The Role of Project Finance in Modern Financing

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ABSTRACT: Project finance schemes are normally accessed from trade finance point such as commercial debts, export credits, leasing mechanisms, subordinated debts, equity and other investment portfolios with positive net present value. Project finance schemes are usually intended to reduce operation costs particularly those arising from insufficient information on potential investments and capital allocation. It is usually appropriate for financing long-term explicit capital intensive project. This study further establishes that in nastiness of the difficulty related with project finance, project financing is an emerging economy. Project financing is an innovative trend or method of financing large infrastructure and industrial projects based on the projected cash flow of a finished project rather than the investors `own finances which is the traditional corporate financing system. The prime motive why project finance is relied upon to fund investment is its abilities to alleviate investment risk and to raise finance at a relatively low cost.

Keywords: *Potential, Investment, Capital, Allocation*, Risk

Introduction

Project financing is the process of determining how to go about obtaining the resources required managing the costs associated with the launch and ongoing operation of a project. While this process sometimes involves the reallocation of resources in order to fund the project, project financing more commonly involves securing loans or other types of financing in order to cover the costs of the project. The goal is often to secure enough assets to launch the project and keep it functioning until it can begin to generate a return and become self-sufficient.

In the light of basic developmental expectation from most governments, contemporary governance in most economies has shifted focus on developing large scale projects through the application of project finance schemes (Andrews, 2010; Esty, 2004; Grahame, 2010). In the last few decades, the number of project finance schemes employed to provide basic infrastructure for public consumption has increased considerably (Fight, 2006). In the United Kingdom alone, a total of 600 projects worth over £56 billion have been constructed over a period of 15 years through project financing (PPPForum, 2011). Globally, the total cost of financing infrastructure through project finance schemes increased from $208 billion in 2007 to $219 billion in 2010 (Andrews, 2010). As a virtue of fact, the role played by project finance schemes in most economies is very significant to their development especially the emerging economies (Esty, 2004).

Problem Statement

In corporate finance, we use firm broadly to refer to any commerce, large or small, and private or public. Thus, a corner grocery store and Telecom companies are both firms. The firm investments in corporate finance are usually termed assets, whereas those assets that the firm projected to invest in the future are called growth assets. To corporate finance or assets, the firm can raise money from only two sources. It can raise funds from investors or financial institution by promising investors a fixed claim interest.

Furthermore, we classified this type of financing to be debt financing. Alternatively, it can also offer a residual claim on the cash flows which is termed as equity or equity finance and so adopted the principle of perpetuity. These problems originated the modern trend in financing known as project finance which has broader scope of raising fund to finance a project. The use of project finance to mitigate underinvestment was as a result of conflict between debt and equity holders within an organisation.

Research Framework and Methodology

Data on project finance was collected from Secondary sources like Articles, Journals, Empirical literatures, Textbooks and Internet sources for analysis on role of project financing in an economy. Qualitative methodology was applied for this research paper. Descriptive research design and analysis on the role of project finance were employed to Investigate the project financing. For the purpose of analysis, a secondary data was used to analyses the various literature on project financing and its role in an economy.
The researcher obtained both primary and secondary data from the various case studies for the analysis of the project financing. The primary data was in the form of interviews with the concern officials. Secondary data was in the form of documents obtained from the internet, literatures reviewed and other articles for the analysis of the of project financing.

The research used qualitative data analysis methods, and trend analysis was also used in analyzing the project finance. Trend analysis refers to the an analysis of the project financing for some conservative years, comparing the differences years within those stipulated periods and an analysis was performed to evaluate the project financing.

Research Framework

The term project finance is used heavily by academics, bankers and the media to portray a range of financing arrangement. Most of the time ganged about in trade journals and industry conferences as a new financing technique, project finance is actually a modern approach to finance infrastructure development in an economy. In recent times project finance has grown as a form of financing arrangement for building pipelines, refineries and other large capital intensive infrastructure projects. According to the (2005) report by the Asian Development Bank, Japan Bank for International Cooperation and World Bank, Asia alone needs to spend over $1trillion on roads, water, communication and other infrastructure projects in a period of five years to meeting the growing needs in urbanization, population growth and growing demands of the private sector (ADB, JBIC, & Work Bank, 2005, January).

