


THE MULTIPLICITY FACTOR

Cynthia Urda Kassis and **Ben Shorten**, *Shearman & Sterling LLP*

More than five years after the Lehman Brothers crisis, and despite gradual improvement, bank liquidity within the project finance market remains constrained. As a result, since the Lehman Brothers' collapse in September 2008, sponsors and lenders have developed various techniques to bridge the liquidity gap. Broadly speaking, the result has almost inevitably led projects to use multi-source financing plans, in which funding is provided from different types of lenders often using different types of financial instruments. As a consequence, project financings have become more complex. This added complexity results in a number of challenges to executing transactions; in this article, we examine some of these challenges and the techniques that can be used to address them.

THE NEW NORMAL

Since 2008, efforts to bridge the project finance funding gap have been concentrated on, firstly, identifying new sources of liquidity, and secondly, unlocking such sources by developing new financial instruments, which will entice these as well as traditional sources to enter or increase their participation in this sector. The focus on unlocking as much liquidity as possible results from the fact that funding from commercial banks, traditionally the largest source of project financing, remains dramatically contracted, with many pre-Lehman banks either severely reducing their lending or exiting the market. Thus, whereas prior to 2008 the trend had been for ever-increasing amounts of project debt to be raised solely in the commercial bank market under vanilla lending structures, often fully underwritten by one or a small number of banks, today most large project funding plans use multi-source structures.

Multiple providers

The mega-fully underwritten commercial bank syndicates of yesteryear have been replaced by financings, which combine multiple lending sources, often with different objectives and therefore very different approaches to analysing, conducting due diligence, structuring and negotiating financing.

The potential mix of lending sources include:

- multilateral or regional institutions such as the International Finance Corporation, the Asian Development Bank, the African Development Bank, the European Investment Bank, the Inter-American Development Bank and the Islamic Development Bank;
- export credit agencies (ECAs) such as the Export-Import Bank of the United States, the Japan Bank for International Cooperation and Export Development Canada, along with a host of European ECAs;
- domestic development institutions such as the Brazilian Development Bank (BNDES), a behemoth of Latin America;
- international, regional and local banks and Islamic financial institutions; and
- the international or local capital markets.

In certain jurisdictions/sectors, pension funds and insurance companies are active project lenders. Private equity as well as hedge and sovereign wealth funds are also now active participants in the project finance debt market. Finally, there has been a resurgence of funding from industry sources such as equipment manufacturers, commodity purchasers and construction contractors.

This is not to say that projects are no longer financed solely by commercial bank syndicates. This does still happen where circumstances permit – for example, high liquidity in the relevant market (such as the Saudi Arabian bank market or in certain Latin American countries), or where the size of the project debt is small enough to be funded from bank liquidity. However, it happens in much more limited circumstances than was the case before 2008.

Innovating with instruments

Along with the entrance of a number of new sources of financing, the resurgence of vendor finance and general efforts to increase participation in the market by all potential sources of funding, we have also seen the development of new financing instruments. In some cases, these instruments have evolved to better address the financial objectives of the new sources, thus enabling their entrance into the market. In other cases, the new instruments reflect the sources developing new techniques to address the needs of sponsors arising from constrained overall market conditions, not only for debt but also equity.

One of the more popular new instruments is streaming/royalty financing, which has developed to address the persistent liquidity gap for funding both equity and debt in the mining sector. One of the major attractions of this type of financing (which is akin to a prepaid (or partially prepaid) forward) is its hybrid nature which results in it providing certain benefits of equity financing without some of the downsides (such as dilution). There are also the debt/equity hybrid instruments favoured by many private equity and hedge funds, which often take the form of mezzanine debt or preferred/quasi-preferred equity.

Another instrument currently in vogue (though not new) is the project bond. Very popular in the late 1980s/

early 1990s, there has been a resurgence of project bonds, in particular for renewable projects and projects in Latin America and the EMEA region. In addition, other instruments in the capital markets are being retooled for use to fund projects including high yield bonds and – in the US – various municipal bond structures.

Finally, with the increased role of domestic governmental institutions in many countries focused on encouraging the development or refurbishment of basic infrastructure, we are seeing a variety of direct lending instruments and credit support facilities from these institutions designed to mobilise funding from other sources. These instruments have a wide range of structures, including tax credit structures and long-term, semi-subordinated debt arrangements (such as under the US Department of Transportation's TIFIA programme).

NAVIGATING THE NEW LANDSCAPE

Faced with a terrain that is more complex than prior to the financial crisis, what are some of the key challenges presented in executing a financing plan today? How can parties seek to manage these challenges and avoid the pitfalls?

The key challenges arise from the diversity of the current financing plans. The different objectives of the sources lead naturally to different approaches to due diligence, the credit analysis and approval process, and the desired terms. The different objectives also potentially lead to concerns across different lenders regarding the administration of the financing in the ordinary course and in the context of restructuring. Below, we have set out a few tactical and strategic actions that may help in efficiently executing multi-sourced financing.

