

WSP Management Solutions

IRM PPP SIG – PROJECT FINANCE

10th December 2010

UNITED
BY OUR
DIFFERENCE



Contents

Ways to finance projects

Advantages of project finance

Disadvantages of project finance

The three components of finance

Project finance in PPP – some observations

Project finance risks

The Technical Advisor

Ways to finance projects

1. Retained earnings
2. Borrowings secured against the organization's assets
3. Borrowings secured against assets and revenues of the project

It is approach 3 which is generally known as project finance.

Advantages of Project Finance

1. The assets of the organization are insulated from failure of the project. Project finance is also known as non-recourse financing.
2. Grace periods on loan repayments to recognize project's ability to generate cash. Not like a loan which you start paying back as soon as you have taken out the loan.
3. Loan repayments can be structured to match the purpose of the project. E.g. advance payments can be made against agreed quantities of oil, minerals, electricity etc.
4. Clear project success factors
5. Clear risk allocation
6. Investment of time and money in reaching financial close makes it very difficult to change the project afterwards.
7. Used to be popular as a means of 'off balance sheet' financing. Accounting standards tightened up in the wake of Enron

Disadvantages of Project Finance

- The large teams of lawyers, bankers and other advisors necessary to reach an agreement and establish the project company or Special Purpose Vehicle makes Project Finance only suitable for large projects.

The three components of finance

1. Equity
2. Bank debt
3. Bond finance

Equity

- Equity providers are last in the queue of funders to get their money back
- In PFI / PPP there is normally a requirement for some risk transfer to the private sector. 10% is a typical equity funding component
- Equity can be pure equity, i.e. funders buy shares in the SPV or
- Subordinated debt or junior debt – a loan more at risk than senior debt & bonds but less at risk than pure equity.
 - Subordinated debt will earn a higher interest rate than senior debt due to its higher risk
 - Since interest repayments are tax deductible there is a tax efficiency to subordinated debt in place of pure equity

Bank Finance

- Debt issued by commercial banks either singly, or more often through syndicates
- It must be repaid before equity or subordinate debt and is therefore known as senior debt
- Can be drawn down as required and there can be a standby facility to be called upon if required
- Priced with reference to the London Inter Bank Offered Rate (LIBOR)
- An arranging bank will establish the appetite of other banks to lend. One bank may offer £25 million at LIBOR + 325 another offers £50 million at LIBOR + 310 etc. If LIBOR is 0.55% then LIBOR + 325 is 3.80%
- Arranger puts together the best deal
- LIBOR changes daily so the SPV may choose to swap the variable interest rate for a fixed rate. The banks will of course charge for this.

Types of syndication

- Underwritten – the arranging bank offers the full financial commitment and then syndicates it, absorbing itself any funding commitment that is not fully subscribed
- Best Efforts – Not underwritten by the arranger and left to market forces
- Club – a pre-existing syndicate looking for a project to lend to

Bond Finance

- A formal contract to repay borrowed money with interest
- The issuer receives a sum of money (the principal amount) from the investor and promises to pay interest payments (the coupon) at fixed intervals until the bond matures. At maturity the issuer pays back the principal amount to the bond holder.
- Bonds can be freely traded in the markets. This means less monitoring of the project by the bond holder but increases the difficulty of renegotiating bond conditions.
- Bonds are attractive to pension and insurance companies who want to match long term liabilities to assets of similar maturity.
- Bond market value moves inversely with interest rates and the sensitivity to interest rate increases with lengthening maturity. The lower the coupon rate the greater the sensitivity to interest rate.

Bond Finance

- 'My word is my bond' – The bond is as good as the promise of the organization issuing it. Thus government backed bonds are generally considered as gilt (depending on the government).
- Some company bonds are considered a better risk than some government bonds.
- Wrapping is when an AAA rated insurance company does due diligence on a project and guarantees the bond. It wraps its AAA rating around the bond. Of course it charges for doing so.

Project Finance in PPP

some observations

- Market dominated by commercial banks - this is having an effect on market liquidity (reported that max size of liquidity in the commercial bank market is around US\$2bn per transaction)
- Long term debt lending difficult (+20 year tenors)
 - good news - signs of syndication market coming back which will improve liquidity
 - bad news is that the impact of Basel III (capital regulations) is largely unassessed
- So we know that debt lending by commercial banks will remain but that it is unlikely that strong liquidity will return any time soon.....
so what are the other options?

