



Everyone's Smart
University

Project Financial Management

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Lecture 10

PMG 615

Financial Structuring and Documentation (part two)

Objectives of this lecture

This lecture examines some of the **main financial structuring issues** likely to arise once the commercial fundamentals and risks of the project, and the cash flow that results from these, have been reviewed as set out in previous chapters.

- The main elements in the financing negotiations between the Project Company and its lenders are likely to include:

- The debt: equity ratio (lecture 8)
- The drawdown schedule for debt and equity (lecture 9)
- The interest rate and fees to be charged by lenders (lecture 9)
- Lenders' control of the Project Company's cash flow (lecture 9)
- Provisions for prepayment (lecture 9)
- Conditions precedent to Financial Close and drawings on the debt (lecture 10)
- Covenants (lecture 10)
- Events of default (lecture 10)
- Voting and enforcement on default (lecture 10)

FINANCIAL CLOSE— CONDITIONS PRECEDENT

Signature of the financing documentation alone does not mean that the lenders will start advancing funds to the Project Company. In order to draw down any debt at all, the project must first reach Financial Close. This is the date at which all Project Contracts and financing documentation have been signed, and the conditions precedent to the effectiveness of the lenders' commitments have been satisfied or waived. The conditions precedent are effectively a checklist of documents the lenders require as the basis for their financing; when these are provided the lenders are obliged to advance funds. (This does not mean that lenders have no obligations before that date; for example, if the financing documentation requires the lenders to keep information about the project confidential, this is effective on signing.)

The list of conditions precedent documentation for a project finance can be of immense length, often running into several hundred documents and certificates. Typical requirements by lenders (all of which must be satisfactory to them in form and content) include:

FINANCIAL CLOSE— CONDITIONS PRECEDENT

Typical requirements by lenders (all of which must be satisfactory to them in form and content) include:

Corporate documentation

- Corporate documentation, board resolutions, etc., for the Project Company
- Signed copies of the Shareholder Agreement(s) relating to the Project Company

Project documentation

- Evidence of title to (or right to use) the project site
- Signed copies of all the Project Contracts and evidence that all their conditions precedent have been fulfilled and that they are in full force and effect
- Contract guarantees, bonds, or other security
- Permits for the financing, construction, and operation of the project

FINANCIAL CLOSE— CONDITIONS PRECEDENT

Financing documentation

Signature of all financing documentation which includes:

- Bank loan agreement, agency agreement
- Bond terms and conditions

Financial due diligence

- Evidence that all investor funding (equity or subordinated debt) has been paid or committed
- Evidence that any other parallel financing arrangements are in place and effective
- Evidence that interest swap or other hedging arrangements are in place
- Evidence that the Reserve Accounts and other banking arrangements are in place
- Evidence that the required insurance is in place
- Up-to-date financial statements for relevant parties

FINANCIAL CLOSE— CONDITIONS PRECEDENT

Financial due diligence (continued)

- Final reports from the Lenders' Engineer, insurance advisers, and any other advisers
- The financial model
- Model Auditor's report (including report on tax aspects of the project)
- Final construction and funding budget and drawdown schedule
- Base Case projections

FINANCIAL CLOSE— CONDITIONS PRECEDENT

Lenders may also require that no **material adverse change (MAC)** to the project should have occurred after the financial documentation was signed, as a condition precedent both to Financial Close and subsequent drawings of the debt (this is known as a MAC clause). The problem with this kind of vague general provision is the Project Company may be left vulnerable to an arbitrary decision by the lenders to stop funding the project. Careful legal drafting is needed to ensure that if a MAC clause is inserted it is reasonably objective and limited in nature.

COVENANTS

Covenants are undertakings by the Project Company either to take certain actions (“positive” or “affirmative” covenants), or not to do certain things (“negative” or “protective” covenants). These undertakings by the Project Company are a characteristic of project finance, being more comprehensive and detailed than usually found in other types of financing. (These controls are typically less stringent for a bond issue). It is through the covenants that the lenders exercise their continuing control over the construction and operation of the project, but they may need to take care that this control does not also make them liable for Project Company obligations to third parties; for example, in the United Kingdom, if lenders are deemed to have acted as “shadow directors” of an insolvent company, this could create liability for them towards other creditors.

