International Finance Course

LUISS Guido Carli, Academic Year 2018-2019

How to Analyse, Structure and Finance direct investments abroad, related to real assets (infrastructure, industrial plants, etc) with a project finance approach:

A greenfield project and operating assets (M&A) evaluation process

by

Federico Merola ("**FM**")

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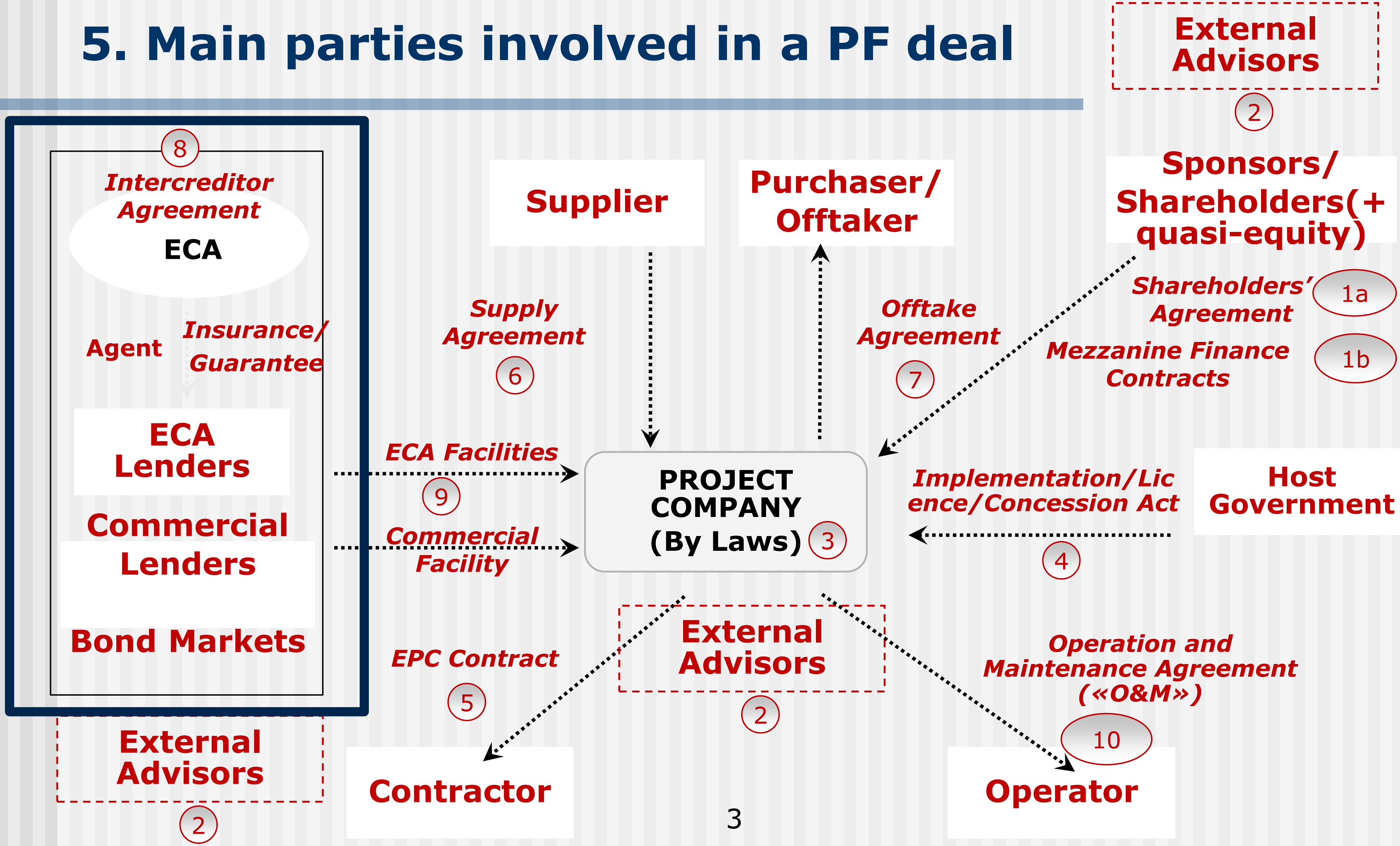
5. Main parties involved in a PF

The key contracts used in a PF deal introduces the concept of managing and allocating risks among various parties involved

A project finance deal can also be seen as contractual network (contracts + sub-contracts) based around the SPV, each one referred to a specific phase or part of the project;

In a sound project finance transaction all the interests of parties involved are satisfied and project risks are allocated equitably between all parties involved in the transaction, with the objectives of assigning risks to the contractual player best able to control and manage them (but negotiation power of various players may twist the optimum desirable balance !).

5. Main parties involved in a PF deal



5. Main parties involved in a PF

- ✓ Sponsors & SPV (Shareholders Agreement)
- ✓ Arranging Banks (Arranging mandate);
- ✓ Lending Banks (Financial Facilities)
- ✓ Institutional Investors (Fund’s Rules for equity/debt funds; Bond Prospectus- Offering Circulars)
- ✓ Export Credit Agancies (“ECAs”)
- ✓ Construction companies (with leading General Contractor and EPC Contract structured as a lump sum turn key contract);
- ✓ Commercial counterparties (Sales Agreement & Purchase Agreement);

5. Main parties involved in a PF

- ✓ Financial & Legal Advisors (Advisory mandates);
- ✓ International and Multilateral Financial Institutions (IFC, EBRD): specific financial facilities
- ✓ Independent monitoring companies: appraisal/monitoring mandates
- ✓ Public authorities (Governments, Municipalities, ECAs, etc): comfort letters; tender for concession contracts and "supporting/securities" contracts
- ✓ Etc.

