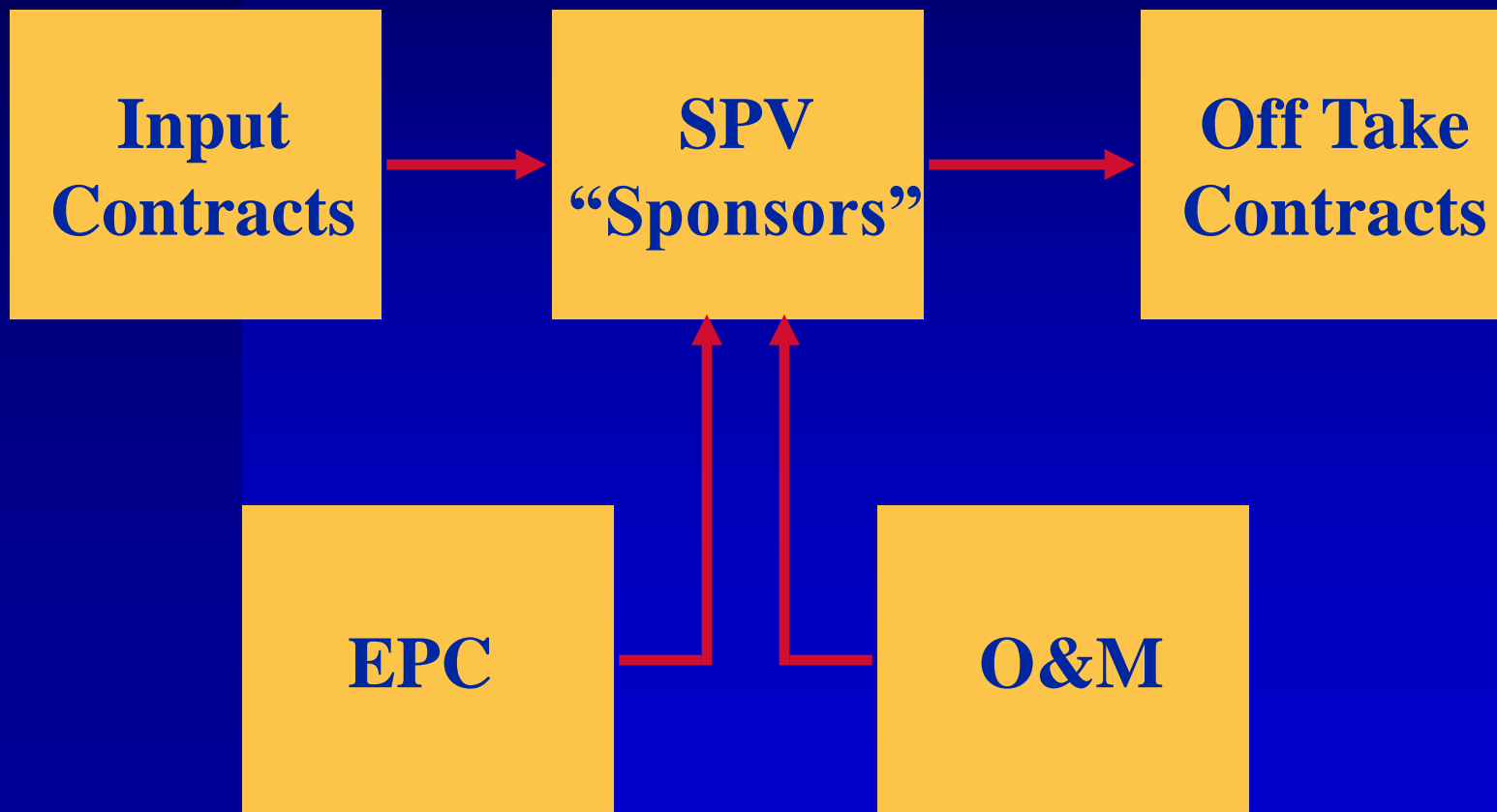
- ✓ Payment obligations of gov't-owned entities
- ✓ Tariff adjustment
- ✓ Forex: availability and transfer
- ✓ Changes in law

Specific Political Risks (cont'd)

- ✓ Uninsurable force majeure
- ✓ Market, if:
 - Monopoly purchasers
 - Traffic dependent on Government decision
- ✓ Expropriation

