Sources of Financing and Intercreditor Agreement

Full Description

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Equity Contributions

Project sponsors are the investors in the project company that are likely to be providing expertise and some of the services to the project company (such as construction or operations services). Sponsor funding is generally through equity contributions in the project company through share capital and other shareholder funds. Equity holds the lowest priority of the funding contributions in a project, therefore the other contributors (such as lenders) will have the right to project assets and revenues before the equity contributors can obtain any return; or, on termination or insolvency, any repayment. Equity contributions bear the highest risk and therefore potentially receive the highest returns.

Equity contributors in project financed transactions might include the project participants, local investors, the host government, the grantor, other interested governments, institutional investors and bilateral or multilateral organizations. Equity investors will want to pay in their equity investment as late as possible in the construction period, even wholly back-ended to save costs and improve their aggregate equity return.

Lenders will prefer front-ended or pro rata equity investment to maintain their cushion ratios on debt drawn-down. Lenders may want a bank or third-party payment guarantee on equity payments to be made later in the project to ensure they will be available at the time agreed.

The shareholders' agreement may involve several documents, for example a development agreement for the pre-financial close phase, and for post-financial close a joint venture agreement and articles of association or incorporation or whatever constitutional documents exist for the project company as well as shareholder loans, stand-by credit, stand-by equity and other similar documentation. The shareholders' agreement will cover topics such as the allocation of development costs, the scope of business of the project company, conditions precedent to its creation, the issue of new shares, the transfer of shares, the allocation of project costs and the management of the project company including decision-making and voting. Such an agreement will often also include a non-competition clause, providing that the shareholders may not enter into activities directly or indirectly in competition with the project company. Shareholder arrangements can also be complex, they may set out special rights of one class of shareholder or give powers of veto to minority shareholders, provide for different levels of priority between shareholders (preference shareholders are paid out for dividends and in case of bankruptcy in priority to ordinary shareholders, for instance). See Joint Venture Checklist and Joint Development Agreement Checklist for more.

As noted in Project Finance - Key Concepts, while the liability of project sponsors is usually limited to the level of their shareholdings, lenders will seek limited recourse to the assets of the shareholders in certain specified situations, up to a limited maximum amount and over a limited period. The extent to which some recourse is provided is commonly called "sponsor support". Where some portion of the project involves more risk than another, recourse may be provided to the lenders to the extent of that risk or until that high risk period has passed.

Alternatively, the amount of recourse allowed to the lenders may be limited in value. In project financing, the construction phase involves particular risks for the lenders. The value of the project against which the lenders provide financing is usually in the operation and the payment stream supported by the concession agreement rather than the physical assets of the project. In a new build project, there will be no revenue stream until the operating period. As the lenders will bear more risk until construction is complete, sponsor support is sometimes provided for the period up to completion of the works. It may also be provided for the period until certain financial ratios are achieved, or until the works have achieved a period of operation at a certain level.

Sponsor support may include:

- shortfall guarantees, where the banks, after enforcing all other security rights, experience a shortfall;
- buy-down undertakings, a promise to prepay project debt to ensure specified ratios, in certain circumstances;
- price guarantees, to ensure pricing of offtake;
- market price purchase guarantees, to purchase a minimum quantity of product at market price over a set period;
- tax loss purchases, where a shareholder agrees to purchase certain tax losses from the project company;
- technical support, extended warranties and maintenance arrangements; and
- contingent equity or subordinated debt commitments to cover construction or other price overruns.

A key issue in limited recourse financing is what obligations the remaining shareholders have in respect of the participation of a joint venturer who wishes to drop out or defaults on their obligations. These issues are usually resolved in the financing agreement or at law.

Debt Contributions

Debt can be obtained from many sources, including commercial lenders, institutional investors, export credit agencies, bilateral or multilateral organisations, bondholders and sometimes the host country government.

Unlike equity contributions, debt contributions have the highest priority amongst the invested funds (e.g. senior debt must be serviced before any other payments are made). Repayment of debt is generally tied to a fixed or floating rate of interest and a programme of periodic payments. The source of debt will have an important influence on the nature of the debt provided. This section will focus on some of the characteristics of project debt.

