LECTURE 1

PROJECT FINANCE

1.1. INTRODUCTION TO PROJECT FINANCE

Project finance is a method used to realize long-term financing for a major project. This could be either the arrangement of project debt, equity, and credit enhancement. Basel II Rules identified through its definition that project finance includes the effect that the lenders look primarily to the revenues generated by a single project as source of repayment and as security for the finance of the project. Project finance is different from conventional loan from corporate finance where loans are against the company's balance sheet and credit-worthiness. On project sponsors' perspective, project finance is a risk sharing mechanism[4] because it spreads the risk between the lender and the sponsors who will participate with only low percentage equity.

Although there are some identified disadvantages of project finance; however, the advantages of adopting project finance concept to finance a project include the fact that it operates in: a non-recourse or limited recourse basis, it is highly leveraged, off-balance sheet, avoidance of restrictive covenants, and attractive debt financing.

1.2. NON-RECOURSE OR LIMITED RECOURSE

The concept of non-recourse or limited recourse transactions is where the lender relied only on the assets of the borrower for the repayment of the loaned money and interests. As we shall see in this report, if the project sponsor default on repayment, the lender can seize only the security taken against the debt.

1.3. HIGHLY LEVERAGED

Highly leveraged borrowing involves the buying of an asset by using the borrowed fund while the lender expects to maximize its profits in return without affecting a pre-existing equity in the project. The risk of highly leveraged debt project finance is that where the project faces a downturn, the promoter of the project may go into bankruptcy, or may possibly default on repayment especially where the promoter has borrowed excess debt. In that case, where the debt is highly leveraged the lenders will be more at risk than the project sponsors itself.

1.4. OFF BALANCE-SHEET

Off balance sheet is where the project sponsor need not show any of the borrowing it is taking in its balance sheet. The consequence of showing the level of borrowing in a balance is that it will be more difficult for the project sponsor to raise funds in a capital market.

However, where the funding is through project finance because the project sponsor must have created a legal structure in the form of a project company (i.e Special Purpose Vehicle) for that particular project; its activities under the SPV is completely kept off the balance-sheet of the project sponsor. This may help the lender to have effective control of the project financed in the sense that the cash flow of the project will not entangle with activities that are external to the balance sheet designed for the financed project.

1.5. BANKABILITY OF A PROJECT

The lenders must ensure that the project is bankable. Bankability of a project entails referencing to the contractual documents underlying the contract. Among the reasons for the bankability of a project is that market practice may change, and/or price of a typical crude oil business may drop significantly. That means, the consideration of the underlying cash flow from the revenue will enhance the bankability of the project since the sponsor does not have any legal obligation to the repayment of the project debt. However, in order to mitigate risks of uncertainty, proper risk assessment and contractual arrangement between the parties will be necessary to address the anticipated risks.

This report will evaluate various aspects of project finance, and analyze how to identify and allocate risks, as well as how to mitigate the risks in project finance, with emphasis on large exploitation of oil projects.