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Project finance transactions in Europe from 2005 to 2015

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Abstract

Today's increasingly popular form of financing is a project financing. Project financing is heavily dependent on the banking system, the financial culture of the legal entities, and the creditworthiness of the organization, who implements the project. Project financing, as a special form of a credit financing was greatly affected by the crisis. In those countries, where the crisis had a deep impact, the project financing remained significantly below the European average. The aim of the study is to make a picture of the project financing in the EU countries, showing the details of the transactions, the debt-equity ratio, the numbers of the transactions, and the average values as well.

Keywords: project financing, transactions, EU members, crisis

1. Overview of literature

Project financing, as a structural financial loan product, is different from the conventional loan products in terms of several dimensions. The point of this type of financing is best described by two standard studies:

- Newitt and Fabozzi (1997): „The financing of a given economic entity, which is considered by the creditor as its cash flow and revenue, serves as the source to pay the credit back, its assets being the collateral."
- Yescombe (2008): „ Project financing is the method of long-term crediting of larger projects where the granting of loans is carried out entirely based on the cash-flow of the project."

Project finance, as a debt financing is able to carry out large projects with high leverage. The priority areas of project financing is summerized by Fight (2006):

- energy sector,
- oil and gas industry,
- mining,
- construction of motorways,
- telecommunication,
- other projects (paper production, chemical industry, construction of hospitals, schools, airports and prisons).

The financing of immovable property needs to be added to this list, since it also represents a significant proportion within the market of project financing. In many times the amounts of the loans are so big that they cannot be financed by only one bank, therefore a project is not financed individually but collectively, which is called syndicated loan. Syndicated loans are such special loans where the money is provided by a group of two or more creditors in the form of a loan agreement. Syndicated lending is situated between the classic and the market-based lending. The loan providers are connected to each other on market terms, and they raise the amount requested by the borrower as one single creditor.

On the basis of the above mentioned definitions and authors we can bring together the inherent characteristics of project financing:

- it is given to an entity created for a specific project (SPV[1]), which has a special economic and financial relationship with the sponsor/owner;
- funding is through employing high leverage (which can even be 80-90% in certain cases[2]);
- due to the separate project company the amount of the loan is not directly charged to the balance sheet of the sponsor/owner[3], and it does not have a negative effect on its creditworthiness[4],
- in the case of non-resource loans the loan cannot be covered by the property of the sponsor/owner, only by the cash-flow of the project[5],
- the transaction is practically based on two main actors: the sponsor and the financial institutes, which are mainly the credit provider banks and the bond issuers,
- the provider of the loan capital does not become the owner of the project company,
- because of the above characteristics, we are talking about a loan asset with an incredibly high risk, and this risk can only be reduced by a competent and trained consultant basis.

From a corporate aspect project financing is a form of funding with many advantages. It is definitely a benefit that it means an off-balance-sheet financing with the use of exceptionally high leverage, as a result of which the borrowed large amount is not charged directly to the balance sheet of the project owner (because it only appears on the consolidated accounts), hence it will not degrade its creditworthiness (Yescombe 2008) as the loan is granted to a project company created specifically for the project's purposes. According to Esty (2007), this legally independent entity established to carry out the project is funded through the equity given by one or more sponsors, and from other sources intended for the project. Moreover, the loan does not even have to be guaranteed by the owner of the project company, since in line with the agreement with the bank (Nádasdy et al. 2011) the transaction can either be a non-recourse or limited recourse funding (obviously sustaining the right of full recourse is also possible). Such credits are mostly covered by the signed contracts (including but not limited to: independent contractor contracts,

[1] Special Purpose Vehicle

[2] This rate has been significantly overwritten by the crisis, since the expectation towards the equity rose, especially in the cases of oil and gas industry, renewable energy, water and mining projects.

[3] Sponsors are actors that provide the resources necessary for bringing the project to fruition, plan and organize its execution, set out the main goals of the project and help achieving those.

[4] The amount of credit only appears in the consolidated reports.

