Introduction to Project Finance

Project Appraisal, Financing and Management

CRISIL CERTIFIED ANALYST PROGRAMME
SEMESTER III

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NMIMS

What is a Project?

- High operating margins.
- Low to medium return on capital.
- Limited Life.
- Significant free cash flows.
- Few diversification opportunities.
- Asset specificity.

What is a Project? (cont.)

- Projects have unique risks:
  - Symmetric risks:
    - Demand, price.
    - Input/supply.
    - Currency, interest rate, inflation.
    - Reserve (stock) or throughput (flow).
  - Asymmetric downside risks:
    - Environmental.
    - Creeping expropriation.
  - Binary risks
    - Technology failure.
    - Direct expropriation.
    - Counterparty failure
    - Force majeure
    - Regulatory risk

What Does a Project Need?

- Customized capital structure
- Asset specific governance systems
  - to minimize cash flow volatility and
  - to maximize firm value.

“Project finance” is not the same thing as “financing projects”.

What is Project Finance?

Project Finance involves a ***corporate sponsor*** *investing in and owning a* ***single purpose****, industrial asset through a legally* ***independent*** *entity financed with* ***non-recourse debt****.*

Cash flow is security to lenders.

Project Structure

- Structure highlights
- Disadvantages
- Motivations

Structure Highlights

- SPV - Independent, single purpose company formed to build and operate the project.
- Extensive contracting
  - As many as 15 parties in up to 1000 contracts.
  - Contracts govern inputs, off take, construction and operation.
  - Government contracts/concessions: one off or operate-transfer.
  - Ancillary contracts include financial hedges, insurance for Force Majeure, etc.

Structure Highlights (cont.)

- Highly concentrated equity and debt ownership
  - One to three equity sponsors.
  - Syndicate of banks and/or financial institutions provide credit.
  - Governing Board comprised of mainly affiliated directors from sponsoring firms/ independent directors
- Extremely high debt levels
  - Mean debt of 70% and as high as nearly 95%.
  - Balance of capital provided by sponsors in the form of equity or quasi equity (subordinated debt).
  - Debt is non-recourse to the sponsors.
  - Debt service depends exclusively on project revenues.
  - Has higher spreads than corporate debt.

Disadvantages of Project Financing

- Often takes longer to structure than equivalent size corporate finance.
- Higher transaction costs (~60bp) due to creation of an independent entity.
- Project debt is substantially more expensive (50-400 bp) due to its non-recourse nature.
- Extensive contracting restricts managerial decision making.
- Project finance requires greater disclosure of proprietary information and strategic deals.

