The Commercial Law Development Program
Presents
Public-Private Partnership Webinar Series

Project made possible through funding by:

Financing and Finance Documents

Today's presenters

Alex Evans
Associate General Counsel
Development Finance Corporation
(DFC)

Justin Pavry
Deputy Chief Legal Officer
Debt & Project Finance
CDC Group Plc.

Ryan Ketchum
Partner
Hunton Andrews Kurth LLP

Topics

1. **Types of capital**
2. Project finance
3. Equity contracts
4. Debt contracts

Financing Structures: Overview

How to Finance Capital Intensive Projects

- **Equity: Pay for it yourself.**
  - Offers a sponsor (*i.e.,* developer) the most freedom, but is generally considered very expensive.
- **Debt: Borrow the money.**
  - Offers less flexibility but is less expensive in the long run.
- **Most Parties use a combination of these options.**
  - Some parties will minimize the amount of debt and increase their equity contribution, or recourse to shareholders' equity (*i.e.*, shareholder guaranties) in order to maximize flexibility.
  - Others prefer the price of using leverage and seek to limit equity contributions, and recourse to shareholders' equity, in order to maximize their long-term returns. Debt is considered a less expensive option because the costs associated with debt are generally thought to be less than the return on equity a party can earn if their equity funds are deployed elsewhere.

Capital structures generally – equity vs. debt considerations

Debt Capital	Equity Capital	Hybrid Capital
Lenders are paid first if the company becomes insolvent	**Equity is permanent, loss absorbing capital**	**Hybrid capital has debt-like and equity-like features**
Short term debt (matures in less than 1 yr.) • Notes payable • Commercial paper • Lines of credit • Current portions of long-term debt **Long term debt (matures in one year or more)** • Loans • Bonds • Notes • Capital leases	**Common stock** • Has voting rights • Paid dividends at discretion of company • No default rights • Most junior interest in the company **Preferred stock** • May be permanent capital or have a term • Pays dividends at specified rates • Has preference over common stock in liquidation • Voting rights not required, but often granted • May contain events of default **Options, warrants** • A right to buy shares at an agreed 'strike price'	**Convertible debt** • Can be converted in shares of common stock at an agreed conversion rate under agreed conditions **Convertible preferred stock** • Can be converted in shares of common stock at an agreed conversion rate under agreed conditions **Shareholder loans** • Loans to a company made by its shareholders • Deeply subordinated (by agreement betw. lending shareholder and senior lenders) • Payments subject to financial covenants • Usually structured as revolving line of credit • Primarily used to increase deductions for interest payments, avoid cash traps

Capital structures – equity vs. debt considerations

The optimum capital structure balances risks and returns to attract capital and maximize shareholder value

	Debt	Equity
Advantages	• Interest expenses are tax deductible • Less expensive source of capital than equity • No dilution of ownership	• Source of permanent capital • No adverse impact on financial flexibility • No increase to company's leverage
Disadvantages	• Decreases financial flexibility • Cash flows committed to debt service • Risk of default • Covenants restrict flexibility • Must be repaid, on schedule	• More expensive source of capital than debt • Dilutes ownership interest of existing owners • Dividends are paid on an after-tax basis

Maximize return

Sponsors want to maximize returns

- So keep them honest through competition
- Then they focus on cost reduction not return inflation

Cheap debt increases equity return

- How?
- Compare:
  - “on balance sheet” = equity only
  - “leveraged” approach = borrow some portion of project costs
- Permits sponsors to use funds efficiently
  - To build multiple infrastructure projects not one
  - And maximize return on each

Maximize return (2)

On balance sheet versus leveraged approach

	Money in	Money out	Per dollar
On balance sheet scenario	50	100	Capital = 1 Return = 1

	Money in	Money out	Per dollar
Leveraged scenario	50	100	
	Split:		
60%	30 Debt	45	Capital = 1 Return = 0.5
40%	20 Equity	55	Capital = 1 Return = 1.75

Junior Debt

Why does junior debt come into a deal?

