

SPECIAL PURPOSE VEHICLES (SPVs) AT THE HEART OF PROJECT FINANCING

Project financing is an innovative and timely financing method that has been used in many high-profile corporate projects. Employing a carefully engineered financing mix, it has long been used to fund large-scale natural resource projects, from pipeline and refineries to electric-generating facilities and hydro-electric projects. Increasingly, project financing is emerging as the preferred alternative to conventional methods of financing infrastructure and other large-scale projects.

A company building a power plant, for example, could find it difficult to pay N10 billion for construction. Instead, they could raise funding from lenders and investors by offering to share in the revenue generated when the plant begins selling electricity to its customers.

This financing model involves the creation of a Special Purpose Vehicle (SPV) which is a separate legal entity where the project's assets, such as a power plant, reside. An SPV is usually a subsidiary of a parent company and the activities of the SPV consist solely in operating the project as well as collecting and disbursing funds among the project's investors, customers, and suppliers.

The SPV is typically designed to be "bankruptcy remote", meaning its assets are protected if the parent company becomes insolvent. This creates an attractive structure for lenders and investors because a project's success is less subject to instabilities at the parent company.

Project Finance refers to the financing of long-term infrastructure, industrial projects and public services based upon a –non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project under the SPV structure.

Project finance is used by private sector companies as means of funding major projects off balance sheet. At the heart of the project finance transaction is the concession company, the SPV which consists of the consortium shareholders who may be investors or have other interests in the project (such as contractor or operator). The SPV is created as independent legal entity which enters into contractual agreements with a number of other parties necessary in a project finance deal.

SPV IN PRIVATE COMPANIES

The process of mobilizing funds using the SPV window is straightforward. A financial institution (the issuer or project sponsor) with assets it wishes to securitize, sells the assets to the SPV. For legal purposes, the SPV is a separate entity from the financial institution, but the SPV exists only to purchase the financial institution's assets. By selling the assets to the SPV, the issuer receives cash and removes the assets from its balance sheet, providing the issuer with greater financial flexibility. The SPV issues bonds to finance the purchase of the assets; these bonds can be traded in the marketplace and are referred to as securitized products.

Perhaps this will offer better understanding: Let us assume a company needs financing for a new product. It could be anything – building a new pipeline, constructing a new building. Because of the already existing debt on its balance sheet, the banks may loan the money at a hypothetical interest rate of, say, 17%. So, instead of applying for the loan itself, the company sets up a special-purpose entity (SPV or the securitization of assets.)

In this understanding, it is better to think of the SPV as a trust. To establish this trust, the company must sell the SPV an asset – any of the ones listed on its balance sheet will do. In

MARKET UPDATE

	15/01/13	15/12/13	09/05/14
Naira/US\$	157.65	159.94	161.45
Brent, US\$/BBL	109.78	107.84	111.8
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.8
MORTGAGE RATE %	22.0	23.0	23.0

STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	09/05/14 Price (N)	%Change in Price
OANDO	24.25	16.00	-34.02
GTBANK	27.02	26.85	0.63
OKOMU	44.00	35.33	-19.70
STANBIC	21.35	22.00	3.04
DANGSUGAR	11.70	9.20	-21.37
FIDSON	2.79	2.36	-15.41
TRANSCORP	4.35	3.67	-15.63
CCNN	11.75	9.30	-20.85

	PRICE(N)	NAV (N)
	31/01/14	09/05/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	09/05/14	% Change
NSE ASI	41,329.19	38,554.19	-6.71
GMA Index	1.50	1.39	-7.97

Source: CBN, SEC and NSE

this case, it sells its receivable balance and therefore must remove it from the balance sheet. The SPE pays the company for the receivables with the money it collects from these new investors and the company gets to beef up the cash section of its balance sheet.

So the SPV has one big asset on its books. It now can hit the market to raise some money for its new project. It is essentially using the receivable as a security to peddle to the market, hence the term – the securitization of assets. With only one asset on its books, investors won't be hard to find. Even better, they are willing to accept a lower interest rate because it appears that the repayment of their loan is a pretty sure thing since the SPV has no other debt.

Assuming the parent company has not offered a guarantee on the loan, the company no longer has connections to the SPV. And in turn, the SPV's creditors now only have claim to the assets of the SPV. And this makes investment sense as the firm just got a lower interest rate for the money it needs to finance a new project and the new investors locked into a reasonably

safe loan.

SPVs IN PUBLIC PRIVATE PARTNERSHIP (PPP)

The SPV structure also has wide application and usage in the public sector under the public private participation (PPP) arrangement. Here the government, state, or other public body (often known as the Concession Authority) awards the SPV a concession granting it a license in which it has exclusive ownership of a specified facility or asset for a fixed number of years and at the end of the concession the asset is handed back to the public sector in a specified condition. The concession sometimes known as the implementation or project agreement is the primary contract between the government and the SPV and forms the contractual basis from which other contracts are developed in the structure shown. The concession normally entitles the SPV to build, finance and operate the facility for a fixed period, although there are other variations.

ATTRACTIVENESS OF SPVs

The attractiveness of SPV in project finance is the ability to fund projects off balance sheet with limited or no recourse to equity investors. The implication is that if a project fails the project lenders recourse is to ownership of actual project and they are unable to pursue the equity investors (issuers or sponsors) for debt. For this reason the lenders who are subscribers to the SPV securities focus on the project cash-flow as this is the main source for repaying project debt.

Also lenders will not normally demand repayment of capital on the loans until the construction phase has been completed and the project is generating cash. Once the construction phase is completed, the project enters its operational phase overseen by the project operator. The operator is responsible for day to day running and maintaining of the project over the life of the concession. If the concession is to be handed back to a public authority at the end of the concession, a specified standard of maintenance will have been agreed at the start of the project.

SPV DEBT EQUITY MIX

The shareholders will invest into the SPV, the level of which can vary. Strong projects with strong cash-flows and low risks can be structured with minimum of 10% equity and 90% debt. This could rise up to 40% equity and 60% debt depending on the financial package being put together. It is in the interest of the shareholders to minimize their equity contributions, as equity commands a higher rate of return and as such is more expensive than the costs of using commercial bank debt. The bank lenders will always seek a comfortable level of equity from shareholders of SPV to ensure that the project sponsors are seriously committed to the project and have a vested interest in seeing the project succeed. "Mezzanine" or "Subordinated" debt may also be used at this stage from infrastructure funds or mezzanine fund providers that will be reflected in the shareholders' agreement for the SPV.

CONCLUSION

Project finance is a finance relies heavily on SPVs for the financing of projects, such as a mine, toll road, railway, pipeline, power station, shipbuilding, hospital etc., which is repaid from the cash flow of the projects. Project finance is different from traditional forms of finance because the financier principally looks to the assets and revenue of the project in order to secure and service the loan. In contrast to an ordinary borrowing situation, in a project financing the financier usually has little or no recourse to the non-project assets of the borrower or the sponsors of the project. In this situation, the credit risk associated with the borrower is not as important as in an ordinary loan transaction; what is most important is the identification, analysis, allocation and management of every risk associated with the project.

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