COVENANTS

- **The main purposes of the covenants are:**
 - To ensure that the project is constructed and operated as agreed with the lenders
 - To give lenders advance warning of any problems that might affect the Project Company
 - To protect the lenders' security

POSITIVE COVENANTS: such as

- Construct, operate and maintain the project in accordance with the Project Contracts, applicable law, and good industry practice
- Provide the agent or security trustee and lenders' advisers with reasonable access to the project and its records
- Maintain the management structure agreed with the lenders
- Obtain and maintain the agreed project insurances
- Supply reports (usually monthly) on the progress of construction, including achievement of milestone dates.
- Provide annual budgets in advance of each operating year

COVENANTS

NEGATIVE COVENANTS: such as

- Undertake any business other than the project
- Merge or consolidate with any other entity
- Agree to any amendment, waiver, or change order in the Project Contracts, or any changes in the project itself (some scope may be given for *de minimis* amendments and waivers)
- Enter into any contracts (other than the agreed Project Contracts), subject to a *de minimis* exception
- Incur any additional debt or issue guarantees for third parties
- Enter into any hedging contracts other than the agreed hedging of interest rate or exchange rate risks
- Incur any capital expenditure not agreed to by the lenders (even if it is funded by equity— this is to ensure the specifications of the project are not changed without lender consent)
- Incur operating costs not provided for in the agreed annual budget (usually subject to an agreed tolerance level).
- Sell, lease, or otherwise transfer any of its assets (subject to a *de minimis* exception)
- Change its financial year end or auditors

EVENTS OF DEFAULT

Project finance lenders do not want to have wait to take action until the Project Company has run out of funds to service the debt; they therefore create a defined set of “triggers” that gives them the right to take action against the Project Company. These are “events of default”— once an event of default has occurred, the Project Company is no longer able to manage the project without lender involvement. Some of these events (such as failure to pay, insolvency, etc.) would apply to any corporate financing, but others (such as failure to complete the project) are peculiar to project finance.

Typical events of default are:

- The Project Company fails to make any payment under the financing documentation on its due date
- Any warranty made by the Project Company (or any other party such as a Sponsor) proves to have been incorrect or misleading

EVENTS OF DEFAULT

Typical events of default are (CONTINIUED):

- The Project Company does not fulfill any of its covenants or undertakings under the finance documentation
- The Sponsors fail to fulfill any of their obligations or undertakings to the lenders or the Project Company
- There is any change in the ownership or control of the Project Company prior to an agreed date
- Insufficient funding remains to complete construction of the project
- Any Permit or license is revoked

EVENTS OF DEFAULT

Typical events of default are (CONTINIUED):

- The project is abandoned (for more than a specified period of time) or becomes a total loss
- The latest ADSCR falls below a certain level; thus, the initial Base Case average ADSCR might be 1.35 : 1, the dividend stop level
- 1.2 : 1, and this “default ratio” level 1.1: 1; as with dividend stops, there is the issue of whether forward-looking ratios should be used in this context
- The Host Government expropriates the project (including creeping expropriation), declares a moratorium on its foreign currency debt, or restricts the conversion or transfer of foreign currency (if the Project Company has borrowed in foreign currency)

WAIVERS, AMENDMENTS, AND ENFORCEMENT ON DEFAULT

Various courses of action are open to the lenders after an event of default, partly depending on what stage the project has reached:

- To waive (i.e., ignore) the event of default
- If the project is still under construction, to freeze any further drawings of funds—known as a “drawstop”
- If the project is operating, to require that all net cash flow be applied to reduction of debt or held in a separate reserve or escrow account under the lenders’ control
- To enforce the lenders’ security

Once the event of default has occurred it is entirely within the lenders’ discretion which of these actions they choose to take. The Project Company may also ask the lenders to waive or amend a particular term of the financing documentation so it does not fall into default in the first place.

WAIVERS, AMENDMENTS, AND ENFORCEMENT ON DEFAULT

If there is a syndicate of banks or a group of bond holders providing the loan, there has to be a decision-making process, or one rogue lender could pull the house down by taking individual action against the Project Company while the rest are trying to find a solution. (Indeed, it is not unknown for a small lender to blackmail the larger ones by threatening to do this, so that the larger lenders will buy out the smaller lender's loan.) The agent bank or security trustee also needs to have clear instructions from the lenders as a whole on what action is to be taken on their behalf. **Voting mechanisms** therefore have to be agreed to in advance between lenders; the Project Company also has an interest in these arrangements, to try to ensure that one or two “hostile” lenders cannot dictate the action taken, against the wishes of the majority.

