PROJECT FINANCE & LOAN SYNDICATIONS

Theories, Procedures & Techniques

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What is Project Finance?

- A Project Finance transaction involves the mobilization of debt, equity, contingent equity, hedges and a variety of limited guarantees through a newly organized company, partnership or contractual joint venture for the purpose of building a capital intensive facility and operating a discrete business activity.

- Two main forms of corporate lending:
  - Full faith and credit of corporate balance sheet
  - Project finance loan

Some Jargons

- **Full Recourse Loan**: A loan in which the lender can claim more than the collateral as repayment in the event that the loan is enforced. Thus a full recourse loan places the Sponsor's assets at risk.
- **Non Recourse Loan**: A loan in which the lender cannot claim more than the collateral as repayment in the event that the loan is enforced.
- **Limited Recourse Loan**: A loan in which the lender can claim more than the collateral, subject to some restrictions, as repayment in the event that the loan is enforced.

Project Financing Mechanisms

- Project financing can be done by:
  - a single bank, or
  - through loan syndication (arranging loan from a number of banks/financial institutions)
- In both cases, credit appraisal remains identical with focus being the same: <u>determining cash flow generating capacity of the project</u>
- However, syndication is *generally* preferred when loan size is large (e.g. say, exceeds Tk. 30.0 crore), and the borrower has strong operational and financial track record so that it is possible to raise fund from the market

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What is Project Appraisal?

- Project finance requires project appraisal.
- Project appraisal is the due diligence conducted on sponsors, technical, market, environmental, financial, legal, and risk aspects, among others, of the proposed project.
- It is the assessment of the viability of proposed long-term investments in terms of shareholder wealth.
- From a commercial bank's perspective, the focus is on whether the project can generate sufficient cash flow to repay its debt and provide an acceptable rate of return to sponsors.

Why is Project Appraisal Needed?

- To stop bad projects
- To prevent good projects from being destroyed
- To determine if components of projects are consistent
- To assess the sources and magnitudes of risks To determine how to reduce risks and efficiently share risks

Components of Project Appraisal

- Sponsors Analysis
- Technical Analysis
- Market Analysis
- Environmental Analysis:
- Financial Analysis
- Legal Analysis
- Risk Analysis

Sponsors & Management Review

- Sponsors review should answer the following:
  - Sponsors track record in implementing similar kind of projects
  - Sponsors financial strength to fulfill base equity and contingent equity commitment
- Management review should answer the following:
  - What are managerial and labor needs of the project?
  - Does organization have the ability to get the managerial skills needed?
  - Is timing of project consistent with quantity and quality of management?
  - What are wage rates for labor skills required?

Technical Analysis

- Review of Technical Expert/Independent Engineer's Report
- Track record of proposed technology
- Adequacy and completeness of the project design
- Quantities of inputs by type needed for investment and operation
- Labor required by type and time
- Input prices and sources of supply
- Environmental impacts

Market Analysis

- Review of Market Expert's Report
- Whether there exists a strong market for the project
- Demand – supply gap
- Price elasticity
- Availability of substitutes
- Sector/Industry Analysis should also be done here
    - Industry competitiveness/structure/tariff/duty/tax/vat, etc.
    - Availability of inputs/raw materials
    - Major industry players
    - State of regulations

Environmental Analysis

- What are the likely environmental impacts from undertaking project ?
- What is the cost of reducing the negative impact?
- Evaluation of the environmental impacts and risks with and without technical measures are taken to reduce these impacts
- Are there alternative ways of supplying the good or service of project without incurring these environmental costs? What are the costs of these alternatives?
- Is it a RED/ORANGE/GREEN project?
- Have DoE and GoB permissions been obtained?

Financial Analysis

- Determination of total project cost and sources of finance
- How to forecast project earnings and costs?
- How to model project profitability under uncertainty?
- What are the DCF tools used in project analysis?
- Key questions asked in financial analysis:
  - What is relative certainty of financial variables?
  - What are sources and costs of financing?
  - What are minimum cash flow requirements for each of the stakeholders?
  - What can be adjusted to satisfy each of the stakeholders?

Typical Structure of Financial Analysis

- Capital cost and financing plan
  - Capital cost
  - Working capital requirement
  - Engineering, procurement, and construction
  - Allocation of loan and equity and disbursement
- Operating costs and earnings projections
  - Revenues
  - Operating costs
  - Pro forma financial statements (IS, BS, SCF)
- Financial projection
- Net present value (NPV) & internal rate of return (IRR)
- Sensitivity Analysis

Legal Analysis

- Is project operation lawful?
  - Review AoA/MoA, check certificate of incorporation, etc.
- Does the project has relevant permission in place?
  - Power project signs various agreements with government. Moreover, it requires at least 30 different consents/permits from govt. line agencies.
  - CNG refueling stations requires 3 basic permissions from RPGCL, Dept. of Explosives and 9 other permission from various govt. line agencies.
  - Schools, universities, hospitals, etc. all have their specific permission requirements.
  - If anything related to export/foreign investment, check for Board of Investment, Bangladesh Bank approval.
  - If anything related to tax, duty, VAT, etc. consult National Board of Revenue.
  - If anything related to capital raising, consult Securities Exchange Commission.

