What is... PROJECT finance?

BANKTrack

Project finance, also called non-recourse or limited-recourse finance, is a form of financing for companies and governments where lenders are repaid only through the revenues generated by the project itself (e.g. the tolls collected from a toll road, the electricity generated by a power plant). Lenders do not have "recourse" to the borrower's own assets if a project fails to generate the revenue projected. Project finance is most commonly directed at large infrastructure projects. After massive privatization and deregulation of industrial sectors in the 1990's, private financing of development projects grew enormously. Although the volume of projects decreased in 2001 as a result of the worldwide economic slowdown and industry-related risks (especially in the power sector), project finance began rebounding in 2002. The total amount of projects financed through private loans amounted to $73 billion in 2003.

The process

Project finance has a particular nature. The deal cycle is typically very long (can take years), and can involve many financiers. The initial costs of big projects are typically very high, while the benefits can only be reaped in the longer term. Since all kinds of risks may arise (financial, technical, environmental, political etc.), and project finance has evolved to be a very complex financing method.

Project finance is comprised of a mix of equity and debt; typically 30-40% of the project is funded through equity contributions, while 60-70% is funded through debt. Project sponsors typically contribute the equity and "own" the project, while debt finance can take two forms: loans and bonds.

Project loans are made by commercial banks, with each lender agreeing that loans will be repaid only from the revenues generated by the successful, completed project. Loans normally contain loan covenants or agreements between the lender and the borrower about what the borrower should or should not do, such as providing regular reports and adequate insurance. Larger, more risky projects often require syndicated loans. These loans are provided by a group of financial institutions called a bank consortium or a syndicate. The bank coordinating the consortium and the syndicated loan is called the arranger, and can be different from the banks' providing the debt.

Projects can also be financed through project bonds. In this case, investment banks underwrite project bonds by buying the newly issued bonds at a guaranteed price, and then reselling them to institutional investors. Like project loans, project bonds rely solely on the success and revenues generated by the project for repayment; these terms and others are outlined in a bond covenant. Bonds can also be derived from project loans. Through a process called securitization, the future income from the syndicated loan is used as collateral for the issue of new bonds.

Actors involved

Most project financing is arranged and financed by European and American banks. Besides banks, other (financial) firms also play an important role. Insurance, for example, is of great importance, given the often risky nature of the projects. Legal and other advisory services are also critical.

Although governments have left project financing increasingly to the private sector,

they remain involved in the design and the conditions of the projects. For example, local governments can purchase the infrastructure or services after the project has been finished. Host governments of the construction companies can be involved when their Export Credit Agencies (ECA's) offer insurance for the payment of their equipment or services. Finally, participants often turn to multilateral development banks like the European Bank for Reconstruction and Development or the International Finance Corporation (the World Bank's private arm) to back the project. As a result, project finance often takes the form of hybrid public-private partnerships.

The projects

The most prominent project finance sectors are telecommunications, power plants, infrastructure, natural and other resources, petrochemical and chemical plants. Most project finance is destined to projects in Western Europe. North America is another major destination, followed by Latin America plus the Caribbean and South-east Asia.

Critical issues

Project lending may result in unsustainable practices because banks and project sponsors (bank clients) often do not produce adequate environmental and social impact assessments of the projects they are financing. In addition, financiers may lack sustainability criteria, and environmental and social regulations in host countries can be weak. Finally, the lack of transparency for individual 'savers' (who are interested in knowing how the bank is using their savings), and the absence of channels for those savers to voice their concerns, also helps perpetuate unsustainable practices.

As a result of the adverse consequences big infrastructure projects can have, civil society has increasingly targeted the financiers involved in the projects.

CSR initiatives in this domain have become very important. The Equator Principles are probably the most salient, since the banks which endorse the Principles arrange over three quarters of total project finance loans by volume.

Glossary:

Underwriting: the process by which an investment bank assists a company or government to issue securities. The underwriter guarantees a certain amount to the issuer, and purchases any securities that are not bought by the markets.

Bonds: promissory notes that oblige the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').

Syndicated loan: loans for large, risky commercial or government projects provided by a group of banks, called a bank consortium or a syndicate. The bank who coordinates the loan does not necessarily provide financing itself.

Loan/bond covenant: agreement between the borrower and the lender (or issuer of the bond) about the conditions of the project, including what the borrower will and will not do.

Securitization: the process of aggregating assets in a pool and issuing new securities backed by the revenues expected to be generated by the pool.

Web references:

www.equator-principles.com
www.banktrack.org
www.hbs.edu/projfinportal
www.ipfa.org (international association for project finance)

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T: +31-30-2334343, F: +31-30-2381112, E: coord@banktrack.org, www.banktrack.org