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## Financial Instruments for Private Sector Development

A Resource Guide

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PEAKS project



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# **FINANCIAL INSTRUMENTS FOR PRIVATE SECTOR DEVELOPMENT**

Following its introduction, this course is set out in 12 sections and two annexes:

Section 1: DFID Programme Requirements

Section 2: Private Sector Activity and Financing Needs

Section 3: Overview of Financing Options

Section 4: Project Finance

Section 5: Equity

Section 6: Guarantees

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Section 12: Issues to Consider in Designing Structures to Manage DFID Investments

Annex A: Definitions of some Financial Terms

Annex B: Public-Private Partnerships

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# Course Introduction

## Objectives

Despite the increasing number of developing countries with improved access to international capital markets, through greater volumes of private financing (in terms of value and number of trades) or lengthened maturities, potential borrowers still suffer from unfavourable financial terms. A weak capital market limits business opportunities, which could increase economic activity, especially employment. Hence there is a need to explore and utilise appropriate financial instruments to stimulate private sector activity and growth.

This course is designed to provide those working in programmes that have a private sector development component with the background on the types of financial instruments that may be relevant and how they might be applied by DFID and other development agencies. The course therefore:

- defines appropriate financial instruments and outlines their uses;
- provides examples of practical applications;
- provides references for further information; and
- should stimulate ideas for supporting private sector financing.

However, the course does not provide any form of certification and attendees will continue to be bound by the policies and procedures of their respective institutions.

## Scope

The focus of this course is on financial instruments most relevant to developing economies. Innovative mechanisms that may help private sector development in emerging markets are therefore considered. Among these can be types of public-private partnerships (PPPs). However, since a separate training course and materials are available on PPP, the subject is not covered in this course but an overview is provided in Annex B.

Due to the focus on development, this course does not cover all types of financial instruments, only those currently available or thought to be under consideration in emerging markets.

## Prior Knowledge

This course assumes some knowledge of the developing economy context.

Knowledge of financial statements and their interpretation is not required for this course but may be necessary in the practical application of financing mechanisms.

Financial terms are used during the course. When these are topics for discussion a definition is provided in the relevant section. For other terms used in the course material that are unfamiliar to you, please refer to the Annex. For any other terms you can quickly access definitions at the following websites:

*<http://financial-dictionary.thefreedictionary.com/>*

*<http://www.investopedia/dictionary/>*

## **Acknowledgements**

Our thanks to all those persons and organisations who have who have contributed material to this course.

## **Feedback**

This course is designed to be of practical value. Your comments on its content and suggestions for improvement are most welcome. Please therefore send your comments and suggestions to:

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# Section 1:

## DFID Programme Requirements

### Introduction

Increasing attention is being paid to supporting the growth of the private sector in developing countries. DFID has therefore begun to participate in the provision of corporate and project financing in various forms: non-fiscal capital, loans, equity and grants.

This section summarises DFID's current view of these financial instruments and its programme requirements for making these available. This sets the scene for a more detailed review of the available financial instruments.

Having reviewed these instruments and some examples of their application, the course concludes (Section 132) with suggestions for designing structures to manage DFID's investments.

### Definition of Non Fiscal ("Returnable") Capital

Non-fiscal capital programmes are those where DFID's investment creates an asset on its balance sheet, signifying a legal and quantifiable right to future economic value for DFID from that asset.

Legal and quantifiable rights arise from the use of financial instruments such as loans, equity (with shareholdings/voting rights)

or a grant with defined repayment terms. We shall now look briefly at these types of instrument in the DFID context. More information on these instruments is provided in the overview of financing options (Section 2) and in the subsequent sections.

The critical requirement to recognition on the balance sheet is that DFID has a legal right to future cash flows from the associated asset. That said, it is important to understand the accounting treatment of these main categories of financial instruments and their possible implications for DFID's operations.

### Loans

A *loan* is where DFID provides funding and is contractually entitled to repayment of this amount over time or at a future date.

The original amount borrowed is known as the *principal*, whilst any additional income levied by DFID as a result of providing this funding is considered *interest*.

