

PROJECT FINANCE

Project finance is a method of financing very large capital intensive projects, with long gestation period, where the lenders rely on the assets created for the project as security and the cash flow generated by the project as source of funds for repaying their dues.

Simply put, project finance is essentially financing on the security of the project itself, with limited or no recourse against the sponsors of the project or other parties involved in the development and implementation of the project. Due to such characteristics of project finance, the loans sought by the borrowers are always approved by the lenders on the basis of strong in-house appraisal of the cost and viability of the ventures as well as the credit standing of project promoters.

Project finance generally covers green-field industrial projects, capacity expansion at existing manufacturing units, construction ventures or other infrastructure projects. The term 'infrastructure projects' is used here in its general and wide meaning to describe physical structures (such as roads, highways, ports, airports etc.) or systems (such as electricity transmission system, pipeline distribution systems) that are designed, built, operated and maintained to provide for certain physical facilities (such as roads, railways, airports, urban mass rapid transit systems) or commodities (such as natural gas, petroleum, electricity) or for the due utilization of natural resources (water, crude oil, minerals) or provision of services (telecommunications, broadcasting, air transport services, waste handling and treatment) through the general public within the specified geographical area. Capital intensive business expansion and diversification as well as replacement of equipment may also be covered under project finance.

An understanding of the possible money streams into a particular project and the possible expenditure streams out of the same is essential to structure the finance. Such understanding would be based on an analysis of the legal framework governing the project, all of the project's documentation including all government approvals with regard to the implementation and financing of the project and the finance documentations.

Project finance is quite often channeled through a project company known as special purpose vehicle or project development vehicle. Internationally, in addition to a private limited company, a limited company, a partnership and an unincorporated entity structure are all recognized as suitable project development vehicle. However, in India, a private limited company is regarded to be an appropriate project development vehicle as it ensures limited liability for the developers of the project, enables the shareholders to incorporate the various terms and conditions agreed to between them in the articles of association of the project company, thereby binding not only the shareholders themselves but also the company to such agreed terms. Besides, a private limited company also has greater avenues open for equity and loan financing.

General legal concepts

The basic legal concerns looked at by private investors at the time of commencing the development of an infrastructure project relate to:

1. The basis for private participation in the concerned sector.
2. The jurisdiction under which the infrastructure sector falls.
3. The nature of the rights being granted to the private developer.
4. The ability (or nature of powers) of the competent authority to grant such rights.
5. The term of the grant of rights, and the conditions subject to which the grant is made.
6. The position of the developer in the event of requisition or nationalization of the infrastructure facility created by private participation.
7. The issue relating to liability under the legal framework.
8. The treatment of liquidated damages and indemnification.
9. The treatment of force majeure events.
10. The treatment of dispute settlement procedures.
11. The tax treatment of investments and revenue streams and the returns from investments and lending to infrastructure projects.
12. The scope of environment regulations
13. The legal framework relating to agreement between investors in a company.

Nature of private participation

The scope and extent of private participation is determined by the concerned Government and can be of varying degrees. The degree of participation by the private enterprise determines the structure of the implementation of the project, the nature of documentation, the risks involved, the legal framework and the relevant issues.

Broadly speaking, the schemes for private participation can be generally categorized as below:

- i. Build Own and Operate ('BOO')
- ii. Build Operate and Transfer ('BOT')
- iii. Build and Transfer ('BT')
- iv. Build Lease and Transfer ('BLT')
- v. Build Transfer and Operate ('BTO')
- vi. Develop Operate and Transfer ('DOT')
- vii. Rehabilitate Operate and Transfer ('ROT')
- viii. Rehabilitate Own and Operate ('ROO')
- ix. Lease Renovate Operate and Transfer ('LROT')

Constitutional aspects

The Constitution of India determines the jurisdiction over various infrastructure sectors in India. India is a federal state with powers distributed between the Centre

and the State. The scheme of distribution of powers envisages four categories of subjects. First, over which the Centre has competence to legislate; second, over which the constituent States have competence to legislate; third, over which both the Centre and the States have a competence to legislate, with the powers of the State being subject to any legislation passed by the Centre; and fourth, the residuary subjects (that is, those not specified in either of the categories) which fall within the competence of the Centre.

