Module 2

Project Bankability and Financing Options

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Backgrounder: Raising Capital

There are three broad ways in which a company or institution can raise money:

1. **through the equity markets**
2. **through the banks, or**
3. **through the bond markets.**

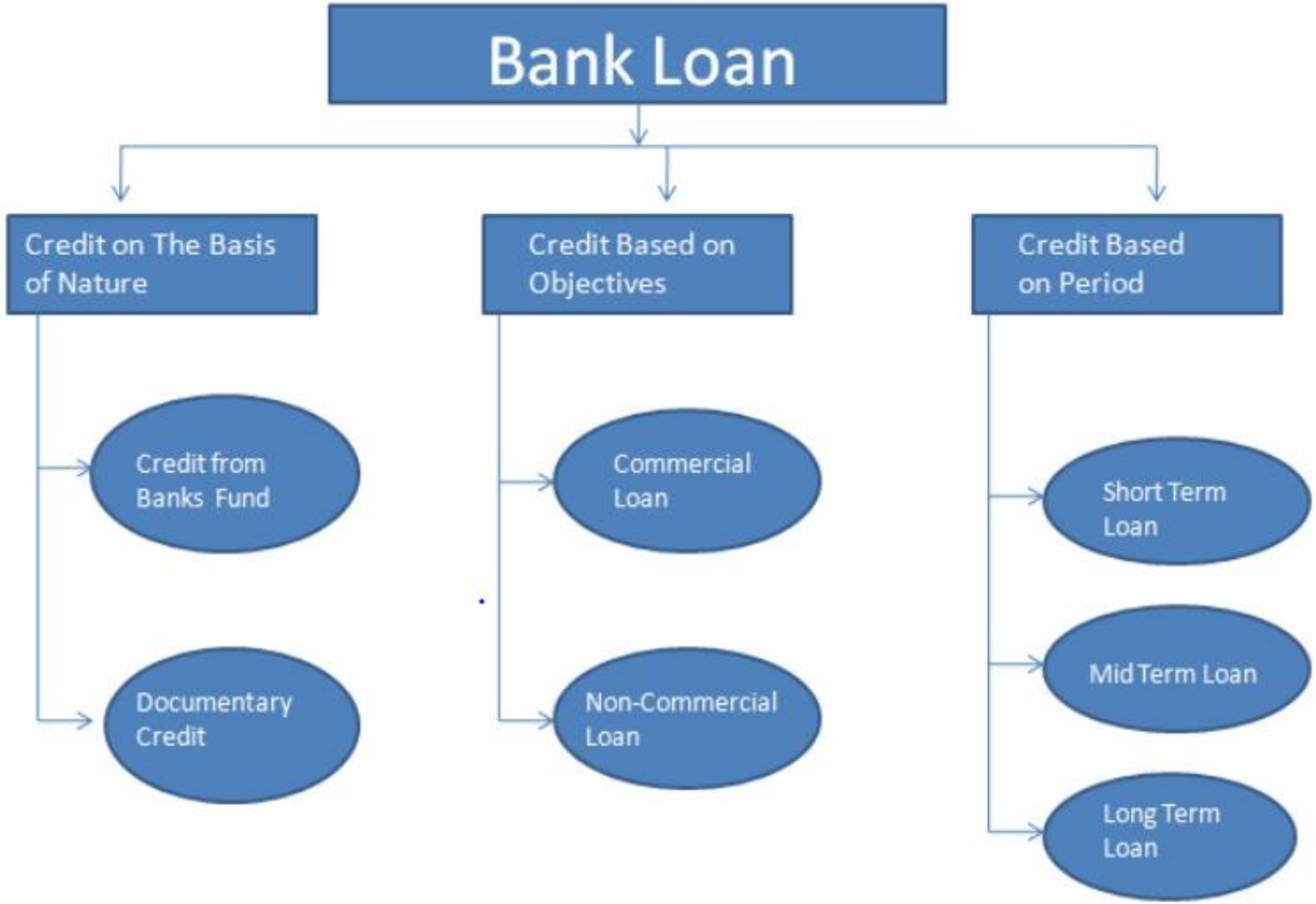
BROAD CHARACTRISTICS	Equity	Bond	Bank Loan
Usual Term	Perpetual	Medium to Long term	Short term
Participation in growth	Yes	No	No
Regular payment	Variable	Fixed	Fixed
Creditor ranking	Low	High	Highest
Voting	Yes	No	No
Legal recourse	Company law	Instigate bankruptcy	Instigate bankruptcy

