Nigeria Infrastructure Building Conference 2014

Project Finance as a viable option for financing Infrastructure Projects

▪PREPARED BY: **Helen Brume**

Divisional Head, Power, Infrastructure & Project Finance

United Bank for Africa Plc

▪LOCATION: **Four Points by Sheraton Lagos**

▪June 26, 2014

PRESENTATION OUTLINE

I. Defining Infrastructure

II. Defining Project Finance

III. Project Finance in Africa

IV. Infrastructure Deficit in Africa

V. Understanding Project Finance

VI. Why Project Finance?

VII. Issues with executing project finance in Emerging Markets

VIII. Questions

DEFINING INFRASTRUCTURE

UBA

- For simplicity, the term '**infrastructure'** has been generically used to refer to any capital intensive asset or group of assets which provide essential goods or services (e.g. utilities, petrochemicals, transportation services, housing etc) and can be contractually structured to provide internally generated cashflows
- Physical systems and structures needed for a society or economy to function
- A country/region's level of infrastructure development is directly correlated with its economic growth and development, and invariably a country's level of infrastructure drives its level of economic activity
- Nigeria has increasing real sector financing opportunities particularly in the areas of:
  - Power
  - Infrastructure (Roads, Bridges)
  - Housing
- Hitherto closed/monopolistic markets are now open to private sector participation e.g. telecoms, power, pensions, oil and gas

DEFINING PROJECT FINANCE

UBA

- Project Finance is defined as "**the raising of finance on a Limited Recourse basis"**, for the purposes of developing a large capital- intensive infrastructure project, where the borrower is a **special purpose vehicle** and repayment of the financing by the borrower will be dependent on the **internally generated cashflows of the project**".

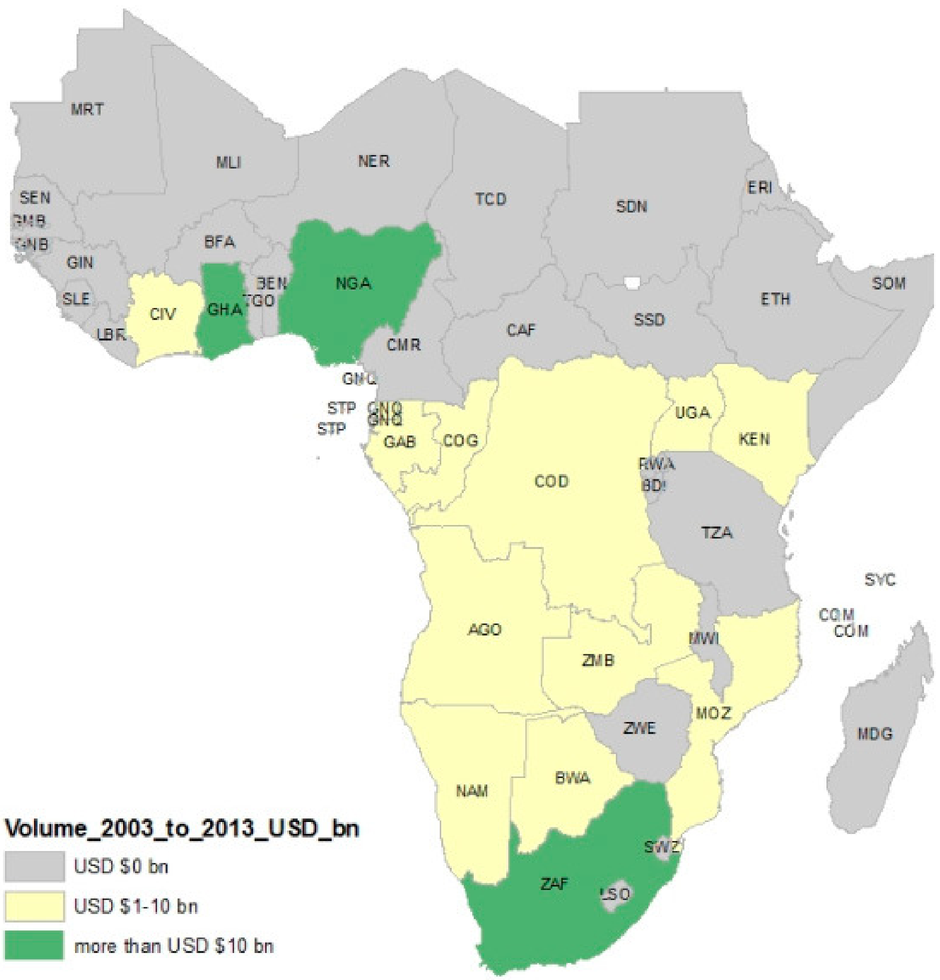
- Research confirms that the Project Finance market continues to be dominated by power and transportation projects. These sectors are highly capital intensive, form essential pieces of national infrastructure, have long asset lives and typically have predictable revenue streams, making them ideal assets for project financing.