Grant of right

For successful implementation of a project it is essential that various rights required for the development of the project are identified and clearly vested in the developer. The nature of rights required by a developer varies with the sector and the format of implementation of the project decided upon. The Constitution of India provides for the Union or the State Governments to enter into contracts and to sue and be sued. The contractual liability of the Centre or the State under the Constitution is the same as that of an individual under the ordinary laws of contract. However, it may be noted that the executive power of the Centre and each State would be subject to the law passed in relation to the concerned infrastructure sector.

The grant of rights to private developers regarding an infrastructure project can be either through a license granted under a governing statute or through a contractual arrangement. The governing contract in a contractual arrangement that vests the rights of development and implementation of the project with a private body, is commonly known as the concession agreement.

There are two routes through which Government can grant right to developer: The memorandum of understanding route, in which the Government and the developer enter into a MOU and negotiate, or the competitive bidding route involving the issuance of bid document inviting tenders in the nature of offers.

Requisition and Nationalization

Indian jurisprudence regarding requisition and nationalization has evolved over the years as the right to property has been altered from being a fundamental right guaranteed under the Constitution to a constitutional right specifying that law would be required to deprive a person of his property. The concession agreement with the Government should therefore seek to formulate clear consequences in event of both requisition and nationalization.

Liability

Under Indian legal framework, liability may arise, (i) under or by Statute - a prior analysis of the Statutes governing the implementation of the project should be undertaken; (ii) under contract- though this liability can be limited, it is important that

projects contractual framework should clearly define respective parties liabilities and (iii) under law of torts- exposure to this liability can be controlled and mitigated by adequate indemnity and insurance cover.

Liquidated damages and indemnification

In project finance documentation, damages is looked at as means for providing an effective deterrent against breach of obligations by the concerned parties. Under Indian law (Indian Contract Act), there is no difference between liquidated damages and penalty as parties can statutorily obtain only reasonable compensation.

Under Indian law, for indemnity to be triggered, loss should be caused by the conduct of the promisor himself or any other person, thus excluding loss caused by natural agency or animals or machines or loss attributable to any specific reason or agency. In view thereof, it is essential to analyze the governing legislation and the legislation constituting the relevant authority to ascertain the nature of indemnity that Government can grant or the extent of indemnity the developer will be entitled to or be required to give the Government.

Tax Aspects

The main taxes that would be applicable to an infrastructure project under Indian legal framework are:

1. Income Tax- This is applicable to project company on commencing commercial operation, on the investor once returns starts from the project company and on the lenders once interest payment starts from the project on the loan facility extended by them. Tax holidays are granted to infrastructure projects, infrastructure capital fund or infrastructure capital company.
2. Stamp duty- This applicable on the legal instruments (including loan and security documents) and payable upon their execution.
3. Works Contract tax- In the event the construction contract of a project is structured to constitute a 'works contract' as defined by the sales tax legislation of the concerned State, this tax is payable.
4. Sales tax- This is payable upon sale of goods by the project company as per the legislation of the concerned State.
5. Excise tax- This is applicable to projects engaged in manufacture of goods subject to excise duty.
6. Custom duty- This is levied on the import of certain goods and commodities into India.

Typical sources of finance for infrastructure projects

The typical sources of finance include the following:

- i. **Debt**
The critical element in the financing of an infrastructure project is the provision of loan facilities to help finance the implementation of the project. Providing guarantees is also a manner in which many promoter companies or affiliates of promoter companies of the project company facilitate financing of the project.
- ii. **Equity**
Equity investment in respect to infrastructure projects can be distinguished into two types: (a) active (or 'direct') equity investors that seek to participate in the management or operations of the project; and the (b) passive (or 'portfolio') equity investors that provide for only their funds.
- iii. **Quasi-equity**
This class can include convertible debentures, preferred stock etc.
- iv. **Contractors, suppliers and purchasers**
It is common to have the construction contractor and the O&M operator having an equity investment in the project company.