Main Kinds of Equity

- Common Stock
- Preferred Stock
- Additional Paid-in Capital
- Contributed Surplus
- Retained Earnings
- Other Comprehensive Income
- Treasury Stock

Source: CFI™

Bank Loan, in general

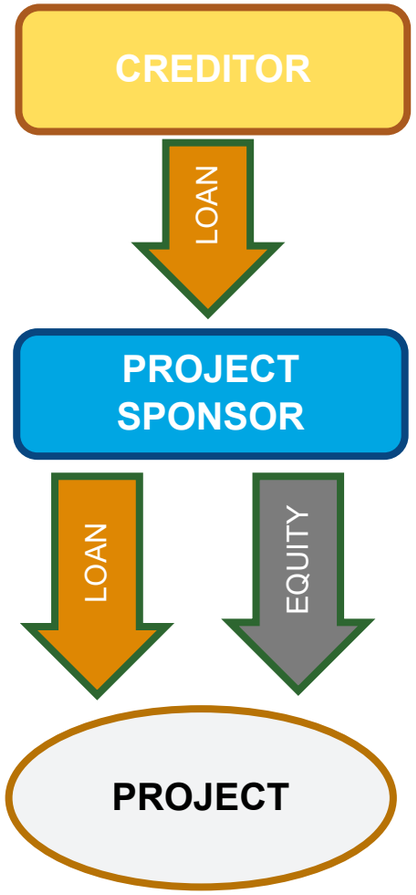


Corporate Finance

When a company raises debt capital it must document the increased level of debt in its balance sheet.

In corporate finance, a company's creditworthiness is mostly assessed by checking its future business outlook and - even more importantly - its balance sheet (depicting all assets and debts the company currently has).

Thus, a company has a strong interest to show a healthy financial situation in its balance sheet.

