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The Plus and Minus of Project Finance

By Barry N. Machlin and Brigette A. Rummel, Mayer Brown LLP

Project finance has endured as a structure-of-choice for complex, capital-intensive infrastructure investments. This endurance has much to do with the benefits of the form for both equity and debt investors in these projects. As is typical, benefits come with burdens, and these attributes also must be considered when determining whether to choose the form for a given investment. Here we review the principal advantages and disadvantages of project finance as a method of development of infrastructure investment transactions. (Note that this article focuses on the use of debt in project finance transactions, as opposed to the incorporation into project capital arrangements of structured equity investments that are used primarily to monetize tax benefits.)

Project Finance Advantages

RISK COMPARTMENTALIZATION

The company that owns the assets of the project and is the focus of the investment transaction is generally a single-purpose entity (**SPE**) known as the project company, formed specifically for purposes of the project and restricted to the conduct of its business. Risk of investment and asset loss is limited exclusively (or principally – see the next point) to this SPE. Such considerations also are especially important when political risk is a factor, as the SPE structure can isolate political investment risks on a country-specific basis, insulating other investments from adverse political events in different jurisdictions. Lenders to the project also favor the single-purpose nature of the project company form, since it limits the collateral damage of other business operations and associated liabilities that could result in credit distress and possibly insolvency. (This lender position is further implemented through financing covenants restricting the project company from engaging in other businesses.)

LIMITED-RECOURSE TO SPONSOR

A fundamental principle of the project finance structure is that the debt accepts that the project business will be their principal (or only) source of repayment and therefore should the project fail, they will need to look to the recovery value of the project, its shares and its assets to satisfy claims for principal, interest and other amounts. As a result, with few exceptions (which themselves can have substantial value even if limited in time or scope) the lenders will not have general recourse to the sponsor(s) following debt default and acceleration. Substantial project sponsors, such as large corporates or financial investors, thus will not see their general corporate assets burdened by potential recourse should one of their project investments fail, significantly limiting sponsor financial exposure compared to corporate financing. Project sponsor exposure typically is limited to the base equity contribution required to capitalize the project company, additional equity negotiated with the lenders to address any cost overruns that arise in project construction, and customary legal recourse for misrepresentation, fraud or other similar "bad acts." (Importantly, in some sectors, such as oil and gas, petrochemical and mining, sponsors may be required to provide completion guarantees, which can obligate them to expend their own resources to complete the project or repay the entire disbursed debt, but these are typically only in place until project completion and thus do not constitute a guarantee for the life of the debt.)

LEVERAGE AND TENOR

Project finance structures typically include a significant debt component relative to total project costs. The resulting debt-to-equity ratio often falls in a range from 60%/40% debt-to-equity to 85%/15% debt-to-equity. (Determination of a specific project's leverage is a function of negotiation and depends on project product, sector, cash flows, country risk and a variety of other factors unique to each project.) Such leverage ratios permit sponsors to apply their equity capital resources to a larger number of projects, limit downside risk in any given project and significantly improve returns on invested capital. In addition, project finance loans typically have longer tenors (7-18 years, with the norm in the 12-15 year range), providing extended stability of debt capital, the ability to manage interest rate risk over an extended time horizon, the ability to stabilize revenue available for equity distribution and other benefits.

OVERALL CREDIT PROFILE

Given that both debt and equity essentially will depend on the project alone to repay debt and produce returns, the successful completion and commercial operation of the project is critical. Since project finance debt tenors are often 12-15 years, and can be longer, production, sales and revenue collection must be robust for extended periods. Thus, project contract terms must be thorough and all parties involved – contractors, operators, input suppliers and product purchasers – must be sufficiently creditworthy to dependably perform their various contracts, in some cases over a significantly long term. This is especially true of the revenue-producing purchase or offtake agreements (and any related parent or state guarantees), since cash flow is the lifeblood of a project. The overall credit profile of a project therefore will be robust, mitigating default and repayment risks. These strengths also can present sponsors with opportunities for favorable refinancing, either of the initial project debt or as a component of a holding-company level financing.