[5] Project financing can be divided into three main groups regarding the right of recourse:

- non-recourse financing, where the sponsor/owner is not liable for the obligations of the project company.
- full-recourse financing, where they take full responsibility.
- limited-recourse financing, where the liability of the sponsor/owner is only limited.

supplier contracts, sales contracts, management contracts)[6], pursuant to which the providers of funds are able to determine the relevance and justification of the project. It is another benefit that in most of the cases project financing produces a better capital allocation than conventional corporate financing (John-John 1991), because due to the deeper monitoring and stricter terms it – by definition – filters out the uncertain or unjustified projects.

The reimbursement of the loans is ensured by the cash-flow derived from the operation of the project, which removes further burdens from the shoulders of the project owner, contrary to the conventional corporate financing. The banks participating in project financing – due to the large credit needs of the project and the major information asymmetry at the initial phase – usually grant the loans in a syndicate and not on their own, in view of the large exposure restrictions and the client risks. The lead arranger banks[7] become internal participants of the project, because along with the sponsors they are present right from the early planning stage and later they will involve the rest of the partners (banks) in the financing (Gatti et al. 2008). The lead arrangers can therefore have a better understanding of the background of the project, and they can familiarize themselves with the contracts on which they will base their financing decision. The loans – if they cannot cover the planned resources – can be supplemented with project bonds, while other forms of financing (lease financing, supplier financing, mezzanine financing) are tertiary in the course of the transaction. The creditors and funders must take into account the long-duration risk, the interest rate risk and the exchange rate risk, but the market- and operating risks have a significant effect too (Szalai 2011). The bigger project financing transactions often cross the borders, because for the reason of the volume, complexity and capital needs of the projects, and also for the sake of ensuring the informed decisions of the banks and reducing the risks they face, it is necessary to involve external consultants as well, who can be (inter alia) legal-, financial-, sectoral- or insurance experts (Kónya 2009). These consultants (provided that the project itself has international aspects too) are employees of bigger international consultancy firms with years of experience in similar projects[8].
Project financing, just like any other kind of financing, can only be successful in countries where the economy is transparent, the contracts are respected and one does not have to expect market failures that could potentially upset the budget balance or even cancel the project (Ahmed 1999).

2. Methodological background and the sample

Many organizations collect and evaluate data with regard to project financing from several aspects. The Thomson Reuters Project Finance International, the International Financing Review, and the IJGlobal database run by Euromoney (among others) contain a tremendous amount of data and information about the transactions, broken down by different criteria. By using the IJGlobal database, this study introduces the trends in project financing before and after the crisis. The IJGlobal database has been chosen because it examines every international project, and it contains their data in detail on the basis of (without aiming to give an exhaustive list) the target area of the project, the leverage and the location. The database is about projects that were

[6] There are other guarantees than contracts, such as (including but not limited to) liens, rights to options, guarantee rights, commitments and various assignments.
[7] The lead arranger financial institutes are called MLAs (Mandated Lead Arranger), but the names lead bank, lead arranger, or lead manager are also widely used.
[8] There are legal and financial consultants in every project financing case. Without them the transaction cannot go forward at all, or only with a huge risk.

