IFF

EQUITY BRIDGE FINANCING

By Richard Capps

IFF

There is an increasing trend in project financings for Sponsors to defer their capital contribution to the Special Purpose Vehicle (SPV) by having the SPV raise 100% debt financing during the construction phase of the project. At practical completion, the equity component of the long-term arrangements (say 30%, for example) is then subscribed.

The controversial issue is whether this delivers a higher value outcome for the Sponsor, if all other factors are the same.

Value

If an entity is not government-owned, there is only one reason for them to participate in the project – and that is to generate value. (Governmental entities may legitimately have all sorts of other motivations – social objectives, policy implementation, etc).

The value is derived from an analysis of the forward-looking cashflows. The dominant evaluation metric in project finance is the Internal Rate of Return (IRR).

The Arithmetic

It is axiomatic that the IRR is increased if the cash inflows in a model are achieved earlier in time or if the cash outflows are delayed. This is because value is a function not only of the amount of the cashflows, but also of their timing – the time-value of money.

However, it is important that a spreadsheet is the servant of the analyst, not the reverse. Value is only created if the Equity Bridge Loan allows the Sponsor to do something that they would not have otherwise been able to do.

The Factual Situation

Leaving aside the improved IRR calculated by the spreadsheet, whether value has actually been enhanced in reality depends on the facts of the specific situation. Let us imagine that the capital costs of the project are $100 million and the deferred equity that has been bridge financed for two years amounts to $30 million.

If it can be demonstrated that the Sponsor can use the $30m for the two year period to do something that would otherwise have been precluded, then it is indeed true that value has been generated – but the value is captured by reference to **another** spreadsheet which captures the other transaction that has been enabled (not the spreadsheet of the project). Against that must be set the incremental costs of establishing and servicing the Equity Bridge Loan over and above the genuine long-term debt portion of the project financing.

The reality is more likely that the debt financier will place constraints on the Sponsor in respect of the $30m deferred commitment. They may wish the $30m to be escrowed,

or they may wish to take some other form of security in respect of the obligation. In which case it is difficult to see how value has been created, since the timing deferral of the actual payment doesn't permit the Sponsor to undertake other transactions during that period that they would not otherwise have been able to do.

Modelling

If the latter case is applicable then the correct way for calculating the cashflows on which the IRR is based would be:

- Show the Sponsor equity injection in the spreadsheet as at the date of its contractual commitment (i.e. Financial Close);
- Impute a liquidity yield income from the commitment date to its actual subscription (i.e. a deposit rate or the yield on investment grade instruments during this period of cash investment deferral);
- Capture all of the costs for establishing and servicing the Equity Bridge Loan.

With this approach, the costs of the Equity Bridge Loan would outweigh the income potential on the deferred subscription monies, and the financing concept would be shown for what it usually is – **a chimera**.

ENQUIRIES

Jeff Hearn
Managing Director
+44 (20) 701 77193

NOTES

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