Structured Financing

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Outline

1. Principles of Structured Financing
2. Challenges to using Structured Financing in water supply service providers
3. The mechanics involved with Structured Financing

Learning Objective

1. To understand basic principles behind Structured Financing
2. To understand some of the challenges facing water service providers in accessing private finance
3. To understand the basic mechanics and risks involved with Structured Financing

Key Messages

Structured finance reduces the risk to the lender resulting in reduced rates of interest and longer tenors.

Pre-conditions include reliable and sustainable cash flows, political stability, bankable projects, legislation permitting ring fencing and revenue intercepts

Utilize risk mitigation measures to further reduce the risk of lending.

Principles of Structured Financing

Why Use Structured Financing?

- Primarily because collateral-based lending is not an option
- Structured financing is about finding the needed mix of revenue sources to attract commercial lenders combined with a package of credit enhancements to mitigate risks and in the end minimize the cost of borrowing
- Structured financing is risk management
- Identifying and, if possible, quantifying the risks to all stakeholders

Explanation of Structured Financing

- Normally commercial financiers make loans backed by collateral or for specific projects which will generate the cash to repay the loan – in both cases the lender is able to look to the collateral or the project for security that the loan will be repaid

- When those options are not available lenders must commit to lending based on the entity's cash flow – and rely on credit enhancements to reduce their risks

- Because service providers do not have assets which can be used as collateral, lenders must **structure** the financing to provide the needed capital at a reasonable level of risk

Structured Financing

Structured financing was created for entities with illiquid assets such as housing (water utilities) but reliable cash flows based on pay history.

Structured financing allows utilities to borrow funds by using their collections (cash flow) as security rather than using their physical assets as collateral.

The benefit of structured financing is that the entity can use its liquid assets derived from its illiquid infrastructure as an alternative funding source.

Structured Financing

Structured financing can consist of a customized package of funding from financiers to an entity (utility). It involves the financing of existing or future identifiable cash flows with limited recourse to the company.

Structured financing can involve different types of funds – senior and/or junior debt and equity – and loans can have greater flexibility with regard to interest rates and tenors than would a standard bank loan.

Structured Financing

A creditworthy borrower/utility would benefit from:

Greater equity and increased levels of funding provided by government in the form of:

- Capital stock and retained earnings
- Junior debt
- Subsidies and other grants
- Results-based financing to help make the project commercially viable

Risk Management & Structured Debt

The reason that debt is structured is to make a viable loan for all stakeholders – however, stakeholders have different agendas in the structuring.

Risk management is a key element in structured financing.

Each stakeholder – borrower, government and lenders have the option to avoid, accept or share a risk in debt structuring.

Structured Financing

Structured financing can be seen in asset-backed secured lending, and large infrastructure projects which transfer risk using legal and institutional entities such as Special Purpose Companies (SPV).

However, utilities can also make use of structured financing with commercial banks and/or other private financiers through the use of a structured obligation bond with the repayment funds held by an independent entity.

Discussion Point

Do you think that the commercial lenders would be interested in making use of Structured Financing for your client WSPs?

1. Yes
2. No
3. Don't know

Structured Obligation Bond

- Structured obligation bonds pledge debt repayment based on one or more specific revenue sources which have proven to be reliable.
- The repayment mechanism is typically structured so that the obligated portion of the pledged revenues bypass the utility's accounts and are held in a separate debt service account that cannot be accessed by the utility thus reducing the risk that the funds will be diverted to other purposes.
- The reduced risk enables the lender to provide longer tenors and perhaps reduced interest rates.

