Project Finance: Financial Alternatives to Traditional Bank Finance Using Credit Enhancements

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One of the most commonly used vernaculars in today's world of commercial lending is the term Project Finance, which has, unfortunately, become one of the industry's most widely misused terms. More formally, Project Finance can be described as a form of asset-based financing, whereby a source of funds agrees to finance a discrete schedule of assets on a stand alone basis. However, therein lies the problem. Such a generic explanation lends itself to a broad application. For our purposes, it is more useful to drill down our definition of Project Finance, in order to establish a greater understanding of what has become a unique application of financing that seeks to fund the development of a project from its inception to its completion.

On a very simple level, any bank-issued construction or SBA loan might satisfy our very basic definition of Project Finance. However, from an industry perspective, Project Finance more typically describes a project that has levels of complexity that may incorporate issues of credit, risk, leverage and size that are commonly unacceptable for traditional "banking" appetites. Projects such as these will often require "enhancements." Enhancements come in all forms, from the more common, such as a SBA guarantee which helps to lend additional security to a bank's position in a project it may not have otherwise done, to a more complex letter of credit ("LOC") or capitalized interest account that funds the interest-only portion of a project during the construction phase. Debt reserve accounts can be another type of enhancement that sets money aside from the initial loan amount that may provide for payments to the lender, after the completion of the construction phase, but prior to the project's stabilization.

Stabilization is a term often used by underwriters to denote a point in the project when the anticipated cash-flows meet established covenants, such as the debt service to make monthly P & I payments to the lender, meet expenses and provide for a level of profitability. Debt service, or more specifically, a Debt Service Coverage Ratio ("DSCR"), is a number that indicates the strength of a project's cash-flow. A number of 1.00 DSCR would indicate that the total of expenses plus loan payments equals the revenue of a project. A number of 2.00 DSCR would indicate the project's cash-flow has two times the amount of revenue needed to satisfy expenses.

Different project applications have different "benchmarks," or standards, on what is minimally acceptable. A common rule of thumb for many projects is 1.25 DSCR, as a minimum. However, the riskier the application of funds, the higher the rule of thumb. Cash-flows that demonstrate higher DSCRs can often act as a compensating element or mitigating factor for credit issues, the need for maximum leverage or financially weak ownership.

Many underwriters like to use the

"bucket approach" for underwriting Project Finance, viewing each component of the deal as a bucket. As an example, several components, or buckets, of a deal might be credit, borrower strength, experience, leverage, overall risk, loan amount, etc. If one bucket should be "light," another bucket that is "overflowing" might be a suitable offset. Therein lies the "art" of evaluating, structuring and, subsequently, making money on Project Finance.

You, the commercial finance professional, need to assess which deals have merit and which don't, as soon as possible, so not to spend hours, days or months working on transactions that have little hope of getting done – often contrary to the staunch belief of the project's sponsor. Chasing other people's "pipe-dream" is a sure way to exhaust your patience, resources and time.

Over the years, I've personally reviewed hundreds of potential deals where either ownership was not prepared to do what was necessary, or the borrower had not proven the viability of the project. Project viability, or redeeming value, is very much related to our Bucket Theory. A project can

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still be accomplished, albeit "short" or light in a couple of buckets, provided other buckets display enough off-setting strength. As an example, a borrower/developer of mine did not have the financial strength to guarantee a $10,000,000 loan to build a steam generation plant. However, he had secured a 20-year minimum "take-or-pay" contract with a strong credit tenant (buyer), which was a tremendous redeeming factor in the deal. Many larger financial entities carry a financial rating that determines their credit grade (A, BBB+, AAA, etc.). That grade can have substantial impact when attempting to secure financing beyond the borrower/developer's personal financial limit.

A short case study of a project may help. In August of 2001, an engineer with 30 years of power production experience approached us with plans to build, own and operate a steam production plant fueled by waste coal. The power plant was to provide steam for the production of heat, hot water and cooling for a state correctional facility. The contract with the state was for a 20-year guaranteed minimum "take-or-pay" contract. A minimum "take-or-pay" contract means that the buyer (the credit tenant) guarantees that he/she will purchase a minimum amount of steam from the vendor (the client) each year for a minimum of 20 years. This contract was an extremely powerful tool because of the "A" credit rating of the state. That credit rating can be used to secure maximum leverage (with respect to the cash-flow of the project).

However, the engineer had never built a power plant on his own. For the last 30 years, he had worked for many large power concerns and performed insurance consulting work. Therefore, his experience was considerable. As an individual, his financial ability to secure and guarantee $10,000,000 was far short of what typical banks required. He had spent two years with 35 brokers and over $300,000 in application and engagement fees in an attempt to secure the money, but to no avail. The contract with the state was time-bound, and his window to complete the plant was drawing near. His inability to secure funding could have meant financial ruin.

Conventional sources saw as major obstacles his inability to personally guarantee funds and his lack of experience in building a plant on his own. The credit rating of the tenant was certainly a positive aspect of the deal, but many questions loomed;

- Could the developer/engineer build the plant?
- Could he build it on time?
- Could the plant be built to specs so it would work?
- Was there ample fuel available regionally? Were there suitable fuel agreements in place for the long-term?
- Did the engineer have the expertise to operate the plant?
- Was the waste coal technology suitable to operate the plant for that region of the country?
- Could suitable "key-man" insurance policies be established to the satisfaction of the lender?
- Could a construction completion bond be retained to ensure the project's completion?
- Could a payment performance bond be secured to ensure that the lender got repaid?
- How much would the Capitalized Interest and Debt Reserve Accounts have to be?
- Would the extra cost of all the additional insurance, bond policies, capitalized interest and debt reserve accounts be too much for the project to bear?

Since the developer had exhausted his monies paying brokers' up-front fees, the project needed to finance 100% of the build costs, plus all closing and enhancement costs of financing. While this might spell disaster for some projects, a strong cash-flow, a tax-exempt structure (which provided for a low interest rate) due to the recovery of a waste fuel, an ironclad contract with an investment-grade buyer and the union of multiple credit enhancements combined for a successful closing in just 75 days!

Many projects never see the light of day because the developer or banker can't structure the deal properly. It's important to know all the tools that are available to support the weak spots in deals. It's always a lot easier to get your price on a transaction when you are able to structure a deal that nobody else can do.

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