

Unpacking Investment Banking



Project Finance

Introduction

Appropriate economic and social infrastructure is a key ingredient for economic growth and development. The world over, budgetary allocations cannot sustain required funding for infrastructure development, hence governments and the private sector

have tended to rely on capital markets and private sector participation to fund large scale capital projects. In addition to funding new infrastructure, rehabilitation and maintenance of existing infrastructure also require substantial funding.

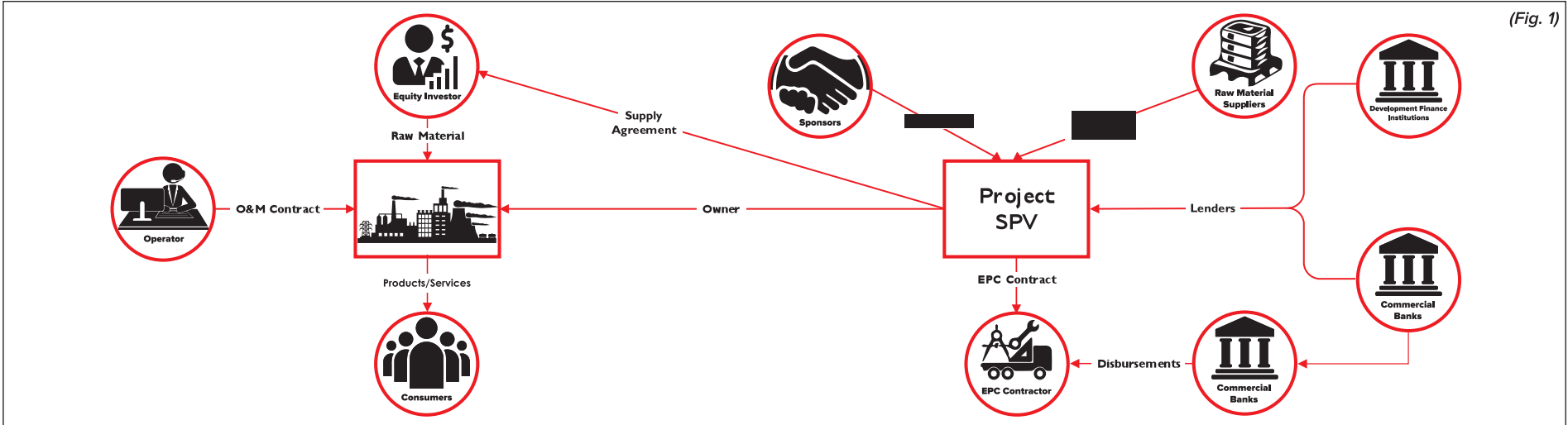
The magnitude of funding for

infrastructure projects requires access to project finance. Project finance can best be described as a financing mechanism used to fund large scale capital projects. The funding mechanism is based on a non-recourse or limited recourse financing structure, wherein investors who fund the project are then paid back using cash flows generated by the project. Access to project finance is therefore largely dependent on the project cash flows as a source of repayment, with the project assets, rights and interests held as secondary security.

Typical Project Finance Structure

As alluded to above, Project financing is typically used to finance large-scale capital projects that require a significant amount of debt and equity, often with construction periods of not less than one year. These types of transactions tend to have high debt levels which normally constitute up to 80% of the total project funding.

The chart below (Fig. 1) shows a typical project financing structure and the various parties involved.



The Sponsor

The sponsor is normally the originator of the project, who bears the initial project development risk. The sponsor can be a single party, but in most instances it is a consortium. In Public Private Partnership ("PPP") projects, the Government/Procurer may also retain an ownership stake in the project.

Special Purpose Vehicle ("SPV")

Typically, in a project finance transaction, an SPV is created by the project sponsors. The SPV in essence assumes the obligations, risks and returns of the project. The project SPV is the borrower in a project finance transaction. Other investors with a strategic interest in the project can also acquire shareholding in the SPV.

Since the SPV is a newly formed entity which does not have its own credit or operating history, it is paramount for lenders to focus on the specific project's cash flows. This means that the financing of the project is not primarily dependent on the equity of the sponsors or the value of the physical assets involved, but will require significant amounts and types of debt and equity. In this case, lenders place emphasis on the performance of the project itself and its ability to generate positive net cash flows. As a result, the lenders will concentrate on the feasibility of the project and the sensitivity of adverse factors to the project's cash flows.

Throughout the development of the project, the SPV will enter into various contracts and arrangements such as Engineering, Procurement and Construction ("EPC"), Operation and Maintenance ("O&M") and supply and off-take. For example, in the case of the Gautrain project in South Africa, the Bombela Concession Company is the SPV that holds the 20-year Concession to design, build, part-finance and operate the project.

Equity Investors

Equity investors take a risk in the project by providing funding, normally in its initial development stages. Often times, equity investors come on board to secure strategic interests in the project. These interests may include participating in the project as a

contractor, operator or raw materials/feedstock supplier. In most infrastructure projects, debt financiers insist that promoters should take an equity stake in the project. As a guideline, for instance, lenders require sponsors to contribute at least 30% of the required funding. In the Gautrain project, private sector equity contribution constituted approximately 20% of the funding necessary for the R26 billion project. Equity partners comprise Murray and Roberts, Strategic Partners Group ("SPG"), Bombardier UK, Bouygues Travaux Publics, J & J Group and Absa Capital.