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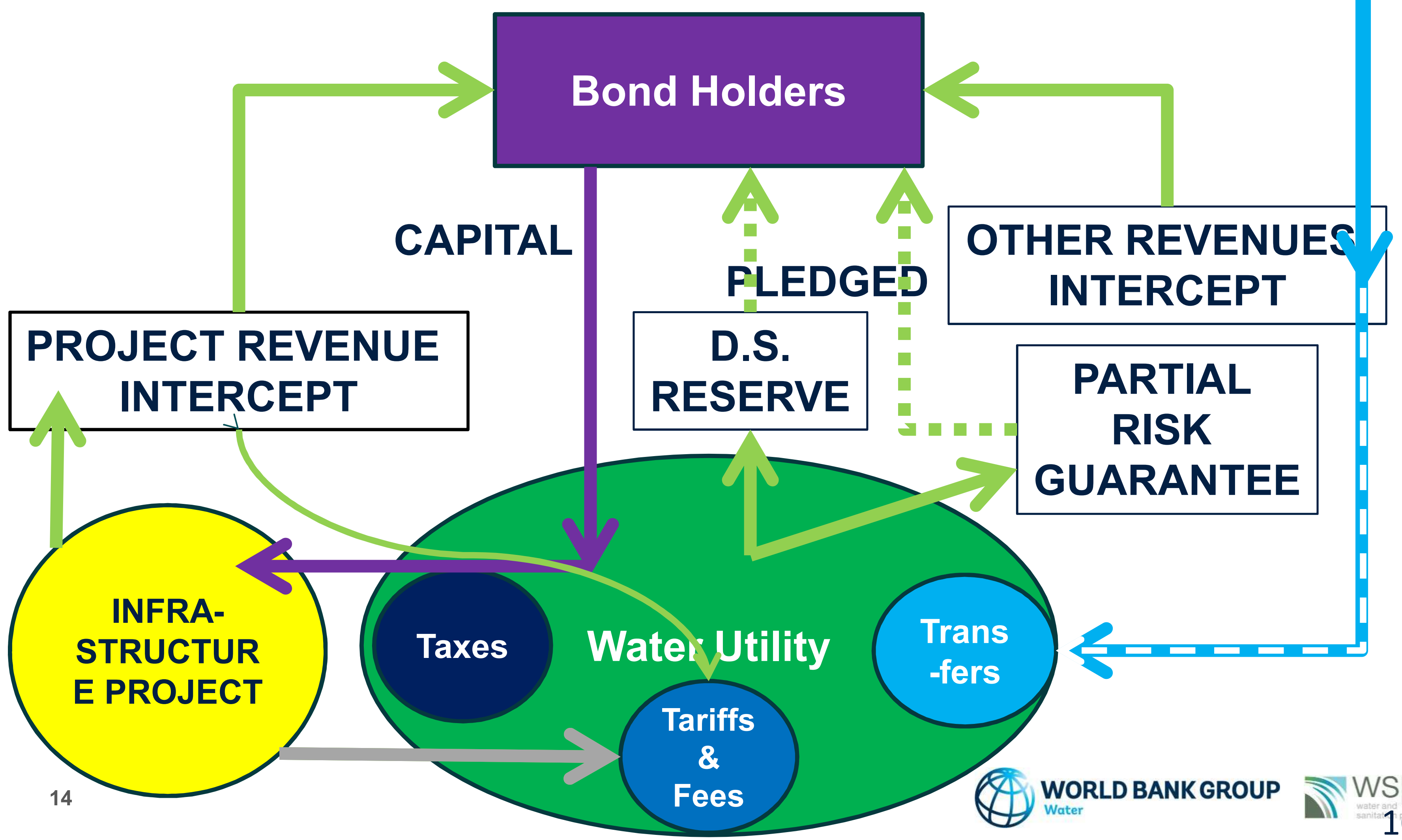
A Creditworthy Financing Structure

Structured Bonds



Definitions

Special purpose vehicle

- a legal entity created by the sponsors to implement a project - this is the entity (company or trust) that acts as the borrower for the project and which procures the works, goods and services

Structured obligation bond

- the borrower's specific revenue sources or net cash flow are pledged and used to pay debt service. Credit enhancements may be added to the obligation.