Loans can be repaid according to various repayment terms – monthly, quarterly, bi-annual or annual, or one-off bullet repayment.

### Equity

*Equity* exists in a situation where, in exchange for providing funding, DFID is allocated a shareholding in a for-profit making entity.

Shares normally offer associated voting rights and the rights to repayment on the breakup of the entity or to dispose of the shareholding.

It is possible for there to be different types of shares and for different types of shareholdings to have different rights attached.

On dissolution of a company, shareholders are normally entitled to their proportion of the net assets or an entity, after deduction of protected liabilities such as secured loans.

## Grants

Grants are normally non-returnable but if used for the purposes of acquiring a financial instrument DFID can make a grant returnable by tying repayment to the performance of the asset to maximize value for money, i.e. the grant is used as a quasi equity-loan instrument.

In order to set up a returnable grant, DFID must ensure that an asset will be created by the recipient and repayment is tied to the value of this asset.

Grants are ordinarily unsecured and are therefore the lowest ranked funders of an entity.

## DFID Programme Requirements

The International Development Act permits the use by the Department of financial instruments for the purposes of development.

However, use of such instruments is not considered the norm, in terms of delivering development, because they impose risks (sometimes new risks) and challenges that have to be mitigated effectively in programme design and management.

HM Treasury approval is required when the Department wishes to use a financial instrument as these instruments are still considered novel and contentious.

Financial instrument programmes may require longer term programme management responsibilities than traditional grant programmes – DFID has to ensure that the programme team and other teams impacted are appropriately skilled and resourced to meet these responsibilities.

Consideration must be given to managing the reputational risk in being a shareholder/lender to a particular counterparty or providing funding for a particular purpose.

It is necessary to understand the ODA treatment of financial instrument programmes and it is a requirement to confirm the ODA treatment of such a programme before proceeding.

Due to the impact on DFID's balance sheet, it is also necessary to understand and to agree the accounting treatment of a programme before proceeding.

Reporting arrangements should be agreed and in place to help assess the valuation of balance sheet assets, the impact on annual

budgets arising from valuation movements, and the development impact of the financial instrument programmes.

DFID is not in the business of making long-term investments. Therefore – and to the extent that DFID is fulfilling its developmental objectives – an exit route for investments must also be agreed and in place to help maximise value for money and to manage the timing and volatility of reflows.

### **DFID Programme Requirements - Loans**

When providing loan funding<sup>1</sup> it is essential that programme teams identify the correct ODA treatment of their programme. Financing provided in the form of a loan will count towards ODA if it meets the requirements of concessional lending, set by the OECD Development Advisory Committee (DAC). If the loan does not constitute concessional lending, the full amount will required to be classed as non-ODA.

Lending is considered concessional if:

- (1) the interest rate charged is below market rate in the country (though note that in some countries determining the “market rate” is not always straightforward); and
- (2) the grant element of the loan is greater than 25%.  
Calculation of the grant element is based on a calculation

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<sup>1</sup> DFID is not a financial services institution and would not provide loans in the normal course of business; it might, however, in the context of a development programme, consider providing a form of loan to help finance a project. In Section 4 therefore refers to “project finance” rather than simply “loans”.

of the differential between the initial amount provided as a loan and the total discounted amount repaid. This calculation takes account of the length of the loan, frequency of repayments, the interest rate charged and applies a default discount rate set by DAC of 10%.

If a loan is concessional, the principal repayments score as negative ODA and therefore have to be factored into DFID ODA monitoring to ensure that we meet our ODA targets.

### **DFID Programme Requirements – Equity**

DAC guidelines on ODA concessionalism for equity instruments are wider than for loans, with no formal calculation basis. DFID’s interpretation of equity concessionalism is that the investment has to be in an ODA eligible entity.

Under current ODA regulations, the purchase of equity is an ODA flow and, therefore, the entire amount of disposal proceeds from that equity constitutes a negative ODA flow. This has an impact where investments are increasing in value and can make it hard to forecast reflows accurately.