- Project financing is largely an exercise in the equitable allocation of a project's risks between the various stakeholders of the project.

- The financing of these projects must be distributed among multiple parties, so as to distribute the risk associated with the project while simultaneously ensuring profits for each party involved.

PROJECT FINANCE IN AFRICA

UBA

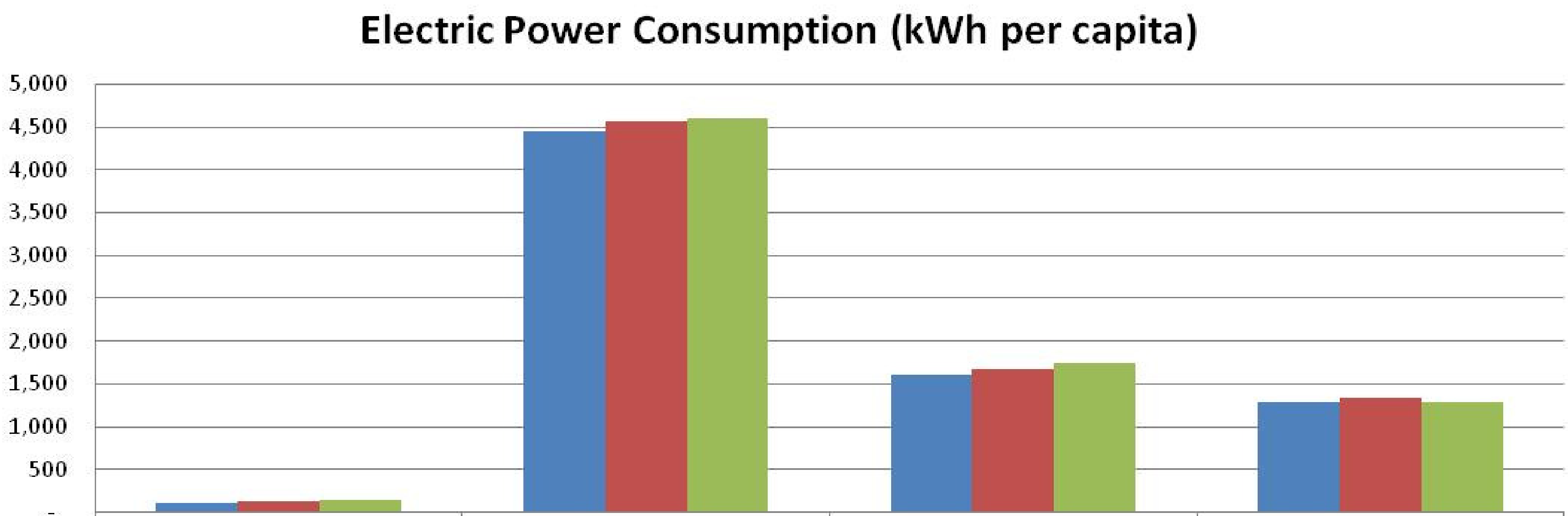


▪Source: World Bank Data

- ❑ Sub Saharan countries had one or more project finance deals in the last 10 years.
- ❑ Top countries were Nigeria (USD 17 billion), Ghana (USD 11 billion), South Africa (USD 10 billion) and Angola (USD 4 billion).
- ❑ These 4 countries accounted for 70% of Sub-Saharan Africa's total.