5. Main parties involved in a PF: Sponsors

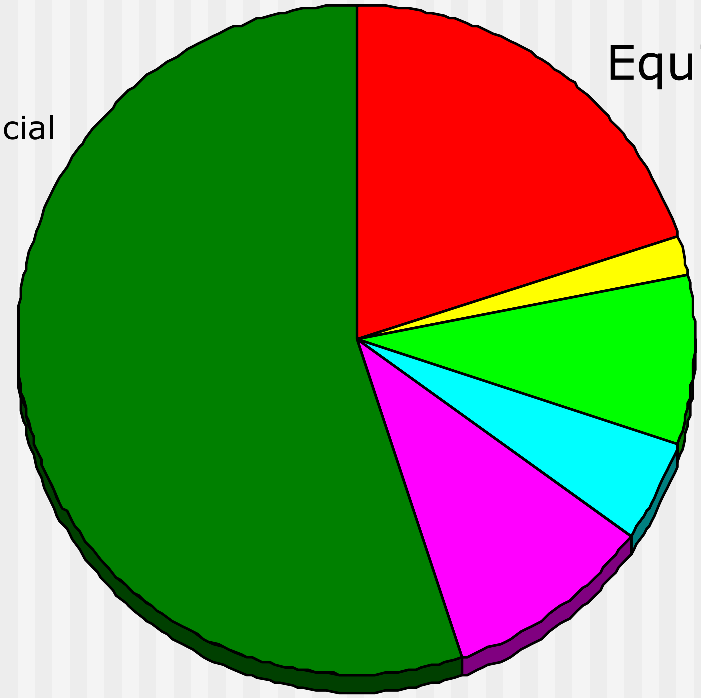
1. *Industrial Sponsors*: the initiative is linked to their core business;
2. *Public Sponsors* (central o local authorities or companies owned by these players): interested to develop public services (PPP);
3. *Financial Investors* (such as infrastructure private equity funds or mezzanine funds or even pension funds directly): to obtain high profits for institutional investors providing capitals:
   - ✓ Greenfield infrastructure funds;
   - ✓ "Brownfield" infrastructure funds;

5. Main parties involved in a PF Deal: financial Structure

Senior Debt

(banks and other financial institutions)

Senior debt is borrowed money that a company must repay first if it goes out of business



Equity (sponsors)

Mezzanine

Subordinated Debts

(sponsors’ financing)

«Quasi»-equity (Sponsors’ and/or specialised investors)

Other Junior debt

Investors and /or Bond Holders (market);

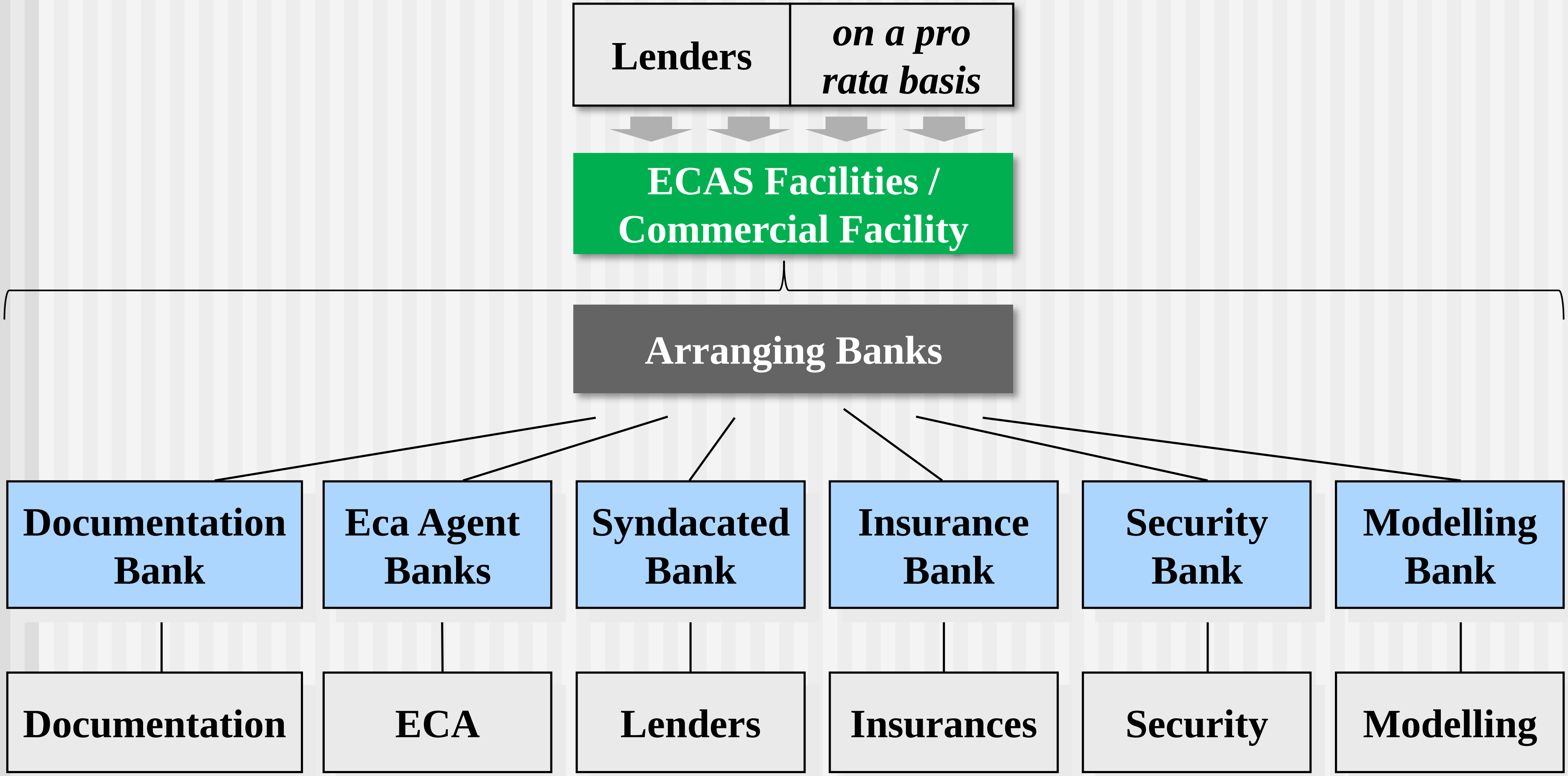
(1) Export Credit Agencies and Multilateral Institutions for credit enhancement