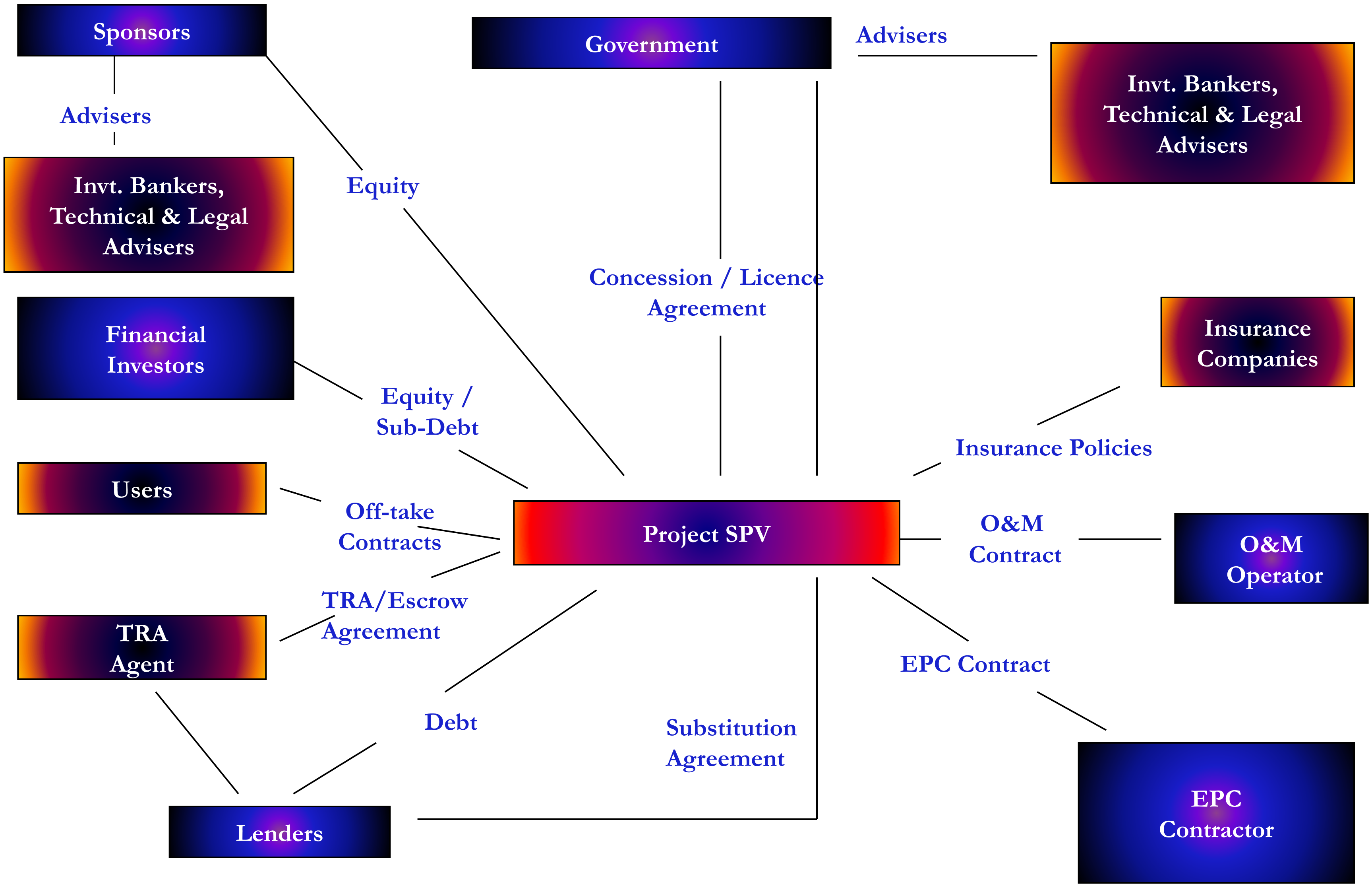
Type of Projects

- BOT - Build Operate Transfer
- BOOT - Build Own Operate Transfer
- BOO - Build Own Operate
- BOOST - Build Own Operate Share Transfer
- BOLT - Build Own Lease Transfer
- DBFO - Design Build Finance Operate
- OMT - Operate Maintain Transfer

Means of Finance

- Equity Capital
- Mezzanine Finance
  - Convertibles
  - Preference Capital
  - Sub-ordinated Debt
- Senior Debt
  - Rupee Term Loan
  - Bonds
  - Foreign Currency Loan
  - Export Credit
  - Supplier's Credit

