Advantages and Disadvantages of Project Financing

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Sladan Benković, Miroslav Milosavljević
Fakultet of Organizational Sciences, Belgrade

The initial decisions on the project involve many issues of great importance. The decision complexity derived from the fact that compound and financially demanding projects are acceptable only if expected social and economic benefits are more influential than costs associated with the project operationalization. According to the previous, project financing comes up as a potentially useful method that governments use for development promoting of the most important resources, or better still, for establishing new independent facilities at the places of major importance. This paper presents advantages and disadvantages of project financing, as one of the financing models, as well as circumstances in which it can be meaningful for investors. The paper particularly points out the fact that project financing is a kind of financing model that strives to satisfy all contract parts, taking into account their mutual interests and a return on joint investments as well.

1. Introduction

Project financing is a financing model which is becoming increasingly important and attractive, due to the scope and the complexity of the projects that can be funded in this way. It is a very useful and attractive technique used in a large number of industries worldwide. Project financing is a model long implemented in the developed countries and is used to maximize the results within the financial means available. In the developing countries, this method of financing infrastructure facilities is by all means present in a broad sense, however, it is expected to yet gain popularity and importance, since, as a rule, the developing countries do not command enough financial resources to start large-scale projects, nor to complete them in a proper way.

Project financing is defined as financing a certain project, most often an infrastructure or a financial one, where the lenders rely on cash flow and project returns as monetary sources to pay the invested funds back. Basically, this means that the investor has an insight into the monetary flows, and that the profit earned is the only way to pay the debts off, i.e., that the "project assets are to ensure the financing of the project itself", therefore it is the only guarantee that the project will be completed.

The driving force of the project financing include its sponsors and investors. The project sponsor is the party "behind the project" and serves as its motive power, most frequently the Government of a country, an autonomous entity of an industry sector, or a consortium, a future buyer of the project products or services. The project financiers/promoters are mainly financial institutions, such as: international organizations for development financing, banks, investment trusts, equipment manufacturers, construction companies, future buyers, etc. [1] A project may have one or more sponsors who promote the project idea and motivate all the participants in its execution.

The governments of the countries worldwide hailed the appropriation of funds of individual investors in the fields of infrastructure and services in a broad range of industrial activities, among them power supply, transport, irrigation and soil improvement, telecommunications, petroleum and gas, mineral resources exploitation, schools and hospitals. Such a manner of funding means improvement of a large number of public works and services without which the quality of operations and work would be hard to achieve.

The start up of investment cycles in Serbia was additionally imposed by the analysis of various models of financing of such projects, so the market is being introduced to the advantages and disadvantages these different methods of financing bring. By the adoption of the Mortgage Act that introduces the notion of the mortgage securing the facility under construction and the new method of receivables classification on the basis of the monetary flow projections (in the past period, such claims were only possible on the basis of the historic financial indicators) provided by the National Bank of Serbia, a legal basis is formed for implementing such a model of financing. Hence project financing earns a special importance as an infrastructure and capital-intensive projects financing, since in this form it means an improvement in the methodology of project evaluating and financing.

2. Project Financing

The project financing is a form of contracting that means firm contractual relations between/among the participants, and, as such, can be applied only in the
projects that are capable of supporting such a form of firm contract and sustain it on an acceptable cost level. Basically, the project financing requires the presence of a real "joint interest" among the parties included in the project execution. Only when each of the parties is really interested in a successful operationalization of the project financing will all the participants do their best to ensure that the project is actually completed. Simultaneously, project financing requires that the financial engineers should design such a financial framework that would contribute to forming of a set of contracts, which will in turn provide benefits from the contracts to all the parties concerned.

The selection of the project financing model prior to the corporate direct financing includes the selection of such an organization form that differs from a traditional company in two basic aspects: [3]

1. The project has a limited life cycle, the same as the legal entity that owns it, therefore the identity of the entity is defined by the project. In case of the traditional company, the identity of the organizational unit is not time-limited.
2. The project unit distributes the cash flow directly from the project to the creditors and to the capital investors on the project. The traditional companies can hold the resulting free cash flow of profitable projects and reinvest it into other projects, according to the company management preferences. The project financing has an opposite approach, therefore the free cash flow goes to the capital investors. As a result, it is they who make the decision on a further investment of free assets.

