GLOBAL OVERVIEW

Project finance through the cycles

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Few things have a greater impact on our business than economic cycles. In boom times, countless lenders chase a torrent of deals, often resulting in project financings that reflect the lax credit standards then prevalent in the market. In tougher times (like the present), the limited number of projects able to withstand economic turbulence have to seek financing in constrained credit markets, whilst other projects are forced to restructure the terms of their original boom time deals in the face of impaired business conditions.

Economic cycles are inevitable, with peaks in demand for both assets and commodities typically followed by troughs. However, demand for investment to address the long-term needs of growing populations and rising expectations for living standards has remained more resilient whatever the business climate than other types of economic activity. Many countries, particularly those with substantial financial reserves (notably the Gulf region states), find the development of infrastructure required for critical services, such as water, transport, power and telecommunications, simply too important to defer. Moreover, the commodity hungry countries of Asia (with China now also investing heavily overseas) will often seek to exploit recession-impaired asset prices to secure access to natural resources across the globe. By contrast, projects whose viability depends on robust market prices for their products, those located in depressed parts of the world and those providing discretionary services will more likely face deferral.

We have of course seen these cycles before. The currency crises of the late 1990s and the electricity sector disruptions caused by Enron are just recent examples. Large-scale projects are deferred, others require restructuring. The economic cycles have, however, always turned and, with lessons learned from prior periods, we seem this time to have avoided the accounting and other abuses that deepened prior troughs. Fortunately, project finance activity often resumes earlier than the broader economic upturn as sponsors seek to invest ahead of the inevitable inflation of construction costs, recognising that projects financed today may not reach completion for years, well after demand for their output has resumed.

What is perhaps of particular concern this time is the extraordinary disruption in the global financial markets, with the availability of bank debt in particular being severely constrained by impaired balance sheets and a dearth of financial liquidity, exacerbated by revised capital adequacy rules.

With fewer commercial banks able to lend, sponsors have had to widen their searches for sources of financing. Islamic tranches are now prevalent in many parts of the world. For projects in emerging markets, multilateral lenders, development finance institutions and export credit agencies have taken on the burden. No longer serving merely as a catalyst to mobilise the involvement of private-sector finance, these institutions are now frequently relied on to fund the vast majority of the debt requirements of large-scale projects. In a range of other countries, most recently the US, public-sector institutions are becoming the lenders of last resort for domestic energy and infrastructure projects.

Modest amounts of commercial debt remain available for sound projects, although at increased cost and with more stringent terms. Banks that have themselves recently been brought under national ownership or control are being encouraged to fund the domestic infrastructure projects that are seen as key to economic stimulus, whilst others are providing non-recourse debt to maintain their ties with leading corporate sponsors. Various long-term investors, such as pension and insurance funds, are once again seeking stable investment opportunities, with a range of well structured private placement and bond issuances reaching financial close.

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The need for sound legal skills in these troubled markets is often greater than during boom periods. Although the principal impact of the credit crunch has been on loan margins and tenors, lenders are now also taking a tougher stance on the allocation of project risks and requiring more robust security packages. Market volatility has affected the stability of loan pricing models, resulting in renewed debate over such standard financing terms as market disruption, yield protection and material adverse change clauses. Likewise, with new lenders involved in negotiating (and not just funding) large-scale financings, there is a heighted need for creativity and diplomacy in co-ordinating a broad range of perspectives across languages, time zones and legal traditions.

Navigating existing projects through changed macro-economic realities presents its own set of complexities. Falling revenues can reduce a project's capacity to address problems as they arise (increasing the likelihood of litigation when things go wrong, which in turn makes resolution of disputes more difficult) and may impair its ability to meet the host government's tax, royalty and other expectations (increasing the risk of political interference and even expropriation).

The lawyers in this guide have been through troubled periods before and will likely hone the skills learned in earlier cycles through this one as well. The collective knowledge of this group has advanced over the years, with a growing number of journals, courses and texts dedicated to our field. Lawyers in many of the world's emerging markets, in particular, have gained sophistication in applying project finance techniques in their local jurisdictions. Although the current challenges are undoubtedly significant, experienced project finance lawyers have the means to help guide sponsors, lenders and host governments through this cycle and on into the next.