Debt financing and Loan Syndication

Where the debt requirement of a project is large and any one or more banks to be associated with the project are unable to fund the entire debt of the project through the term of the project; debt financing is usually achieved through the process of syndicated financing. Loan syndication essentially means a process of involving numerous different lenders in providing various portions of a loan to a single borrower to meet the borrower's financially project requirements.

For effective administration of syndicate financing, all communications and payments to the borrower generally are routed through an agent bank appointed by and representing the syndicate. The number of agent banks is dependent on the complexity of the financing rather than the size of the project. One of the main principles underlying syndicate financing is that all decisions to be taken by the syndicate with respect to the loan facility extended by them to the borrower is on basis of majority. The security interest in accordance with the finalized security structure is created. Subject to fulfillment by the parties of all precedent conditions the required documentations are executed. Once the conditions precedent to the drawdown are fulfilled and actual drawdown of loan under the syndicated facilities is completed, the effective financial closure is said to be achieved.

The main sources of finance for the implementation of infrastructure projects in India can be divided into:

- (i) International sources: These include (a) Multilateral Agencies: these include the World Bank Group (comprising the International Bank for Reconstruction and Development, the International Finance Corporation and the multilayered

the Investment Guarantee Agency and Asian Development Bank; (b) International Government funding agencies: these include the Department of International Development of the British Government, USAID; (c) International Commercial Banks such as ABN Amro, Citibank etc; (d) Export credit agencies such as Export Import Bank of the United States, Hermes Kreditversicherungs AG.

- (ii) National sources: These include (a) the public financial institutions; (b) private commercial banks (such as HSBC, Citibank, ICICI Bank, HDFC Bank, etc.); (c) nationalised banks (such as the State bank of India, Central Bank etc.); and (d) certain large non-banking financial companies (such as Infrastructure Leasing and Financial Services Ltd (IL&FS), G. E. Capital Services India (GE Caps).

External Commercial Borrowings (“ECB”)

ECB occupies a very important position as a source of funds in India. The Government has been streamlining ECB policy to have access to international financial markets.

The Reserve Bank of India (“RBI”) vide notification A.P. (DIR Series) Circular No.60 dated 31st January, 2004 has amended the guidelines for transactions relating to ECB. Under the automatic route arrangement, any legal entity, registered under the Companies Act, 1956 except financial intermediaries (such as banks, financial institutions, housing finance companies and non-banking financial companies) will be eligible to enter into loan agreements with overseas lender(s) for raising ECB with a minimum average maturity of three years for an amount upto USD 20 million or equivalent. Besides, the Government has under the automatic route also allowed ECB above USD 20 million and upto USD 500 million or equivalent with minimum average maturity of five years. The Government has further stipulated that for ECB upto USD 20 million the borrower can have call/put option only if the minimum average maturity of three years is complied with before exercising the call/put option. ECB above USD 500 million will require the approval of the Empowered Committee of the RBI.

Borrowers are permitted to raise ECB from recognised lenders, that is, internationally recognized sources including international banks, international capital markets, multilateral financial institutions, export credit agencies and suppliers of equipment, foreign collaborators and foreign equity holders. It is also open to the borrowers to decide upon the security to be provided to the lender/supplier. However, creation of charge over financial securities, such as shares, and immovable assets, in favour of overseas lender is subject to regulations relating to foreign direct investment (“FDI”) into India and acquisition/transfer of immovable property in India.

ECB can be used for import of capital goods, new projects, modernisation/expansion of existing production units but not for general corporate purposes. Further, there are all-in-cost ceilings for ECB – for loans with minimum average maturity period of

three years and up to five years, it is 200 basis points above six month LIBOR and for loans with minimum average maturity of more than five years, it is 300 basis points above six month LIBOR.