(2) Each type of financing has a different priority level in being repaid if the company decides to liquidate. If a company goes bankrupt, senior debtholders, who are often bondholders or banks that have issued revolving credit lines, are most likely to be repaid, followed by junior debt holders, preferred stock holders and common stock holders.

5. Main parties involved in a PF: bank and bank's roles

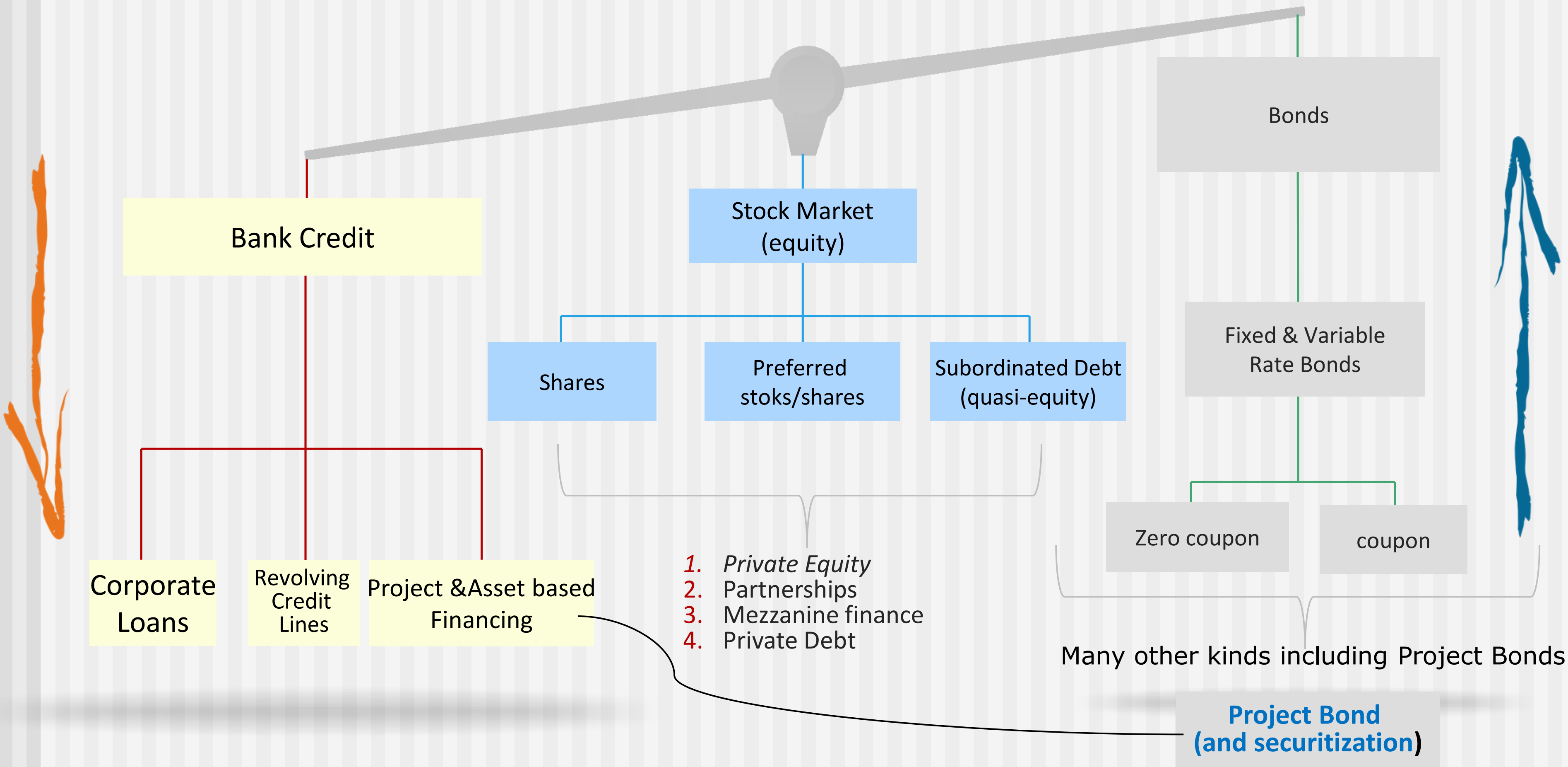
1. Advisory (Term Sheet; Information Memorandum & Financial Model);
2. Arranger (structure and syndicate the PF facility);
   - ✓ Agent Bank (manage the PF Facility);
   - ✓ Eca Agent (Manage the Export Credit Facility)
   - ✓ Syndication Bank(s)
   - ✓ Modelling Bank
   - ✓ Guarantor (Realises bank guarantees);
   - ✓ Trustee / Escrow Account
3. Underwriters & Lenders (underwrite the PF Facility);