### **DFID Programme Requirements – Returnable Grants**

No specific DAC guidance is available on returnable grants as the traditional definition of grant funding is that it is non-returnable, thereby the full amount of an outflow counts as ODA if paid to an eligible entity.



In the absence of guidance, we would consider returnable grants to be most similar to equity instruments, due to the variable repayment amount, and accordingly would apply the same recognition criteria for ODA scoring as applied to equity instruments.

Payments will score for ODA when payable to an ODA entity. The full amount of repayment will score as negative ODA. As with equity, it will be difficult to forecast the valuation of repayments.

### Accounting Treatment of Loans

Loans are accounted for initially, on DFID's balance sheet, at discounted cost – based on discounted expected future cash flows of principal repayments. The discount rate applied is the higher of the interest rate applied by DFID to the lender or an HM Treasury standard discount rate.

Accounting standards require DFID to include loans on the balance sheet at the recoverable rate. Therefore, DFID needs to reassess the carrying value at each balance sheet date.

If it is identified that the borrower will be unable to repay the full amount borrowed, DFID will have to impair its asset and reduce the carrying value to the amount deemed recoverable. Such impairments score to DFID's Annually Managed Expenditure budget, which is a voted control total.

### Accounting Treatment of Equity

Equity investment will initially be recorded on DFID's balance sheet at cost.

Accounting standards then require DFID to revalue its equity investments on at least an annual basis, at the balance sheet date, at what is termed "fair value".

Fair value is the amount for which items would be exchanged in an arm's length transaction. In the absence of a readily available buyer and market value, DFID has previously used its proportion of audited net assets to form a basis for valuing its shareholding. However, this does not necessarily equate to what someone is willing to pay to acquire these shares. External specialist advice may be required to form the basis of a valuation and to assess the valuation supplied. Annex C provides more information on investment valuation and shows how complex the process can be; and, therefore, why specialist advice may be needed.

If DFID's equity interest valuation increases above cost this increase is required to score to revaluation reserves with no impact on budgets until the date of disposal.

If the equity interest is deemed to fall in value the asset is required to be impaired to the deemed fair value. Any reductions in value would be deducted firstly from revaluation reserves (to the extent that any gains have previously been recognised) but will then require to score from DFID's Annually Managed Expenditure (AME) budget.



*What if there is an increase in the value of a previously impaired asset over a financial year but the value still remains below the cost level?*

### Accounting Treatment of Returnable Grants

The financial instrument asset will initially be recognised at cost.

The asset will subsequently be revalued to fair value at each balance sheet date – what is due to be repaid under the terms of the agreement. External specialist advice may be required to form the basis of a valuation and to assess the valuation supplied.

As with equity instruments, any increases in value, above cost, will score to revaluation reserves.

Reductions in value would be deducted firstly from revaluation reserves (to the extent that any gains have previously been recognised) with any reductions below cost scoring to DFID's Annually Managed Expenditure budget.

### Loans – Financial Risk

The principal financial risk is the risk of default on repayments by the borrower. This is particularly relevant to programmes being approved using loan funding where the probability of repayment is low.

### Loans – Other Risks

DFID has to consider various elements to protect itself from reputational risk through either who it has elected to provide lending to or how the funding has been used.

When considering charging interest we have to balance the need to ensure concessionality that will help private sector development with the need to maximise value for money for the British taxpayer in achieving reasonable returns.

If there were an incorrect assumption that a loan is concessional it would require retrospective restatement of ODA and would increase the risk of UK failure to meet the 0.7% or equivalent target.

### Equity – Financial Risks

The main risk associated with equity is the risk of a downward revaluation and how DFID budgets for falls in value, without incurring an excess AME vote. This is a real risk as in the majority of our proposed investments and sectors where there is not a proven history of positive returns and increases in value. (That said, past performance is not always a wholly reliable indicator of future performance.)

There is the very real risk of a lack of a secondary market and buyers to enable DFID to have an exit route that will enable it to secure recovery of its investment funding. This also potentially poses difficulty in forming an effective basis for valuation,

particularly where there are different types of equity holders. In this case, it may be appropriate to engage external financial advisors to help form a basis for valuation and to assist in the assessment of the valuation of the investment throughout the programme.