The use of project finance and its feebleness through olden times and into present times indicates that project finance definitely serves an economic purpose. According to the empirical research by Kleimeier and Megginson(2000)clearly shows that project finance is a distinct form of financing.Habib and Johnsen (1999) and Esty (2003) argue that firms invest in particular assets and assume that project finance mitigates transaction costs from investment in definite assets. Esty and Megginson(2003) examine how concentrated ownership of project companies and syndicate size reduces agency costs within project companies. The researcher examines the motivations for investment firms undertaking the project finance decision itself.

Nevitt(1979),Esty (2003) have defined project finance as the financing of assets in which lenders are contented to look only to the cash flow and earnings from those assets as the source of funds from which the loan will be repaid and to the assets themselves as security for the loan. The non-recourse or limited recourse nature of projects financing is the sine qua non of this form of financing (Esty, 2003).Project finance characterized by separate incorporation by investing firms called sponsors, concentrated ownership of equity by the sponsors, highly detailed contracts between parties especially suppliers, buyers, contractors, lenders, government and are very high leverage.

Esty(2003) also observed that these assets are decomposing assets that do not require general managerial skills for generating cash flows unlike for example biotechnological investment. Project finance investment shows high debt, high level of formal and legally binding contracts. The transactions cost economics perspective specifies vertical integration, long term contracts and high debts levels as a means of mitigating transaction costs (Esty, 2003).Project structures show all three of the systems for mitigating post contractual opportunism, economizing on transaction costs and the characteristics of self-regulating contracts. Project finance may also be used to mitigate underinvestment incentives (Esty, 2003).

Main Findings of the Study

The empirical data analysis from the primary, secondary sources and the other literature reviewed sources has shown the project finance and the role of project finance and this was possible due to results from the study enumerated as below:

The Creation of Job and the Expansion of Private/Public Sector

Governments create jobs in the private sector by funding projects. Capital, infrastructure, building and bond projects are some government-funded projects. When one level of government funds a project, it often attracts funding from other levels of government, sometimes from private foundations, and sometimes from the private sector in terms of private capital fundraising (Art, 2011).

In lieu of using the traditional means of financing projects in corporate finance, project finance schemes has over the years yielded positive results in constructing long term projects without necessarily having sufficient funds (Esty, 2004). Project finance involves the financing of an independent economic unit, legally created with funds from one or more parties/firms. This type of financing is a non-recourse debt which offers the project company concession to offset the debt with the cash generated from the project after completion. In actual fact, the assets of the project company serves as collateral for the loan accessed (Yescombe, 2002). In such schemes, a legal company is created with sponsors and other financiers mandated to complete the purported project. These parties' ranges from project sponsors, governments, contractors, financiers and suppliers (Fight, 2006).

The major source of finance under project finance schemes are normally accessed from trade finance, commercial debts, export credits, leasing mechanisms, subordinated debts and equity (Graham, 2010). Significantly, each project has a unique profile, apparently, each individual risk can easily be allocated and distributed wholly or partially (Graham, 2010). Project finance schemes are usually designed to reduce transaction costs especially those arising from inadequate information on possible investments and capital allocation (Parker, 2012). It is normally suitable for funding long-term and specific capital intensive projects such as construction of energy plants, energy supply, telecommunication, airports and harbors, railway systems, tunnels and bridges, chemical and petro-chemical wastes (Yescombe, 2002).Hence, expansion on both the private and public sectors, This expansion also brings about employment avenues.

Project Financing Initiative

In the UK, most project financings have been carried out under the Government's private finance initiative (PFI) and are known as Public Private Partnerships (PPPs). PFI was introduced in the early 1990s and aimed to introduce private sector skills and finance into the provision of public sector services. PFI is structured so that the private sector obtains finance - usually from a bank - to design, build and operate a facility for the benefit of the public.