The initial and the main characteristic of the project financing model is the establishment of an entirely new company that is also called the special Purpose Vehicle – Single Purpose Vehicle (SPV), Special Purpose Company (SPC), Special Purpose Entity (SPE) – Single Purpose Entity or Single Purpose Company (SPC) and is a legally independent company whose purpose of establishment is project financing. This entity (most commonly, the incorporated limited liability company, or limited partnership) is set up for the purpose of accomplishing narrow, specific, temporary goals. The primary goal is the isolation from financial risks and bankruptcy, although one of the goals can often be the deduction of tax base and risk. The project organization is financed by the post-entry funds/property, because of the possibility of disposal on the basis of the standard ownership rights.

Such companies are most commonly established for the purpose of executing a concrete project. Here, a number of companies join to build a facility, a part of infrastructure, or to develop a technical innovation. In case of large projects, the investors insist on forming such a company, where the credit risk is limited to special projects. In this sense, there is no threat from other risks from the business activities that the investor (most often a bank) may not be able to get an insight in. The project organization is owned by one or a number of subjects, whereas in certain cases the law provides that the ownership share be percentual, but is not owned by the subject in whose name it is established, that is, is not owned by the sponsor.

3. Direct and project financing relationship

Project financing is most frequently compared to direct (corporate) financing, provided by way of a credit. Here the choice of financing modalities is defined by the characteristics of the project under way, the cost of capital, and the risk that the project itself is exposed to. Therefore, it is important to know that, even if the project financing is possible, it does not mean that the project should be realised in that particular way. The advantages and disadvantages of such financing modalities have to be carefully analysed, in order that the decision be made as to which of the above mentioned two modalities will bring more benefits to the project stakeholders, and to the company itself, too. [3]