As regards prepayment, borrowers are free to prepay ECB up to USD 100 million without prior approval of RBI, subject to compliance with the stipulated minimum average maturity period as applicable for the loan.

Security offered in project finance transactions

An essential ingredient in project finance is the creation, perfection and enforcement of a security interest in favor of the lenders. Thus, the lenders have not only to ensure that a security is in place but are also required to ensure that all the steps required to protect the validity of that security against third party interest are undertaken and that the security will have priority over all third party claims, if any, asserted. The two crucial factors that are to be borne in mind with regard to the structure of a security are: firstly, law governing the sector to which the project relates to prevent any specific legal frame work from imposing restrictions on the security; and secondly, the amount of stamp duty payable thereon.

Emphasis on the structure and creation of security interest is to enable lenders to have recourse to the borrowers of the project for its implementation and recovery of the amount due to them. This can be possible only if the enforceable security interest is created in favor of the lenders vis-a-vis the following:

- (i) all the physical immovable assets of the project,
- (ii) all the physical movable assets of the project,
- (iii) all the intangible assets of the project,
- (iv) all the revenue, (including insurance) streams of the project;
- (v) all the rights of the project company, which are required for due implementation of the project under the main project contract; and
- (vi) the majority shareholding in the project company.

Overview of applicable laws with respect to security

If the security interest is being created and perfected in relation to an immovable property, the following laws are applicable:

- (i) In relation to the creation of the security interest, the Transfer of Property Act and the Stamp Act applicable in the relevant jurisdiction and any specific statute governing the concerned infrastructure sector (including but not limited to any license or approvals obtained in relation to the project).
- (ii) In relation to the perfection of the security interest so created, the Registration Act, the Companies Act, and any specific statute governing the concerned infrastructure sector (including but not limited to any license or approvals obtained in relation to the project).

If the security interest is being created in relation to a movable property, the following laws are applicable:

- (i) In relation to the creation of the security interest, it would depend upon the type of movable property (for example, shares, vehicles etc.). However, generally speaking, the laws that could in all probability be applicable would be the Indian Contract Act, the Sale of Goods Act, the Companies Act, the Transfer of Property Act, the Securities Contract Regulation Act, the Depositories Act, the Stamp Act of the relevant State and any specific statute governing the concerned infrastructure sector (including but not limited to any license or approvals obtained in relation to the project).
- (ii) In relation to the perfection of security over a movable property, the main requirement is only under the Companies Act. It mandates that in order for any charge over, any property of the company, to be effective against the liquidator and any creditor of the company, the charge should be registered with the Registrar of Companies, and also that if a person holding the shares does not himself hold the beneficial interest in those shares, but holds them for the benefit of any other person, such person should file a declaration to that effect with the company. The Registration Act only provides for an option to register instruments which create any interest in relation to movable property.

Private equity

Private equity capital or financing is money raised by a business in exchange for a share of ownership in the project development vehicle/company. Ownership is represented by owning shares of the project company outright or having the right to convert other financial instruments into shares of that project company. From the cost point of view, equity capital is usually a more expensive source of finance compared to debt financing. Cost is high because the dividend expectations of equity investors are normally higher than interest rate and also because dividend is an appropriation of profit and as such is not allowed as an expense under the Income Tax Act, 1961. Further, tax is levied twice on the project company, once on its profits and again on the dividends declared by it out of such after tax profits. On the other hand, interest paid on the debt is a tax-deductible expenditure. This reduces the cost of debt.

In India, a venture capital firm is one of the key source of private equity financing for new and emerging businesses. Typically, such venture capital investors provide capital unsecured by assets to new and young companies, which on one hand inherently carry a high degree of risk and on the other the potential for rapid growth.