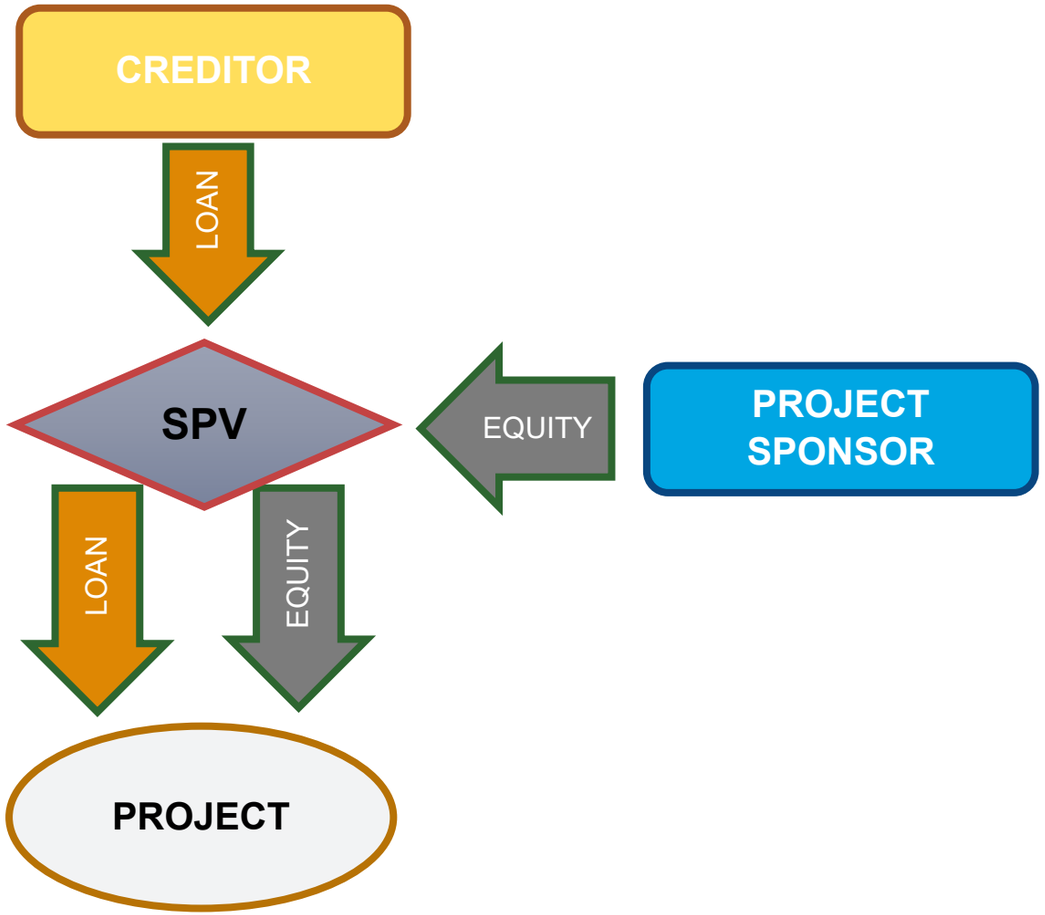


Project Finance

When it comes to big investment projects, the amount of capital needed might even be prohibitively high for the company to burden in its own balance sheet.

A new, separate business entity – a so called "**Special Purpose Vehicle" (SPV)** – which acts as debtor.

The project sponsor itself invests equity capital into the SPV, which in turn raises the debt capital necessary to finance the project. In this way, the project sponsor's balance sheet remains free of the debt capital raised to finance the project.



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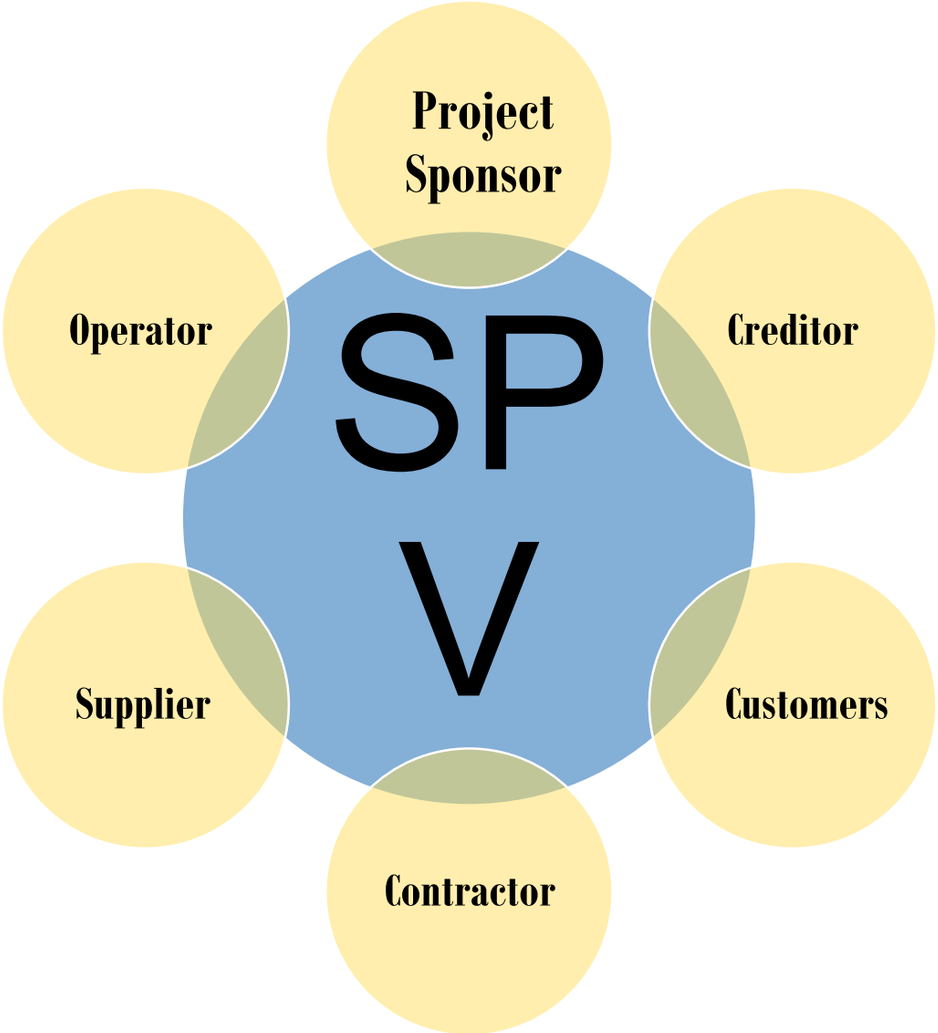
Corporate Finance Vs Project Finance

