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SESSION 6
11.30am – 1.00pm

Project Finance

Nick Lattimore
Director- Investment Banking Division
Deutsche Morgen Grenfell Australia Limited

Paper available for collection after presentation

18th Annual Banking Law Conference
The Changing Nature of Financial Services

Project Finance - New developments from a lenders perspective

Nick Lattimore
Director & Head
Project Finance & Advisory

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Sections

1. Overview of the current markets

2. Trends in project finance

Section 1

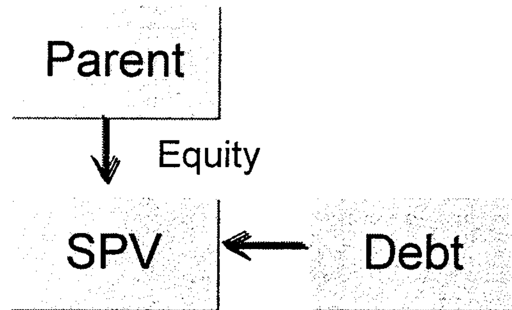
1. Overview of the current markets

2. Trends in project finance

Basic elements of Project Finance

- **Historically, Project Finance has been typically used to fund the development or acquisition of single purpose assets with strong cash flows that have limited or defined asset lives (10-50 years)**
- **Limited or no recourse to the project sponsors**
  - Separation between Parent and subsidiary entity's (Project Vehicle)
  - Off-balance sheet financing through a Special Purpose Vehicle ("SPV"), or though a Unincorporated Joint Venture;
  - Non recourse in the sense that financing does not have recourse to the project sponsors (except in certain circumstances).
  - Additional security or recourse, may be sought in higher risk periods (eg. construction, commissioning, ramp up).

Simple Investment Structures



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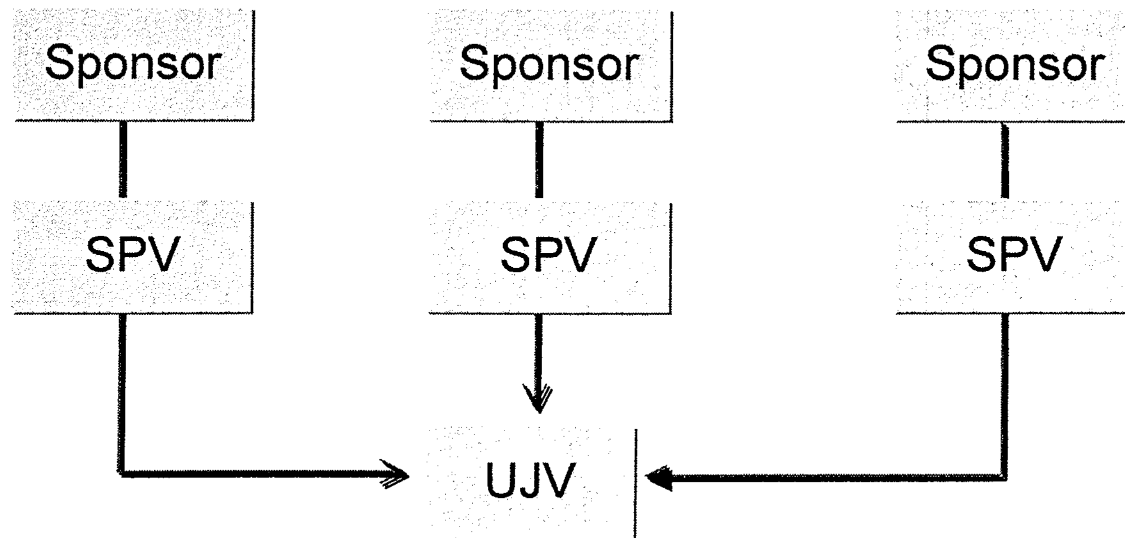

Share of assets, income, output
(issues of Trust, Partnership and Company Law)