- Balancing the following factors:
  - Equity return
  - Tariff
  - Debt coverage

Junior debt could be a solution

- Equity return and tariff remain unchanged, chunk of debt becomes junior, senior DSCR is met
- Higher risk should mean higher return for sub debt. Can make projects uneconomic
- For clean tech projects, concessional finance may bridge the gap
- “Mezz” debt generally more equity-like
- “Sub” debt more debt-like
- Key difference: if the junior debt doesn’t get paid, timing of acceleration/enforcement

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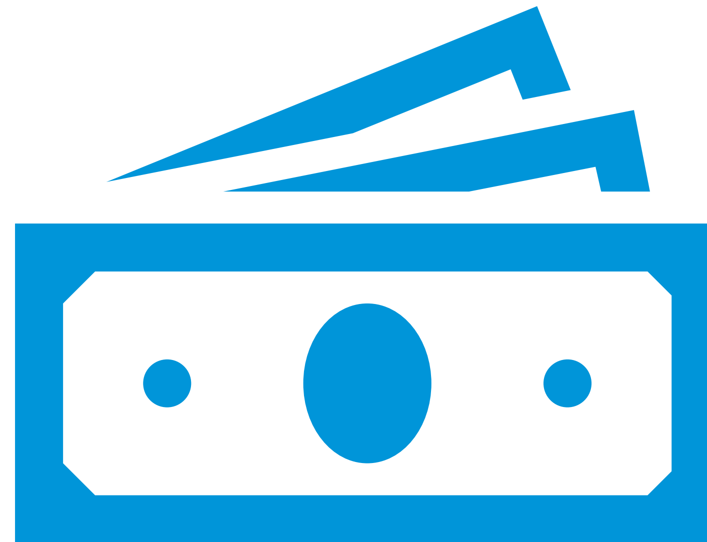


What is project finance?

Project financing is a
limited or non-recourse loan structure
for
capital-intensive infrastructure projects,
with
the project's assets, rights, and interests held as collateral,
and
the project's cash flows used for repayment.

A Project Company in Context

Sponsor 1

Sponsor 2

Sponsor 3

Shareholdings

Lenders

Project Company

Host Country

Finance Documents

Government Support Agreement

EPC Contractor

Offtaker

Engineering, Procurement & Construction Contract

Power Purchase Agreement

Advantages and Disadvantages of Project Financing

- Advantages
  - Limited recourse
  - High debt to equity ratios
  - Longer tenors
- Disadvantages
  - Considerable time and effort
  - Considerable up front costs

Limited/No Recourse

Principle behind Limited/No Recourse:

- Sponsors want to spend a defined amount and no more
  - But project costs can increase and neighbors can sue
  - Solution: establish a project company (*i.e.*, a special purpose vehicle (SPV))

Characteristics of a Project Company:

- Undertakes and implements project
- Acts as the borrower
- Structure creates solid protection of the corporate veil subject to limited exceptions:
  - Shadow directorship
  - Specific categories of liability (*e.g.*, environmental)
  - Fraud

What the lenders demand given their position

What is the Lender's position?

- No recourse to the shareholders of the project company
- Access to a single revenue stream
- No subsidiaries bringing money in
- Lower return than the sponsors

Resulting characteristics of a lender:

- Conservative:
  - focused on down-side protections
  - The natural ally of the host country
- Debt is senior to equity in payment and upon insolvency
- Right to periodic payments
- Rights to accelerate and enforce security
- Control of key actions (but beware shadow directorship)

Bankability

To attract financing, a project must be “bankable”

What is “**Bankability**”?