5. A multi-sourced ECA PF facility structure

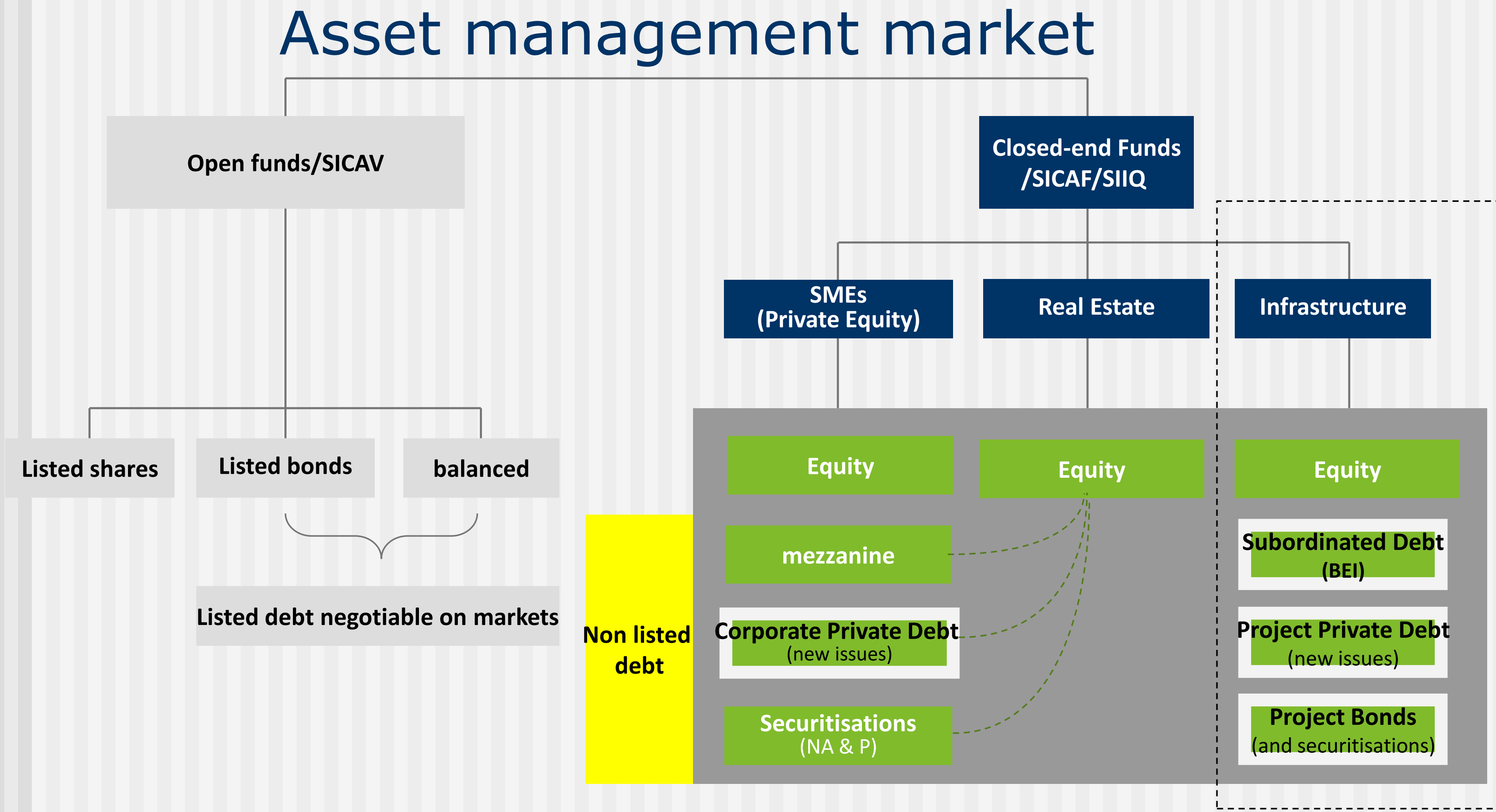


5. Financial Markets: credit crunch