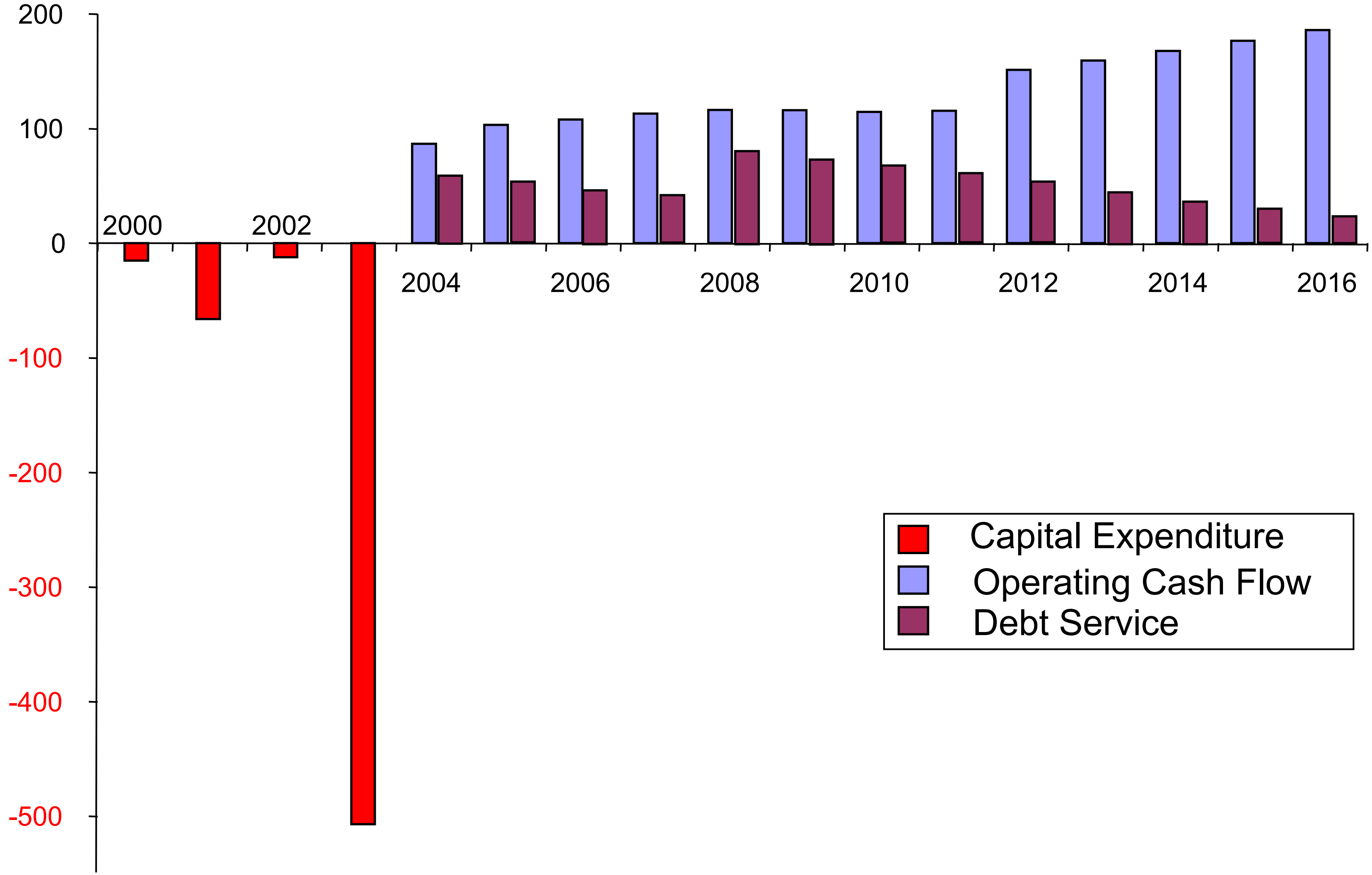
Deal Diagram



Key Components

- Cash flow projections based on technical, market and financial analysis
- Risk allocation through project contracts and financing agreements
- Structured financing
- Security and documentation
- Project monitoring and compliance

Base case analysis shows adequate debt servicing capacity of the enterprise.



Why Investors Use Project Finance

- High leverage
- Tax benefits
- Off-balance sheet financing
- Borrowing capacity
- Risk limitation
- Risk spreading
- Long-term finance
- Enhanced credit
- Unequal partnerships