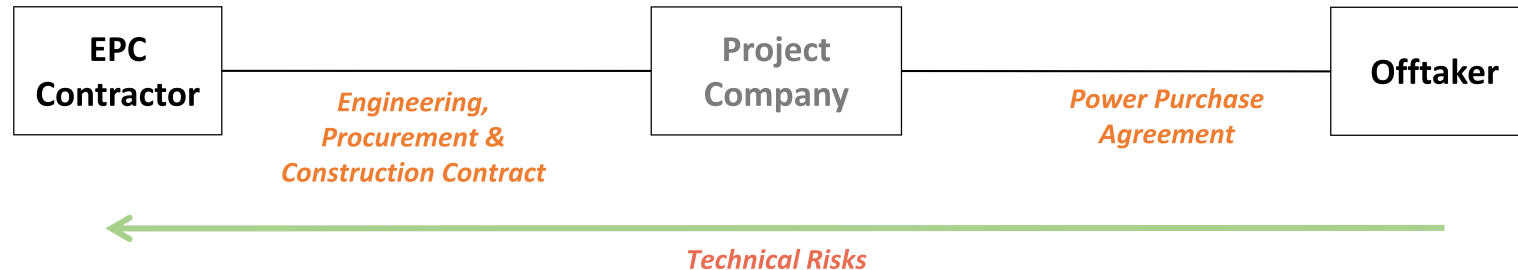
- Flexible concept
- Confidence (by a lender) that the project company can service its debts
  - Secure revenues
  - Certainty on expenses
  - Appropriate risk allocation

Bankability

- Project participants must identify, assess, and allocate business risks faced by project company
- Identify and assess risks
  - Market risk
  - Technical risks
  - Credit risk
- Allocate risks to a specific party
  - The party best able to mitigate, reduce, or manage the risk
  - Risks allocated by project agreements
  - Many risks “flow through” agreements to re-allocate the risk to another party

Bankability

- Risks are allocated to the party best able to manage the risk using 'back-to-back' contractual provisions



- **Power Purchase Agreement**
  - Project Company shall construct, test and commission the power plant within *x* months
- **Engineering, Procurement, & Construction Contract**
  - Contractor shall construct, test and commission the power plant within *y* months

Co-financing

Why do we co-finance and how should we do it?

Cause:

- Risk diversification = institutional limits: country, sector, individual project

Effects:

- Club deals model: strong oversight of complex projects but too many cooks
- Lead lender model: “quick” lender/borrower negotiations but:
  - inefficiency of repeating to co-lenders
  - asymmetry of information leads to mistrust
  - loss of oversight

Hybrid solution:

- Lead lender takes first cut at comments on dd reports and transaction documents (90%)
- Co-lenders review those docs with LL comments built in and add all important 10%
- Co-lenders attend meetings in listening mode and engage directly in the break-out sessions

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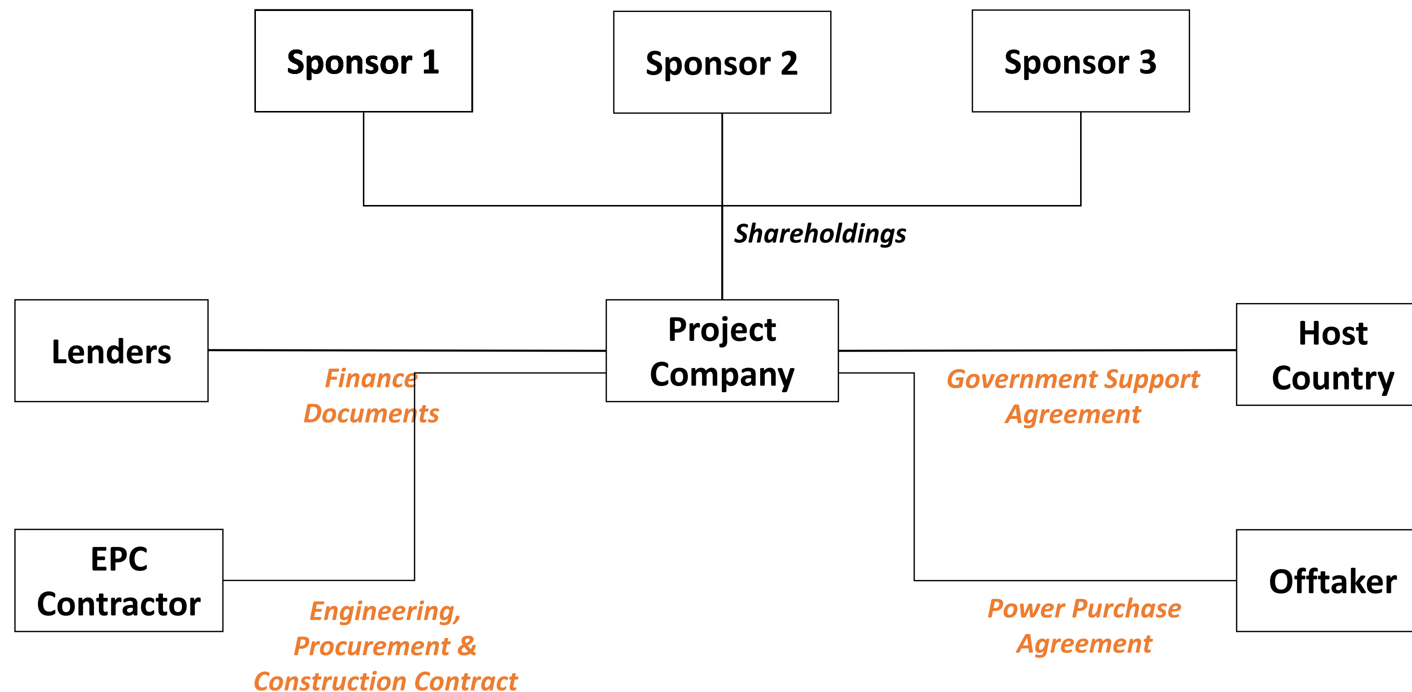
Equity Contracts