and securitisation

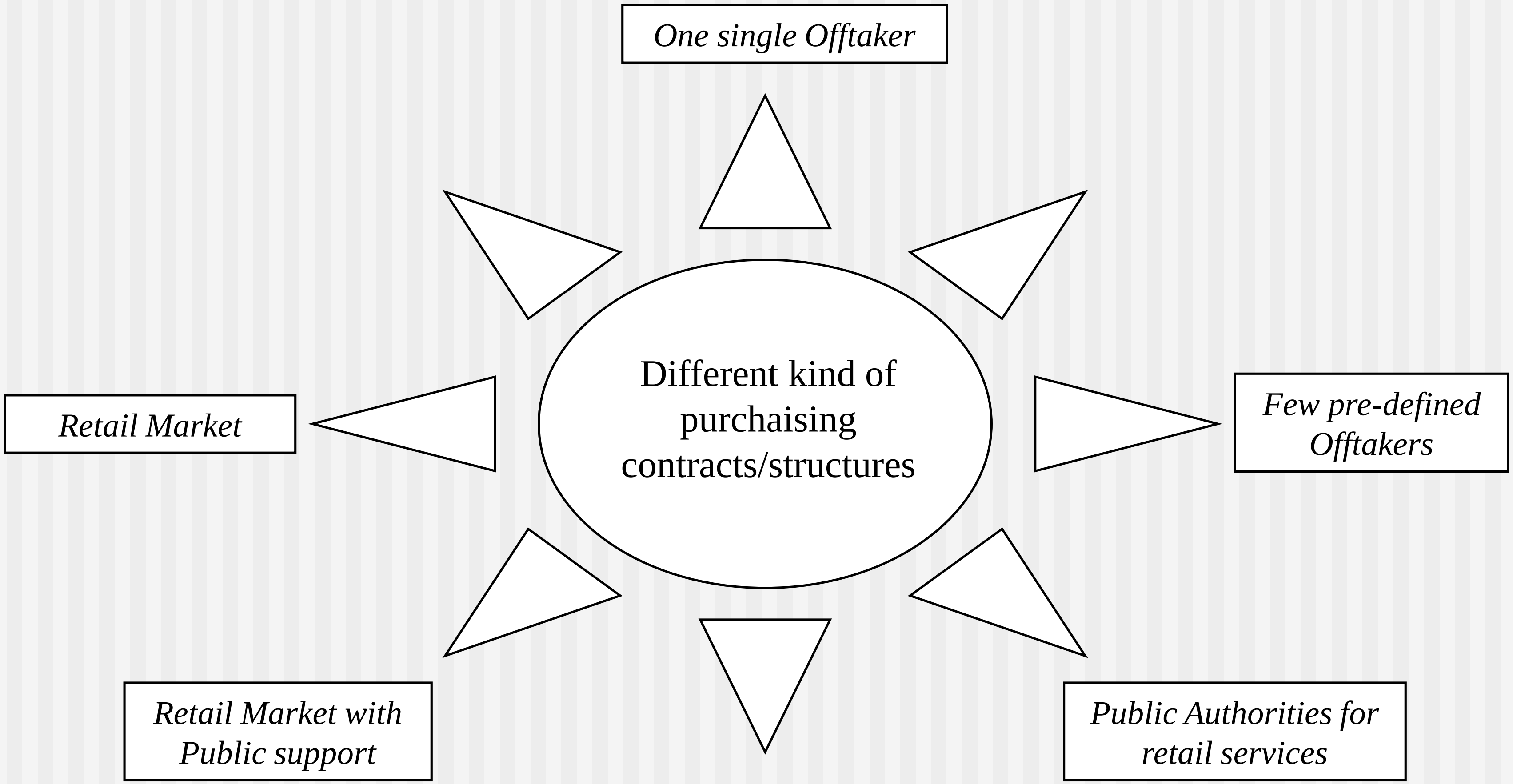
Credit crunch and Basel III increases debt securitisation