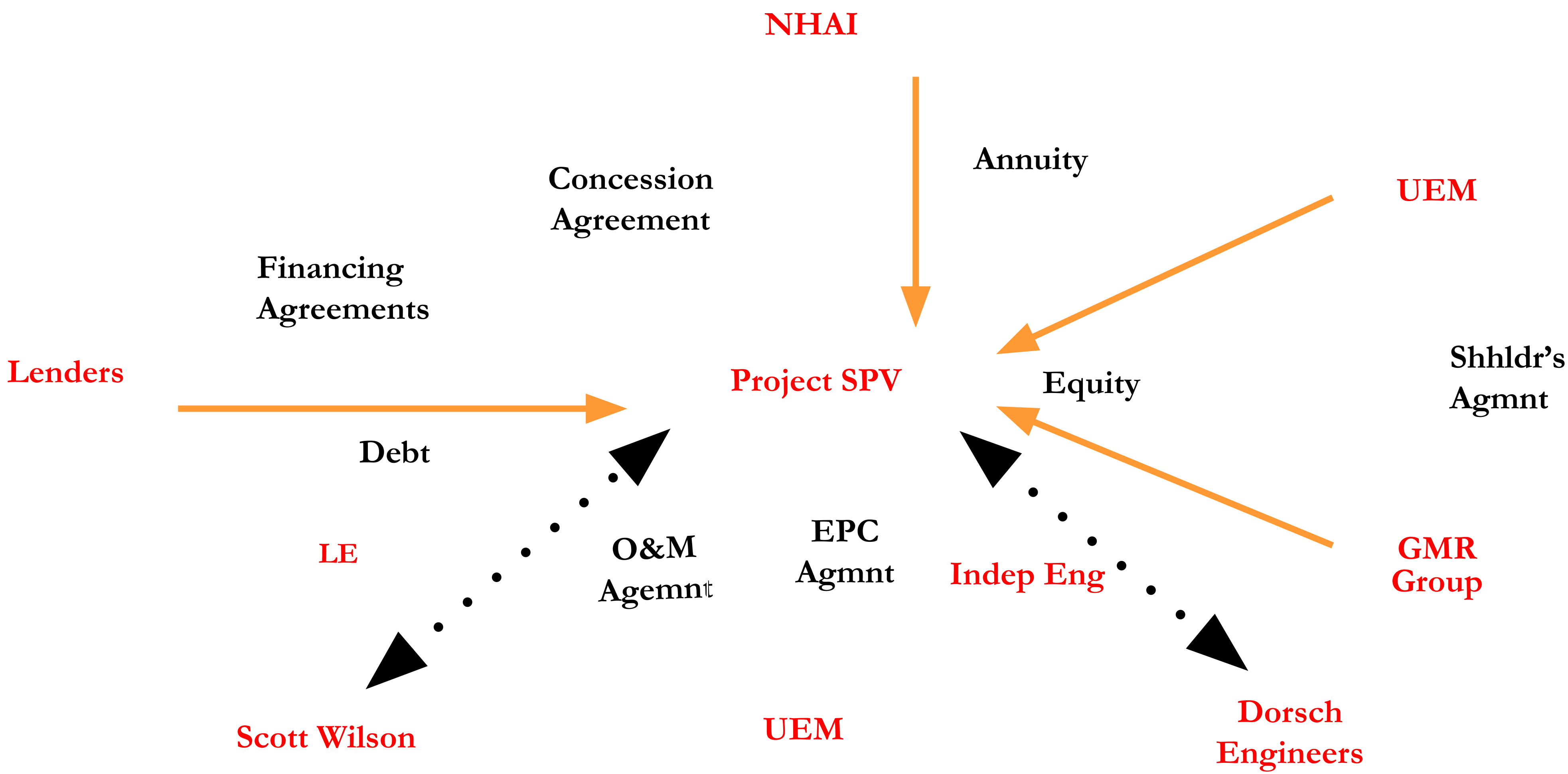
Benefits of Project Finance to Third Parties

- Lower product or service cost
- Additional investment in public infrastructure
- Risk transfer
- Lower project cost
- Third-party due diligence
- Transparency
- Additional inward investment
- Technology transfer

Case Study - 1

- Project : 4-laning of 59 km on NH5 on annuity basis
- Concession Period : 17.5 years (incl construction period)
- Promoter : GMR Group
- Project Cost: Rs 315 crore
- Financed in a Debt-Equity Ratio of 3:1 by way of:
  - Equity: Rs 1 crore
  - Preference Capital: Rs 78 crore
  - Debt: Rs 236 crore

Case Study - 2


NHAI
Annuity
Concession
Agreement
UEM
Financing
Agreements
Lenders
Project SPV
Equity
Shhldr's
Agmnt
Debt
EPC
Agmnt
LE
O&M
Agemnt
Indep Eng
GMR
Group
Scott Wilson
UEM
Dorsch
Engineers

INFRASTRUCTURE

- Transport – road including toll road, a bridge, rail system, a highway project, a port, airport, inland port.
- Telecommunication – basic or cellular, radio paging, domestic satellite services, broadband network, internet services.
- Energy – generation, distribution, transmission, gas supply
- C&I – a water project, irrigation project, water treatment system, industrial park, SEZ, education and hospitals.

Thank you