INFRASTRUCTURE DEFICIT IN SELECTED SECTORS- TOP 4 AFRICAN COUNTRY PEER COMPARISM

UBA



	Nigeria	South Africa	Egypt	Tunisia
2009	120	4,451	1,608	1,285
2010	135	4,571	1,671	1,350
2011	149	4,604	1,743	1,297

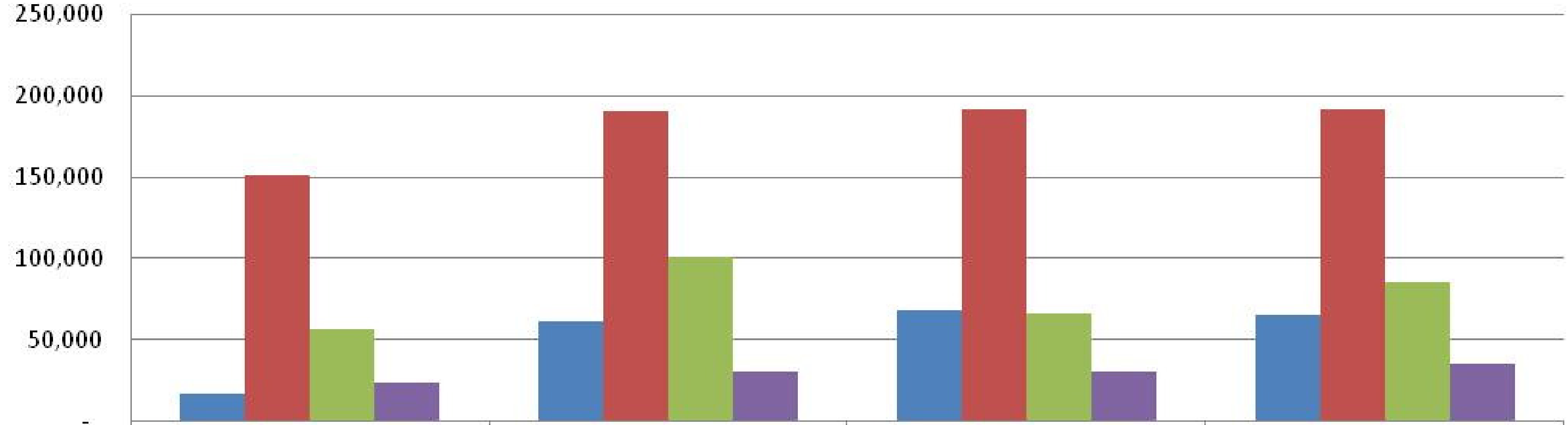
▪**Source: World Bank Data**

- Nigeria’s power sector investment has continued to trail its peers. Given its large population base there is a desperate need to increase investment in the sector.
- The process has already commenced with the privatization of the power distribution and generation companies (PHCN Successor Companies and the NIPP assets).

INFRASTRUCTURE DEFICIT IN SELECTED SECTORS- TOP 4 AFRICAN COUNTRY PEER COMPARISM

UBA

Air transport, registered carrier departures



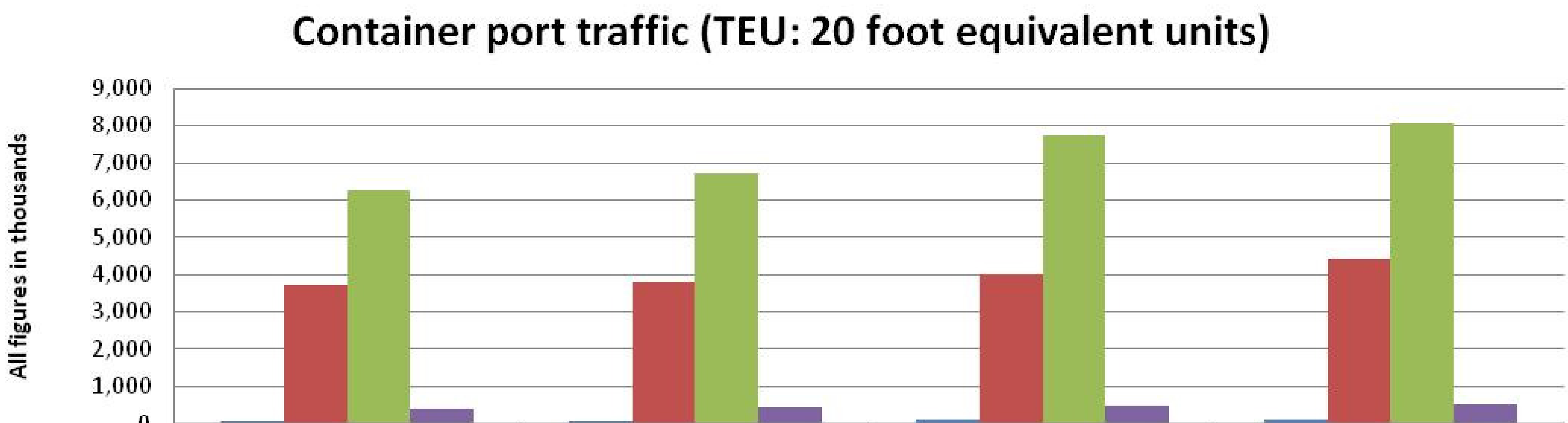
	2009	2010	2011	2012
Nigeria	16,851	61,789	68,014	65,632
South Africa	151,292	190,441	191,507	191,730
Egypt	56,414	100,636	66,672	85,307
Tunisia	24,225	31,098	30,810	36,024

