

Study of Project Finance Versus Corporate Finance

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Abstract: The term Project Finance (PF) has been used to explain many types of financing of projects both with and without recourse. A specific element of project finance is the necessity of creating Special Purpose Vehicle (SPV). A guarantee for return of capital used to finance project are the SPV's assets. In traditional or corporate financing, the sponsoring company typically procures capital by demonstrating to lenders that it has sufficient assets on its balance sheets. This study attempts to study project financing as an alternative method of financing projects and compare this methods and argue why project finance should be used, instead of traditional or corporate financing methods.

Key words: Project finance, corporate finance, non-recourse, assets, capital, Iran

INTRODUCTION

Project finance approach: The term Project Finance (PF) has been used to explain many types of financing of projects both with and without recourse. There is no singular definition of project finance. Wynant defined project finance as a financing of a major independent capital investment that the sponsoring company has segregated from its assets and general purpose obligations. According to Peter and Frank (2000), the definition of PF could be summarized as:

A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the sources of funds from which a loan will be repaid and to the assets of the economic unit as collateral

The International Project Finance Association (IPFA) defines Project Finance (PF) as, 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. Project financing techniques date back to at least 1299 A.D. when the English Crown financed the exploration and the development of the Devon silver mines by repaying the Florentine merchant bank, Frescobaldi with output from the mines (Kensinger and Martin, 1993).

Characteristics of project finance: Investments that are liable to be financed through this method have the following main characteristics:

- Projects evolve through two clearly differentiated stages: construction and operation
- As the financing is made to measure, its structuring tends to be costly and therefore is only justifiable for large-scale projects
- The bulk of the investment is aimed at tangible assets
- The totality of the project's assets are pledged to financial creditors
- High leverage is usually employed
- Investments are usually long-term (e.g., 20 years)
- The only purpose of the financing is to complete the project and as such it has a limited lifetime

The key to project finance is in the precise forecasting of cash flows. In effect, the possibility of estimating cash flows with an acceptable level of uncertainty allows for the allocation of risks amongst the various interested parties based on their relative advantage. The ensuing certainty in cash flows renders the existence of high debt levels and enables the project assets to be separated from the companies and sponsors involved in it. A special company is created, a special-purpose vehicle or SPV to take care of the project. The SPV prepares the plans, becomes responsible for the financing and operation of the project when it is completed. It has no track record and consequently no standing or market position on its own.

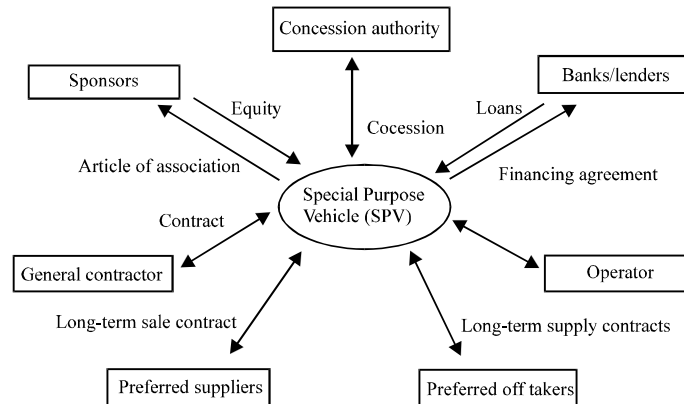


Fig. 1: The project's participants and their connections with the SPV

An example of such project finance participant structure and the connections with the SPV is shown in Fig. 1.

Once the project is completed and in operation, it should start to generate revenue for the sponsor and other participants for a period of time specified in the contract. When the claims of the capital providers are satisfied, two scenarios are possible:

- The sponsor (and other participants) operates the project and obtains revenue from it
- The SPV is dissolved and the assets are taken over by the entity that initiated the project or are divided among the partners depending on what has been agreed in the contract. The completion scenario is usually agreed in advance

Traditional on-balance sheet financing: Traditionally companies have been using various methods for funding their capital expenditure requirements like corporate bonds, term loans, asset-based security funding, equipment leasing, venture capital and most common of all initial public offerings or subsequent offerings of equity capital. These all forms are conventional ways in which the firms are either raising new equity capital or funds from the lenders. As shown in Fig. 2, the lenders are providing the funds to the parent company (the investing firm) and then the parent company is investing the funds in the project assets. In this form of financing, commonly known as corporate financing or the balance sheet financing although, the financing is done for the project but the lender looks at the cash flows and assets of the whole company in order to service the debt and provide security (Pandey, 2005). According to International Finance Corporation (Ahmed and

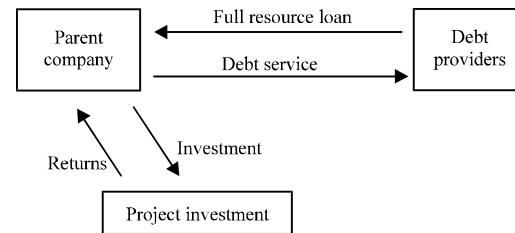


Fig. 2: Traditional on balance sheet funding

Fang, 1999) in corporate financing primary source of repayment for investors and creditors is the sponsoring company, backed by its entire balance sheet, not the project alone. Therefore in traditional or corporate financing, the sponsoring company (the company building the project) typically procures capital by demonstrating to lenders that it has sufficient assets on its balance sheets. That is in the case of default, the lender will be able to foreclose on the sponsoring company's assets, sell them and use the proceeds to recover its investment. In project finance, the repayment of debt is not based on the assets reflected on the sponsoring company's balance sheet but on the revenues that the project will generate once it is completed (Pandey, 2005).