5. Financial Markets: asset manager (infrastructure equity and debt funds)



5. Main parties involved in a PF: Commercial counterparts - the offtake (market risk)



5. Main parties involved in a PF

Cogeneration Project abroad

Bonds / Offering Memorandum

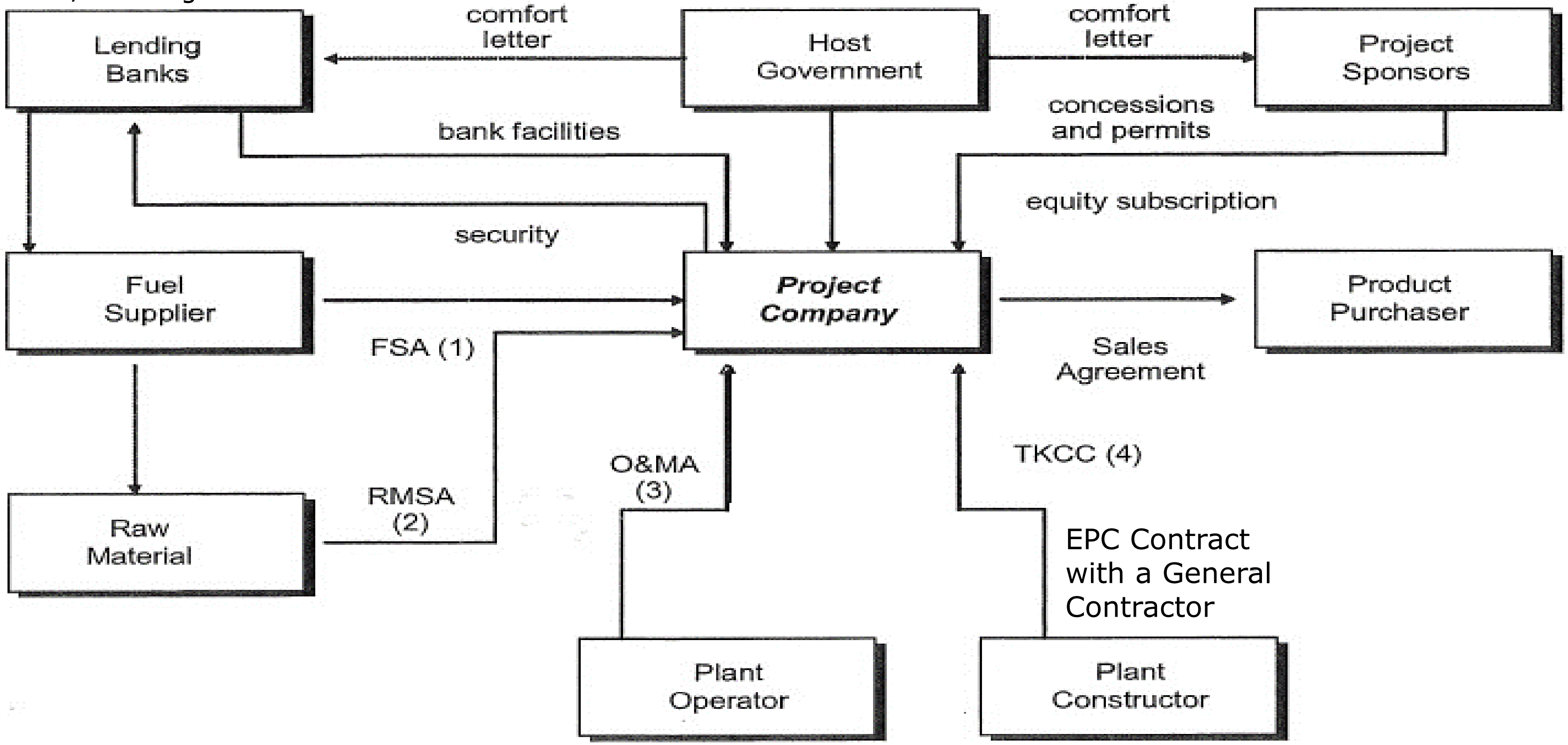


FIGURE 1.2

Typical contract structure of a project finance deal. (1) Fuel supply agreement; (2) raw material supply agreement; (3) operating and maintenance agreement; (4) turnkey construction contract.

5. The Main Parties Involved – Public Players Definition of PPP

PPP may be defined as: "*a form of durable cooperation between the public and private sector where the two parties jointly develop goods and services sharing risks, costs and resources*"

EU and the Green Paper on PPP (2004):

- ✓ PPPs describe a form of cooperation between the public authorities and private operators.
- ✓ The primary aims of this cooperation are to fund, construct, renovate or operate an infrastructure or the provision of a service.
- ✓ PPPs are present in sectors such as transport, public health, education, national security, waste management, and water and energy distribution.
- ✓ At European level, they help implement the European Initiative for Growth and trans-European transport networks.

5. The Main Parties Involved – Public Players Definition of PPP

The Green Paper distinguishes two types of PPP:

- **PPPs of a purely contractual nature**. In this case, the partnership is based solely on contractual links and may fall within the scope of European Directives on public procurement;
- **PPPs of an institutional nature**, where public and private entities may share a direct partnership in a SPV. These PPPs involve cooperation within a distinct entity and may lead to the creation of an ad hoc entity held jointly by the public sector and the private sector or the control of a public entity by a private operator.

There is no specific legal framework for PPPs at European level.

The Green Paper therefore seeks to examine whether the Treaty establishing the European Community (EC Treaty) and its secondary legislation is suitable and sufficient to cope with the particular challenges posed by PPPs.

(please see http://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=URISERV%3Al22012)

5. The Main Parties Involved – Public Players Definition of PPP

Dominant counterparty: Public sector

Dominant counterparty: Private sector

Types of contractual structures			
Operation & maintenance services (O&M)	**Concession (public ownership of the facilities)**	**Concession (private ownership of the facilities)**	**Full privatization**
• Management of public facilities by private parties • Leasing agreements	• Rehabilitationofexisting facilities, management, and transfer • Design, building, management, and transfer (service agreements withthe public administration)	• *Design, building, own,* management, and transfer • Merchant plants	• *Assetsales* • Divestitures
Main risks and relative allocation among the involved parties			
• Construction: Public • Investment: Public • Commercial: Public • Operation: Private	• Construction: Public • Rehabilitation: Private • Commercial: Public/Private • Operation: Private	• Construction: Private • Commercial: mainly Private • Operation: Private	• Investment: Private • Commercial: Public/Private • Operation: Private

Low or relatively low	Risk incurred by the private partners	High or very high
Predominantly public	Responsibility for financing	Private
Public	Project governance	Private

FIGURE 1.1

Different alternatives available to public administration to procure goods and services.

Source: Gatti et al. (2010).