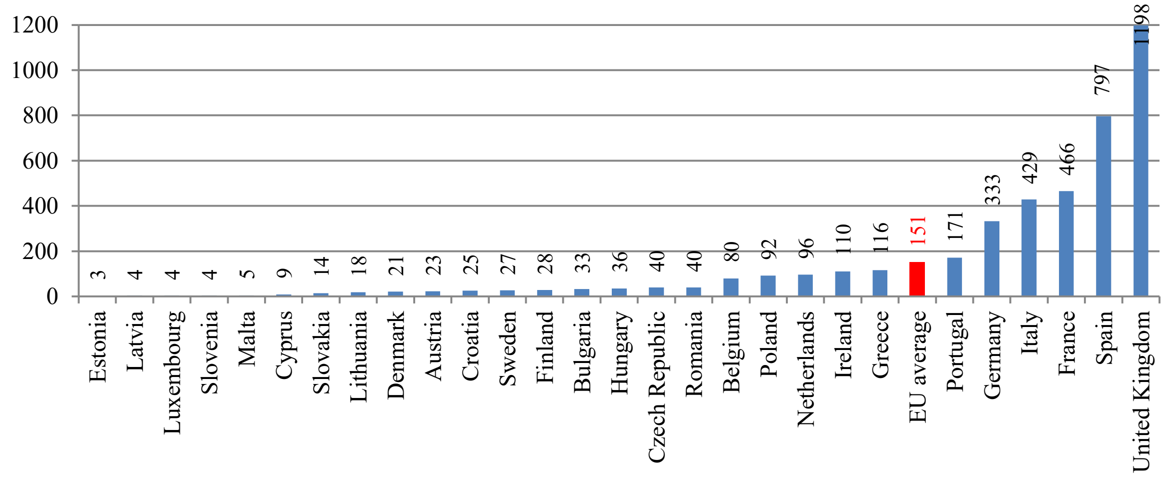
launched with the help of a notable international involvement, thus information on the smaller, mainly domestic transactions cannot be found among the collected data. This analysis addresses every transaction carried out between 2005 and 2015, whether they can be considered financially closed or not. On top of this the study does not distinguish between the transactions as to where the target areas of the projects are, so that we could get a full picture of the project financing activity of the European Union member states.

3. Results

Europe, together with North America, plays a lead role in the number and value of the project financing transactions. However, the credit and bond markets of project financing have not shown continuous improvement in the past ten years (Csiszárik-Kocsir, 2016). Financing has suffered a major negative impact from the recent crises: the mortgage crisis and the Mediterranean crisis, to name just the most important ones. As a result of the crises the regions that had been at the end of the list have slipped down even more, while the regions where the creditors sensed political-economic risks have almost completely been fallen off the map of investment targets.

If we take a look at the 28 member states of the European Union, it becomes clear that there is an enormous gap regarding both the number of project financing transactions and the value of these transactions. This kind of gap can also be seen in other areas as well, namely in the macro- and micro economic characteristics. As the below picture describes, according to the recorded data of the 28 member states, the average number of project financing transactions was 151, 2% of which belonged to the least active Estonia, whereas the United Kingdom with the most transactions represented 793%. These two numbers are perfect examples for the orientation of the resources funding the projects towards the more developed regions. The underperforming countries, mostly the recently joined ones and for the most part the ones from Eastern Europe, are far below the EU average. Of all the examined transactions (4,222 pcs) only 828 can be linked to them, which is 19.61% of all the transactions. The countries performing above the average – predominantly the western states – completed several times the average number of transactions. 80.39% (3,394 pcs) of all the transactions can be attributed to the six countries that perform above average. They are included in this group because they either have a more developed bank system, or the western capital has considered them to be investment targets. Spain, Portugal and Italy have gotten into this circuit mainly due to tourism and their strong relationship with Germany, while on the other hand the other countries like the lead member states of the Union – as countries with significant amount of capital – have been able to increase the number of transactions in the fields of transport, renewable energy sources and investments in energy too.