Venture capital firm also provides for an active rather than passive form of financing by seeking active involvement in the management of the project company in which they are investing. The purpose of such involvement is to add value to the investing company and also an effort on their part to enable the company to grow and achieve a greater return on their investment. In majority of the cases, such involvement is sought by acquiring a seat on the board of directors of the investing company. The exit strategy adopted by venture capital investors is a strategy to liquidate their

holding in the company to realize capital gains on their investments. This could include different exit options depending on the exit climate including market conditions and industry trends. Some of the exit options resorted to by venture capitalists are providing for a share buy-back, arranging a public offering of shares and providing for a merger with a larger firm.

Foreign Direct Investment

Investments into India is not permissible in certain sectors like: (i) agricultural or plantation activities, (ii) real estate business, or construction of farm houses, (iii) agriculture (excluding floriculture, horticulture, development of seeds, animal husbandry, pisciculture and cultivation of vegetables, mushrooms etc. under controlled conditions and services related to agro and allied sectors) and (iv) plantations (other than tea plantations). In other cases investments can be made either with the specific prior approval of the Government of India, that is, the Secretariat for Industrial Assistance/Foreign Investment Promotion Board (SIA/FIPB) or under the automatic route.

The list of the activities requiring the approval of the Government is given in Annexure-A to Schedule 1 to the Notification No 94 under the Foreign Exchange Management Act (“FEMA”) and details of the activities/sectors which are covered under the automatic route is given as Annexure-B to the said Schedule. The automatic route is not open for those non-resident investors who have/had a previous financial/technical/ trademark collaboration in an existing domestic company engaged in the same or allied activity. If the activity or manufacturing item of the issuer company requires an Industrial License under the provisions of the Industries (Development and Regulation) Act, 1951 or under the locational policy notified by Government of India under the Industrial Policy Resolution 1991 or the investment is sought in excess of the prescribed sectoral limits automatic route is not available and in such cases, specific approval of FIPB would be required.

A person resident outside India (other than a citizen of Pakistan, Sri Lanka or Bangladesh) or an incorporated entity outside India, (other than an entity in Bangladesh or Pakistan) has the general permission to purchase shares or convertible debentures or preference shares of an Indian company subject to certain terms and conditions, under the automatic route. The coupon rate on preference shares/ convertible debentures should not exceed State Bank of India’s prime lending rate plus 300 basis points.

Price of shares issued to persons resident outside India would be worked out on the basis of Securities and Exchange Board of India (“SEBI”) guidelines in case of listed shares. In other cases valuation of shares would be done by a Chartered Accountant in accordance with the guidelines issued by the erstwhile Controller of Capital Issues. The price so calculated is the minimum price at which shares can be purchased by the persons resident outside India.

An Indian company issuing shares or convertible debentures should submit to RBI the details of advance remittance, not later than 30 days from the date of receipt of the amount of consideration. After the issue of shares, the Indian company should file a report in Form FC-GPR not later than 30 days from the date of issue of shares with the Regional Office of RBI where the registered office of the company is situated.

ADR/GDR

An Indian corporate can raise foreign currency resources abroad through the issue of American Depository Receipts (“ADRs”) or Global Depository Receipts (“GDRs”). Regulation 4 of Schedule I of FEMA Notification no. 20 allows an Indian company to issue its rupee denominated shares to a person resident outside India being a depository for the purpose of issuing GDRs and/ or ADRs, subject to the condition that:

- (i) the ADRs/GDRs are issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Central Government thereunder from time to time,
- (ii) the Indian company issuing such shares has an approval from the Ministry of Finance, Government of India to issue such ADRs and/or GDRs or is eligible to issue ADRs/ GDRs in terms of the relevant scheme in force or notification issued by the Ministry of Finance, and
- (iii) the Indian company issuing such shares is not otherwise ineligible to issue shares to persons resident outside India in terms of these Regulations.