### **Equity – Other Risks**

There is an increased reputational risk associated with being a shareholder/owner of an entity. DFID must therefore carefully consider the co-investors and the nature and scope of activities that the company can/does perform.

DFID may have to take account of HMRC concern over jurisdiction of government owned and supported entities in the light of the UK government stance on tax avoidance.

Other than speculative purchases and sales on stock exchanges, which are not relevant to DFID's programmes, equity is by nature a long-term investment. This introduces governance issues as well as concern at the structure of equity vehicles. For example: Who is best placed to carry out DFID's voting rights and to protect DFID's interests; and, as a potential majority shareholder, should DFID have a direct interest and, if so, who should act in this role?

### **Returnable Grant - Risks**

There is always the risk that the repayment value will fall below cost. There is also the difficulty of how to ascertain a reliable valuation basis for the fair value of our asset.

Linked to this is the risk of our grant asset falling in value below cost and therefore requiring a significant AME budget to absorb falls, so as not to incur an excess vote.

As with other instruments, there is the reputational risk posed by who we have provided a grant to and how the funding is used.

### **How to Manage Programme Requirements**

There must be early engagement of the various stakeholders and appropriate advisers at the design stage. Inputs from private sector policy advisors, legal advisors and financial advisors are needed to ensure that both the programme delivery objectives and effective governance arrangement requirements are met.

As we shall see in later sections, a clear due diligence framework must be used on loan/equity and returnable capital programmes. If basic standards are not met, then this must be highlighted and approval sought to proceed with the programme in a proposed form that takes account of the shortcomings.

## Section 2:

# Private Sector Activity and Financing Needs

### Introduction

This section surveys how the private sector invests and allocates financial resources in developing economies:

- What types of organisations are doing what and why;
- The need for financing; and
- Initial steps to raise finance.

### Who is Doing What and Why

When considering investment, account must be taken of the current and changing business environment. It is therefore useful to take stock of who is doing what, where and why in the countries where DFID is or may be active. For a brief overview, we look at what multinational, regional and national companies are doing in their current corporate roles and as project developers.

#### Multinational Companies

Major companies dominate the production and distribution of consumer products. Such companies (including, for example, Nestlé, Proctor & Gamble, Unilever) are expanding in order to

supply growing middle classes in developing economies. Industrial products too are expanding to meet local needs (e.g. Lafarge). And, generally speaking, banking and financial services are dominated by global financial institutions.

As project developers, the multinationals see new opportunities to develop greenfield sites; but these are becoming more limited in developed markets and “returns” are lower. Multinationals who are particularly active as project developers include Acciona, Actis, AES, EdF, and Mainstream.

#### Regional Companies

The regional companies are following similar trends to the multinationals. In Africa there is the expansion in the banking and retail sectors from South Africa and Kenya, e.g. Standard Bank, ABSA, and Shoprite.

In regions experiencing above average growth these companies have ambitions to expand their presence and market share in high growth markets. However, in some cases such companies can sometimes be an arm of government, e.g. Eskom in South Africa.

#### Domestic Companies

Domestic companies are naturally seeking to reinforce market share and presence in their own markets. A few of these are emerging into large firms, e.g. Dangote, that will be among tomorrow’s regional and multinational companies.

In terms of project development, domestic companies have a limited presence but, where they are active, there tend to be challenges with transparency; and this, in turn, raises governance issues.

### **Financial Constraints on Private Sector Activity**

In many developing economies the private sector operates with the following financial constraints:

- Limited budgets and internal funding capacity;
- Limited management capacity, with a business often dominated by one person;
- Borrowing limitations, usually dictated by a company's charter documents; but there is in any case a need to protect shareholders from excessive risks and to generate profit;
- There is limited or no long term capital available in the domestic banking system;
- Interest rates are often prohibitively high, which would added considerably to the cost of doing business; and
- There is the frequent presence of corruption, which in some countries is endemic. This too adds to the cost of doing business.