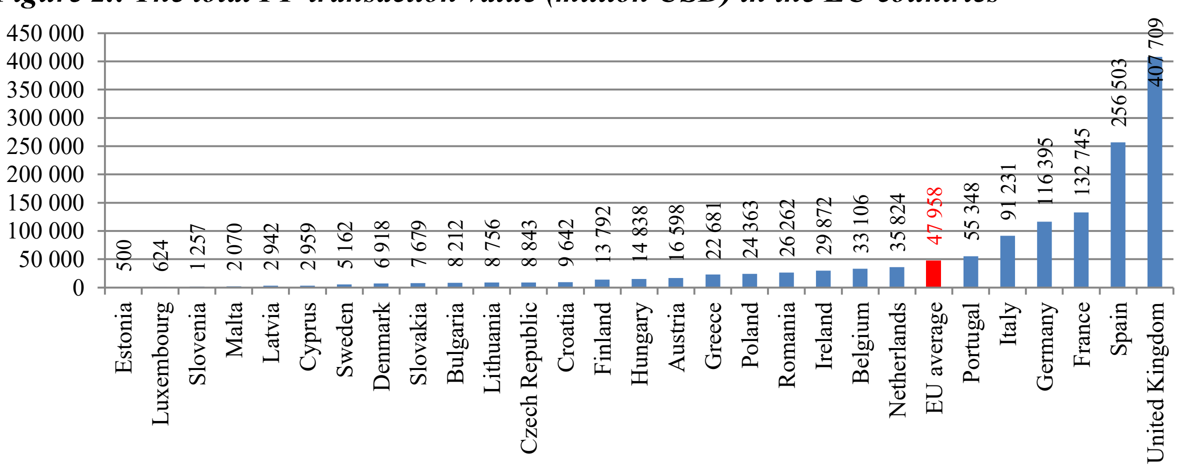
Figure 1.: The number of the PF transaction in the EU countries



Source: own compilation according to the IJGlobal data

After the number of transactions it is also worth analysing the total transaction value in respect of the 28 member states. The total transaction value amounted to 1,342,831 million USD, 21.07% (282,900 million USD) of which can be attributed to the underperforming countries, while the remaining 78.93% (1,059,931 million USD) belonged to the previously introduced six countries with an above-average performance. The countries from Central and Eastern Europe are all below average, in fact, their activity does not even reach half of the average transaction value of the EU.

Figure 2.: The total PF transaction value (million USD) in the EU countries



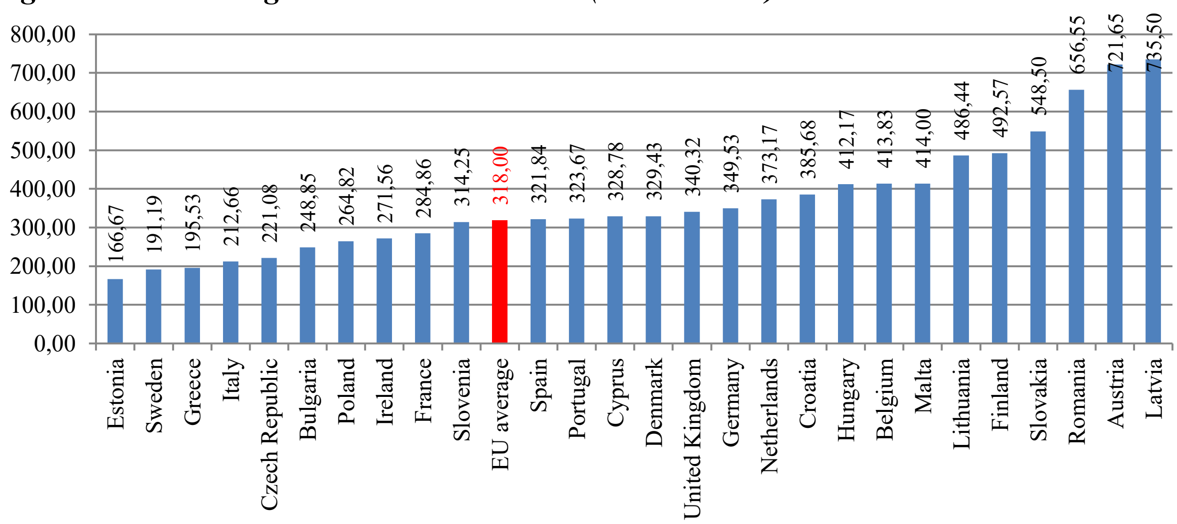
Source: own compilation according to the IJGlobal data

Following the examination of the number of transactions and the total transaction value it is useful to compare the development of the average transaction value as well. In the context of the average values the picture is not so polarized anymore. We can see that in connection with the member states the transactions have an average value of 318 million USD[9]. It can be established

[9] Rounded figure!

that the countries that used to be at the forefront are not at the cutting edge anymore on the basis of the average value per transaction. As the below graph shows, the countries with small number of transactions have a very high transaction per capita figure (Slovakia, Romania, Hungary, etc.), which indicates that in their case project financing is an instrument of funding usually smaller number of investments with high value and therefore with strategic importance.