WAIVERS, AMENDMENTS, AND ENFORCEMENT ON DEFAULT

Voting arrangements need to cover:

- A decision to waive an event of default, so that no further action need be taken on the matter
- An advance waiver (i.e., permission to the Project Company to take an action that would otherwise be a default; e.g., to issue a change order to the Contractor, sell an asset above the *de minimis* level set out in the covenants, or amend some aspect of the Project Contracts)
- Amendments to the financing documentation, both to correct errors and to change the provisions to avoid future defaults or allow the Project Company to make some change in the project
- Instructions to the agent bank or security trustee (e.g., to enforce security after an event of default)

WAIVERS, AMENDMENTS, AND ENFORCEMENT ON DEFAULT

Typical voting arrangements on such issues could be:

Waivers and permissions. These usually require a “normal” majority, usually $66\frac{2}{3}$ –75% of the lenders (by value of their participation in the finance), except for “fundamental” defaults such as nonpayment (and possibly fundamental changes to Project Contracts), for which 100% majority would be needed. (Individual banks may, however, retain the right to withhold further drawdowns if the Project Company is in default in the construction period, i.e., without a syndicate vote.) Amendments to financing documents. Amendments that amend the lenders’ security, repayment dates, repayment amounts, or interest rate require 100% consent; other amendments may be made with a $66\frac{2}{3}$ –75% vote.

Amendments to financing documents. Amendments that amend the lenders’ security, repayment dates, repayment amounts, or interest rate require 100% consent; other amendments may be made with a $66\frac{2}{3}$ –75% vote.

Typical voting arrangements on such issues could be (CONTINUED):

Enforcement. If the required majority is not achieved for a waiver, the agent bank or security trustee issues a notice of default: the next stage is enforcement action against the project security; there can be a sliding scale of voting for this: 75% of the lenders must vote for enforcement within, say, 90 days of the notice of default, 66²/₃% for the next 90 days, and 51% thereafter; however, some lenders may insist on the right to take individual enforcement action if the agent bank or security trustee does not do so once a notice of default has been issued, especially if the default is caused by nonpayment.

The main practical problem with any voting arrangement is that usually a bank lending as a relatively small participant in a syndicate does not want to be bothered with voting on small issues: for most banks, this means the loan officer having to prepare and explain a paper on the issue to the bank's credit department, and for a minor or technical waiver this is not a very productive use of the loan officer's time. Therefore, actually getting banks to vote at all is difficult. As a result, if the hurdles for voting majorities on day-to-day amendments and waivers are set too high, the Project Company's business can be paralyzed.

One solution to this problem of inertia in voting is the “silence equals consent” route; if, for example, a 75% majority is required, this can be achieved by getting a 75% majority of those lenders who actually vote by a defined deadline, not of all lenders. This approach is not just beneficial to the Project Company, since paralyzing the Project Company’s business through voting inertia is seldom in the interests of the lenders as a whole. The issue becomes even more acute where there are a large number of bond investors involved, who are likely to be less concerned about such issues than banks. In such cases some decisions may be delegated to the agent for the commercial banks, if any, or a special agent for the bond holders.

INTERCREDITOR ISSUES

If the Project Company has one syndicate of lenders, they can act as a single block through the voting arrangements described above. But it is quite common to have more than one group of lenders, for example, a bank syndicate and bond investors, an ECA-backed loan and a bank syndicate lending without ECA cover, domestic banks and foreign banks.

An Export Credit Agency (ECA): An export credit agency offers trade **finance** and other services to facilitate domestic companies' international exports. Most countries have ECAs that provide loans, loan guarantees and insurance to help eliminate the uncertainty of exporting to other countries.

INTERCREDITOR ISSUES

Each of these groups will have their own loan agreement with the Project Company, but the lending groups also need to establish machinery for working together, or the Project Company will soon find itself like a bone between two dogs, with the project in pieces after being pulled in different directions by different lenders. Although the Project Company may not be a direct party to these intercreditor arrangements, it has a strong interest in ensuring that they are practical and workable.

As a minimum, the intercreditor arrangements need to establish:

- Common arrangements for Financial Close (usually Financial Close cannot be reached in one loan if it is not also simultaneously reached in the other)
- *Pro rata* sharing of security.
- Common voting arrangements for waivers, amendments, and enforcement action: voting in such cases is normally by lending group; each group of lenders decides on its own voting rules, and then the decision of each group becomes one block of votes (*pro rata* to that group's exposure) in the intercreditor voting, although it should be noted that commercial banks are reluctant to get into a position where their ability to take action can be blocked by public-sector lenders or others who may not be motivated by purely commercial factors.

INTERCREDITOR ISSUES

It is preferable for the intercreditor arrangements to extend well beyond this, through the signature of a **much wider-ranging Common Terms Agreement** (the agreement has a variety of other names, such as Project Co-ordination Agreement or Co-financing Agreement). Under this arrangement, the individual loan agreements cover little more than the amount of the loan, and perhaps the interest rate.