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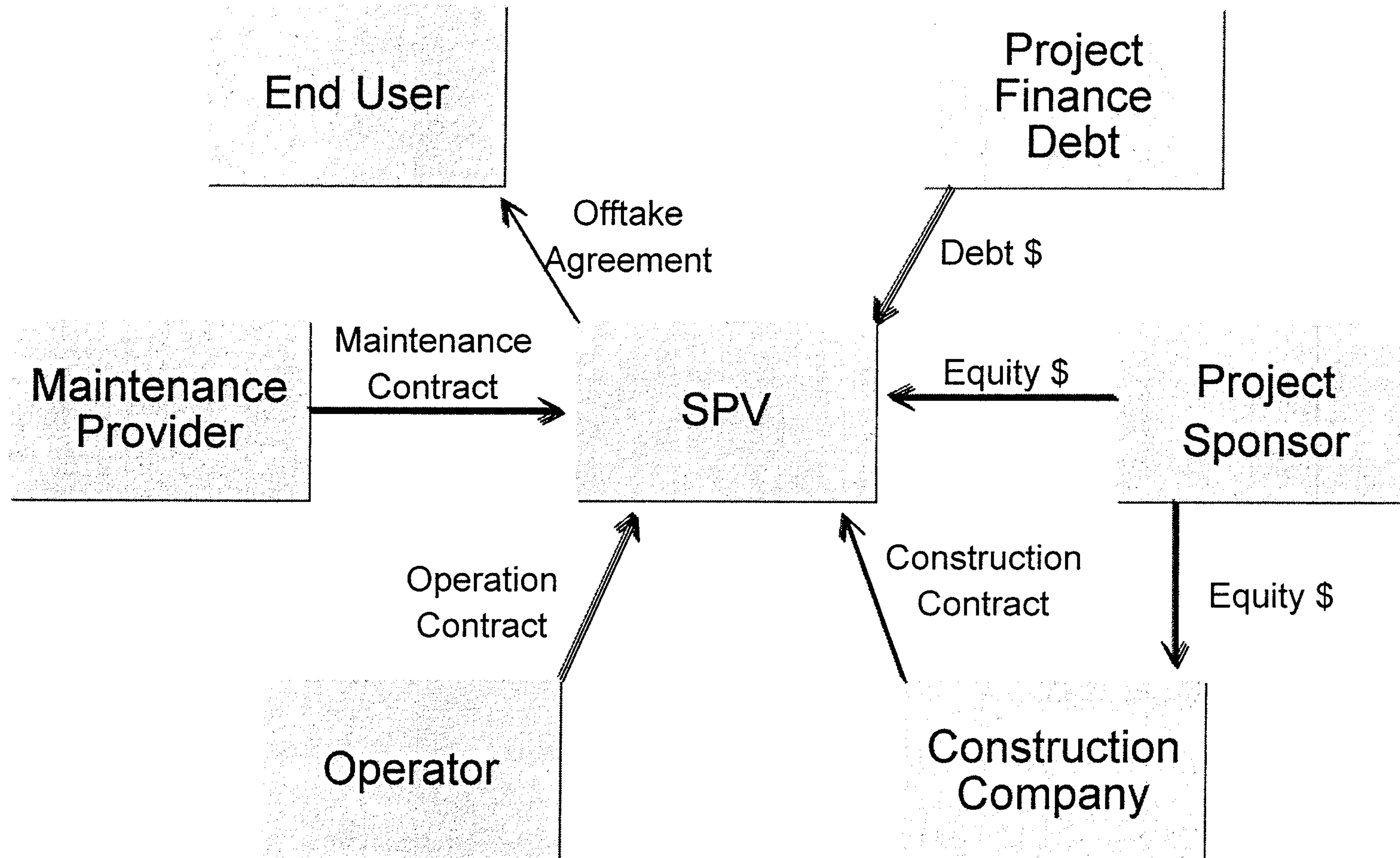
Basic elements of Project Finance

- **Source of funds for debt service**
  - Primarily look to project cash flows
  - Project assets provide as collateral ("Fixed and Float Charge")
  - contract enforcement, assignment are critical
  - Insurance products becoming more prevalent.