Managing the process

Increasing the number of funding sources (by including multiple tranches of lenders and/or multiple types of financing instruments) typically complicates the negotiation of the financing phase of a project. However, the challenge comes not just from managing a larger or more diverse group of lenders, but from the specific requirements that each brings to the process. For example, as public institutions, ECAs and multilaterals often have prescribed board and stakeholder approval processes that include infrequent meetings and long pre-meeting notice periods once the documentation is agreed. Debt capital market issuances typically involve set procedures required by relevant rating and listing agencies, as well as satisfaction of applicable statutory requirements. Islamic financing structures are subject to approval of the shariah committees of each of the participating financial institutions. "New" lender classes such as pension funds and private equity may not be familiar with project finance principles and need a high degree of discussion through the process.

To address the management issue, sponsors and financial advisers must be highly forensic and proactive in planning the financing process, so that the various issues are considered in accordance with the relevant timeline (working backwards from the target financial close date).

The increased number of participant groups and the issues that this brings often means that the process benefits from a higher number of face-to-face meetings to achieve timely financial closing, though finding a mutually agreeable time to meet can be a challenge if not planned well in advance. Such meetings should be incorporated into the timeline.

Seeking alignment

With more diversity in the lender groups and types of instruments involved, it is important that one seeks, to the fullest extent possible, to use lenders with a common approach who have previously worked together. Using lending sources and structures that have been previously combined, and thus have previously negotiated common covenant packages and intercreditor arrangements, can avoid the extended negotiation process which comes from being a pioneer in structuring such arrangements. It can also prove beneficial in avoiding the "lowest common denominator" effect of multi-source negotiations. And it increases the likelihood of a successful closing as there is precedent for success.

Regarding the "lowest common denominator" effect, though it may be possible to negotiate an arrangement under which certain lenders receive different treatment from others, this outcome is not guaranteed outside certain historically agreed market practices such as in bank/bond financings, where bondholders have a much lighter covenant and event of default package than the ECA and commercial lender tranches.

By combining sources and structures with care, sponsors can consider the benefits thereof and avoid inadvertently losing such benefits due to inconsistent requirements of other sources/structures within the financing plan.

For example, if a covenant-lite arrangement is the goal, combining project bonds with ECA or multilateral financing might not be appropriate, whereas a project bond/Term B financing may be more effective. Alternatively, if maximum refinancing flexibility is sought, combining structures which require pro rata repayment in all circumstances or have high prepayment premium would not be optimal.

Pushing the envelope?

Given the process issues in multi-source financing, sponsors need to be mindful of the parameters in which they are operating. The general rule of thumb is: the more liquidity that is needed, the less room sponsors have to be aggressive. In other words, where relatively large quantities of debt are needed, the terms and conditions tend to be more conservative (especially where one or more MLAs or ECAs are anchor lenders). Therefore, any bankability analysis needs to take into account the likely requirements of the participating institutions and any sponsor-proposed term sheet should be crafted with this constraint in mind. In addition, alternative sources such as royalty/streaming or private equity arrangements, which tend to be entered into in advance of other elements of the financing plan, need to have terms that anticipate the needs of the balance of the lending group.

The pricing/tenor balance

With multiple classes of lenders and financing instruments, it is critical for sponsors to avoid the "lowest common denominator" effect, particularly on financial terms (ie, funding costs/average life/maturity at the level of the worst offer). Many lenders, though not all, will accept pricing differentials between different lending sources. In fact, multiple debt sourcing can be useful in creating pricing tension amongst different lender groups. There remains a risk of cross-pollution, however, so sponsors need to be mindful of managing lenders' expectations. Differentials in average life and maturity of debt can be more difficult to achieve, especially outside the bond context. In crafting the financing plan, knowledge of the internal lender policies on acceptable mismatches in this regard is very important.

Made-to-measure intercreditor

Multiple lender groups and financial instruments mean more complex intercreditor arrangements, as the various interests and objectives often compete. While certain decisions can be made based on customary pool majority-voting principles, others may need to be on the basis of tranche voting or individual lender sign off. For example, ECAs often require veto/control rights regarding policy matters irrespective of the size of their participation.

There are a number of customary considerations to be addressed in any intercreditor structure, such as consent/waiver voting, control over enforcement in a default scenario and consultation arrangements. However, it is important to recognise that many intercreditor arrangements are highly bespoke, based on, among other things, the specific composition of the lender group and the exposure of each group. Thus, precedent is more relevant for process considerations and evidence a particular group's ability to agree an arrangement, rather than the ability to replicate exact structures.

DRAWING CONCLUSIONS

The multiplicity of funding sources and financial instruments is expected to continue for the foreseeable future. It is therefore critical to achieving successful financing that the complexities and challenges arising from such multiplicity be recognised and pro-actively managed. This will often require a combination of multilateral and bilateral negotiations, finely balanced to manage the expectations of all. Finally, it needs to be recognised by both sponsors and lenders that highly bespoke financing plans mean that a one-size-fits-all approach based on precedent cannot be followed; flexibility and creativity will need to be employed.