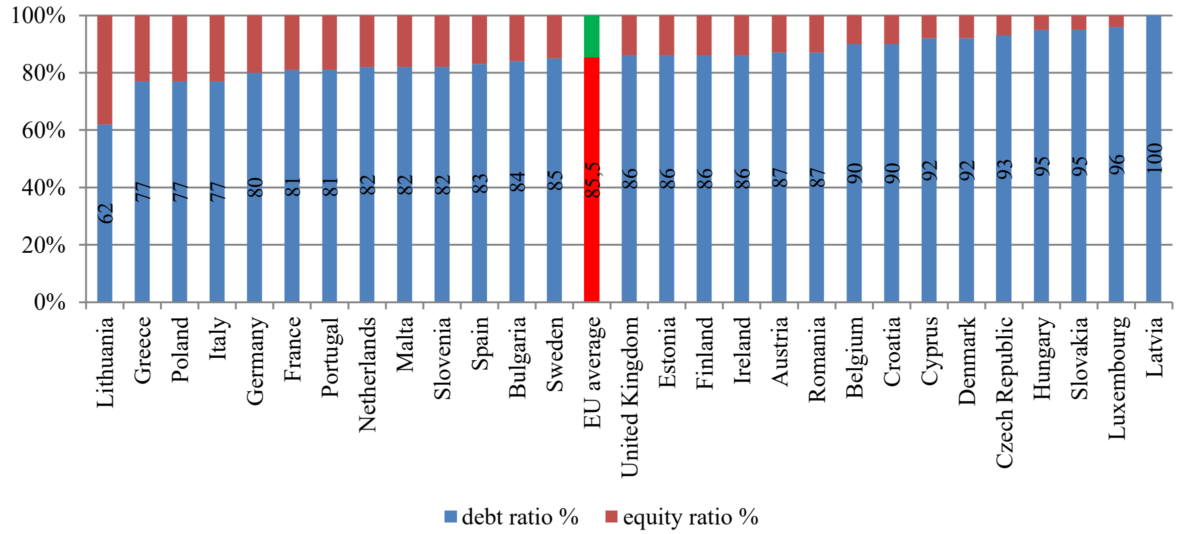
Figure 3.: The average PF transaction value (million USD) in the EU countries



Source: own compilation according to the IJGlobal data

The key characteristic of project financing – contrary to the conventional corporate lending – is that it provides funds for the projects by using high level of leverage. The average rate of external capital – equity was 83-17% in 2015 globally. With regard to the examined 10 years the rate is extremely diverse, especially when evaluated by investment target areas or regions. It can be concluded that in the European Union member states the projects have been running with 85.5% external capital ratio, according to the figures in the records. Half of the member states have been able to use the credit resources for their project financing transactions by more than this rate. The United Kingdom that produced the highest number of transactions and highest transaction value has funded its project financing transactions with an average of 86% external capital ratio. The countries of the Visegrad Quartet – as the graph demonstrates – can show up a credit ratio higher than 90%, which is particularly good, considering the development level of the credit markets.