	Corporate Financing	Project Financing
Project sponsor …	… is at the same time debtor and is liable for entire debt	… has established a SPV as intermediary which acts as debtor
Lenders focus on…	… debtor's balance sheet as indicator of past performance and projected future performance	… project's projected future cash flows
Financing depends on …	… debtor's creditworthiness and guarantees provided	… project's economic viability
Capital is repaid through …	… proceeds of all company operations …	… surplus generated by the individual project only
Financing is guaranteed by …	… assets of the project sponsor	… project assets only
Capital is shown …	… in project sponsor's balance sheet	… in SPV's balance sheets

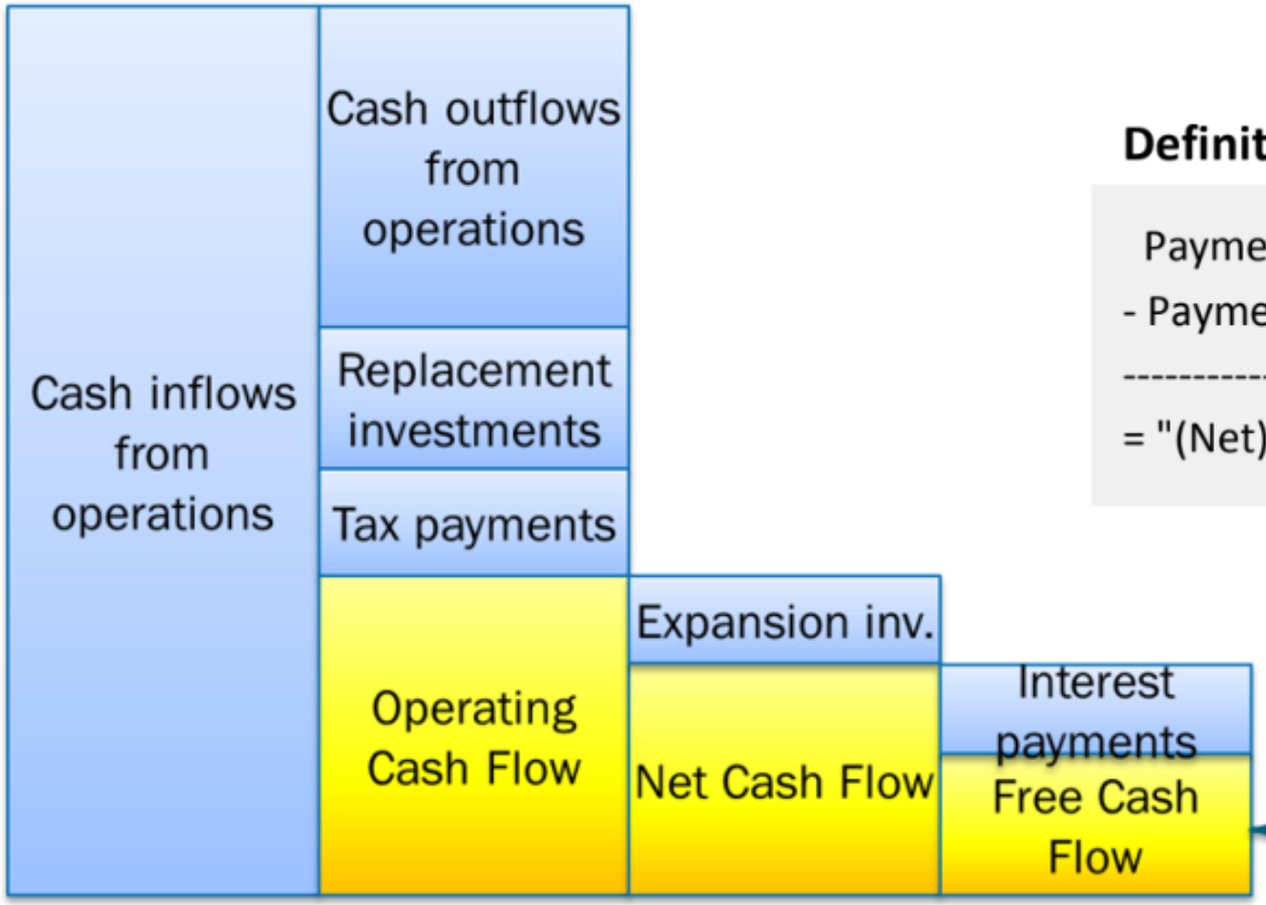
