

Hello and welcome project finance course.

In this lesson we will be talking about what project finance is.

Suppose that an investor has an idea such as building a power plant, or airport or a highway.

These projects are called infrastructure projects.

And infrastructure projects are expensive to build, they are capital intensive projects that require a lot of money. It is rare that a single company can finance such large projects.

The solution is project finance.

Project finance is basically raising necessary capital to finance such capital intensive infrastructure projects.

The feature of project finance is – it is a long term debt financing of a specific project

This project's assets and cash flows are isolated.

The project is incorporated as is a Special Purpose Vehicle.

The project has to generate sufficient cash flows to cover debt repayments and dividends after covering operating expenses and capital expenditures.

The project has a finite life.

A Special Purpose Vehicle - is a legal entity (usually a limited liability company of some type) created to fulfill narrow, specific or temporary objectives.

So, what are the steps involved in project finance.

First – investor also called a project sponsor set's up a special purpose vehicle with a sole purpose of designing, building and managing a specific project.

Then, the project sponsors develop the project - they carry out necessary technical and economic studies, they obtain necessary permits from the authorities, they acquire the land where the project will be built, and then they conclude the necessary contracts such as offtake agreements and construction contracts. When all the studies, permits and contracts have been concluded the project reaches a financing stage.

At financing stage project sponsors negotiate with lenders on the debt financing for that specific project.

When project sponsors and lenders reach the agreement, they inject the equity and debt financing into spv to finance the construction costs of the project.

Typically, the construction costs are financed with 70% debt and 30% equity, so project finance is highly leveraged transaction.

As we pointed out, the assets and cash flows of the project are isolated and therefore lenders rely on project's cash flows only.

In case something goes wrong and project cash flows shrink resulting in spv not being able to service the debt.

The lenders cannot go after the project sponsors other assets.

Therefore, project finance is called a non-recourse financing. Lender's has no recourse to project sponsors other assets.

So how is this different from corporate finance?

In corporate finance investors and lenders inject capital into a holding company which then initiates multiple different projects.

These different projects serve as a collateral for the debt. In case there is problem with debt repayment or interest payments, the lenders can go after all the assets of the holding company and recover the debt through sale of those assets that the holding company owns.

To remind ourselves, in project finance, the project sponsor can have multiple SPVs with a specific project in each SPV, and when there is a problem with the specific project, the lenders cannot go after project sponsor's other assets. They must rely on the assets and cash flows from that specific SPV.

To summarize - the Project finance - is financing of a long-term infrastructure project using a non-recourse financial structure, which relies only on the project's cash flows for debt repayment, with the project's assets held as a collateral.