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Direct financing</th>
<th>Project financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free cash flow</td>
<td>Managers have large powers in deciding on free cash flow allocation between dividends and reinvestment, Cash flow is complex, hence it is allocated according to the company policy.</td>
<td>Managers' freedom of choice is limited, As per contract, the free cash flow has to be distributed to investors.</td>
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<td>Criterion</td>
<td>Direct financing</td>
<td>Project financing</td>
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<tr>
<td>Overhead charges</td>
<td>➢ Investors are exposed to overhead charges of free cash flow,</td>
<td>➢ Overhead charges of free cash flow are reduced,</td>
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<td>➢ Granting the management freedom of choice, some specific projects are more difficult to</td>
<td>➢ The freedom of choice enjoyed by the management may be related to the project</td>
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<td></td>
<td>operationalize,</td>
<td>performance,</td>
</tr>
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<td></td>
<td>➢ Overhead charges are higher in comparison to project financing.</td>
<td>➢ Close supervision from the part of investor is easier,</td>
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<td></td>
<td>➢ Overhead charges are lower in comparison to internal financing.</td>
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<tr>
<td>Contents of loan contract</td>
<td>➢ Creditors take into consideration the entire sponsors’ property when evaluating their credit</td>
<td>➢ Creditors take into consideration the concrete property or part of property when estimating the</td>
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<td>worthiness,</td>
<td>capacity for servicing borrowed funds,</td>
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<td></td>
<td>➢ Most often, the debt itself is not insured (especially in cases the borrower is a large company).</td>
<td>➢ Debts are mostly insured,</td>
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<td></td>
<td>➢ Debt contracts are concluded in accordance with the characteristics of the project.</td>
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<td>Indebtedness capacity</td>
<td>➢ Debt financing uses part of the sponsors’ indebtedness capacity.</td>
<td>➢ Credit support from additional sources, such as that on the basis of accounts receivable from the</td>
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<td>project product buyers may be used to support the project loan,</td>
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<td>➢ The sponsors’ indebtedness capacity may successfully be enlarged.</td>
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<td>Bankruptcy</td>
<td>➢ The danger of expensive and long-term loans is possible to avoid,</td>
<td>➢ Lower costs of financial problems solving,</td>
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<td>➢ Creditors enjoy benefits from the entire sponsors’ ownership portfolio,</td>
<td>➢ The project may be isolated from potential bankruptcy,</td>
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<td>➢ Financial difficulties in one key business line may draw the cash from “successful” projects.</td>
<td>➢ The creditors’ chances of reclaiming the principal are by far more limited, i.e., the debt cannot</td>
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<td>be repaid out of the returns earned from other unrelated projects.</td>
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<td>Organization</td>
<td>➢ Large-scale works are usually organized in a corporate form,</td>
<td>➢ The project is usually organized in the form of partnership or a limited debt exposed company, which</td>
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<td>➢ The cash flow generated on the basis of employing different parts of property and the project are</td>
<td>most often contributes to a more efficient use of tax reliefs in relation to property,</td>
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<tr>
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<td>consolidated.</td>
<td>➢ Property related to the project and the cash flow are separated from the sponsors’ other activities.</td>
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<tr>
<td>Monitoring and control</td>
<td>➢ Control is primarily related to management,</td>
<td>➢ There is management, however, it is under control in comparison to classic organizations,</td>
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<td></td>
<td>➢ Board of directors monitors the corporate performance important for shareholders,</td>
<td>➢ Clear separation of property from cash flow provides a higher level of responsibility towards the</td>
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<td>➢ Investors are granted a limited right to monitor business activities,</td>
<td>employed assets of the investors,</td>
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<td>➢ The conditions stipulated in the contract define the relationship between the capital and the debt,</td>
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<td>they simultaneously contain the conditions and provisions to aid their control and monitoring.</td>
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<td>Risk allocation</td>
<td>➢ Creditors are entitled to damages from the project sponsor,</td>
<td>➢ Creditors’ right to damages is limited, in some cases their rights towards project sponsors do not</td>
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<td>➢ Different types of risk are present, depending on the portfolio contents,</td>
<td>exist,</td>
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<td>➢ Some types of risk may be transferred to other players by insurance purchase, or by a higher level</td>
<td>➢ Financial exposure of creditors is project defined, although additional credit support may partially</td>
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<td>of engagement in the risk precaution activities etc.</td>
<td>mitigate this type of risk,</td>
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<td>➢ Conditions stipulated in the contract distribute the risk according to each individual project,</td>
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<td>➢ Project risks are allocated to those that can deal with them in the best possible way.</td>
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<td>Financial flexibility</td>
<td>➢ Financing is relatively easy to contract,</td>
<td>➢ Higher transaction and contracting costs,</td>
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<td>➢ Internally generated financial funds may be used to fund other projects, in accordance with the</td>
<td>➢ Financial agreements are precisely structured, and their life cycle is long,</td>
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<td>conditions in the capital market.</td>
<td>➢ Internally generated cash flow can be saved and used for the purposes of the new projects of capital</td>
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<td>owners.</td>
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4. Advantages of project financing of the project

The financial evaluation of infrastructure and capital-intensive projects is complex. The implementation of project financing means the use of a specific technique of risk and uncertainty, which is what makes the design of the Monetary flow report extremely complex. Project financing is an applicable financing model even in the low credit worth countries, in case the project earns enough hard-currency income to regularly service the liabilities to creditors and in case there are a legal and other guarantees that thus earned income will be used to service the debts incurred in project financing.

The aim of project financing is not to conceal the debt from the creditors, credit rating estimating agencies or shareholders, but to share the project risk.

In addition to reducing the project and the financial risks, there are still a number of other important advantages of project financing, among which are [2]:

- the sponsor has the opportunity to obtain the required capital to complete the project which he himself cannot ensure;
- it is easier for the project to get the guarantees the sponsor would otherwise have difficulties in obtaining;
- in case of the creditor’s low credit worthiness, and the project is good, chances are better that financial funds and more favourable conditions for the project are obtained;
- the financial load per investor related to the debt servicing is considerably smaller;
- the project can comply with certain investment regulations that the sponsor himself would find hard to satisfy;
- it is easier for the sponsor to avoid certain problems (e.g., blame in case of failure, etc.);
- the costs per investor are considerably lower, etc.

An extremely important characteristic of project financing is the firm belief that the investment funds will be earned back, with a due return on investment. This usually stems from the guarantees, both direct and indirect, issued by a third party, most commonly the state itself. The need for these projects to be insured comes from the fact that they are capital-intensive, i.e., that they most often require that a high amount of borrowed funds be invested. In such a case all the above mentioned sources of funds are possible, however, each brings its own costs and risks.