Example: RE Project Stakeholders

Renewable energy projects operate with a relatively high degree of uncertainty. To compensate:

- Detailed risk sharing agreements between project sponsor(s) and project owner (the project owner might be obliged, for instance, to guarantee repayment in the case of project failure),
- A stringent scheme of regular project audits performed by project sponsors,
- Compliance monitoring (reporting) requirements as part of the financing arrangement,
- Etc.



“Cash Flow” as Indicator of Project Attractiveness



Definition: Cash Flow

Payments received ⇒ "Cash inflow"
- Payments effected ⇒ "Cash outflow"

= "(Net) Cash Flow"

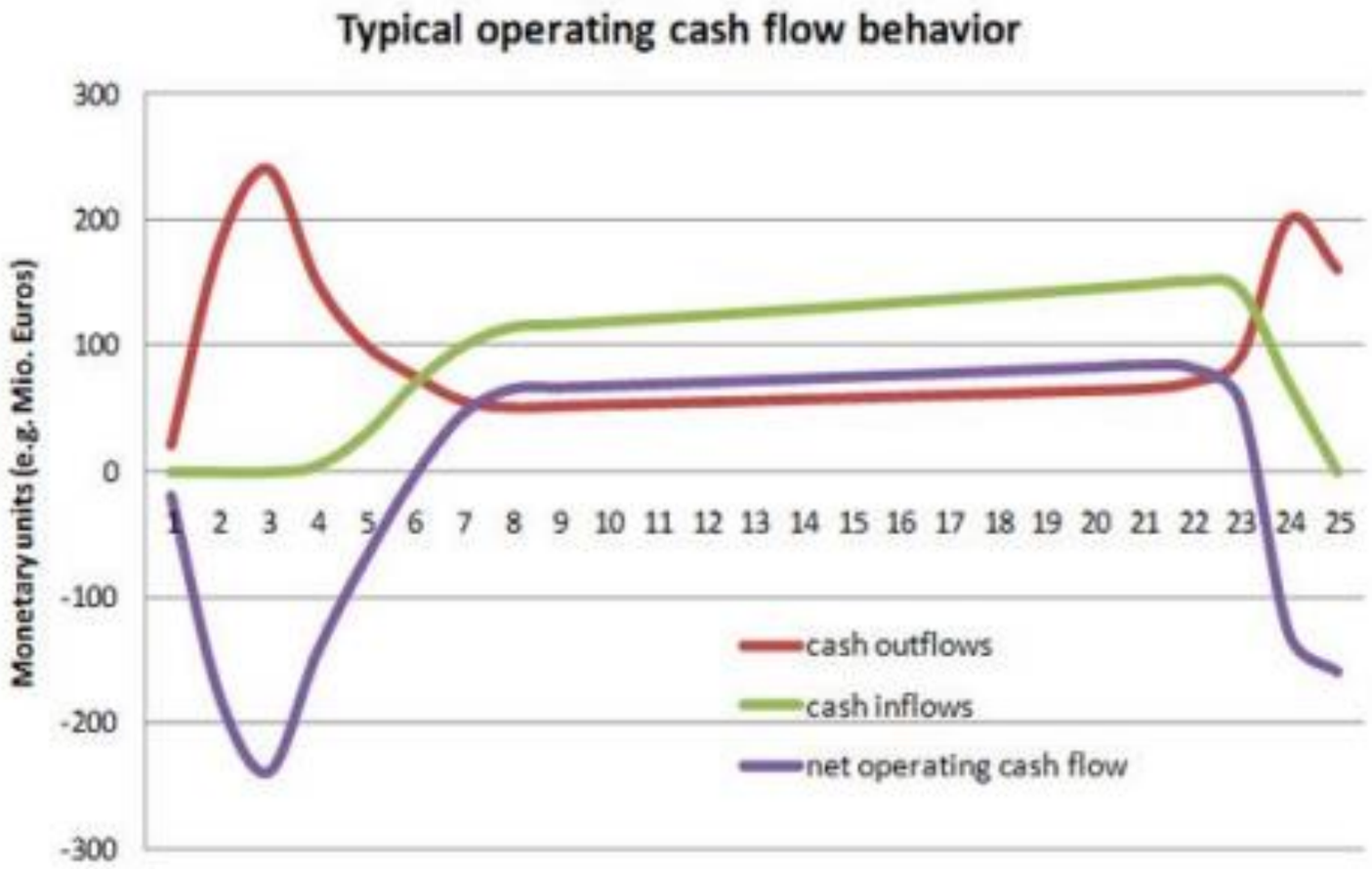
Operating activities
Investing activities
Financing activities