6. Advantages in using a PF approach: the Sponsors' prospective

A sponsor can chose to finance a new project (locally or abroad) using two alternative solutions:

1. On-balance sheet (corporate financing)

Lenders are guaranteed by all assets and cash flows of the sponsor, even deriving from other pre-existent initiatives (corporate creditworthiness evaluation);

2. Off–balance sheet (project financing)

Lenders can solely relay on cash flows and assets of the financed initiative (cask flows and debt cover ratios evaluation)

6. project finance vs corporate finance

TABLE 1-1 Main Differences Between Corporate Financing and Project Financing

Factor	Corporate Financing	Project Financing
Guarantees for financing	Assets of the borrower (already-in-place firms)	Project assets
Effect on financial elasticity	Reduction of financial elasticity for the borrower	No or heavily reduced effect for sponsors
Accounting treatment	On balance sheet	Off-balance sheet (the only effect will be either disbursement to subscribe equity in the SPV or for subordinated loans)
Main variables underlying the granting of financing	Customer relations Solidity of balance sheet Profitability	Future cash flows
Degree of leverage utilizable	Depends on effects on borrower's balance sheet	Depends on cash flows generated by the project (leverage is usually much higher)

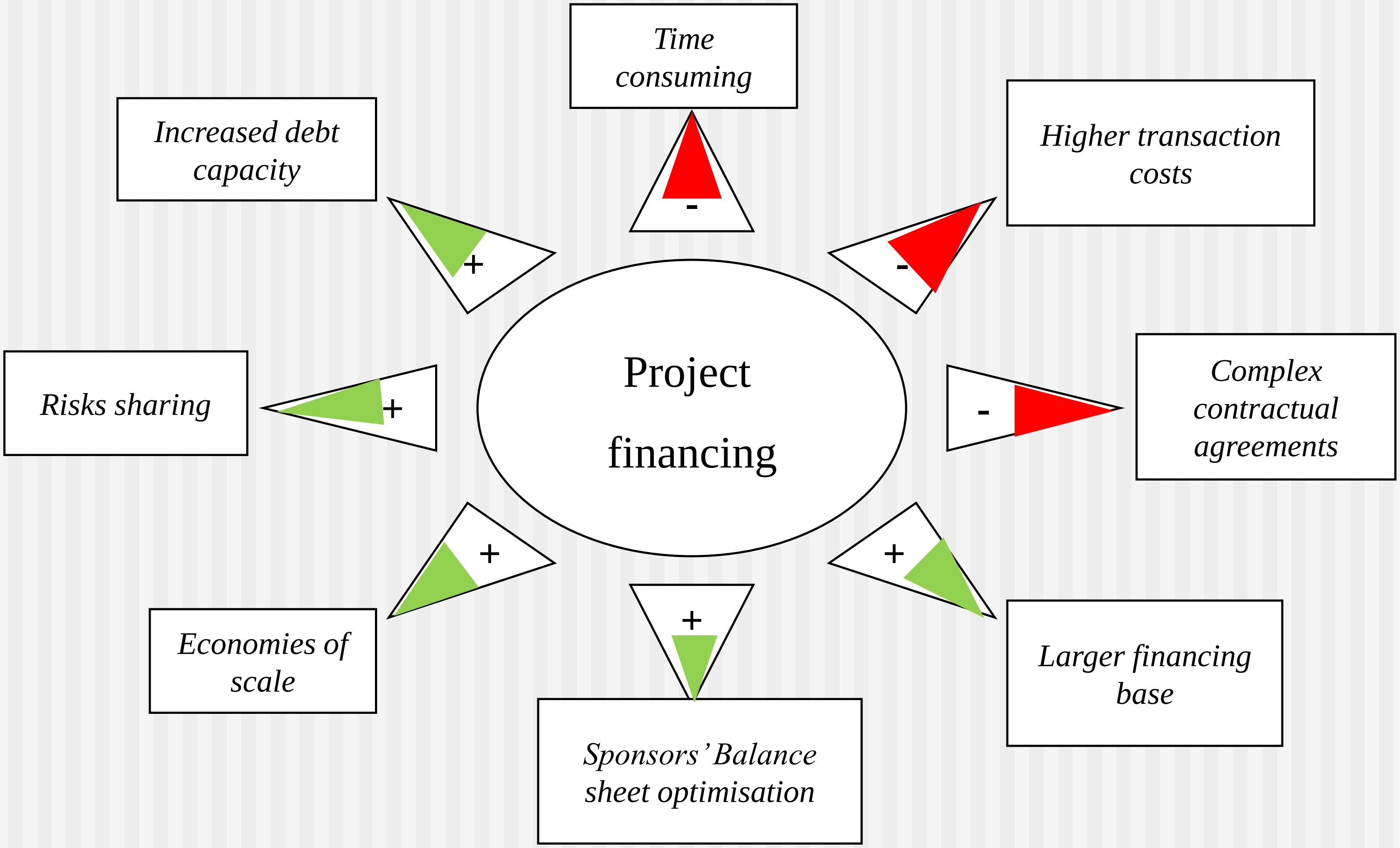
6. Advantages in using a PF approach: the Sponsors' prospective

- ✓ Balance Sheet optimisation (debts **off-balance sheet**);
- ✓ **Ringe fence** from personal/other assets of the sponsors;
- ✓ Higher **Risk Sharing** among various participants in the deal;
- ✓ **Financial leverage optimisation and access to various funding sources (= higher IRR);**
- ✓ **joint venture and partnership facilitated;**
- ✓ **Fiscal benefits** (if any).