General obligation bond

- backed by the full faith and credit of government/utility – proceeds for debt service come from the general fund.

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Definitions

Senior debt – provided by the lenders – typically forms the largest source of funding for the SPV (trust/company). First claim on SPV revenue

Equity – grants from government or shareholders' contributions. Last claim on SPV revenue

Junior (mezzanine) debt - ranks between senior debt and equity in terms of claims on SPV revenues

Discussion Point

Are the capital markets capable of providing funding to the WSPs in your client country or would the commercial bankers be a better source funding?

1. Capital markets
2. Commercial bankers
3. Both
4. Neither

Challenges to Using Commercial Financing in a Water and Sanitation Service Provider

Issues in the Water and Sanitation Sector

- It is estimated that about 1 billion people lack access to safe water and 2.4 billion people lack access to improved sanitation
- Total capital costs to meet SDG targets for water and sanitation are $114 billion annually
- Infrastructure financing gap is huge – Africa needs about $22 billion annually
- Private finance is needed to fund this gap to enable utilities to provide the services demanded
- Governments can not achieve SDGs without commercial financing

Challenges to Using Commercial Financing

The nature of the water supply and sanitation sector and its operators makes using commercial financing more difficult than in other sectors such as power.

To make better use of commercial/private financing, efforts must be made to address:

- Challenges from the public sector
- Challenges from the private financial institutions

Challenges – Public Sector

Limited resources – governments do not have the financial resources to finance the needed infrastructure

Use of private financing - resistance to private financing is declining due to the large financing gap – however, a related concern is that borrowing by utilities will lead to problems of too much debt and the need for bailouts

Undue political interference – the essential nature of water supply and sanitation results in undue interference by elected officials resulting in:

- A lack of clear separation of roles and responsibilities including policy, regulation and operations
- Limited institutional autonomy for regulators and operators
- Tariffs below cost recovery levels
- Inefficient service delivery and utilities not being operated on commercial principles

Challenges – Private Financial Institutions

The challenges or barriers to attracting the private sector to the water supply and sanitation sector and developing opportunities for commercial structured financing include:

- Government's weak support for the sector
- Lack of 'investor experience' *(recall the experience of being a holder of debenture or shares of a corporation from another industry)*
- Investment opportunities not structured and portrayed to be creditworthy.

Challenges - Private Financial Institutions

Weak Government Support for Sector Projects

1. Lack of political commitment to sustainable operations (vs. focus on party welfare/ winning elections).
2. Lack of coordination across levels of government.
3. Weak or non-existent regulatory framework.
4. Absence of enabling environment for private investments.
5. Lack of credit culture at sub-sovereign levels.

Challenges - Private Financial Institutions

Lack of 'Investor experience'

1. Fragmented and small commercial banking sector.
2. Small or weak local capital market.
3. Lack of expertise in assessing credit risks.
4. Lack of investor expertise in the WSS sector.
5. Problems of scale and investment policies of pension funds and other institutional investors.

Challenges - Private Financial Institutions

Issues with availability of creditworthy investment opportunities

1. Utilities not financially sustainable from operations.
2. Utilities with weak governance frameworks.
3. Lack of transparency.
4. Shortage of creditworthy financing transactions (bankable or ‘prepared’ proposals) for WSS projects.

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Attracting Commercial Financing

- Increase political support for commercial financing in the sector to help close the financing gap (advocacy effort)
- Strengthen the governance in the sector and at the utility level (advocacy effort)
- Strengthen the creditworthiness of the utility (internal effort)
- Address the concerns of the capital investment communities and identify actions to address their concerns and mitigate the risks that they perceive (advocacy effort)
- Inform the commercial financiers of the potential to investing in the sector (advocacy effort)

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Leveraging Public Sector Funds

Some of the actions that governments can take to enhance a loan/bond and attract private financiers include:

- A supportive institutional framework – particularly with regard to regulation and how to resolve loan defaults - how any “workout” will be negotiated by mutual agreement among all parties.
- Providing reserve funds to strengthen the financial capacity of the borrowers.
- Make use of blended finance.