Available for:
- Payout to owners
- Liquidity increase
- Reduction of share capital

Cash Flow Through Project Life-Cycle

Project Cash Flows

- Initial Investment
- Operating Cost
- Taxes
- Revenues
- Grant and Subsidies



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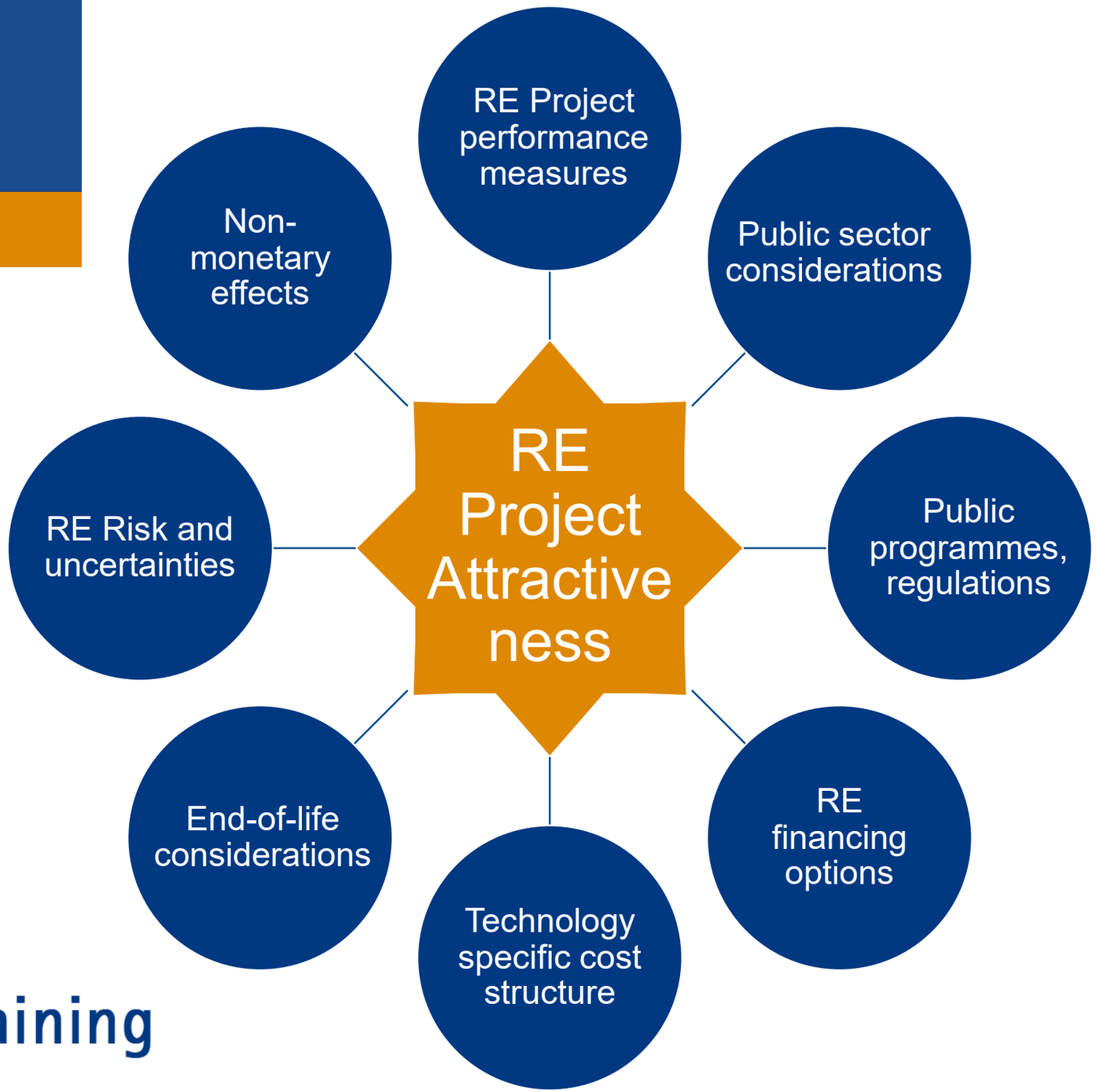
RE Project Appraisal as Template for Wastetwater Project Appraisal