Usually referred to as private finance initiative (PFI), project finance initiative is another means of procuring infrastructure by the public sector (Parker, 2012). The United Kingdom is one of the countries that have capitalized on the immense benefit of PFI to develop most of its infrastructure (Fight, 2006). This financing scheme was introduced in the early 1980's in the UK and fortunately has the support of all the political parties. In recent times, the United Kingdom has developed over 860 PFI projects worth over £239 billion (Parker, 2012).Under the project Finance Initiative (PFI), the public sector engages the private sector in a long-term contractual arrangement to design, build, finance and operate projects in the health sector, educational sector, housing sector, and general infrastructure (Parker, 2012).

The scheme permits the private sector construct and operate the project for a specified period of time usually over 25 to 30 years. Central to the concept of PFI is the allocation of project risk to the private sector. Notable among these risks are cost overruns, delays, management inefficiencies (Fight, 2006; Parker, 2012; Yescombe, 2002). In essence, PFI's aims at encouraging innovation and good design, efficient management and maintenance of assets, enhanced productivity and quality service delivery unlike the conventional public funded projects.

Major Parties to Project Finance

Project finance is a long-term method of financing large infrastructure and industrial projects based on the projected cash flow of the finished project rather than the investors' own finances. Project finance structures usually involve a number of equity investors as well as a syndicate of banks who will provide loans to the project.

The core parties to Project Finance Initiatives are government agencies, Project Company or contractor, financiers and the Treasury (Fight, 2006). The governments' agencies are the specific public departments that engage the private sector to design, build, finance and operate the project (Yescombe, 2002). These public authorities normally seek approval from the central government to engage the private in such arrangements. The project company is made of the private organization or a consortium of companies engaged to accomplish the project (Parker, 2012). The financiers on the other hand are the financial institutions such as banks and lenders that advance funds towards the development of the project. In essence, the government agency(s) engage these private companies together with the banks that finance the project in a typical PFI's.

Discussion the Implication of the Study

This section forms the conclusion of this study and the aims of the study as well as what has been discussed in the literatures which were discussed in relation to the secondary and primary research that have been carried out. The section is going to take a conclusion view on the study based on the analysis, information and result that has evolved during the course of the study. Recommendations are also given at the end along with a proposal of areas that will need further development and attention.

The end of this research has been to generally fit the aims and objectives of this study. Recommendation for the future is however made to further improvement upon the findings of this research. Based on the findings of the research, it is recommended that:

As project finance is the best method of financing long-term project in modern system of economy which enables one organisation to repay with the generated cash flow of the project compared with the transitional system of corporate financing aiming at only two objectives.The investors or the company undertaking the project needs to work with more expert team so as to ensure the completion of their projects.

Projects or contracts under project finance arrangement could be funded through commercial debts, expert credit, leasing mechanisms, private foundation, international organisation, private sector and capital fundraising. Therefore, it is preeminent for financiers to know the type of finance that could best aid their projects or contracts.

The lenders or financiers to project finance are sometimes financial institution that provides loans to the project company to develop or construct the project and so take a security interest in the entire project assets since some of these projects are for longer periods. In most cases the financiers appoints financial managers of the fund so as to have strong control over the fund. This also goes a long way to improve the completion of the project and repayment of the fund.

The project finance transactions play an important role in financing development throughout the world. However, the complexity that describes the project finance transactions requires several contractual agreements among numerous players involving the sponsors, financiers, contractors, Suppliers and off takers (Hillion, 2011).Therefore, since, project finance has several contractual agreements, project finance companies should take it into consideration when applying for project financing.

Project finance encourages new investment by structuring the financing around the project`s own operating cash flow and assets without additional sponsor guarantees. Thus, the main reason why the project financiers relied upon project finance to fund investments which is its ability to alleviate investment risk and to raise finance at a relatively low cost to the benefit of financiers and investors alike(Ahmed,19999).

On the whole, the research feels that the objectives of this research have been met and have provided more insight into the project finance. It is also hoped that the findings of this research will assist future studies that examines activities that pertain to the role of project finance in an economy.

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