Risk Analysis

- **Fundamental Principle of Risk allocation:**
  - Risk should be allocated by contract or otherwise, to the party best able to mitigate or control risk.
- **Major Risks Involved in Project Finance:**
  - Construction Risk
  - Credit Risk
  - Marketing and Operating Risk
  - Financial Risk
  - Political Risk
  - Legal Risk
  - Environmental and Social Risk
  - Force Majeure Risk

Project Financing Parameters

- **Loan Limit**: Determining maximum borrowing capacity of the project
- **Currency**: May be denominated in either local or foreign currency.
- **Capital Structure**: Maximum debt-to-equity ratio up to 80:20
- **Loan Tenure**: Maximum tenure of the loan depends on project nature. Tenure will typically include a grace period, which commemorates with length of construction period and timing of revenue generation by the project
- **Facility Nature**: Both funded and non-funded (L/C, BG, etc.). Funded facilities may include revolving credit for working capital facility
- **Rate of Interest**: Rate of interest is 13% pa or lower.
- **Fees & charges**: As applicable
- **Securities**: Primary (first charge on project assets), and collateral (PG, corporate guarantee, R/M on other immovable properties, lien on financial assets, FDR, shares, etc.)

What is Loan Syndication?

- As per Encyclopaedia of Banking and Finance (EBF), "Syndication" means a temporary association of parties for financing and execution of some specific business purpose
- EBF also defines "Syndicated Loan" as loans extended by multiple banks where the overall credit involved exceeds an individual lender's legal lending or other limits
- Syndicated loan is made available by a group of FIs in pre-defined proportions under the same credit facility following common loan documentation formalities
- Loan syndication is different from club financing (where many banks finance a single borrower) in terms of deal origination, mechanism, documentation, disbursement, monitoring, management, etc.
- Essential Characteristics: (i) single borrower, (ii) more than one lender, (iii) common loan & security documentation

Why is Loan Syndication Required?

- Banks are restricted to take funded exposure on a single borrower up to 15% of their capital, and non-funded exposure up to 20% of their capital
- Banks also set prudential loan limit internally to restrict loan exposure on a single customer
- Bangladesh Bank further limits percentage of total credit portfolio that can be in form of large loan (i.e. loan size exceeding 10% of Bank's capital) based on percentage of classified loan. For example, large loan can be maximum 56% of portfolio for NPL below 5%, maximum 52% for NPL exceeding 5% but less than 10%, etc.
- Infrastructure projects and capital intensive industrial undertakings require lumpy investment that isn't possible for a single bank to address

Advantages of Loan Syndication

- Diversification/sharing of risks, cost sharing and pooling of resources and reputation
- Participating banks play useful roles by providing informative opinions and/or additional expertise even after the funding has been extended
- Popular scheme for financing large and medium scale projects
- The ability of the customer to deal with single Bank/FI ("Lead Bank" and "Agent Bank") as a one-stop service point
- Syndication provides borrower with a complete menu of financing options, which usually results in more competitive loan pricing, product innovations and wider cooperation
- The opportunity for the borrower to establish a track record with many banks from just a single transaction

Parties to a Loan Syndication

1. **Borrower:** An institution or individual that raises funds in return for contracting into an obligation to repay those funds, together with payment of interest over the loan. Borrower selects/mandates a bank to work as the Lead Arranger for the deal.
2. **Lead Arranger:** Responsible for raising/arranging the fund. Lead Arranger or Bank co-ordinates all activities related to a particular syndication deal from proposal origination to final disbursement of the loan. It also performs following functions:
   - Assists the borrower to structure the project and set important loan parameters, prepare the information memorandum, formulate a plan to raise the fund within an agreed time schedule
   - Has the responsibility for much of the loan selling
   - Acts as the first port of call for questions and answer them authoritatively in order to head off problems and sensitivities before they arise

Parties to a Loan Syndication…cont'd.