Companies make use of project investment when investing into large projects, where they most commonly use the so-called structural financing. The structural financing is one that allows the investors to track the monetary flows due to having formed a project organization, as a unit responsible for the achievement of the defined financial goals. Project financing is a special focus of interest of both the manufacturing companies, and those in the field of power processing and transport. The reasons are normally their limited capital sources, but also [2]:

- avoiding the burdening of their balance sheets;
- avoiding to disclose the debt so that it does not affect the share price, i.e., avoiding financial reaction;
- avoiding the fall in the sponsor’s credit worthiness due to the concrete debt;
- limiting direct responsibility in the risk laden stages of the project execution and putting into effect.

As far as the project investors are concerned, it is important to point out that there is an increasing interest in joint ventures worldwide. The factors influencing entering the project execution with partners are numerous, the most common being the following:

- the project is beyond the financial or management capacities of only one company;
- the financing risk is lower for each of the participants in the execution of the project;
- it is financially more justifiable to enter the joint venture with another company;
- one or a number of partners enjoy tax relief.

Project financing should be applied each time it is possible to reduce the post-tax capital costs, and each time the sponsor’s credit is unacceptable, and therefore does not ensure the funds required for the project financing with acceptable funds. The advantages of such a project financing are reflected in: [3]

- achieving economic rent;
- achieving economy of scope;
- risk distribution;
- increase in debt capacity;
- reduced overall assets costs;
- arbitrary placement of free cash flow;
- reducing the cost of solving the financial deviations from what was planned and agreed upon;
- reducing regulatory costs.

a) Achieving economic rent

One special advantage of the project financing is reflected in applying this financing model in natural resources exploiting, especially in the period when these resources are possible to store, or are obtained at relatively low cost. The administrative sector which controls the disposal of the natural resources stocks, can contract a long-term sale, whose project financing it
supports, since that earns an over-than-average return rate on invested funds. The economists define this portion of overall revenue that is higher than expected as economic rent. The project sponsors have before them a choice to cash the economic rent by entering long-term sales contracts, where these contracts can be used as collaterals for credits necessary to finance the development of raw material basis. Project financing also has the advantage of allowing the sponsors the disposal of a generated cash flow necessary for project debts servicing, while earning the investors the return on the capital invested.

b) Achieving economy of scope

Project financing is especially applicable in cases of two or more manufacturers joining forces to build a new plant in the presence of the economy of scope in production. Concretely, two aluminium producers may decide to build a plant to process aluminium near the site where both partners have large bauxite basins at disposal. A similar example would be one of companies situated in a highly industrialized area, where they can agree on cooperation in terms of forming a joint venture. Thus they can rationalize in purchasing the energy necessary for heating and joint sales of the electric power to the local power plant.

c) Risk distribution

A joint venture contributes and allows the sponsors to share the project risk. If the cost of capital is high as related to the capitalization the sponsor realizes, the decision on project financing by own funds can seriously imperil the sponsor’s future. Similarly, the project may be too large for the host country, in financial terms, to justify financing from the country’s own sources. Consequently, in order to reduce the sponsor’s exposure to risk, the sponsor or the host country for the project may search for one or a number of partners to form a joint venture.

d) Increase in debt capacity

The project financing of a company allows it for the project sponsor to finance the project through the credit sources of financing. The funds for the project are raised on the basis of the contracted liability, when: 1) the buyers close a long-term contract to buy a product/service and 2) when the contract provisions are set in such a way as to allow for the free cash flow for the project, providing for the debt to be fully serviced under reasonably acceptable conditions. In case any unforeseen costs arise, and the cash flow is not high enough to service them, additional credit support agreements are closed, or often a foundation is established to support the project financing. It should be pointed out that the company established for the purpose of project financing is often in a position to be financed at a fairly higher level of indebtedness compared to the funds invested than it would be normal in the sponsor capitalization. The indebtedness level compared to the funds invested the project realizes depends on the collateral level, that is, the risk the credit worthiness participants are exposed to, the project type or the profitability.