Lenders

As discussed above, debt funding constitutes a huge component of project cost. Lenders may vary from Development Finance Institutions ("DFIs"), local and international Commercial Banks, local and international infrastructure and pension funds. In the Gautrain project, a consortium of banks were part of the lenders to the project who contributed 80% of the project funding. 71% of this debt funding was provided by bank syndication and 9% through a mezzanine debt funding facility.

Management Company

The management company is the operator who is awarded the O&M contract by the SPV. The management company will manage the project for the duration of the concession period. In the Gautrain project, a concession company called The Bombela Operating Company (BOC) was established to operate and maintain the Gautrain system.

Advisors

Advisors to the project finance transaction will consist of Financial Advisors that seek to safeguard the interests of the various parties to the project. Financial institutions would naturally have a different financial advisor to the sponsor of the project tasked to review the financial model developed by the sponsor's financial advisors

Project Finance Funding Approaches

Large scale projects are usually funded through various funding approaches so

as to create an acceptable risk return profile for financiers and other parties involved in the project. In addition, the usage of various funding approaches is also meant to achieve flexibility to cater for variations in the project parameters or changes in project status during construction periods and/or after project completion.

Typically, in a project finance funded project, minimal equity is used. A range of up to 30% equity financing is not unusual. In most instances, quasi-equity financing such as convertible debt is utilised. Convertible debt gives the lender the rights to convert to ownership or equity in the SPV if the loan is not paid back in time and in full. It is however expensive as it is often subordinated to other senior debt.

Debt can usually constitute up to 80% of the total project funding. Debt can be sourced from a variety of providers such as DFIs. The Plumtree-Harare-Forbes road project obtained USD200 million from DBSA. DFIs usually provide long term debt, with low interest rates.

Export Credit Agencies can also provide guarantees that work as security mechanisms in a project finance structure. Supplier credit facilities are also common in project financing. The participation of an equipment supplier in a project would mostly entail the exclusive supply of certain equipment by the supplier to the project.

Long and short term asset finance, through operating and financing leases, usually cater for project vehicles and project site equipment and thus are an important aspect in large scale projects. Conventional senior debt, which is usually sourced from financial institutions, plays a major component in meeting project funding requirements for both capital items of the project as well as working capital requirements. Senior debt can come in the form of bonds, debentures, and overdrafts.

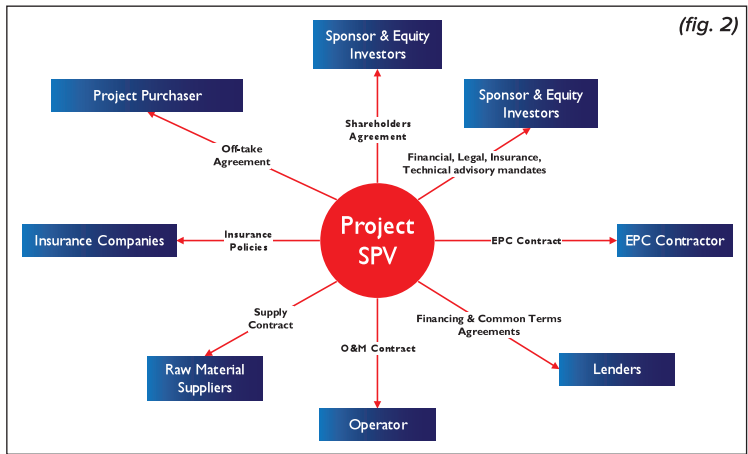
The various forms of funding are therefore geared towards ensuring that various risks of the project are borne by a party more suited to carry the risk and

hence the overall funding cost of the project.

Contractual Relationships in Project Finance

Project finance has a wide array of legal project documentation and agreements. These Agreements have

to be drafted, negotiated and agreed to by two or more parties and bilateral agreements may have effect on other relationships within the project delivery team. *The diagram below (Fig. 2) shows the various contractual relationships and the examples of documentation that may be required;*



Projects usually face delays in the absence of a full set of agreements of all relations in a project finance transaction. Shareholder Agreements that define relationships, roles, duties and obligations of fellow shareholders in the project are the focus of project lenders and the EPC contractor, and form a major focus area of their project due diligence documentation. The EPC Contract is also one of the most important contracts in project finance as it determines the capability of the chosen contractor to deliver the project at the pre-determined price. The securitisation of the revenue forms the ultimate base for lenders to advance debt facilities to the project, hence securing an off-take agreement with an off-taker is of paramount importance to the success of the project. The operator on the other hand is not willing to accept responsibility for shortcomings of the delivered project if it results in operational down time. The operator therefore has to have confidence in the EPC contractor.

Conclusion

Project finance solutions are ideally suited for large scale capital projects. Zimbabwe can benefit from the use of project finance in meeting its infrastructure deficits in areas such as transport

(road, rail and air), energy and electricity generation and transmission, dam construction and water supply. The success of the Plumtree-Harare-Mutare highway project has encouraged Government of Zimbabwe to seriously consider other project finance mechanisms other than budgetary allocations. The Kariba South Power project and more recently the Beitbridge-Harare-Chirundu highway project are all relying on project finance mechanisms to deliver the projects.

The scope to generate sufficient cash flows forms the basis for financiers to consider an array of project finance options. The developed infrastructure forms secondary security to the investors and financiers.

Legal documentation in a project finance transaction is of paramount importance as they define long term contractual obligations between parties, hence the need to ensure that all aspects of the relationships are properly documented.

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