

PROJECT FINANCING

An Overview

Fieldman, Rolapp & Associates

A stylized, teal-colored silhouette of a mountain range is positioned in the bottom right corner of the slide, extending from the right edge towards the center.

What is a Project Financing?

"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."

-- From: Peter K. Nevitt, *Project Financing*, Fourth Ed. (London: Euromoney Publications, 1983), p. 3

What is a Project Financing?

- ◆ Typically, non-recourse to the borrower
- ◆ Alternatively, recourse only to a "special purpose financing corporation"
 - *relies heavily on the structural features of the financing arrangement (rather than borrower's good intentions) to ensure repayment*

Characteristics of Project Financing

- ◆ Capital formation process emphasizes apportionment of risk
- ◆ Lenders rely on certainty of cash flow
 - *cash flow assumptions usually beyond control of the participants*
- ◆ Equity providers rely on structural features to maintain control
 - *assumptions presume that economic risks are isolated by legal structure*
- ◆ As a result, it is the legal framework which is subject to most intense negotiations

Prototypical Project Financings

- ◆ Independent power projects are largest segment of project financing in the United States
 - Accordingly, are often used as model for others
- ◆ Typically rely on fuel supplies, power sales contracts, proven technology, efficient management and appropriate governmental climate as underpinnings
 - *ISO 4 contract example in Central Valley*
 - *others include: Title XIs, pipelines, alternative energy facilities, hotels, hospitals, toll roads, etc.*

The Players In A Project Financing

- ◆ Developer: sponsors the project
 - (and the SPC, if applicable)
- ◆ Equity: provides equity capital
- ◆ Lender: provides primary or secondary debt
- ◆ Others: construction companies, technology companies, or suppliers may take equity or debt positions
- ◆ Customers: also may take debt or equity positions in the project

Objectives Of The Parties: Developer

- ◆ Non-recourse financing
- ◆ Off-balance sheet financing
- ◆ High level of leverage
- ◆ Insulate project from other assets
- ◆ Maximum use of available tax benefits

Objectives Of The Parties: Equity

- ◆ Maximum return on capital
- ◆ Minimum cash outlay
- ◆ Position that "mimics" lender's
- ◆ Control in default scenarios
- ◆ "Customized" tax/accounting treatment

Objectives Of The Parties: Lender

- ◆ "Bulletproof" covenants and remedies which cover:
 - *completion risk*
 - *basic performance*
 - *efficacy*
 - *Technology or obsolescence*
 - *law/regulatory change*
- ◆ Sensitivity assumptions must be proven
- ◆ Demonstrated project viability assures timely repayment
- ◆ Timely repayment is the essence of a "good loan"

Objectives Of The Parties: Others

- ◆ Minimize debt/equity positions required to "get the business"
- ◆ Output purchasers desire technology/efficacy control
- ◆ Developer desires input (fuel) control
- ◆ Lender's position is usually superimposed over every other

Apportionment of Debt/Equity Risk

- ◆ Establishing acceptable rate of return entails analysis of:
 - *completion risk*
 - *cost overrun risk*
 - *technology failure*
 - *financial failure of contractor (not developer)*
 - *law change (includes regulatory threat)*
 - *casualty loss*
 - *price of raw material*
 - *value of output materials*
- ◆ Default remedies are critical outcome

Six Steps in Risk Analysis

- ◆ Evaluate contracts (which, along with the physical assets) constitute the enterprise
- ◆ Assess technology and construction risks
- ◆ Analyze competitive position of the completed project
- ◆ Determine counterparty exposure and credit risk
- ◆ Appraise legal structure for weaknesses and threats
- ◆ Evaluate quality and probability of cash flow projections

Negotiating A Project Financing

- ◆ Term sheet (where lender usually establishes whether or not is to be "club" deal or will be "sold down" later)
- ◆ Commitment letter (where basic relationship between debt/equity participants is forged)
- ◆ From the above the flow of funds and other basic documentation follow:
 - *credit agreement*
 - *inter-creditor agreement*
 - *construction contract*
 - *security agreement*
 - *depository/fiscal agreement*
 - *guarantees*

Putting It Together

- ◆ Process is iterative
 - *requires simultaneous negotiation across many fronts: equity, debt, operations, output*
- ◆ Lender calls the shots since it is usually in superior position and lenders don't provide venture capital
 - *other players typically adjust to lending requirements*

Typical Lenders

- ◆ Banks (who syndicate it)
- ◆ Pension funds (mostly taxable)
- ◆ Insurance companies (mostly property and casualty)
- ◆ Captive finance companies
 - (e.g. G. E. Credit)
- ◆ Others
 - (development banks, e.g. IBRD, the “World Bank”)

More Information

Harvard University Business School:

<http://www.hbs.edu/projfinportal/>

Major Rating Agencies:

Fitch Ratings

<http://www.fitchibca.com>

Standard & Poor's

<http://www.standardandpoors.com>

Moody's Investors Service

<http://www.moody's.com>

About Fieldman, Rolapp & Associates

In 1966, when the late Bill Fieldman founded the firm that was to become Fieldman, Rolapp & Associates, he established a standard of quality and integrity in consulting services to local government that remains as a hallmark of the firm to this day. We know that being "biggest" is not the key to being the "best" and we continually strive to improve the knowledge base of our industry and of public financial management throughout our service area through outreach activities such as today's event.

Close to forty years later, the firm is continually expanding its areas of involvement in municipal finance and now provides those services to a wide array of local governments and non-profit organizations throughout the western United States. The ever-changing market in which today's government agencies operate requires not only technical skill, but also innovation and creativity. Both of these attributes are part of the firm's culture.

The firm is an independent firm - that is, we have no connection to other financial service providers. Each of the firm's owners is actively engaged with client business. That's critical to understanding our clients' needs and responding proactively as those needs change over the course of time. Meeting the public's expectation for excellent financial stewardship of public assets is our challenge. Meeting that challenge requires strong leadership and good information. We hope that the information and resources you found in today's presentation will be useful in that regard.

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