e) Reduced overall assets costs

Whenever the project financing contributes to solving overheads problems important in solving a concrete problem, the project will be in a position to raise funds at a cost lower than that gained by the sponsors. The project organization can obtain a higher level of indebtedness in comparison to the funds invested than the sponsors would be able to realize and maintain themselves, as the future project capital costs will benefit from trading debts at lower costs, in exchange for equity capital.

f) Placement of free cash flow

The project unit’s life cycle is limited, therefore its “dividend policy” is defined by contract at the moment any external capital financing is negotiated. The cash flow that is not required to cover operational costs, is used for debt servicing, or for capital improvements approved of by the investors. Hence the approach where the investors, rather than professional managers, make decisions as to how the free cash flow will be reinvested. In this sense, the advantage of the project financing is in that it eliminates the will and the wishes of the Board of directors and grants more freedom to the investors to decide upon the manner of distribution of the cash flow obtained. Simultaneously with the reduction of the risk that the free cash flow can be retained and reinvested without the consent of the capital investors of the project, the equity capital costs of the project are reduced.

It should be mentioned that in such circumstances the sponsor is not in a hopeless position, since he has the option to negotiate with the investors about new projects he considers profitable, and that would be of interest for the investors themselves. In case the investors agree to allow the funds to be used for any additional investment enterprise of the project unit, their dues are stipulated to amount to the compensation they earn, that is, to the dividend.

g) Reducing the costs of resolving financial disorders

The structure of project liabilities is less complex than the structure of the sponsor’s overall liabilities. The
capital structure of the project unit normally includes only one debt class, and the number of creditors is rather small. It is a general rule that the time and the cost accompanying the resolving of financial disorders increases with the increase in the number of creditors, as well as with the increase in the debtor’s capital structure complexity. This is the consequence of the fact that the traditional organization, over a period of time, has a tendency to accumulate a large number of receivables, including those for the pensions, which can be rather heavy in case of the company insolvency. On the other hand, independent project units with one debt class, especially if the debt is recorded by a smaller number of sophisticated financial institutions, has a tendency to rise out of financial disorders more easily.

In case of the traditional organization, direct debts of the sponsor will be covered by an entire portfolio of the sponsor’s property, therefore, if one business line fails, the creditor will nevertheless be paid back, thanks to the project sponsor’s other business lines. In case of the project financing of the project, however, the project property will be separated from the sponsor’s other property, therefore the access to the property is limited by the level of the reimbursement that the sponsor guarantees to the creditor by a project debt contract. Hence one more advantage that is reflected in the fact that the separation of the project property from the other property owned by the sponsor, isolates the creditor from the risk of the sponsor’s sudden bankruptcy.

h) Reducing regulatory costs
Certain types of projects, such as joint investment, include legal and regulatory costs that are more easily handled by experienced sponsors; consequently, they are less expensive. Concretely, chemical and petroleum companies that enter a joint project, may be faced with considerable costs that result from the ignorance of legal and regulatory provisions accompanying the investment. When the projects are run by a team of experts from the field, project financing may lead to the economy of scope, due to the expert control over legal and regulatory costs. The economic sustainability of the project will depend on the further cooperation of a number of external organizations that are not under the direct control of industrial organizations, whereas using the knowledge and experience of the expert team, reputed for having successfully completed similar projects, will reduce operational costs to a considerable extent. More precisely, the project status independence that results from the desire to create a long-term profitable project will reduce the risk for the companies that jointly finance the production.

5. Disadvantages of project financing
Project financing does not result in a less expensive capital under all conditions and in all projects, therefore the costs of contracting are also very important. It is those costs and the negative effects accompanying them that may prevail over all the advantages of the project financing. Therefore, it is important that some of the disadvantages of project financing be also pointed out.

a) Complexity
Project financing is founded upon a set of contracts that require the negotiations with all the participants engaged in the project. The negotiations themselves may be rather complex and hence expensive to conduct. An important feature of negotiations in the analysis of project financing is the time necessary to negotiate, and it is by a rule by far longer than with the traditional direct financing.