▪Source: World Bank Data

- Due to under investment and poor policy formulation, Nigeria's Aviation Sector investment has continued to trail its peers with the exception of Tunisia.
- The current situation presents unique opportunity for restructuring of the Aviation Sector and subsequent expansion of existing infrastructure

INFRASTRUCTURE DEFICIT IN SELECTED SECTORS- TOP 4 AFRICAN COUNTRY PEER COMPARISM

UBA



	2009	2010	2011	2012
Nigeria	87	101	107	111
South Africa	3,726	3,806	3,990	4,424
Egypt	6,250	6,709	7,737	8,047
Tunisia	419	466	493	513

- Source: World Bank Data

- Nigeria's poor investment in port terminal development has continued to impact negatively on port traffic growth resulting in low revenues.
- There are ongoing Federal and State government initiatives to develop new port facilities in Lekki, Badagry, Olokola and other locations.
- These new projects will require optimal financing structures to bring them to reality.

UNDERSTANDING PROJECT FINANCE

INFRASTRUCTURE FUNDING OPTIONS IN NIGERIA

UBA

Financial Institutions/Financial Markets	Project Financing	Government Contributions	On Balance Sheet Funding
Capital Market (Bond Debt)	"Limited Recourse" or "Non Recourse" based project financing	Various levels of Government contributions (Advanced payments, joint ventures etc) and guarantees	Balance sheet funding by major corporates
Commercial Debt			
Multi Lateral funding			
Development Finance Institution			

Project Finance has been deemed the most common, and often most efficient, financing arrangements for PPP projects.

FUNDING SOURCES FOR INFRASTRUCTURE DEVELOPMENT UNDER A PROJECT FINANCE STRUCTURE

Funding Sources

- **Senior Funding**
  - Development Finance Institutions
  - Multilateral Finance Institutions
  - Commercial Banks
- **Junior Funding**
  - Equity
  - Mezzanine Debt
- **Government Contributions**
  - Joint Ventures/PPPs
  - Direct Contract/Advance payments
- **Corporate Balance Sheet Funding Options**
  - Internally Generated Revenue
  - Corporate Guarantees

- **Project financing involves optimizing any combination of the funding sources.**

FUNDING SOURCES FOR INFRASTRUCTURE DEVELOPMENT UNDER A PROJECT FINANCING STRUCTURE

UBA

S.N	Senior Debt Funding Source	Key Attributes
1	Commercial Bank debt	1. Flexible on drawdown and prepayment 2. Usually no rating required 3. Open mainly to short term funding
3	Export Credit Agency Covered Debt	1. Large deal appetite 2. Up to 100% cover may be available 3. Longer tenor may be difficult
4	Multilateral Debt/Development Finance Institutions	1. Focus on development projects 2. Long tenors and attractive pricing 3. May be indexed linked 4. May include guarantees, insurance and/or direct lending 5. Bank/Monoline guarantee may be required 6. Extensive execution timeframe
5	Debt Capital Market	1. Long average life 2. Less expensive relative to commercial debts 3. May be index linked 4. Prone to market risk

FUNDING SOURCES FOR INFRASTRUCTURE DEVELOPMENT UNDER A PROJECT FINANCING STRUCTURE

UBA

Investment funds and individual financial investors have started to appreciate the potential of project equity investments and some have been established for the specific purpose of investing in infrastructure projects.