These instruments are issued by a Depository abroad and listed in the overseas stock exchanges like NASDAQ. The proceeds so raised have to be kept abroad till actually required in India. There are no end use restrictions except for a ban on deployment/ investment of these funds in real estate and the stock market. There is no limit up to which an Indian company can raise ADRs/GDRs. However, the Indian company has to be otherwise eligible to raise foreign equity under the extant FDI policy.

The ADR/GDR can be issued on the basis of the ratio worked out by the Indian company in consultation with the Lead Manager of the issue. The Indian company will issue its rupee denominated shares in the name of the Overseas Depository and will keep it in the custody of the domestic Custodian in India. On the basis of the ratio worked out and the rupee shares kept with the domestic Custodian, the Depository will issue ADRs/GDRs abroad.

Investments by Venture Capital Funds

A SEBI registered Foreign Venture Capital Investor (FVCI) can invest in Indian Venture Capital Undertaking (“IVCU”) or in a Venture Capital Fund (“VCF”) or in a Scheme floated by such VCFs subject to the condition that the VCF and IVCU should also be registered with SEBI. They can purchase equity/equity linked instruments/ debt/debt instruments, debentures of an IVCU or of a VCF through initial public offer

or private placement or in units of schemes/ funds set up by a VCF. RBI, on application, may permit a FVCI to open a foreign currency account or rupee account with a designated branch of an authorised dealer. The purchase/ sale of shares, debentures, units can be at a price that is mutually acceptable to the buyer and the seller /issuer. Authorised dealers (that is, banks) are also authorised to offer forward cover to FVCIs to the extent of total inward remittance net of investments liquidated.

Transfer of shares and convertible debentures - Non-resident to Resident/Resident to Non-Resident

General permission has been granted to non-residents for transfer of shares and convertible debentures of an Indian company as under:

- (i) A person resident outside India (other than non resident Indian and overseas corporate body) may transfer by way of sale or gift the shares or convertible debentures to any person resident outside India (including non resident Indians); provided transferee has obtained prior permission of SIA/FIPB to acquire the shares if he has previous venture or tie-up in India through investment in shares or convertible debentures or a technical collaboration or a trade mark agreement or investment in the same field or allied field in which the Indian company whose shares are being transferred, is engaged.
- (ii) Non resident Indian and overseas corporate body may transfer by way of sale or gift the shares or convertible debentures held by him or it to another non-resident Indian; provided transferee has obtained prior permission of Central Government to acquire the shares if he has previous venture or tie-up in India through investment in shares or convertible debentures or a technical collaboration or a trade mark agreement or investment in the same field or allied field in which the Indian company whose shares are being transferred, is engaged.
- (iii) The person resident outside India may transfer any security to a person resident in India by way of gift.
- (iv) A person resident outside India may sell the shares and convertible debentures of an Indian company on a recognised Stock Exchange in India through a registered broker.

Recently, the Government has dispensed with the requirement of obtaining the prior approval of the FIPB in respect of transfer of shares/convertible debentures, by way of sale, from residents to non-residents (including transfer of subscriber's shares) of an Indian company in sectors other than financial service sector (i.e. banks, non-banking financial companies and insurance) provided that the activities of the investee company are under the automatic route and the transfer does not attract the provisions of Takeover Regulations prescribed by SEBI. Further, the requirement of prior approval of Reserve Bank for transfer of shares and convertible debentures by a person resident in India to a person resident outside India and by a person resident outside India to a person resident in India, has been dispensed with. Now, only filings have to be made with the authorised dealer. However, this dispensation is not

applicable to transfer of shares from resident to non-resident in financial service sector.

Conclusion

The key to any project finance is to use a right mix of debt and equity. Further, there should be a right mix of foreign currency and rupee loans. It is also essential that there should be flexibility in respect of switching from foreign currency to rupee loan and vice versa. There are a number of issues highlighted herein above which need to be considered for the purpose of financing of the project. Besides, it is important that due care is taken in drafting the documents concerning the financing of the project.

Source: Souvenir, International Conference organized by Bhartiya Society in Mumbai with ASC as its knowledge partner