Typical developments financed by project financing

- **Resource projects: Metal & Mining, Oil & Gas, Agricultural.**
- **Infrastructure projects:**
  - Greenfields
  - Brownfields
  - Privatisations
- **Oil and gas developments**
- **Power stations and utilities**
- **Property developments**
- **Railways, roads and other transport**
- **Refining and processing facilities**
- **Water and sewerage plants**

Generic Project Finance Structure



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The market is currently undergoing significant change

- The number of bank arrangers is declining due to amalgamation of banks, changes to bank capital requirements and banks earnings models (ie. RAROC);
- Major sponsors have moved to recourse banking, citing lower cost o funds and more flexible lending arrangements;
- The market is now characterised by a wide range of varying quality sponsors, and very different opportunities across infrastructure, privatisation and resources;
- Many projects now incorporate significant technology risk (tolling, nickel laterites, magnesium, pig iron);
- US Capital markets are just re-opening to high yield debt'
- Public equity markets generally poor, but quality transactions are still able to be done;
- Non investment grade paper in Australia remains a very small market;
- Low A$ is encouraging significant new development.

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Section 2

1. Overview of the current markets

2. Trends in project finance

Related Party Transactions

- **Many projects now have multiple sponsors who have two (or more) roles in the transaction;**
- **The operator, contractor, off-taker and supplier (and potentially others) who have specific roles in the project are more often becoming part of the capital structure, subscribing equity or debt (mezzanine normally).**
- **The dual roles cause specific issues including:**
  - transparency of the commercial arrangements will require careful negotiation and documentation;
  - generally these parties are not long term investors requiring exit mechanisms which in turn require lender approvals;
  - covering situations where the "investor" defaults on their contractual obligations;
  - term, renewal and cancellation of contract all need careful consideration.

Role of the Financial Sponsor / Institution

- **Wider range of Institutions now investing in Projects, in forms of equity, senior debt and mezzanine debt;**
- **Emergence of specialist funds for certain types of Projects - ie. Airport, Infrastructure, Resources etc.;**
- **Not that "passive" anymore - specialist managers who will have a board seat and will require actions;**
- **Need to consider their financial goals - they are not a traditional sponsor:**
  - may not put in more funds if things go wrong
  - focussed on cashflow
  - will exit at a point in time
  - may need to "mark to market"
- **Often have a difference tax profile so need to structure to give them specific benefits**
  - franked dividends
  - capital gains
  - debt v equity

Reliquification of Project Portfolio's

- **Securisation of project finance loans was led by CSFB but followed by other major global banks;**
- **Provides additional bank lending capacity in what is a shrinking bank market by freeing up balance sheet allocations;**
- **helps by increasing bank returns by increasing net returns via the pooled approach but: -**
  - banks will still wear first loss (with equity and mezzanine debt);
- **Banks will increasingly look to facilitate reliquification by their capacity to assign loans - need to be aware from the documentation and from the client perspective.**

Risk Finance

Additional insurances that add value by improving the credit of the transaction such as:

- revenue short falls (volume or price)
- commodity price fluctuation
- weather, political unrest
- asset residual value

Derivatives

- weather
- energy
- credit (contractor, sponsor, etc)
- interest rates
- FX
- commodity prices

Non-Traditional

- enterprise risk
- residual value
- contingent capital
- cashflow volatility
- political risk ie. convertibility

Risk Finance (cont'd)

Driven by:

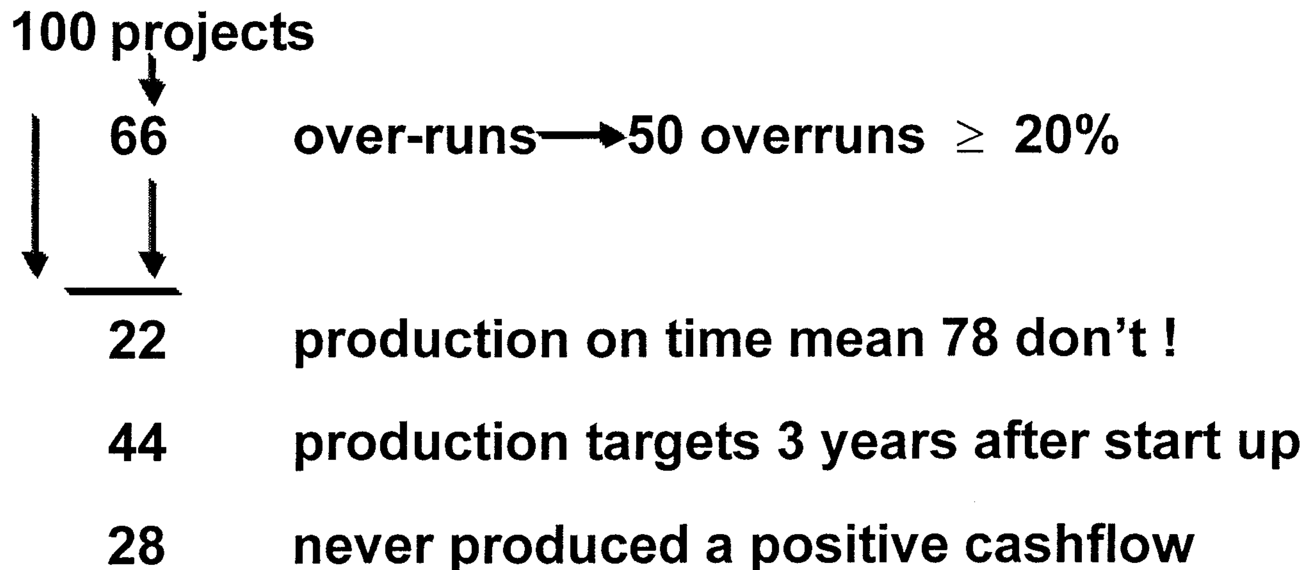
- supply of product by insurance companies is improving;
- rating agencies will use to re-rate;
- spreads between investment and non-investment grade credits creates real value for the premium;

Targeted Insurance is less restrictive on Insurers capital requirements

- less expensive to sponsors;
- in tune with risk apportionment

Managing Completion Risk

On time, on budget and on performance delivery of the Project has always been critical.

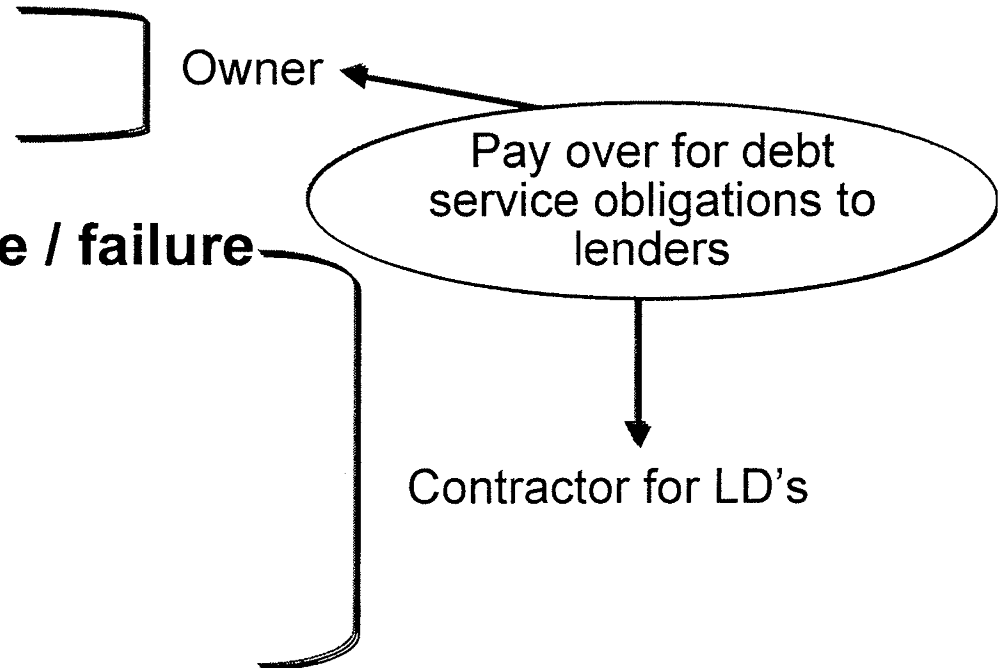


importance of Lenders Acceptance Tests, completion undertakings and deep pocket sponsors

Delay in Start - up Insurance:

