



PROJECT FINANCE

Understanding
the lesser-known
element of
private funding
for infrastructure.

By Dale Richmond

The term “public-private partnership” (P3), is becoming more and more well-known and understood in Canada. It often goes hand in hand with “project finance,” a term that’s not as well understood.

Two of the more common and comprehensive types of P3s in Canada are design-build-finance-operate (DBFO) and design-build-finance-maintain (DBFM), where the developer, a private-sector partner, finances a project for the government and is then paid back over time for the satisfactory performance of the infrastructure or service. Project finance describes the way the private sector raises money to finance these projects. A basic understanding of project finance can help everyone understand why and how private-sector partners, the developers, organize to deliver public-purpose infrastructure through P3s.

Traditionally, governments have funded infrastructure projects by paying for their procurement upfront, using current revenues or by issuing debt. With P3s, the government typically pays for the availability of the infrastructure over a long period of time,

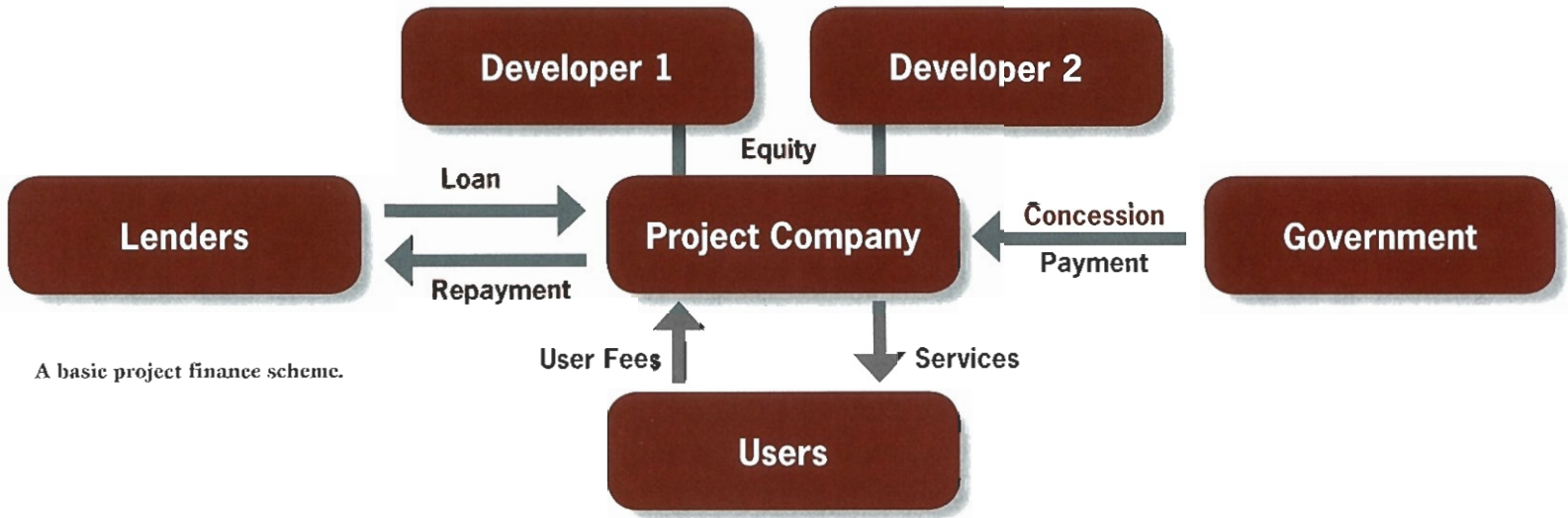
spreading out its costs to help with cash management and to match its payment to the use of the infrastructure.

So while P3s are similar to debt in that no current revenue is spent upfront and repayment is over a long period, they are quite different in that the government itself does not issue any debt. Instead the developers arrange all the financing necessary to design, build and operate the project.

For any given project, a private-sector partner has the option of using corporate finance or project finance to raise funds. With corporate finance, a company raises equity or debt based on its own collateral and capacity to do so. This may be suitable for smaller and shorter-duration projects that won’t strain the company’s balance sheet or limit its capacity to undertake other and future projects. But most public-purpose infrastructure projects are too large for this, so the private sector partners turn to project finance.

The key distinguishing feature of project finance is that funds are raised based on the cash flow that is generated by the project once it is constructed and in service, and not on the collateral or creditworthiness of the developer(s). For example, consider a highway P3 with a concession period of 25 years. The government has agreed to pay the developers a fee each year for the availability of the highway, or perhaps it is a toll highway and the developer will collect tolls. This long-term cash flow to the developers is the asset against which it can borrow the money necessary to build the highway upfront.

Generally, the developers of a project create a special purpose, bankruptcy-remote, legally-independent company in which they are



A basic project finance scheme.

the principal shareholders. The newly-created project company usually has the minimum equity required to issue debt at a reasonable cost, with equity generally averaging between 10 and 30 per cent of the total capital required for the project. Individual developers often hold a sufficiently small share of the new company's equity to ensure that it can't be construed as a subsidiary for legal and accounting purposes. The project company is the company with which the government executes the P3 agreement and to which it pays the concession fees. In turn the project company pays principal, interest, dividends and operating expenses from the fees.

Capital markets are very interested in providing financing to P3-based infrastructure projects.

The bankruptcy-remote nature of the project company means it is sufficiently legally separate from its owners, the developers, that bankruptcy of the developers can't cause the bankruptcy of the project company. This protects the government and the lenders, isolating the infrastructure from the long-term corporate success or failure of the developers. This is not to say that failure of a developer could not be problematic, but it does ensure that the infrastructure is protected so that the lenders can step in and operate it if necessary. The rights of the lenders to protect their investment in this way are set out in a "lenders-direct agreement" between the government and the lenders.

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The final legal structure of each independent project is different. The chart on page 35 lays out a simple project finance scheme. It shows that the project company may have more than one developer, generally for one of the following reasons:

- the project exceeds the financial or technical capabilities of one developer;
- the risks associated with the project have to be shared;
- a larger project achieves economies of scale that several smaller projects will not achieve;
- the developers complement each other in terms of capability;
- the process requires or encourages a joint venture with certain interests, for instance, local participation or empowerment; and/or
- the legal and accounting rules stipulate a maximum equity position by a developer, above which the project company will be considered a subsidiary.

In large projects, different legal vehicles may be established to perform specific functions like construction, maintenance and actual ownership. The structure is often dictated by tax and other legal conditions, as well as by the credit implications for each participant. It's also very common for a developer to be more than simply the financial owner of the project company, but to provide one or more key services to the project company. For example, design, construction, or some aspect of operations.

Project companies will seek out financing from a wide range of sources to secure debt and equity at the lowest cost. Capital markets are very interested in providing financing to P3-based infrastructure projects, which often achieve high credit ratings because of the expertise of the developers and the stability of Canadian governments. As a result, Canadian public-purpose infrastructure is now being financed by a wide range of banks, financial institutions, equity funds, and pension funds. 🌱



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