3. **Agent:** Performs following functions:
   - Preserve all security documents and provide administrative & monitoring activities during tenure of the loan
   - Act as the agent for the banks (not for the borrower) and to co-ordinate and administer all aspects of the credit facility once relevant documentation has been executed
   - The activities include disbursement of money, collection of money, e.g. commitment fees, front-end fees, interest and repayments of principal
   - Responsible for transmitting any post-closing waivers or amendments requested by the borrower and negotiating them with the syndicate banks
   - Inform the participating banks regarding progress of the project
   - Circulate audited financial statements regularly
   - Call for a review meeting time to time where the borrowers and the representatives of the participating banks will be present

Parties to a Loan Syndication…cont'd.

4. **Participating Banks/Financial Institutions (FIs):** A group of Banks/FIs committing to some extent for participation in the syndication deal
5. **Joint Arranger/Co-Arranger:** One or more mandated banks who will act jointly to raise the fund from the syndicated market
6. **Numerous other participants may remain present such as Security Trustee, Book Runner, Model Bank, etc.**

Loan Syndication Fees & Charges

- **Loan Processing Fee (Flat):** A lump-sum non-refundable amount to be paid to the Lead Arranger for processing the loan.
- **Arranger's Fee:** Fee to be paid for arranging the fund based on syndicated amount before signing of the agreement to the mandated bank/Lead Arranger or group of banks for arranging a transaction (This fee will not be shared to the participating banks).
- **Agency Fee (Flat):** Fee payable to the Agent Bank for preserving all security documents and for rendering administrative & monitoring activities as Agent over tenure of the loan.
- **Participation Fee:** Fee to be paid on syndicated loan amount to the participating banks based on participation amount.
- **Management Fee (Annual):** Fee on outstanding loan amount at each year end during loan period to be shared by all participating banks.
- **Commitment Fee (Quarterly):** Fee payable on undrawn portion of loan limit.
- **L/C Commission:** L/C opened by the Front Bank (Lead Arranger or L/C opening Bank) and a commission to be realized, of which L/C opening Bank may retain a percentage as skim and the rest is shared on pro-rata basis.

Loan Syndication Process

1. **Pre-Signing Stage:** Includes time period covering following two phases:
   - **Pre-mandate stage.** During this phase, the details of the proposed transaction are discussed and finalized through an indicative <u>Term Sheet</u>. After finalization of Term Sheet, a <u>Letter of Mandate</u> is obtained from the borrower. This time period is rarely shorter than one month and can be as long as one year.
   - **Post-mandate stage.** During this phase, loan syndication takes place and facility agreements are negotiated and finalized. It is concluded by a closing or signing ceremony. This phase may take six to eight weeks.
2. **Post-Signing Stage:** Period covering after execution/ signing of syndication loan and security documents till full and final adjustment of syndicated loan facility.

Pre-Mandate Stage

1. Selection/Identification of customer for syndication
2. Negotiation with the customer about terms and conditions of the proposed structure of the syndication deal.
3. Preparation of a Term Sheet reflecting the outcome of discussion and negotiation between the lead arranger and the borrower. A term sheet is a document, which is not generally intended to be legally binding until it forms part of a formal offer, setting out the main agreed terms and conditions to a transaction between the borrower and arranger.
4. Finalization of Term Sheet for obtaining a Letter of Mandate from the borrower. Mandate is the authority to act in the marketplace on behalf of the borrower according to agreed terms and conditions.

Post-Mandate Stage

1. Preparation the Information memorandum (IM)
2. Launching the syndication deal (arranging a road show)
3. Instruct legal counsel to start drafting documentation
4. Sell the deal
5. Visit to the project site
6. Getting "CIP" (Commitment in Principle)
7. Obtaining Final Approval
8. Negotiate documentation with the borrower
9. Negotiate documentation with the banks
10. Allocate the deal among participants based on fund raising status
11. **Arrange closing ceremony and signing, and <u>Post-Signing Stage Starts</u>!!!**

Information Memorandum

1. IM is a document prepared in connection with a proposed credit facility containing details of the borrower, its business and financial condition, and a description of the proposed transactions.
2. IM may also contain substantial amounts of additional information such as, in case of a project financing, experts' reports on the viability of the relevant project aspects, etc. Typical organization of an IM may follow the following structure:
   - Circulating Page (Cover Page of IM)
   - Disclaimer (Second Page of IM)
   - Executive Summary
   - Management of the Company
   - Market Aspect
   - Technical Aspect
   - Financial Analysis
   - Group Performance
   - Review of the Equipment Supplier
   - Risks and Mitigations
   - CIB Report (Summary)
   - Security Arrangements
   - Representation & Warranties

Classification, Provisioning, Rescheduling & Write-off

- Classification, provisioning, rescheduling and write-off of syndicated loan shall similar to other corporate loans. And, issues related to classification and provisioning like calculation of base for provision, due for recovery, recovery etc. shall also be similar.