Figure 4.: The debt-equity ratio in the EU countries

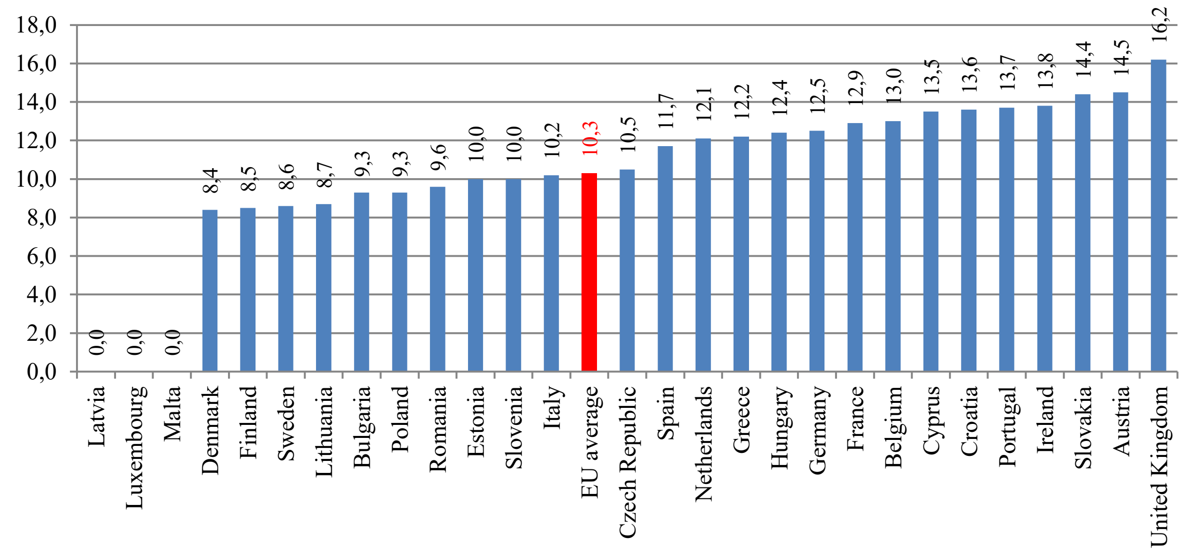


Source: own compilation according to the IJGlobal data

The return is a crucial question for the projects. We deem projects worthwhile and acceptable if they can earn the capital invested in them in a relatively short period of time, thereby reducing the risk of the investors. The project financing transactions take a very long time until they reach the stage of financial closure. A project can be considered financially closed, if the project company that had taken the loan out paid all its debt back towards the funders, and consequently the funders have no claims whatsoever against the project company. This usually takes 15-18 years, but sometimes even longer. Be that as it may, the capital invested in the project might be recouped sooner, after 10-12 years. This is the period of time when a project breaks even, and from that moment it can start gaining profit for the sponsors. If we take a look at the below graph we can see that the projects of the EU member states generate a return after an average of 10.3 years, although there are also projects that become remunerative earlier or much later[10]. The United Kingdom has the longest payback period, but the capital is committed on a long term basis in the Austrian and Slovakian projects as well.

[10] There were no profitability data available regarding Latvia, Luxembourg and Malta.

Figure 5.: The average maturity duration (years) in the EU countries



Source: own compilation according to the IJGlobal data

4. Summary

In light of the above analysis, the European Union reflects wide variations in the field of project financing, just like in any other areas. It can be categorically stated that the European countries that have highly developed and strong bank systems actively engage in the project financing transactions too. On the other hand the eastern member states cannot boast a lot of notable project financing transactions due to the political transition, the conditions of the bank system and its dependence on foreign resources. It can, however, be asserted that in the case of these latter countries the high transactional value also appears alongside the small number of transactions, which proves that they rather fund the more significant energy-, transport-, and gas and oil industry investments through project financing, instead of the typical corporate projects. Project financing – with the high leverage – bears both with numerous risks and advantages. Because of the strict background check, which is a result of the high risk-taking activity of the banks, the return on the project becomes more certain, hence the risks of the sponsors are reduced. Still, due to the high risk, this form of financing is only operational if the chosen target country has no political and economic liabilities.

Unfortunately, as far as we can tell, in the near future neither Europe nor the majority of the continents will be immune to economic turning points. The refugee crisis, the Brexit and the already planned Frexit are all events that are precursors of another crisis, which will inevitably have an effect on the credit markets as well. With the resources becoming more expensive, the ceilings for outstanding loans being reduced and the banks acting more and more cautiously, the global market of project financing is also forced to change, but hopefully not in a drastic way, like it happened during the previous crises.

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