WHAT IS PROJECT FINANCE?
BANKING HANDY GUIDE
An introduction

The project finance model is typically used for the purpose of financing the delivery of long-term infrastructure or natural resource projects, with deals including a wide variety of energy (e.g. wind, solar and hydro) and infrastructure (e.g. roads, schools and hospitals) assets.

While this structure has many of the same features as a general corporate finance deal, its highly structured and multi-phase nature means that there are a number of project finance-specific concepts.

This guide looks at the key features of project finance before discussing some of the terminology you would expect to see on this type of deal.

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What are the key features?

• A special purpose vehicle (SPV) is used to hold all rights and assets required for building and running the project.

• The majority of the finance on a project finance deal is debt, with a smaller amount of equity investment being injected by a sponsor (i.e. the ultimate owner of the SPV).

• Detailed facilities agreement which deals with both the construction and operation phases of the project. The SPV will be the borrower under the facilities agreement.

• Full suite of security (e.g. floating charge, standard security, share pledge and assignation in security) and step-in rights to allow the lender to take control of the project in the event of a default by the borrower.

• The main recourse available to the lender in the event of a default relates to the cash flow generated by the project, rather than the specific assets of the borrower or sponsors. Project finance is therefore generally known as ‘limited recourse’ or ‘non-recourse’ finance.

• Allocation of risk between the parties and risk mitigation are important and hotly negotiated points, because of the many risks which are associated with large projects. Examples include environmental risk (where issues with the project site lead to delays with construction) and technical risk (where the technology fails to perform to the required level).

• Often a public element with private entities building and operating projects for public-sector bodies under a concession or project agreement.

Did you know?

Brodies advised the purchaser on the financing of its successful bid to acquire the Lochaber Hydro Plant and Smelter Works and the Kinlochleven Hydro Plant and various related estate lands from British Alcan Aluminium.
Key terminology

**Bankability**

Whether a project is ‘bankable’ or not depends on the willingness of lenders to provide finance. This decision will be based on a number of factors which are assessed by lenders carrying out due diligence. Where a project is not considered to be ‘bankable’, public authorities or governments may step in to provide guarantees in order to give assurances to lenders.

**Borrower**

As mentioned above, the borrower (or project company) is an SPV which does not have any assets other than those which relate directly to the construction and operation of the project. The majority of the rights held by the borrower are contractual, but it will also own the relevant property rights relating to the project site.

**Cash flow waterfall**

This dictates how the revenues generated by the project are allocated, both before and after a default. Generally the order of application of proceeds is as follows: first, repaying the lender (including expenses, principal amount of the loan and any interest); second, payment of the capital and operating costs of the project; third, maintenance of debt service cover amounts (see below); and fourth, payment of dividends to the sponsor/holding vehicle.

**Concession agreement**

A contract between a public-sector body and a project company, which allows the project company to carry out the project – e.g. by allowing it to use land owned by the public-sector body. This is central to the BOT (build, operate, transfer) model which sees the project company build the asset, operate it for a certain period and then transfer it to the public-sector body which granted the concession.

**Contractor**

Construction and engineering companies who construct the project on behalf of the SPV, and who have experience of building similar assets. These companies will usually take on the risk of construction overrunning on time.

**Direct agreements**

An element of the security package which creates a direct contractual relationship between the lender and the project document counterparties. In the event that the borrower defaults or the project is not operating effectively, the direct agreement allows a lender to step into the contract.

**Financial covenants**

Project finance deals require detailed forecasting models to predict the performance of the asset over the life of the loan. At regular calculation dates, the ability of the borrower to repay the loan is tested by reference to the financial covenants set out in the facilities agreement. These include various cover ratios which look at different variables relating to the project, such as the debt service cover ratio, loan life cover ratio, and debt to equity ratio. These assess whether the cash flow generated by the project will be sufficient to meet the loan repayments at a particular date or over a specific period of time and whether there is a sufficient equity cushion.
Financial model

This is used to assess the viability of the project, and for testing the ‘health’ of the project throughout its life, and the life of the loan. The financial model is used to calculate the cover ratios at set calculation dates, to test whether the borrower is able to repay the loan.

Lenders

Project finance deals are usually financed by a syndication of major banks because of the high-value nature of the underlying project.

Off-taker

The party who buys the product created by the project – e.g. the energy generated by a wind farm.

PPP/PFI

In the context of infrastructure projects, a ‘Public-Private Partnership’ is a cooperation agreement between the public and private sector with the end goal of delivering services or facilities for use by the general public – e.g. schools or hospitals. A subset of PPPs is the ‘Private Finance Initiative’ model which uses private investment (in the form of debt and equity) to deliver public-sector infrastructure projects, which is then paid for by the public-sector body over the life of the project.

Project bond

A source of finance for projects, which provide long-term funding options at a fixed rate. This funding option tends to be cheaper than bank debt, but does have disadvantages such as the fact that bonds are generally repayable on maturity, rather than in installments over the life of the bond.

Project documents

Contracts which the SPV enters into with a variety of counterparties relating to the construction of the project asset, as well as the operation and utilisation of the asset once it’s operational.

Sponsor

Investors who set the ball rolling on the project by setting up the SPV and obtaining the funding and contracts required for the construction and operation of the project. Sponsors have an equity investment in the SPV.

Step-in rights

These allow lenders to step into the various contracts which the SPV enters into with contractors. If the project is not performing properly, having step-in rights allows the lender to step-in in place of the SPV to take control of the project.

How Brodies can help you

Brodies’ infrastructure finance practice draws a wealth of experience from a number of legal service areas, including finance, projects and real estate. The practice advises widely within the sector, acting for a number of different of borrowers and lenders on a variety of projects.

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