b) Indirect credit support
The debt costs in project financing are higher compared to those in direct financing, for all the borrowers, without exemption, which is the result of an indirect credit support. More precisely, the credit support in project financing is carried out through obligations stipulated in the contract, not through direct payments, therefore the lenders of project financing are deeply concerned about having to continually answer the contractual obligations and service debt. Cautious about what might happen in some unexpected conditions, the creditors often require a premium of 50 to 100 percent basis points, depending on the contract between the borrower and the lender.

c) Higher transaction costs
Due to its high complexity, project financing requires higher transaction costs compared to those incurred in direct financing. The higher transaction costs reflect the contracting costs that are part of the project financial structure designing. They result from the analysis and introduction of different taxes characteristic of the project, as well as from numerous legal issues, such as the documentation dealing with the stock issue and a consequent ownership of the project, the documentation related to borrowings, etc.

The end goal of project financing is to raise enough assets necessary for the project to be operationalized and a high enough profit so that the invested funds can be easily paid back. One way of achieving this goal is the insurance provided by a third party, which was discussed above. The projects supported by a third party without that party earning a direct benefit from the project are, however, rare.
6. Conclusion

A well developed and quality infrastructure is a precondition for the development of any country. Project financing may prove to be an attractive financing model in case of large scale projects that can survive as independent economic units, i.e., in case the sponsor companies are sensitive about employing debts in project financing and the risk accompanying the project execution. Project financing appears especially adequate in cases the companies wish to retain operative control over the project, accept complex contracts, firm obligations and a rigid financial audit that normally accompanies project financing as a financing model.

Agreements on project financing include the mutual interests of different parties concerned, therefore, the expected economic returns for each of the participants is proportionate to the risk they take in the project execution process. Project financing has numerous advantages compared to direct financing founded on the corporate basis. Potential benefits are possible to be achieved only after a careful analysis by expert financial engineering. The project organization, its legal framework and its financial plan should reflect the nature of the project, the designated project risk, the profitability, the participants’ credit worthiness, tax reliefs, the sponsors’ and the state’s financial standing, as well as other factors that largely affect the desires of prospective investors and creditors.

Project financing is more efficient in allocating the risk and the revenue in comparison with the direct corporate financing, therefore the contracts related to project financing are concluded in such a manner as to allocate the project risk and revenue in a most appropriate way, in accordance to the participants in the project execution. It is for this reason that the project financing minimizes the credit impact upon the project sponsors, hence the contracts that support project loans are drafted so as to minimize direct financial obligations of the project sponsors. The result of the credit support from other participants, project financing allows for a higher level of relations between the debt and the project company capital than the project sponsor could achieve through internal financing. Furthermore, we must also take into consideration the fact that the project leverage is often twice as high compared with corporate balances, consequently leading to a higher financial risk, but to higher returns as well, provided the project is successful.

Project financing is also accompanied by higher transaction costs compared to conventional financing, and these are mostly related to the stipulation of contract obligations. The cost of control is also an important item, hence it is clear that project financing as a model of financing is especially appropriate in case of large projects where it is possible to earn enough returns to cover necessary expenses and higher transaction costs. Consequently, project financing is an especially appropriate choice when it comes to financing infrastructure projects both in developed countries and in developing countries, such as Serbia.

Project financing includes a choice of the alternative organizational form which is largely different from the corporate form unlimited in time. As companies most often dispose of a portfolio of assets whose returns are not perfectly correlated, their managers have a range of choices to choose from when allocating the free cash flow and so they try to sustain their position by new investments into property and into new business. Project financing is related to strictly defined property, hence it may be organized in the form of a company, a partnership or a limited liability company. The life cycle of the project company is limited, since the life cycle of the project itself is limited too. The free cash flow in the project company is primarily distributed towards investors, or creditors, who can then decide whether to refinance further or invest into new projects.

From the aspect of property, project financing can be viewed as form of financial engineering, since every financing is based on the property available, and the financial framework, too, is defined on the basis of the project itself. The role of financial engineering in project financing is especially important when it comes to the analysis of the project risk management, the interest rate, the currency and the credit swap the project sponsors use to reduce the risk. All the above mentioned tools used in risk management used in combination with securities, such as forward, futures and optional contracts may be crucial in project financing contracting, since the allocation of exposure to risk is of vital importance in the project structuring and financing.
REFERENCE