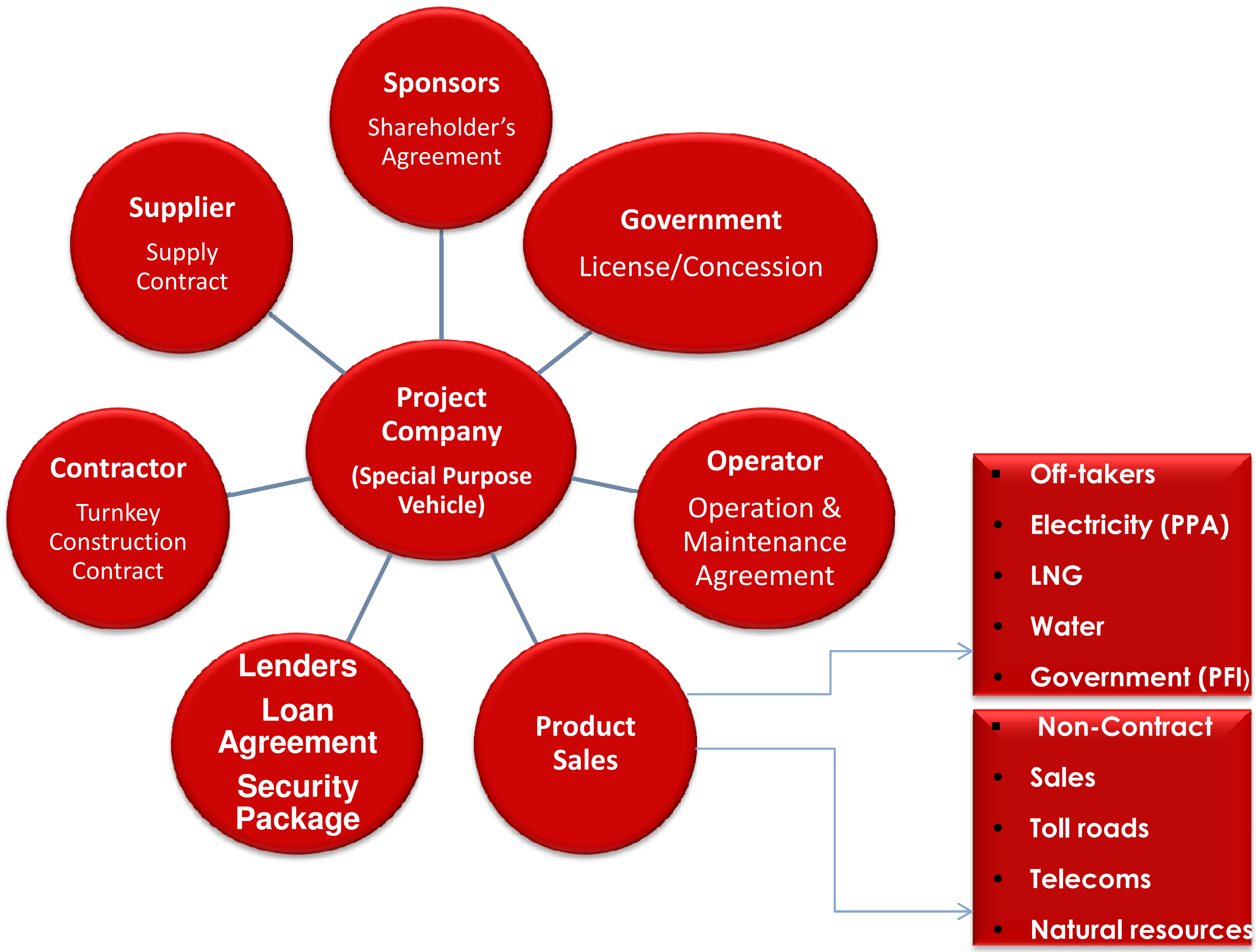
S.N	Junior Debt Funding Source	Key Attributes
1	Junior Debt	1. Tranching of debt to match risks may be efficient e.g., to allow investment grade rating on senior tranches. 2. Junior debt could allow optimized utilization of concession length. 3. May be provided by same institutions providing senior debt.
2	Third Party Equity	1. Specialized funds – typically higher return requirements than "industry" equity investors. 2. Will take minority stakes and rely on the sponsors presence as shareholders to ensure operational management.
3	Sponsor Equity	1. Shareholder loans to achieve cash efficiency. 2. Bridge loans allow back-ending of actual disbursement to maximize IRR. 3. Sponsors typically require control of the project company.