Where multilateral organizations and export credit agencies number amongst the lenders, the debt package may benefit from certain insulation from political risk and preferential treatment by the host government in relation to repayment, although such lending may be more difficult to obtain due to restrictions and requirements of multilateral organisations and export credit agencies.[2] Some of these multilateral organisations also benefit from preferred creditor status, providing greater comfort to the lender group.

Commercial banks are desirable as long?term debt providers, given their flexibility in renegotiating loans and reacting to new or unforeseen conditions. This flexibility may not be available, for example, from bondholders. Another source of project debt is equipment suppliers. Suppliers will provide financing in order to sell their equipment, and may provide more aggressive terms accordingly.

Finance lessors pay for assets and lease them back to the project company. Whether or not the lessor is the equipment supplier, it can provide competitively priced financing, in particular to the extent the lessor can set off the cost of equipment against its profits (since the project company will not have profits in the early years to benefit from this set off). Leasing can provide additional benefits in the financing of infrastructure projects, in particular additional or earlier tax allowances, new sources of finance, and improved security interests where asset ownership is retained off-shore in a more security friendly jurisdiction. But leasing also adds complexity to an already complex structure, adding another creditor’s interests and influence over project assets.

Syndication

In syndicated lending, each amount advanced by one of the syndicated banks constitutes a separate loan, with the bank's obligations and rights being several. The banks will not underwrite each other's obligations, and each bank will want to sue separately and make its own set off arrangements. The agent bank for the syndicate will verify conditions precedent, receive funds, calculate interest rates and make demands on the borrower on behalf of the syndicate. Only certain bank actions will be subject to majority bank control, for example acceleration (where the whole amount due under the loan becomes due and payable immediately).

Shari'a financing

Large project finance transactions provide an opportunity to combine different forms of finance, and given their size and complexity may require a diversity of sources of funding, for example Islamic (compliance with Shari'a law) and conventional interest based financing.

One of the key challenges of Islamic financing is that the Islamic financing institution, possibly through a special-purpose vehicle, will own the underlying assets, which therefore would not be available as security for other lenders. The intercreditor arrangements between commercial and Islamic financing institutions will need to address these challenges.[3]

For more information on Shari'a finance, see:

- Hassan, M. Kabir and Mervyn K. Lewis (eds.), *The Handbook of Islamic Banking*, Edward Elgar, Cheltenham, UK and Northampton, Mass. 2007, ISBN 1 84542 0837. Paperback edition, 2009, ISBN 978 1 84844 4737 (e) 978 1 8572 5414.
- Mobilizing Islamic Finance for Infrastructure PPPs, jointly published by the World Bank Group and the Islamic Development Bank Group (IsDB), and funded by the Public-Private Infrastructure Advisory Facility (PPIAF), this report represents the first systematic effort to capture and disseminate knowledge on deploying Islamic finance for infrastructure PPP projects

Bank Guarantees/Letters of Credit/Performance Guarantees

Bank guarantees form an important part of project financing, allowing counter-parties immediate access to payment without the cost of locking up cash. Such guarantees may be "on demand" or only payable once the default is proven in court, adjudication or arbitration.

A bank issuing a guarantee, letter of credit or performance bond will fix the amount and obtain a counter indemnity from the customer, possibly secured against fixed or floating charges or cash deposits. The issuer will be entitled to convert the counter indemnity payments into loans or demand immediate repayment. The issuers will enter into the intercreditor agreement to ensure sharing of rights over project assets.

The International Chamber of Commerce has developed rules for demand guarantees, which have been accepted and recognized by bankers, traders and international organizations including UNCITRAL, FIDIC and the World Bank.The current edition, the ICC Uniform Rules for Demand Guarantees, URDG 758, was officially endorsed by the UN Commission on International Trade Law (UNCITRAL) at its 44th annual session in Vienna from 27 June – 8 July 2011.

Bond/Capital Markets Financing

Bond financing allows the borrower to access debt directly from individuals and institutions, rather than using commercial lenders as intermediaries. The issuer (the borrower) sells the bonds to the investors. The lead manager helps the issuer to market the bonds. A trustee holds rights and acts on behalf of the investors, stopping any one investor from independently declaring a default. Rating agencies will assess the riskiness of the project, and assign a credit rating to the bonds which will signal to bond purchasers the attractiveness of the investment and the price they should pay. Bond financing generally provides lower borrowing costs, if the credit rating for the project is sufficiently strong. Rating agencies may be consulted when structuring the project to maximise the credit rating for the project.