Discussion Point

Do you think that the commercial financial institutions in your client countries would consider the water sector as financially viable and as potential borrowers of commercial funds?

1. Yes
2. No
3. Don't know

Challenges & Action Planning

Too Little Long-Term Financing

26. CREDITWORTHINESS unknown
A. Financial Management Assessment lacking
B. Credit Rating lacking

Potential Actions

Action 26.1 Talk with other water utilities, that are rated, to learn from their experiences with the rating process. [B]

Action 26.2 Engage, raise awareness, and reach consensus among key stakeholders on independent assessments of sub-nationals' financial reliability. [A]

Action 26.3 Prepare 3 years of audited financial statements and 5 years of projected budget estimates to be used in creditworthiness evaluations. [GEN]

Action 26.4 Develop a list of possible Independent Public Finance consultants with the requisite expertise assist the water utility in engaging with the capital market and with rating agencies or other entities that can assess and document creditworthiness. [GEN]

Action 26.5 Complete a comprehensive Financial Management Assessment highlighting areas where improvement can be made. [A]

Action 26.6 Complete a PEFA (Public Expenditure & Financial Accountability) assessment, or a PEFA with the addition of a Debt Management Performance Assessment (DeMPA). [A]

Action 26.7 Start a formal rating process with a recognized credit rating agency. [B]

Action 26.8 Obtain a national scale Private/Shadow Credit Rating from a reputable credit rating agency . [B]

Action 26.9 Obtain a national scale Public Credit Rating (either institutional or transaction-based) from a reputable credit rating agency. [B]

The Mechanics of Structured Financing

Pre-conditions to Structured Finance

While there are clear advantages to Structured Financing as a tool to finance infrastructure projects, there are some practical pre-conditions

Sustainable operations and reliable cash flows.	Political stability and support for the sector.	Bankable projects with creditworthy financing structures.
Legislation regarding ring fencing and revenue intercepts.	Strength of the balance sheet.	Accessible financing – low interest rates and long-tenor.

Pre-conditions to Structured Finance: Bankable Projects and Creditworthy Structures

What is a bankable project?

What is a creditworthy financing structure?

What is a Bankable Project?

1. A bankable project has sufficient cash flow and a high probability of success.
2. A bankable project must be well defined and consistent with the utility's business plan .
3. The project proposal should have clear investment requirements and time lines, realistic forecasts of future operations which indicate a reliable net cash flow that can either be used to service the debt or provide the utility with a positive net cash from operations.

Discussion Point

Do you think that the sector risks are the larger concern of the commercial financial institutions in considering lending to the water sector or is it the lack of capacity to develop/implement bankable projects?

1. Sector risks
2. Lack of bankable projects
3. Both
4. Don’t know

What is a Creditworthy Financing Structure?

One which fairly allocates risk to all stakeholders and includes a package of risk mitigation measures.

A capital structure capable of financing 20% to 40% of the investment costs.

A clearly identifiable and secure source (or sources) of revenue for servicing debt.

Support (if needed) from government in the form of subsidies to provide needed capital and to make the project commercially viable.

Credit enhancements to encourage commercial financiers to participate

Credit enhancements to reduce risk of default

Creditworthy Borrower

Even a financially strong creditworthy borrower capable of financing a significant portion of the investment would benefit from efforts to manage the risk of the loan to:

1. Lower the interest being charged,
2. Extend the maturity date and
3. Eliminate some of the debt covenants.

Conclusions

Structured finance is needed because WSPs cannot make use of collateral based-lending.

Structured financing is about finding the needed mix of revenue sources to attract commercial lenders combined with a package of credit enhancements to mitigate risks and reduce the cost of borrowing

Structured financing is essential to enable WSPs to access commercial financing and achieve SDG 6

Thank you

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