Project Finance in PPP

some observations cont'd

- Everyone looking to institutional investors (e.g pension funds and insurance companies)....

This appears like a logical fit for PPP but the biggest problem is that accessing this market for infrastructure requires credit enhancement to make an investment grade rating (BBB+/A-)

- Period of time when a wrapped bond competed successfully with bank debt but monoline downgrades have all but ended this model....

Can the capital markets be accessed again?

- New products being considered are funding 'first loss' tranche of debt which will improve the rating (HWC)
- Unwrapped bonds?
- What about debt for construction and bond for stable state ops?

Project Finance Risks

REMEMBER it's all about the CASHFLOWS from the ASSET

Therefore key risks to project finance could be summarised as;

1. Asset/Project not being completed on time, on budget – or ever!
2. Asset/Project not operating at its base case capacity/failing to generate sufficient revenue to service the debt
3. Asset/Project prematurely coming to an end

Note there are all sorts of other PF structuring risks that Lenders consider (swaps, lending ratios, reserving requirements, syndication.....)

Project Finance Risks cont'd

So looking at these risks in a PPP context

1. Asset/Project not being completed on time, on budget – or ever!

UC cannot flow until the asset is operational and therefore could delay loan repayment – generally managed by LDs for delays but not forever!

2. Asset/Project not operating at its base case capacity/failing to generate sufficient revenue to service the debt

Poor performance vs contract requirements can lead to payment deductions (generally backed off to FM contractor) – demand risk dynamics???

3. Asset/Project prematurely coming to an end/terminated

(PPP has comp on term arrangements as the asset alone is not sufficient to be pledged as security)

Technical Adviser Introduction

Market demands have led to dedicated Project Finance TA teams
.....being technically competent isn't enough

Important to consider that the scope of a TA appointment can vary -
public vs private and primary vs secondary

So lets consider the key risk headings for a TA when advising a project
finance lender on a primary PPP transaction.....

- Deliverability of technical solution
- Commercial assumptions
- Contractual framework/conditions
- Monitoring procedures

Technical Adviser – key considerations

Deliverability of the technical solution

Regulations / technology / specification / site issues - think waste plant vs student accommodation

Competence and capacity in the supply chain

Programming requirements – risks in getting the asset up and running.....

 impact of delays on revenue,

 commissioning,

 certification of completion,

 longstops

Technical Adviser Risk Analysis Commercial

It's all about modelling downsides.....

- *basic premise is that all technical risk is flowed away from the SPV to its subcontractors....*

- Robustness of capital and operational expenditure (fm and LIFECYCLE) – pricing relative to market is first step in modelling downside....
- Security package provided by subcontractors - performance bonding/guarantees/LDs

- Sensitivity of payment stream/project cash flows

Direct payments – tolls (some volume/demand risk)

Indirect payments – shadow tolls (may still depend on volume)

Availability based – simply being available to use

PERFORMANCE

Technical Adviser Risk Analysis Contractual Framework

Severity of performance monitoring regime vs complexity of delivery

Assessment of technical risk transfer (*PPP structures typically have a high flow through of risk to allow a higher ratio of debt to equity*)

Assessment of sensitivity of default termination triggers – modelling of headroom between PA/CA/subcontracts

Feature of PPP contracting is capped contract liabilities! – *this is fundamental*

Technical Adviser Risk Analysis Monitoring Procedures

Active presence during construction delivery – certification of loan drawdowns

Operational reviews – assessing performance

Technical Adviser Summary

So what exposure would a PPP project finance lender theoretically have without a good TA?

- Risk that the technical solution doesn't deliver
- Off market commercial assumptions/contract pricing
- Contractual framework/conditions that may not sufficiently manage downside risks
- Lack of visibility/early warning of on site construction/operational issues – affecting ability for lender to take informed decisions

So why WSP?

£959m

Order book

9,000

Global WSP
Employees

Permanent
Offices in

35

countries

13

Dedicated
technical project
finance experts

1

Team

committed to you