Bond financing provides a number of benefits to projects including lower interest rates, longer maturity (which can be very helpful given the duration of most of these projects) and more liquidity. The disadvantages associated with financing through bond issues include:

- “negative carry”, bond financing is drawn all at once, up front, and therefore interest is charged on the entire amount from day one. The borrower will have to bear the "cost of carry", being the interest paid on the bond proceeds, from the date of receipt to the date it is used to invest in capital expenditure;
- less certainty in the underwriting process due to the volatility in the securities market, uncertainty unless the bonds are underwritten (which is rare);
- less flexibility during project implementation (e.g. to approve waivers and amendments), given the diversity of bondholders and the difficulty of getting approval for changes;
- more time and cost, due to more extensive disclosure processes and the rating process; and
- lack of export credit agency and other support for bonds.

Bond financing has seen limited usage for initial project financing, but is commonly used for refinancing, once construction risks have been largely mitigated.

Mezzanine/Subordinated Contributions

Located somewhere between equity and debt, mezzanine contributions are accorded lower priority than senior debt but higher priority than equity. Examples of mezzanine contributions are subordinated loans and preference shares. Use of mezzanine contributions (which can also be characterised as quasi?equity) will allow the project company to maintain greater levels of debt to equity ratio in the project, although at a higher cost than senior debt.

Subordination involves a lender agreeing not to be paid until another lender to the same borrower has been paid, whether in relation to specific project revenues or in the event of insolvency. Subordination can be achieved either by contract or through corporate structuring (where the subordinated lender provides debt to a holding company, which only has access to project revenues or assets once the lenders to the subsidiary company have been satisfied). Contractual subordination may create challenges in some jurisdictions, where subordinated lenders holding funds on trust for senior creditors is not enforceable.

Mezzanine financing for project financed transactions can be obtained from shareholders, commercial lenders, institutional investors and bilateral and multilateral organisations.

Mezzanine contributors will be compensated for the added risk they take either by receiving higher interest rates on loans than the senior debt contributors and/or by receiving partial participation in the project profits or the capital gains achieved by project equity. Sharing in capital gains may be provided by way of a share option or convertible right or some other "equity kicker” given to the mezzanine contributor. A common form of mezzanine debt is associated with construction cost overruns. Lenders will want to see standby or contingency funding available to address potential construction cost overruns, usually in an amount of about 10% of the project's overall funding, while still satisfying the various project ratios if those amounts are drawn. Therefore stand-by debt will need to be balanced with stand-by equity commitments.

Security and other rights tend to be managed through trustee arrangements, with one of the lenders or a third party acting as agent for the lender group, holding and acting on security rights.

Intercreditor Agreement

An intercreditor agreement will often be entered into by the lenders in order to address key issues between the different sources of financing. Intercreditor issues include:

- Order of drawdown of funds;
- Coordinating maturity of loans;
- Order of allocation of debt service payments;
- Subordination;
- Holding and acting on security rights;
- Management of drawdowns, insurance funds and technical advisers;
- Exercise of discretions;
- Voting on decisions, e.g. variations of lending agreements, waiver of requirements, accelerate loan, enforce security, terminate hedging arrangements; and
- Management of payments.

Examples of Intercreditor Agreements

Examples of intercreditor agreements are included in the following project documents included on PPPLRC:

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[1]For more information, go to J Delmon, Private Sector Investment in Infrastructure, 2nd Ed, Kluwer

[2]For more detailed discussions of development finance institutions, see Denton Wilde Sapte, Public Private Partnerships: BOT techniques and project finance, (2nd Edition, 2006).

[3] For more information on Sharia law, see Hassan, M. Kabir and Mervyn K. Lewis (eds.), *The Handbook of Islamic Banking*, Edward Elgar, Cheltenham, UK and Northampton, Mass. 2007, ISBN 1 84542 0837. Paperback edition, 2009, ISBN 978 1 84844 4737 (e) 978 1 8572 5414.

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