UNDERSTANDING PROJECT FINANCE

UBA

Definition	Applicable Project Scenarios	Common Features
Limited Recourse financing	Start-ups or "Green-field"	Capital Intensive – Tend to be large scale projects
Sponsors/ parent companies are not liable for Project debt	Expansions or "brown-field"	Highly Leveraged – Debt of up to 80% of Capital
Repayment based on Project Company cash flows only	Public Private Partnerships (PPP)	Long Term – Tenor Typically range from 7 – 20 years
Project risks allocation to parties best able to manage the risk	Refinancing	Independent Entity is set up (Project Special Purpose Vehicle (SPV)) with a finite life
	Acquisitions	Non-recourse or Limited recourse financing
	Privatizations	

TYPICAL PROJECT FINANCE STRUCTURE



TRANSACTIONAL STAKEHOLDERS IN PROJECT FINANCE

UBA

SPONSORS

- The equity investor(s) and owner(s) of the Project Company – can be a single party, or more frequently, a consortium of Sponsors.
- Subsidiaries of the Sponsors may also act as sub-contractors, feedstock providers, or offtaker to the Project Company.
- In PPP projects, the Government/Procurer may also retain an ownership stake in the project and therefore also be a Sponsor.

GOVERNMENT

- The government may contractually provide a number of undertakings to the Project Company, Sponsors, or Lenders which may include credit support in respect of the Procurer's payment obligations (real or contingent) under a concession agreement.

CONTRACTORS

- The substantive performance obligations of the Project Company to construct and operate the project will usually be done through Engineering Procurement and Construction (EPC) and Operations and Maintenance (O&M) contracts respectively.

TRANSACTIONAL STAKEHOLDERS IN PROJECT FINANCE

UBA

OFFTAKER/ FEEDSTOCK PROVIDER

- More typically found in utility, industrial, oil & gas and petrochemical projects.
- One or more parties will be contractually obligated to provide feedstock (raw materials or fuel) to the project in return for payment.
- One or more parties will be contractually obligated to 'offtake' (purchase) some or all of the product or service produced by the project.
- Feedstock/Offtake contracts are typically a key area of lenders due diligence given their criticality to the overall economics of the project (i.e. the input and output prices of the goods or services being provided).

LENDERS

- Typically including one or more commercial banks and/or multilateral agencies and/or export credit agencies and/or bond holders.
- Its important for lenders to be comfortable with all of the other stakeholders to consider lending to the project.

PROCURER

- Only relevant for PPP - the Procurer will be the municipality, council or department of state responsible for tendering the project to the private sector, running the tender competition, evaluating the proposals and selecting the preferred Sponsor consortium to implement the project.

WHY PROJECT FINANCE?

WHY PROJECT FINANCE?

UBA

The financing of projects must be distributed equitably among multiple parties, so as to distribute the risk associated with the project while simultaneously ensuring profits for each party involved.

Optimum Risk Allocation

- Allocation of risks to the parties best able to manage them
- Mitigate sovereign risks

Limited Recourse to Sponsors

- Debt raised on the merits of the Project rather than the credit of the Sponsors
- Might be treated by equity analysts and rating agencies as non-Sponsor debt.