### **The Need for Financing**

Businesses need finance to buy assets (capital expenditure) and to meet daily running costs (working capital). Businesses or entrepreneurs may want to raise finance to:

- buy new replacement production equipment to become more efficient;
- buy additional equipment to expand;
- invest in a new business opportunity;
- import or export; and/or
- form a joint venture with a foreign company.

### **Some Examples of Investment Needs**

The investment need is so great we cannot provide even a near full list; but here are a few examples of some typical ongoing businesses and projects in need of investment:

- Port expansion;
- Developing and producing tablets for educational purposes;
- Production and distribution of bio-fuels;
- Real estate development;
- New mining project;
- New rail system; and
- Power transmission and distribution.

## Investment Needs

The scale of most of the foregoing examples is such that no individual investor has either the means or the risk appetite to meet the full financing needs. Other financing sources are therefore required.

Multinationals may have the financial resources but are wary of risks in developing economies and must protect the interests of their shareholders.

Local firms are generally too small, lack experience and represent a greater risk.

Against the background of a difficult domestic credit market, this course deals with financial instruments that can assist businesses in emerging markets to exploit opportunities for diversification, establishing new industries, expansion, harnessing new technology, or exporting.

Before any entrepreneur or business considers raising finance there are some initial steps to be undertaken.

## Initial Steps to Obtain Finance

The first step is for a business/promoter to undertake a clear market analysis to generate a strategy. Specifically, the business should examine:

- Doing business in the given country (focusing on: starting a business, ownership laws, taxation, financing sources and

interest rates, import and export restrictions, repatriation of funds, availability of foreign exchange, etc.).

- Market fundamentals (focusing on existence of institutions, regulators and clear policies, market size, and actual and potential competitors).
- Growth opportunities (particularly is the market growing and is there a “need”).
- Risks (particularly politics, stability, and wider risks which are “beyond their control”).
- Financing, particularly: Could the project be financed either locally or internationally?
- Infrastructure: Is there appropriate supporting infrastructure for the business to succeed?
- Workforce: What skills are required and what are available locally?
- For international businesses these are usually weighted and balanced to prioritise countries and markets.
- For domestic or regional businesses, many of these are less important. Although, depending on the business, they will remain important, particularly: (i) financing; and (ii) market fundamentals.

For all businesses, strategy and high level investment decisions are an “art” based on fact!

## How Businesses Implement their Strategies

International businesses acting as inward investors will:

- Validate their strategy through in country work over 3 – 6 months;
- “Set up shop” – establish a local legal presence, transfer some staff and employ locally;
- Focus on developing and deepening their understanding of local markets and relationships within those markets;
- Develop a pipeline of opportunities for investing;
- Validate this with their “owner”; and
- Proceed.

Regional and Domestic business will follow a similar path, although they will only engage in the last few steps.

## The Difficulty of Implementation

At this point it is worth restating that, in developing economies, capital markets tend to be weak and rarely offer long term finance. Meanwhile, businesses need long-term finance to purchase fixed assets or to finance projects with a payback over many years; however, local banks may only provide short-term overdraft or loan facilities at relatively high rates of interest that are unsuitable and unattractive. Thus, many local companies and entrepreneurs with good ideas are often deterred from attempting to implement their ideas.

## The Limited Availability of Loan Capital

To give an idea of the difficulty that the private sector has in accessing finance in developing economies, compare the average domestic credit made available to the private sector in 2012 as a percentage of GDP:

|                               |        |
|-------------------------------|--------|
| Low income countries          | 30.7%  |
| Lower middle income countries | 42.3%  |
| Upper middle income countries | 95.3%  |
| High income countries         | 152.3% |

*Source: World Bank*

## Limited Use of Bank Finance for Investment

World Bank data for 2013 also show the small percentage of companies in developing countries using banks to finance investment; for example:

|             |     |              |     |
|-------------|-----|--------------|-----|
| Afghanistan | 1%  | Mozambique   | 11% |
| Bangladesh  | 25% | Sierra Leone | 7%  |
| Ghana       | 16% | Tanzania     | 7%  |
| Kenya       | 23% | Uganda       | 8%  |
| Nepal       | 17% | Zambia       | 10% |
| Nigeria     | 3%  |              |     |