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Main Costs of Projects – Wastewater etc.

- **Investment Cost**
- **Operating Cost**
- **Maintenance Cost**
- **Finance Cost**

Investment Cost

Also sometimes termed “capital cost” or “initial investment”, this cost type groups all cost elements that occur only once at the beginning of the project.

Investment cost comprises cost for purchasing and installing equipment, for site preparation, acquisition of necessary permissions or licenses, professional planning and advice, for connecting the project to the grid system or building access to public grids (for wasterwater to energy projects), etc.

Operating cost:

This cost type comprises all cost elements that occur during regular operational mode of the system after it has been put into productive mode.

Operational cost can be cost for raw material or for operating staff, but also tax and insurance payments, land lease, or cost for feeding in energy into the public grid or access fees (for wasterwater to energy projects).

Main Categories:

- Fixed, or
- Variable

Maintenance Cost:

Maintenance cost comprises all cost elements that occur in order to retain or to restore the productive capacity / operational readiness of the system. Covers:

- preventive maintenance measures or repair measures
- Such maintenance measures can be:
  - small and frequent (replacement of small components, regular checking procedures, etc.), or
  - big and infrequent (unplanned repair of significant damage, exchange of major component, etc).

Finance Cost:

The most important cost element is interest payments to providers of debt capital.

Other typical cost elements are one-time cost for acquiring venture capital, consortium building, cost for financial guarantees, etc.

Finance cost can be one-time cost elements (similar to capital cost) or recurring cost elements (similar to operational cost

Module 3, Part A.3

Structure and Capital Raising

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Determining Optimal Capital Structure and Financing Structure

1. The main question is how much of the necessary capital for the project is provided **through equity and how much will be debt capital**. The mix between equity and debt capital generally is referred generally is referred to as "capital structure" of the project.
2. The second question concerns the **maturity of debt capital**: how long must the debt capital be available to the project? This mainly depends on the project's ability to generate sufficient cash flow surpluses to service this debt.
3. The third question relates to **the mix of different types of debt capital** available.

Internal vs External, Equity Versus Debt Financing

Project sponsors have an intrinsic motivation to keep their own capital engagement in the project as low as possible. They profit from all project surpluses in excess of debt service (interest payments, capital repayment). **Thus, the more profitable the project, the higher the relative return to project sponsors.**

However, the higher the share of debt capital in the project's financing structure, the higher the possible return for projects sponsors and the higher the risks for both project sponsors and lenders.

How big the equity share will be, though, finally depends on:

- The project's capacity to generate cash surpluses (forecasted operating cash flows)
- The project's perceived risk profile (degree and magnitude of project risks)

Internal vs External, Equity Versus Debt Financing

Equity capital	Debt capital
Not repayable	Repayable
Grants ownership in the business entity	No ownership in the business entity
Right to receive (part) of the company's profits => volatile and depending on surplus left after interest and tax payments	Right to receive interest payments => fixed and independent of economic situation of project
Right to influence / determine company management	No right to influence company management

Table 1: Main differences between equity and debt
Source: Taschner

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Internal vs External, Equity Versus Debt Financing

EXAMPLES	Internal finance	External finance
Equity finance	Retained earnings	New shares issue
Debt finance	Provisions	Bank loans, supplier credits, bond issues

*a provision is an account which records a present liability

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