Governments liked project finance because it allowed private money to fund particular development needs; corporations preferred it because it allowed them to finance projects off their balance sheets. Bankers and investors found the project finance structure appealing because it allowed them to diversify their portfolios while sharing risks between many participants.

Project finance versus corporate finance: The two essential features that distinguish project finance from corporate finance are:

- Cash flow separation
- Non-recourse financing

Cash flow separation and verifiability: In project finance, the legally independent incorporation along with the absence of multiple current and future projects, enables the project company to easily separate project cash flows from the cash flows produced by the assets of the sponsor. Such cash flow separation is difficult to accomplish in corporate finance. Furthermore, the presence of a single discrete project in a legally separate entity enables the lender to easily monitor project cash flows.

In contrast in corporate finance, project cash flows become co-mingled with the cash flows from other assets making the monitoring of such cash flows relatively more difficult. The ability to separate project cash flows along with the decreased cost of monitoring such cash flows, enables the project company to enter into detailed contracts with its lenders (Subramanian and Tung, 2007).

Non-recourse financing: Apart from cash flow separation, project assets are legally separated from those of the sponsoring firm in project finance. This separation of project cash flows and assets enables the project company to be financed with non-recourse debt.

Thus, the project company's debt-holders do not have recourse to either the cash flows or the assets of the sponsoring firm. In contrast, in corporate finance, the lenders can rely on the cash flows and assets of the sponsor company apart from those of the project itself (Subramanian and Tung, 2007). The main differences between traditional financing and project finance are shown in Table 1. Esty (2003) argues informally that project finance

reduces the agency costs of free cash flow encountered in corporate finance. The first motivation to use project finance, the agency cost motivation, recognizes that certain assets, namely large, tangible assets with high free cash flows are susceptible to costly agency conflicts.

The creation of a project company provides an opportunity to create a new, asset-specific governance system to address the conflicts between ownership and control project companies utilize joint ownership and high leverage to discourage costly agency conflicts among participants. The provider of capital in project finance does not analyze the credit capacity of the SPV and there is no traditional guarantee of repayment by the entities involved in the SPV.

Hence, project finance may be described as financing with higher risk for the lenders in other hand, project finance greatly minimizes risk to the sponsoring company as compared to traditional corporate finance because the lender relies only on the project revenue to repay the loan and cannot pursue the sponsoring company's assets in the case of a default.

If the project fails, the lender can only liquidate certain assets of the SPV to recover its money but does not have the right to make any claims against the project's sponsor and their assets (Pyka, 2010).

According to IFC, in corporate finance if a project fails its lenders do not necessarily suffer, as long as the company owning the project remains financially viable. In project finance if the project fails investors and creditors can expect significant losses. Project finance has two important advantages over traditional corporate finance: it can increase the availability of finance and reduce the overall risk for

Table 1: Main differences between traditional financing and project finance

Items	Corporate finance	Project finance
Destination of the financing	Multipurpose	Single purpose
Duration of the financing	Variable	Long-term and limited by the lifetime of the project
Financial structure	Dept-holders not related	Dept-holders tied by a general agreement
Risk analysis	Highly dependent on financial statements and cash flow	In addition, technical considerations, contractual agreements and the dept structures are all very important
Liquidity of the financial instruments	Can be high if they are negotiated on capital markets	Generally, low as the financial agreement is private, made to measure and impregnated with contractual relationships
Financial costs	Relatively low	Relatively high owing to both the structuring costs and the low liquidity of the instruments
Room for management to make decision	Plenty if the company has open capital	Little, owing to the rigid contractual structure
Agency costs	High if the company has open capital	Low as the contractual structure leaves little margin for independent action by the partner

major project participants, bringing it down to an acceptable level. For a reason, a compelling reason to consider using project finance is that the risks of the new project will remain separate from its existing business.

CONCLUSION

Project finance as an alternative to corporate finance has experienced rapid expansion in infrastructure finance in Asia as well as in Europe in the 1990s. For example, PF as an effective debt instrument has widely been applied to finance Private Infrastructure Projects (PIPs) in developing as well as developed environments (Esty, 2000). Unlike most PF studies that focused on how a particular PF arrangement worked, this study attempts to study project financing as an alternative method of financing projects and why should project finance be used, instead of traditional or corporate financing methods. The researchers are not suggesting that the companies immediately and completely shift from traditional financing to project financing for all types of projects but companies must select project finance or corporate finance according to the characteristics of a project, project revenue stream, environment's policy and economic situation, sponsoring company's balance sheet and the risks rate that are tolerable to the sponsoring company. For example, project finance is most suitable for a project where there is a predictable revenue stream to support debt repayment. As well as in corporate finance if the

sponsoring company can not demonstrate to lenders that it has sufficient assets on its balance sheets it does not success to procures capital.

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