Project companies are closely held private companies

- Sponsors may hold their interest indirectly (not shown here)
- Corporate documents often more complex than for a publicly held company



Equity Contracts

Equity Contracts may include:

- Shareholders Agreement
- Equity Subscription Agreement
- Lock-up Agreement or Equity Retention Agreement
- Shareholder Support Deed

Equity contracts must be consistent with

- Formation documents of project company
  - Certificate of incorporation (or articles of incorporation, memorandum of association, charter)
  - Bylaws (or articles of association or regulations)
- Corporate law of jurisdiction in which project company is organized

Shareholders Agreements

Equity commitments	**Corporate governance**
• Base equity contributions • Standby equity contributions • Contributions schedule • Capital contribution defaults	• Appointment of directors • Frequency of board meetings • Special board meetings • Reserved matters (shareholders) • Reserved matters (board of directors) • Executive officers (titles, appointment rights) • Transactions with affiliate • Deadlocks
Transfers of equity • No equity transfers in breach of project agreements • Rights of first refusals • Drag-along rights • Tag-along rights	**Books and records** • Monthly, quarterly, annual information for shareholders • Inspection rights • Audit rights
Defaults and remedies • Events of defaults • Remedies	**Dispute resolution** • Arbitration

Partial Alternatives to Shareholders Agreements- Equity Contracts

Equity subscription agreement

- Used to commit shareholders to contribute equity
- **When is it used?**
  - Often in private equity transactions

Shareholder support deed

- Used to commit shareholders to contribute equity
- Security agent appointed by lenders is also a party
- **When is it used?**
  - if project company prohibited from becoming a party to shareholders' agreement

Equity retention agreement

- Used to impose equity retention obligations without a full shareholders' agreements

Government as an Equity Partner

- **Governments may partially finance PPP projects by making capital contributions in exchange for shares in the project company**
- **Contract package should clearly define rights and obligations of the public partner as shareholder**

Benefits

- Government may gain better access to information
- Financial information
- Board level decisions
- Government shares in project upside (and downside)
- Government board members can remind sponsors of government objectives
- Local content
- Transfer of skills, development of human capital

Concerns

- Actual or perceived conflicts of interest with regulatory functions
- Concerns that governments may interfere by exercising shareholder rights
  - Partially addressed by recusal provisions in shareholders' agreement

Government as an Equity Partner

- Typical governance rights attached to various ownership levels:

	1%-5% (Syndicate Member)	10% - 30% (Minority Investor)	25% - 40% (Co-investor)	40% - 50% (Co-Lead Investor)
Board Composition	No Member	Single Board Member	Either (i) board controlled by lead investor, (ii) balanced board that can be swung by non-exec. directors, and/or (iii) co-investors rely on reserved matters	Either (i) deadlocked board, (ii) balanced board able to be swung by non-executive directors, and/or (ii) reliance on reserved matters
Committee Participation	No	No	Yes	Yes
Director Attendance Required	No	Yes, for first meeting only	Yes, for first meeting only	Yes, with reversion to deadlock procedure if quorum not achieved
Appointment of Non-Exec. Directors or Chairman	No	No	Limited consultation rights	Yes

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Debt Contracts

Term Sheet

- Financial term sheets spell out the basic terms for the loan or guaranty being offered (amount, tenor, fees, pricing). It is not unusual, however, for parties to use this initial document as a road map for their entire deal.

Finance Agreement

- This document should include all of the lender's rights and the borrower's obligations in respect of the loan, other than those specifically related to collateral.

Security Agreements

- These documents detail the lender's rights in respect of collateral being pledged by the borrower. The type of documentation required will depend on the governing law and the type of asset being pledged.

Guaranty Documents

- Sponsors may offer full or partial guaranties to minimize lenders' risk and obtain more favorable pricing. Depending on the perceived risk of a project structure, such guaranties may be required.

Project Documents

- While not technically debt contract, these agreements form the basis upon which a debt facility is structured. These documents govern the borrower's rights vis-à-vis the project: right to build, construction and operation arrangements, sale of project output, etc.

Term Sheet

What has to go in a loan/guaranty term sheet?

- Amount, tenor, pricing and repayment profile.

Why include more?

- This depends on what the parties want to use the term sheet for. Some lenders use this as a roadmap for the entire deal, while others use it to establish basic terms before moving to definitive documentation. A standard term sheet will include the loan/guaranty amount, the tenor, pricing, fees, the repayment schedule, the parties, the basic purpose and structure of the project, the material conditions precedent and covenants and other information we deem material.

Term sheet tips.

- This document represents your handshake deal. It is heavy on business points and parties should speak up if there is anything in here they do not understand.
- This is a good time to discuss important "gating" issues that may determine whether the parties can ultimately reach agreement.

Finance Agreement

What is in a Finance Agreement

Basic Loan Mechanics

- Amount, tenor, pricing, repayment schedule, mandatory and voluntary prepayments.

Representations & Warranties

- All the things a lender wants a borrower them to tell them at signing and when they disburse funds. Diligence vs. risk allocation.

Conditions Precedent to First Disbursement

- The things a lender needs before one dollar goes out the door.

Conditions Precedent to Each Disbursement

- The things a lender needs every time they disburse funds.

Affirmative Covenants

- All the things a lender wants a borrower to do starting when they sign the finance agreement.

Negative Covenants

- All the things a lender *doesn't* want a borrower to do.

Finance Agreement Continued…

Events of Default

- This is where a lender details what could require a borrower to have to repay the entire loan early. These generally include missing a payment to the lender, not paying someone else, getting a big judgement against them, lying to the lender in their representations, breaking their promises to the lender by not doing the things detailed in affirmative covenants ***or*** doing the things spelled out in negative covenants, going bankrupt, etc.

Remedies

- This explains what a lender can do if a borrower triggers an event of default. Usually this is the ability to demand immediate payment of the entire loan amount (*i.e.*, acceleration).

Boilerplate

- Governing Law
- Submission to Jurisdiction
- Arbitration (if relevant)
- Severability
- Notice Information

Finance Agreement – CPs

Sample CPs to Initial Disbursement

- Transaction Documents
- Authorization
- Ownership
- Consents
- Site
- Security Interest
- Insurance
- Accountants
- Legal Opinions
- Appointment of Agent
- Accounts
- Financial Projections
- Construction Budget
- Operating and Credit Policies
- Environmental and Social Requirements
- Due Diligence
- Fulfillment of Conditions to Subordinated Loan
- Approval of Construction Contract
- Independent Engineer Report

Sample CPs to Every Disbursement

- Disbursement Request
- Representations and Defaults
- Change in Circumstances
- Note
- Closing Certificate
- Financial Information and Project Progress
- Payment or Reimbursement of Expenses
- Central Bank Registration; Consents
- Equity Contributions
- DSR Requirement
- Independent Engineer Certificate
- Funding Arrangements
- Fulfillment of CPs of Other Senior Loan
- Other Documents

Security Documents

Types of Documents

- Different documents are required depending on what the pledged asset is and where it is located.

