Capital availability drives US project finance

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The project finance market has been especially dynamic since the start of the world-wide Covid-19 pandemic in early 2020. After an initial pause, the market came back strongly, largely shaking off concerns around supply chain issues and capital availability. In fact, debt capital is available from a wide variety of providers, with borrowers generally able to find the right type of financing necessary for their projects.

The project finance market is currently being driven by a number of factors, including the recently passed Infrastructure Investment Act (derived from the American Jobs Plan, as proposed by the Biden administration and approved by the Senate) and the pending reconciliation bill, known as the Build Back Better bill, which includes a number of important provisions that didn't make it into the first bill.

The overall package included significant measures to encourage a wide variety of project finance sectors, including public transportation infrastructure, clean water, and especially renewable energy generation.

The renewables sector is poised to accelerate, with provisions for the extension of the Production Tax Credit and the Investment Tax Credit, as well as an innovative "direct pay option" that would allow the owners of renewable energy assets to receive payments directly from the US government in lieu of claiming tax credits (which requires the owners of the assets to have sufficient taxable income to monetize the credits).

The wide variety of available capital

The life-blood of project finance continues to be the availability of capital, matching up to the specific structure, characteristics and needs of each project. Project finance participants like to say that there are no cookie-cutter deals in the sector, and that's largely accurate.

While not every transaction is unique, they are always tweaked and tailored to suit the specific needs of each borrower. Below we look at a number of different types of debt available in the project finance sector, and where they fit in various transaction structures.

Commercial bank debt

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Commercial bank debt is the most plentiful source of capital available for project finance transactions. According to the *Infrastructure Journal* league tables, there were 125 active commercial bank lenders in the US market in 2021, with 231 deals done accounting for $74 billion in funded debt.

There are vast differences in the level of activity among lenders. Of that list of 125 banks, 70 did more than one deal, and the most active six banks did 40 or more deals each. Commercial banks have long been the predominant providers of capital in the project finance sector, due in part to the flexible nature of that capital.

Commercial bank debt is floating rate, with interest charged at some spread over a benchmark rate (predominantly LIBOR, although that is about to change with the wind-down of LIBOR).

The floating rate typical in commercial bank debt makes it well suited to construction financing, where multiple drawdowns of the total commitment by the lenders happens over some period of months or years as the project is built. Post-construction, term loans from commercial banks can last up to fifteen years or more, although shorter “mini-perm” structures of 5-7 years are more typical these days.

The term of the debt is dependent upon many factors, but it is especially tied to the contracted cash flows of each project and how long those last. For example, if a power project has a 20-year power purchase agreement with an investment-grade utility off-taker, the debt providers may be willing to lend for up to 15 years or more.

However, if a power project is selling into the merchant market and has hedged its revenues for five years, then the debt providers will likely not go out beyond five years (at least not without a significant pay-down of the debt).

The flexibility of commercial banks extends beyond plain vanilla construction financing and term loans, with many lenders also providing revolving credit facilities and so-called “warehouse” facilities. These warehouse facilities are well-suited to developers who are building a large number of projects (such as smaller solar power projects) and want quick access to construction capital. These projects will then be placed into a longer term-loan facility, a private placement or a structured finance vehicle.

Institutional investing

Institutional investors, such as life insurance companies and pension funds, have long been active in the project finance sector, drawn in by the long-life nature of the assets and the long-term structures of the transactions. These long-tenor deals match up well with incoming capital on insurance policies or from teachers and workers moving towards distant retirements.

Bond financings in project finance occur primarily in the form of fixed-rate private placement transactions. Many years ago, bonds were frequently used as “take-out” financing post-construction, with borrowers able to find more attractive rates and terms with bonds than from bank loans.

Due to their fixed-rate nature, bond financings were seen as less flexible, as early pre-payments require the debtor to make the investors whole to compensate them for missed interest from early breakage of the loan. As commercial bank debt became more plentiful and less expensive, borrowers moved away from bond financings (especially in the decade following the financial crisis).

These days, bonds financing is enjoying a resurgence as borrowers look to alternative places to find capital. Bond investors are providing more flexibility, such as delayed draw provisions for construction financing. According to the *Infrastructure Journal*, there were 58 bond financings in the US project finance market in 2021, valued at $23 billion of funded debt coming from 58 arrangers. Of those 58 bond arrangers, 23 of them did only one deal each, and only 6 did more than five or more deals each.