Management of Multi-sponsor issues

- Projects often too large for single sponsor
- Mitigate exposure to other sponsors
- Enforces project discipline

RISK ALLOCATION TO PROJECT PARTIES

There are a number of typical risks associated with project finance structures. These should be allocated to those parties which can control them best

Government (Risks allocated to Government by: Concession Agreement)	Project Company (Residual Risk)	Contractors (Risks allocated to contractors by: Construction Contract and O&M Contract)
Right to Build	Finance Risks	Construction Cost
Discriminatory Law	Tax	Design
Title to Land	Other Laws	Construction Time
Demand	Demand	Latent Defects
Force Majeure	Force Majeure	Inflation
Other Approvals (where applicable)	Construction Cost	Safety
	Operation & Maintenance Performance	Ground Conditions
	Operation & Maintenance Cost	Operation & Maintenance Cost
	Inflation	Operation & Maintenance Performance

RISK DIMENSIONING AND ALLOCATION THROUGH THE PROJECT LIFE CYCLE

UBA

S.N	Project Risk	Sponsor	Contractor	Lender	Host Government / Offtaker
1	Technical feasibility	YES	✖	✖	✖
2	Commercial/financial feasibility	YES	✖	✖	✖
3	Project economics	YES	✖	✖	✖
4	Permits/authorization	YES	✖	✖	YES
5	3rd Party Intervention	YES	✖	✖	YES
6	Political change	YES	✖	✖	YES
7	Completion	YES	YES	✖	✖
8	Schedule	YES	YES	✖	✖
9	Cost	YES	YES	✖	✖
10	Design changes	YES	YES	✖	✖
11	Interest rate escalation	YES	YES	✖	✖
12	Consequential damages	YES	✖	✖	✖

RISK DIMENSIONING AND ALLOCATION THROUGH THE PROJECT LIFE CYCLE

UBA

S.N	Project Risk	Sponsor	Contractor	Lender	Host Government / Offtaker
13	Force majeure/country risk	YES	YES	✖	YES
14	Currency changes	YES	YES	✖	✖
15	Foreign exchange availability	YES	✖	✖	YES
16	Market changes	YES	✖	YES	✖
17	Capacity/production shortfalls	YES	✖	YES	✖
18	Fuel/materials supply interruption and cost/escalation	YES	✖	YES	YES
19	Interest rate escalation	YES	✖	✖	✖
20	Currency depreciation	YES	✖	✖	YES
21	Statutory change/civil unrest/strikes	YES	✖	YES	YES
22	Natural disasters	YES	✖	YES	YES
23	3rd Party Liability	YES	✖	✖	✖
24	Residual Value	YES	✖	✖	YES
25	Operation & Maintenance Cost / escalation	YES	✖	YES	✖

STAKEHOLDER MOTIVATIONS FOR PROJECT FINANCE

UBA

- When well structured, project finance provides compelling reasons for stakeholders to use project financing as a method of infrastructure investment:

1

Sponsors: The limited Recourse nature of project finance means that lenders only recourse is to the assets of the Project Company.

- High Leverage: Project finance are typically high leverage transactions using up to 90% debt. Sponsors are able to make lower equity injections;
- Enhanced shareholder equity returns
- Reduction in post Weighted Average Cost of Capital of the project company

2

Lenders:

- Extraction of a return commensurate to the level of risk
- Additional returns through the provision of the associated products and services required by the Project Company

3

Government:

- Fiscal Optimisation: Since the financing responsibility is transferred to the private sector, the government is able to amortize the cost of the asset over the term of the concession.
- Process Efficiency: PPP is effective in eliminating inefficiencies from the government procurement process
- Performance Risk: Under a PPP relationship, the risks of constructing and operating the asset are passed to the private sector. Sponsors are heavily incentivized financially to ensure full asset performance.

ISSUES WITH EXECUTING PROJECT FINANCE IN EMERGING MARKETS

TYPICAL CHALLENGES OF PROJECT FINANCING IN EMERGING MARKETS

- A project may be subject to a number of technical, environmental, economic and political risks, particularly in developing countries and emerging markets.

Lack of National Infrastructure Blueprint	Unclear legislative, legal, investment and operational framework	Weak regulatory enforcement
Inadequate financial modeling to enable proper affordability and value for money assessments	Technical capacity gaps	Lack of institutional framework for PPP project preparation
Complicated interrelationships amongst the parties (Same stakeholders play multiple roles)	Investment funding tenor – difficulty in attracting long term funding	High country risk and transaction pricing

GLOSSARY

- Project Finance by David Gardner – HSBC
- World Bank – Project Finance in Africa

THE END