PROJECT STRUCTURE

Host Government



Parties Involved In Project Finance

Party	Role
• Sponsors	- Investors - Development
• Project Company	- SPV, [Operator], [EPC consortium]
• Financial Advisers	- Advice on Structure - Information Memorandum
• Legal Advisers	- Agreements - Negotiations
• Lenders	- Debt Financing

Parties Involved (cont'd)

Party	Role
• Experts	- Advise participants - Studies - Independent opinions
• Input Providers	- Inputs
• Buyer	- Purchase Output
• Host Government	- Permits, Clearance - Assurances
• Multi-Bilateral Agencies	- Financier - Insurer/Guarantor
• Private Insurance	- Insurer

Sponsor & Participants

- Long-term investors
- Equity investors must be at risk
- “Real” cash equity investments
- Equitably *share* the risk
- Credible EPC and O&M contractors (fixed-price lump sum, track-record)
- Creditworthy participants and financial information are *ESSENTIAL*.
- Support may be required for entities which do not meet test for creditworthiness.

Project Risks

- ✓ Project development/finance mobilization
- ✓ Construction (cost & time)
- ✓ Performance (O&M)
- ✓ Compliance with local laws and regulations (environment, health & safety)
- ✓ Market

RISK RATING COMPONENTS

- country conditions
- offshore currency generation
- host government commitment
- legal/regulatory framework
- risk allocation/owner risk sharing
- project cost
- devaluation
- quality of contracts
- participant ability to perform
- technical feasibility
- financial feasibility

Equitable Risk Allocation

- Reasonable assurance of repayment
- Financially viable and “bankable” projects
- Risk sharing
- Mutually acceptable solutions
- Commercial contractual arrangements

Risk-sharing Arrangements

PRE-CONSTRUCTION AND CONSTRUCTION RISKS

	Sponsors/ Equity	Lenders	Contractors (Turnkey, O&M)	Utility	Gov't.	Insurance
Pre-construction Risks						
Development Initial consents/ permits	○				○	
Construction Risks						
Cost Overruns	○		○			
Change Orders	○			○	○	
Delays	○		○			
Completion	○	○	○			
Force Majeure	○	○	○		○	

Risk-Sharing Arrangements (cont'd)

MARKET RISKS

Market Risks	Sponsors /Equity	Lenders	Contractors (turnkey, O&M)	Utility	Gov't.	Insurance
Interest rate				○		
Forex Availability	○				○	○
Currency Devaluation						
Electricity Demand						
Inflation						
Fuel Price						
Cost Escalation						
Force Majeure	○	○	○	○	○	

Risk-Sharing Arrangements (cont'd)