RISK ALLOCATION

Although project finance can be utilized for any size project, it is particularly useful in very large or complex projects, where the financial burden and associated risk can be very high. The project finance structure allocates risk across the involved parties, with the various participants absorbing performance and financial risks in line with their relative expertise or roles. For example, contractors pay liquidated damages for underperformance of their project construction duties, offtakers can have take-or-pay obligations to ensure the project revenue stream, suppliers may bear the cost of replacement if they fail to supply an input, and a state ministry may provide guarantees to support the performance of state-owned entities. Further, equity investment is frequently diversified in joint venture or other multiple shareholder structures, spreading the equity risk across a group of investors. The effect of this risk allocation and sharing approach allocates various project risks to the parties best placed to absorb them and permits sponsors to engage in higher risk/higher return investment opportunities.

POSITIVE OUTCOME BIAS

In the event of a project failure, lender incentives are strongly aligned in favor of project restructuring as opposed to asset foreclosure and sale. Ongoing project operation resulting in the generation of cash flow to repay debt – even if stretched or reduced as a result of a workout process – is far preferable to the piecemeal resale of project equipment or a forced sale of an entire project on an urgent basis. Most projects are designed expressly to capitalize on their location, to take advantage of a specific resource (e.g., minerals), market advantage (e.g., geographic location) or fiscal opportunity (e.g., tax incentive program). Maintaining the project as a going concern in its original site and form normally provides a much better upside to the debt than dismantling the project and selling the used components for redeployment. While project restructurings can, of course, result in significant pain for equity investors, the likelihood of retaining some (even significant) equity value over the long term is substantial, and it is likely project finance lenders will be motivated to collaborate on solutions to project troubles, particularly if the lead investors provide personnel, skills or relationships that enhance the restructured project's likelihood of operational capability (and hence revenue generation).

POLITICAL RISK UMBRELLAS

A variety of governmentally owned or affiliated entities offer loans and guarantees that provide not only debt capital for projects, but also a so-called "umbrella effect" that gives enhanced protection against adverse political risk events. These entities include national and multinational development finance institutions (**DFIs**) that provide capital to support less-developed country economic and social development, export credit agencies (**ECAs**) that provide credit support to facilitate the sale and export overseas of domestic goods and services from their home countries and multilateral financial institutions (**MFIs**) that have been formed by agreement among member nations to support development in the emerging markets. A host country may consider that the "cost" of adverse governmental action against a project that a DFI, ECA or MFI supports (such as an expropriation, imposition of foreign exchange controls or breach by a state entity of its contract with the project company) is much higher (and possibly prohibitive) since the "official" nature of such entities raises the political, diplomatic and, potentially, international economic consequences of such a hostile act. Thus, the involvement of DFIs, ECAs and MFIs can be a significant political risk mitigant, providing protection for both equity investors and lenders to a project.

OTHER FINANCIAL BENEFITS

Project finance also may present sponsors with accounting or other financial benefits. As a special-purpose entity, a project company may provide off-balance sheet treatment possibilities depending upon applicable accounting rules, affording a further financial benefit to the parent or group. The isolation of project finance debt to the project company, and the limiting of collateral pledged to secure such debt to project assets only, also may take such debt outside the scope of restrictive covenants in other group or company financings, especially cross-default-of-other-indebtedness provisions and financial ratio and negative pledge covenants. Thus, a mix of project and corporate finance may optimize financial opportunities for sponsors.

Project Finance Disadvantages

TIME AND MONEY

Since the project is a start-up enterprise, every aspect of the new business must be created, implemented and integrated to develop, have constructed and enable operation of a new facility, capable – over a long time horizon – of satisfying both lender needs for a high level of repayment certainty and equity investment hurdle rates. Projects require the involvement of many necessary parties, multiple contracts, and often challenging geographic, legal and political environments. Achieving financeability of the project so that debt can be raised can require extensive risk allocation negotiations with project counterparties to modify contract terms. Lenders also will require extensive independent review and advice in technical, financial, environmental, insurance and other areas, in addition to transaction legal counsel, usually from a lead firm with overall transaction responsibility and local counsel in the project site location. The complexities of the process and the number of involved parties results in both significant timeframes for the financing process and higher transaction costs when compared to the corporate finance model.