All the other provisions are set out in the Common Terms Agreement, e.g.:

- A common repayment schedule
- Conditions precedent to Financial Close and drawings
- Agreement on priority of drawings on each loan and adjustments between lenders at the end of construction, or if there is a default, to keep the loans on an agreed *pro rata* basis
- Representations and warranties
- Covenants

INTERCREDITOR ISSUES

All the other provisions are set out in the Common Terms Agreement, e.g.:

- The cash flow cascade and Reserve Accounts
- Events of default
- Appointment of an intercreditor agent as a central conduit for payments and voting
- Voting and enforcement procedures
- Security documentation

If these issues are not covered in a common agreement, the Sponsors will have difficulty negotiating exactly parallel terms in separate financing agreements, and if exactly parallel terms are not negotiated, the Project Company is likely to have great difficulty keeping the different groups of lenders from moving in different directions, to the detriment of both lenders and investors.

INTERCREDITOR ISSUES

Further intercreditor issues arise if groups of lenders are not on a similar footing:

- Fixed-rate lenders
- Lenders with different security
- Lessors
- Subordinated or mezzanine lenders

FIXED-RATE LENDERS

Fixed-rate lenders are in a similar position to interest swap providers when a default takes place: they may also have a breakage cost. This does not normally give them any extra voting rights, but is taken into account in determining their *pro rata* share of any enforcement proceeds.

A problem may arise, however, if the fixed-rate lender charges a very large penalty for terminating the loan; for example, the amount due on early repayment may include not just the principal and interest amounts outstanding and breakage costs, but also the discounted NPV of the future profits for investors.

Floating rate lenders usually do not claim future loss of profit in this way. This may lead to a large discrepancy in the relative size of the claim that the different groups of lenders have on a default. (Similar problems may arise where one group of lenders is lending on an inflation-indexed basis.)

LENDERS WITH DIFFERENT SECURITY

If one lender group has, for example, a Sponsor guarantee that another group has not, then it is evident that the former cannot be inhibited by the latter from enforcing their security after a Project Company default, and *vice versa*.

LESSORS

If the Project Company finances part of the project costs through leasing, the equipment financed is legally owned by the lessor (leasing company), who are likely to be reluctant to share the value of this security *pari passu* with other lenders. But any other lenders will not wish the lessor to deal separately with key components of the project. Therefore, an agreement will be needed both to coordinate on foreclosure and probably to share the benefits of a sale.

INTERCREDITOR ISSUES

SUBORDINATED OR MEZZANINE LENDERS

Subordinated debt provided by the investors in lieu of equity cannot be used to give them any extra rights either before or after a default. The lenders will require them to agree that they have no security rights and cannot take any enforcement action to recover this debt, or otherwise obstruct the senior lenders, until all the senior lenders' debt has been fully repaid.

Mezzanine debt may be provided by third parties unconnected with the Sponsors or other investors, usually secured by a second mortgage or junior position on the senior lenders' security. Such mezzanine lenders are placed in the cash flow cascade above distributions to investors, and so are repaid if sufficient cash flow is available after prior payments have been made. They accept that if the financing package as a whole is in default, and enforcement action is taken, they will only be repaid if the senior lenders are fully repaid.

SUBORDINATED OR MEZZANINE LENDERS (continued)

But there are a number of potentially difficult issues with mezzanine lenders. In general, these issues revolve around the concern that senior lenders have of “Samson in the temple” behavior by mezzanine lenders; if the project goes wrong and there is only enough money to repay the senior lenders, as the mezzanine lenders have nothing to lose they can threaten to pull the whole project to pieces unless the senior lenders share some of the value that their loans still have.

Senior lenders therefore restrict the rights of mezzanine lenders in a number of ways to try to avoid this happening:

- **Timing of drawings.** Senior lenders may wish mezzanine loans to be drawn first by the Project Company, in a similar way to equity funding; mezzanine lenders may only be willing to fund *pro rata* with senior lenders.

SUBORDINATED OR MEZZANINE LENDERS (continued)

Amendment to Project Contracts. Any amendments to the Project Contracts require senior lenders' consent; they normally require freedom to allow such amendments without interference by mezzanine lenders.

Blocking of payments. The place of the payments to mezzanine lenders in the cash flow cascade may raise issues: do the senior lenders' DSRA, or the Maintenance Reserve Account, have to be filled up before mezzanine lenders can be paid; can payments to mezzanine lenders be blocked in a similar way to payments to investors (e.g., if cover ratios fall below certain levels)?

SUBORDINATED OR MEZZANINE LENDERS (continued)

Default. Mezzanine lenders want to have the right to take enforcement action if they are not paid when due. It is difficult for senior lenders to exclude the mezzanine lenders completely from taking action; a common compromise is to require the mezzanine lenders to wait, say, six months after a payment default before they can take action (and of course such action will trigger action by the senior lenders, so ensuring that any enforcement proceeds still accrue to them first).

Reference:

Principles of Project Finance

By:E.R. Yescombe

First edition

This lecture taken from chapter 13