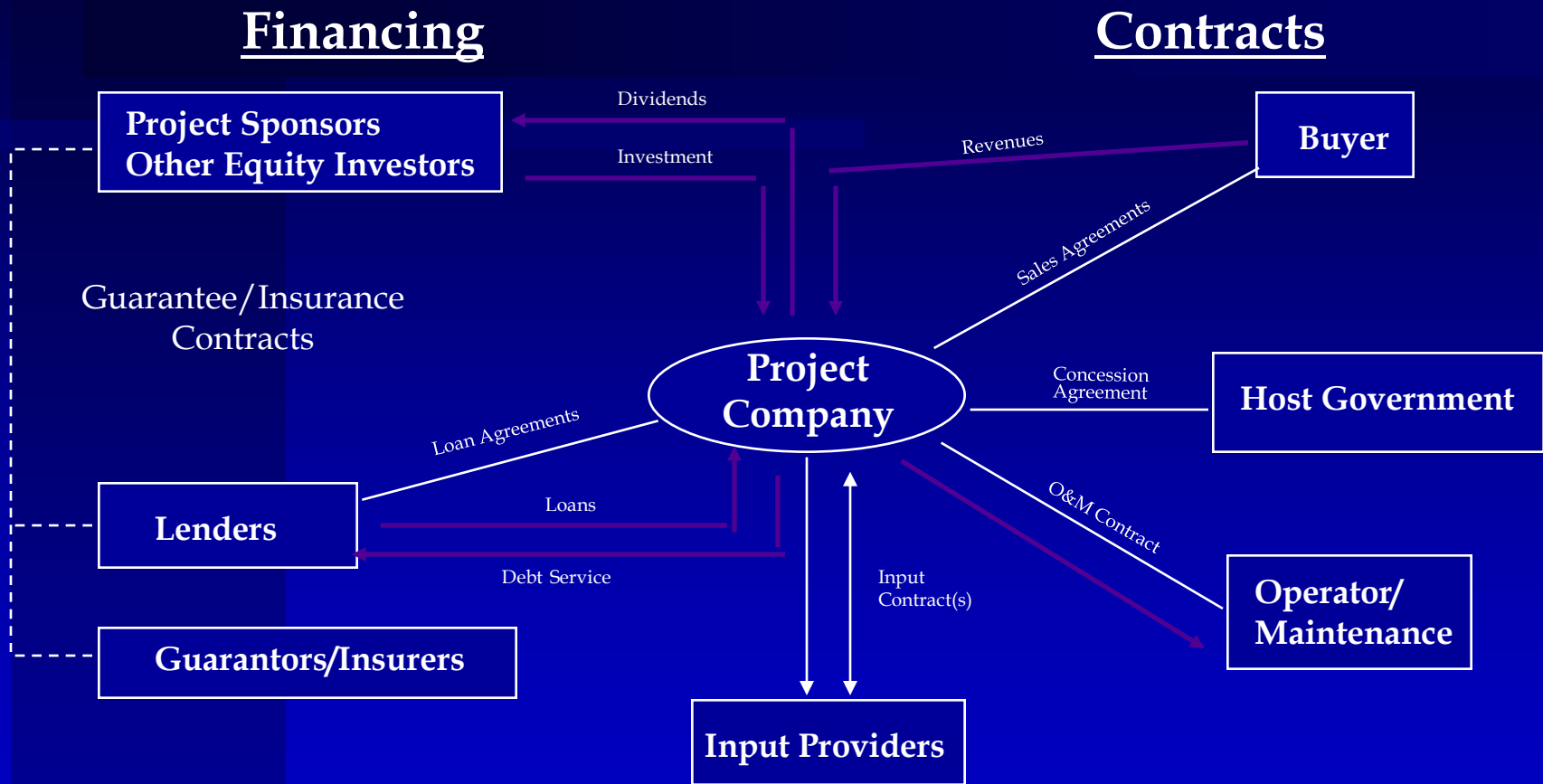
OPERATIONAL, REGULATORY, AND OTHER RISKS

	Sponsors/ Equity	Lenders	Contractors (turnkey, O & M)	Public Utility	Gov't.	Insurance
Operational Risks						
• O & M Cost Overruns	○	○				○
• Maintenance	○	○	○			○
• Force Majeure	○	○	○		○	
• Performance	○	○	○			
Performance Risks						
• Changes in Law				○	○	
• Taxes				○		
• Environmental	○	○			○	
• Consent Condition	○	○			○	
Compliance						
Other Risks						
Performance payment obligations of gov't. entities	○	○			○	

Security Package

- Clear Allocation of risks and obligations
- Key Agreements
 - Power Purchase Agreement
 - Construction Contract
 - Fuel Supply Contract
 - O&M Contract
 - Govt. Support Agreement
 - Credit Agreement
 - Inter-creditor Agreement

Typical Structure



----- = Guarantee

———— = Agreements

————> = Cash Flows

Govt. Support & Guarantees

- Reduce Performance Risk
- Reduce Credit Risk
- Mitigates Foreign Exchange Convertibility Risk
- Contractually Binding Obligations

6. PROJECT FINANCE – Other remarks

- **Local financing**
(depth, experience, sourcing, terms, Islamic or Conventional)
- **Capitalized interest during construction**
- **Export Credit Agencies (ECAs) participation**
limited only by content
- **Maximum credit terms allowed by OECD**
(“OECD Consensus” for ECAs)

PROJECT FINANCE – Other remarks (cont'd)

- **Greenfield or project expansion**
(Parallel Project Revenue – Portugal April 25 Bridge, UK Dartford Tunnel)
- **No requirement of a direct sovereign guarantee**
- **No country or project funding limits**
(ref: Basel's internal ratings-based approach, "single-customer" lending limit)

Project type considerations

- Infrastructure vs. export-oriented projects

(currency matching helps mitigate FX risks unless there is deep local currency funding & stable FX)

- Projects with no long-term off-take contracts

(Rental Power Plants or STIPPS, Merchant Power Plants)

- Projects with market price risk for commodity products

(speculative, weather-correlation, volatile: need for sufficient cushioning, DSCR)

- Cross-boundary projects

(TAPI, Chad-Cameroon Oil Pipeline, Qatar-UAE Gas Pipeline)

For More Information

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