EXECUTION AND MATERIAL ADVERSE EVENT RISK

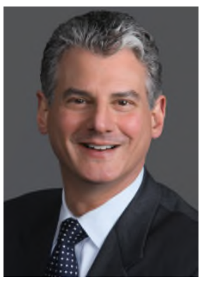
The multiple parties, need for cycles of negotiations and resulting extended timeframe of many project financings create transaction stresses and expose the effort to adverse event risk. Pre-financing project development activities can take several years, the financing phase can absorb another year or two, and typical project construction timelines range from one to three years, with the largest and most complex projects potentially taking as much as five to six years to bring to operations. Project finance is a marathon, not a sprint, and sponsors must have both the personnel and financial resources capable of sustaining such long-term efforts. During these long timeframes, political and economic events may present challenges to the success of the project. While foreseeable events should have been addressed in the risk assessment and mitigation phases of the project, the lengthy timeframe of project finance provides opportunities for political changes, unanticipated macroeconomic events or other unforeseen circumstances to disrupt transaction progress. Examples of such occurrences abound, even in the most developed economies with high degrees of respect for the rule of law.

LENDER DILIGENCE AND OVERSIGHT

As discussed above, lender recourse to sponsors in project finance structures is limited; such recourse also is overwhelmingly focused on funding the completion of the project. Once operational, debt is reliant on project operations and the performance of the various parties to the project contracts for repayment. This dynamic results in significant risk transfer to the lenders, who generally will be funding 65-85% of project capital. As a result, lenders engage in extensive due diligence of all aspects of the proposed project, the involved parties, the proposed business opportunity and the assumed performance of the enterprise. Financeability of the project will depend on satisfactory implementation of the agreed risk analysis and mitigation plan through extensive involvement of lender technical advisors and various administrative and security agents during the lending and repayment phases. Detailed and frequent reporting requirements will need to be followed by the project company, as well as a typically lengthy and detailed set of conditions to lending, covenants and events of default that establish boundaries for the project company's business operations until repayment of the debt. Modifications to the project's physical facilities, amendments to project contracts, variance from agreed budgets for operational and capital expenses and many other project operational details, all will require lender consideration and approval.

CONCLUSION

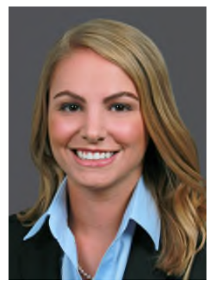
Project finance has significant advantages for the financing of large-scale infrastructure investments in both developed and emerging economies. Although there are disadvantages to the structure, for most sponsors, these issues are manageable through planning, implementation of a focused execution strategy and team and ensuring the availability of financial resources for the up-front diligence, risk allocation and pre-financial close phases of such transactions. As increased emphasis is placed on the use of public-private partnerships, privatization schemes and other programs aiming to mobilize private capital to develop key infrastructure assets, the project finance structure will remain prominent and attractive for such investments.



BARRY N. MACHLIN
Chicago
+1 312 701 8574
bmachlin@mayerbrown.com

Barry Machlin is a partner in Mayer Brown's Global Projects group and concentrates on international and domestic project finance and infrastructure transactions of all types. Barry has led or had a central role in transactions involving more than 60 countries spanning a wide range of sectors, including power (coal, gas, wind and nuclear), oil and gas (pipelines, petrochemical and other facilities), ports and aviation, satellite and telecom, and other areas. He has represented sovereigns, state-owned enterprises and investors in privatization matters and cross-border investment and financing transactions. He has acted for, or had major roles in, transactions involving more than 20 ECAs, IFIS, DFIs and PRI providers. He served for four years on the Firm’s global Partnership Board, and is a former co-chair of the Global Projects group.

Barry has consistently been ranked in Band 1 by *Chambers USA* (Projects) and is highly ranked in both the *Chambers Global* and *Chambers Latin America,* as well as named a “Leading Lawyer” in the *Legal 500 United States.* Barry was named Project Finance “Dealmaker of the Year” by the *American Lawyer* for his leading role in the Panama Canal’s Expansion Project.



BRIGETTE A. RUMMEL
Chicago
+1 312 701 7659
brummel@mayerbrown.com

Brigette Rummel is an associate in Mayer Brown's Chicago office and a member of the Banking & Finance practice and the Gobal Projects group. Brigette’s practice focuses on advising lenders (including commercial banks, export credit agencies and multilateral agencies), investors, project owners and contractors in connection with the financing and development of international and domestic projects. She has participated in transactions on several continents and across a range of sectors, including renewable energy, petchem and infrastructure.

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