Covers

- **all non-site force majeure**
- **change of law**
- **Contractor non performance / failure**
  - engineering
  - design
  - procurement
  - construction
  - commissioning



- **often doesn't pay for 30 days**
- **only payable for contractually due liabilities / damages, therefore clear documentation required.**

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Dealing with a Mix of Lenders

- **Traditional Bank market is shrinking**
  - Bank amalgamations
  - Heavy risk allocation impacting on capital requirements
  - High syndication risk
- **Institutions are looking for yield enhancement via direct lending ie. AMP, AXA (Nat Mut), Colonial etc.**
- **Capital Markets issues (credit enhanced) can be structured for longer terms and with little or no amortisation. In addition, some product, like CPI Bonds in fact provide for a capitalising component.**

Dealing with a mix of lenders (cont'd)

With different lenders, often in different debt products, but sharing the same security, issues arise. For example, consider the following capital structure.

Product	$'m Amount	Term	Subscribed	Amortisation	Security
Project Bond	$200	25 yrs	outset	nil	Senior Pari Passu
Banks – Term	$300	12 yrs	on completion	full	Senior Pari Passu
Bank – Construction Bridge	$500	3 yrs	18mths progressive	refinement by Term Debt & Equity	Senior Pari Passu
Mezzanine	$50	15 yrs	12 mths	nil	Second
"Equity"	$200m	n/a	on completion	n/a	Nil

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Dealing with a mix of lenders (cont'd)

Issues in construction

- what happens if borrower default and only Project Bonds drawn;
- what if Banks exercise a draw-stop right - do they share in the credit drawn by earlier lenders?
- How are adverse or positive movements in currency dealt with in default situations for multi-currency facilities

Issues in Operation

- refinancing of bank debt
- increase in debt
- inability to repay mezzanine at maturity
- voting rights/percentages will change over time; ie. As Bank Term Debt amortises, they become a lesser voice in the capital structure.

The Evolution of the "Mini-Perm"

- **Traditional project credit facilities (construction converting to long-term permanent debt which fully amortises) now being replaced by the "mini-perm" - construction plus 3-5 years non-amortising and refinance into capital markets or "corporate" style facility;**
- **often supported by the cash-sweep as a refinancing tool**
  - non or limited release of equity of excess cashflows (held in escrow or used to repay debt).
- **re-financing risk seen as acceptable to wider range of lenders;**
- **lack of capital payments shows improved ratios;**
- **less restrictive covenant structures (COO, additional indebtedness etc).**

Combining Projects - the multiple project pooling concept

- Similar to borrowers, lenders can also benefit by pooling assets;
- establish a master facility with a specified set of limited and limiting conditions for inclusion/exclusion;
- allows diversification of some risks (ie. Market, geography);
- can spread significant facility costs over more than one transaction
- Used in:
  - water - treatment plants;
  - energy (ie. Wind farms, composting etc);
  - oil and gas;

Funding for Public Private Partnerships

- **Just about to take off in Australia**
  - offtaker is often Governments (social)
  - performance requirements will dictate desire of parties ie. Benchmarker
- **Most likely will result in a different risk profile than BOOT - eg. Shadow tolls rather than direct -- change in law**
- **Likely to lead to:-**
  - higher gearing (up to 90%+)
  - longer term

Funding for Public Private Partnership

- Still strong focus on construction and operations and maintenance;
- Will be renewed interest by capital markets to facilitate term outcomes and this will generate strong opportunities for credit enhancement;
- Pricing will likely to be lower than for “similar risk” private sector transactions;
- analogous to monopoly assets = low equity returns;
- Introduce new players (ie. UK / Irish Banks).

An increasing role for mezzanine / subordinated debt

- Growing number of potential institutions are interested in providing a lever of higher risk debt
- Bank lenders (yield enhancement)
- Institutional players (cash yield)
- Lower in the cashflow waterfall and in the security package means significant risk premium (margins circa 4-6%);
- Tends to be 5% - 15% of capital structure;
- Issues relate heavily to the inter-creditor regime, ie:
  - refinancing risk
  - rights on default
  - changes to ratios, cash release or other covenants mechanisms
  - rights to call on contingent equity or access cashflow when in lock-up

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