Mezzanine financing

Mezzanine or subordinated financing has become increasingly popular with both lenders and borrowers. For lenders

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who can get comfortable with the risks, being in a subordinated position can increase the return they receive. For borrowers, this type of capital allows them to add leverage to a project without jeopardizing the position of the first-lien lenders and the protections they enjoy.

We often see subordinated debt in the form of term debt at a holding company level, above the project company. Typically, the "holdco debt" is repaid only from upstream cashflow paid by the project to the equity owners. The lenders are taking a bet that there will be sufficient excess cash flow at the project level to flow up to the equity owners, and they do not enjoy any claim to the hard assets being financed at the project company level.

Early-stage development debt

Early-stage debt capital can be notoriously hard to source – and it's typically the most expensive type of debt. Equity usually serves in the capacity of providing early-stage capital to developers who are working hard to bring projects to the market (but might not have "shovel ready" projects ready to bring to the bank market for financing).

The problem with raising equity is that developers' interests in their projects get diluted, and they potentially lose control. While development debt can be expensive, there are firms out there specializing in this segment, which has historically been "under-banked." Development debt is highly flexible and more patient in terms of being repaid than traditional term debt, and the lenders use their knowledge and skill sets to help developers get their projects completed.

Structuring project finance transactions

The various types of financing described above may be used by developers for so-called "greenfield" projects – those that are being built from the ground-up in a new location, as well as for "brownfield" projects – those that are being renovated, upgraded or built on existing locations. Often, debt capital is raised to finance the acquisition of a project by one entity from another. It also may be used to refinance older debt, to extend the term, get better pricing or improve terms and conditions.

As a third-party provider of trust and agency services on project finance transactions, Wilmington Trust is brought in on financing spanning all types of assets and structures, as outlined above. Most often, we come into deals where there are one or more groups of lenders whose interests need to be represented. In our most typical roles, we serve as a collateral agent, holding physical and non-physical assets that have been pledged by the borrower in support of the financing.

We also serve as a depositary agent, opening and maintaining operating and reserve accounts and running the cashflow waterfall. Another role we serve in is that of an administrative agent, tracking affirmative covenants and helping to coordinate the review and approval of consents, waivers and amendments.

More recently, we have seen an uptick in private placement transactions in the project finance market. On those deals, Wilmington Trust is brought in to serve as a trustee, paying agent, registrar and sometimes noteholder representative.

Covenant packages for lender protection

With regards to affirmative covenants, those can vary quite a bit from one type of debt product to another. The basic covenant package includes the provision of quarterly and annual financial statements, with the annual statements being audited. These are typically accompanied by an officer's certificate, which verifies the accuracy of the information being provided and might also include details on other financial covenants.

Those financial covenants could include the calculation of a debt service coverage ratio ("DSCR"), which provides a quick glimpse into the financial health of a project and its ability to service its debt load at a given point in time.

Lenders may also have to provide a loan life coverage ratio ("LLCR"), which provides a look-forward view towards the project's ability to pay off the remaining debt based upon the latest model and assumptions. Another typical covenant is the provision of an annual budget for the coming year, which is reviewed by the lenders and the independent engineer.

As lenders provide financing higher up in the organizational structure, some of the project-focused covenants will fall

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away, and typically the list of affirmative covenants becomes shorter. However, with different types of debt – especially that which is provided against more risky assets or those without long-term contracted cash flows – there can be additional covenants.

Those covenants are designed to provide additional protections to the lenders and might include cash sweeps and target amortization schedules (on deals that have limited or no fixed amortization of principal during the term of the financing). Cash sweeps may be in effect throughout the term of a transaction, or they may be triggered by some other event, such as the DSCR falling below a certain agreed-upon level or a key counterparty losing an investment-grade credit rating.

Overall, the project finance market today is characterised by a large supply of capital from a wide variety of sources, each providing a different product that can be tailored to suit the needs of just about any project. Borrowers today are well-positioned to find and structure the financing they need at a price that suits their project.

This overall availability of capital, coupled with the strong outlook for the sector (driven in part by the Infrastructure Investment Bill), seem to indicate the continued strength and vitality of the project finance sector.

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