6. Disadvantages

- ✓ Complex Contractual Structure;
- ✓ Higher Costs (analysis, arrangement, evaluation, negotiation, financing, monitoring, etc.);
- ✓ More time consuming implementation;
- ✓ More controls on any single step of the project;

6. Advantages and Disadvantages



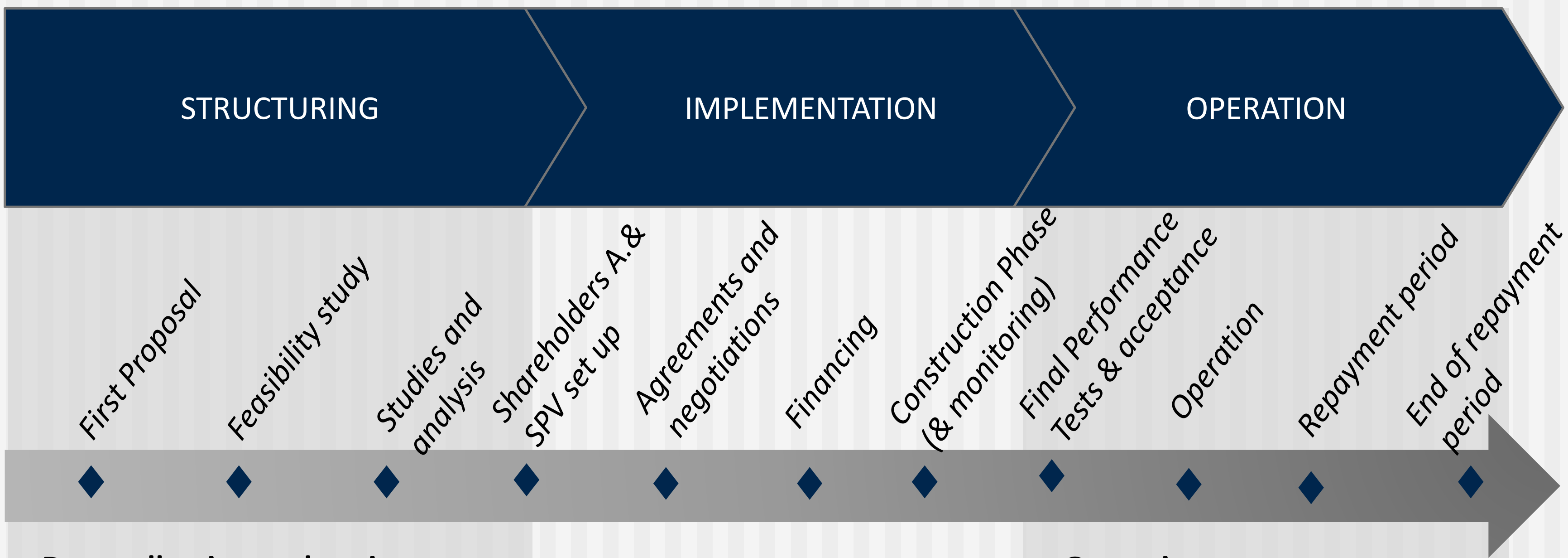
6. Major Misunderstandings

- ✓ Commercial risks equally taken by banks and sponsors;
- ✓ Political risks taken by lenders (and Sponsors);
- ✓ No equity needed

7. A PF deal: various steps require strong project management skills

PROJECT PHASES

STEPS



DOCUMENTS

Data collection and project analysis/Structuring:

- ✓ Feasibility study
- ✓ First Draft of the Information Memorandum, including:
  - ❖ Financial model
  - ❖ Term-sheet

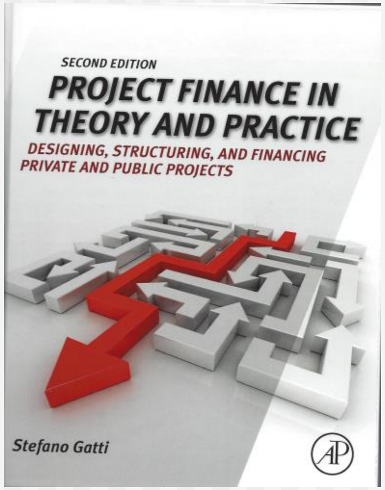
Implementation:

- ✓ Negotiations & closing of main contracts
- ✓ Drawdown of financing (and equity injections)
- ✓ Construction Phase
- ✓ Pre-Completion Monitoring report

Operation:

- ✓ O&M;
- ✓ Supply & Purchase
- ✓ Project Management
- ✓ Repayments

7. Materials (2)



Project Finance in Theory and Practice

(by Stefano Gatti)

- ✓ **Chapter 1**: Introduction to the Theory and Practice of Project Finance (Page 1 – 14 mandatory);
- ✓ **Chapter 2**: The Market for Project Financing: applications and sectors (discretionary)
- ✓ **Chapter 3**: Project Characteristics, risk analysis and risk management (Page 43 – 49; 52 - 75)
- ✓ **Chapter 4**: The Role of Advisors in a Project Finance Deal (just to be red by those interested in the subject);