Perfection

- It is not enough just to agree that there is a lien with the borrower. A lender must also put the rest of the world on notice of its existence. This process is known as perfection of the lien and can be accomplished in different ways depending on the governing law and type of asset.

After-Acquired Property

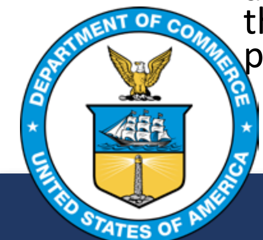
- Many countries permit lenders to obtain a lien on moveable property a borrower doesn't own yet. In countries where this isn't possible, a lender may need to require periodic updating of security documents covering moveable property acquired by the borrower after the loan is made.

Taxes and Fees

- Registering a lien in certain countries can require payment of a large fee or tax.

Direct Agreements

- In addition to security documents that grant a lender a lien or pledge over an asset, lenders will often also seek to have a collateral assignment of an important revenue, service or supply contract. These allow the lender to avoid the termination of the contract if the borrower fails to abide by its terms, and also allows the lender to step-in to the shoes of the borrower (or designate a third party to do so) to satisfy the borrower's obligations thereunder.



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- Pre-Qualification and Evaluation
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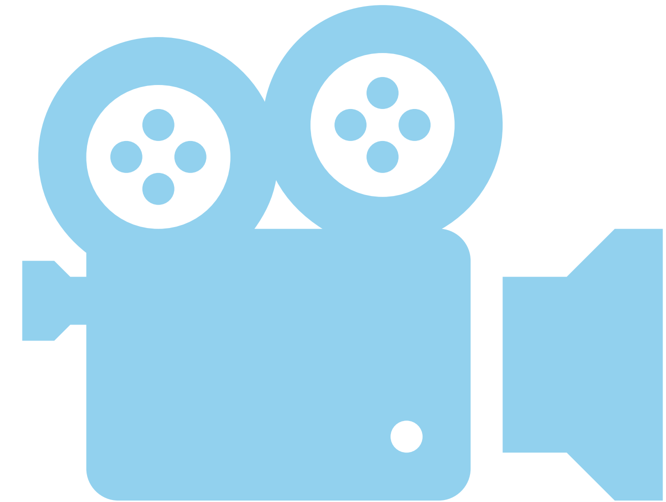

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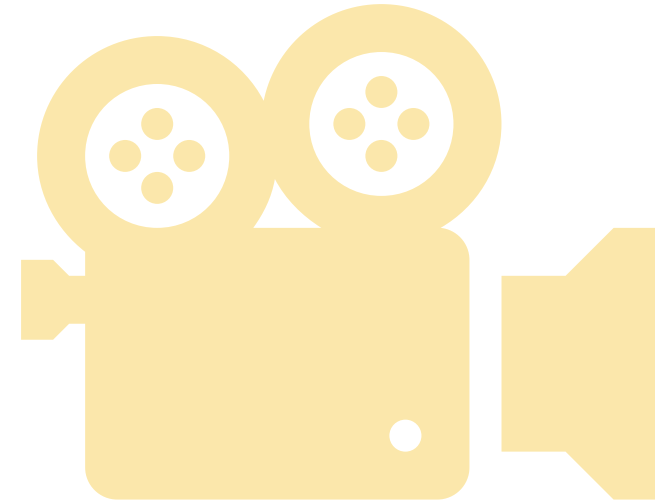

Tel: +1 202 482 2400

1401 Constitution Avenue,
NW, Washington,
DC 20230

www.cldp.doc.gov

Mohammed Loraoui
Attorney-Advisor
Power Africa Portfolio
Mloraoui@doc.gov

Hana Damore
Attorney-Advisor
Asia Pacific Portfolio
Hdamore@doc.gov