Not only is long term finance generally unavailable, interest rates are prohibitive:

## Current Central Bank Interest Rates

Commercial rates of interest are, of course, higher but compare the central bank interest rate as at 12 March 2014:

|              |       |            |        |
|--------------|-------|------------|--------|
| Australia    | 2.5%  | Bangladesh | 7.25%  |
| Canada       | 1%    | Ghana      | 18%    |
| Euro Zone    | 0.25% | Kenya      | 8.5%   |
| Japan        | 0.1%  | Nepal      | 8%     |
| New Zealand  | 2.5%  | Nigeria    | 12%    |
| South Africa | 5.5%  | Mozambique | 8.25%  |
| Switzerland  | 0%    | Tanzania   | 12%    |
| UK           | 0.5%  | Uganda     | 11.5%  |
| USA          | 0.25% | Zambia     | 10.25% |

Source: Trading Economics

## Why Financing is Difficult

Financing can be difficult for various reasons but, depending on local circumstances, the principal reasons are often due to one or more of the following:

- Local financial institutions generally cannot lend long term and have to charge high interest rates;
- High interest rates reflect both the economic situation and risks;

- Companies rarely have a solid and consistent financial performance to provide comfort to potential financiers or have sponsors who can provide acceptable guarantees; and
- There is sometimes a political element that concentrates ownership of commercial activity and deters other entrants.

Hence the need for innovative financing mechanisms that assist the private sector and complement domestic capital market development. This is where development finance institution (DFIs) play an important role.

## DFIs Response to Financing Needs

DFIs do not compete with domestic finance institutions: their involvement is in response to a market failure or to distinct gaps in the market.

Due to different country risk dimensions and different legal structures, the financial instruments that may be employed will also differ.



## Section 3

# Overview of Financing Options

### Introduction

This section surveys the types of finance available or potentially available to the private sector:

- Financing options
- Corporate finance
- Project finance
- Structured and trade finance
- First loss investment
- Debt finance in developing economies

### Financing Options

Every entrepreneurial activity requires some financing, the type(s) and level of which depend on the nature and scale of the activity.

At the most basic level, a sole trader may self finance his business; but once a larger scale level of activity is envisaged, other forms of financing are required.

The most common types of financing in developing economies are *corporate finance* and *project finance* but other important means of finance, described in this course, are also available.

### Corporate Finance

*Corporate finance* is the term used to denote finance made available to an incorporated entity for the purpose of its every day business. Such financing can be in the form of:

- Debt
- Equity
- Mezzanine finance
- Bonds
- Insurance
- Guarantees
- Swaps
- Hedge
- Export Finance

These are all forms/categories of *financing methods*, often referred to as *financial instruments*. Note that *swaps*, *hedging* and *export finance* are all forms of *structured* and *trade finance*.

### Debt

#### Definition

Debt finance involves borrowing money with a promise to repay the amount borrowed over a prescribed period of time, plus interest at a predetermined rate.

Debt financing can come from selling bonds, bills, or notes to lending institutions, individuals, and sometimes, to investors.

Debt is normally classified as either *senior debt* or *subordinated debt* and it is important to understand the distinction.

### When Debt Is Used

Debt finance is used:

- to lower the cost of capital, thereby increasing returns to the borrower;
- to avoid dilution of ownership; and/or
- because, in most cases, the principal and interest payments on a business loan are classified as business expenses, and are thus allowable expenses for business income tax purposes.

### How Debt is Used

A company may use various kinds of debt to finance its operations including: (1) secured and unsecured debt; (2) private and public debt; and (3) syndicated, club and bilateral debt. In developing economies, debt financing is usually secured and syndicated.

Borrowing is commonly required to finance projects (as opposed to financing existing business operations). Project financing is complex and is dealt with in Section 4.

### Senior Debt

Senior Debt has as priority with respect to interest and principal over: (i) other classes of debt; and (ii) all classes of equity by the same issuer. It therefore has priority in the event of *liquidation* or a *cash waterfall*.

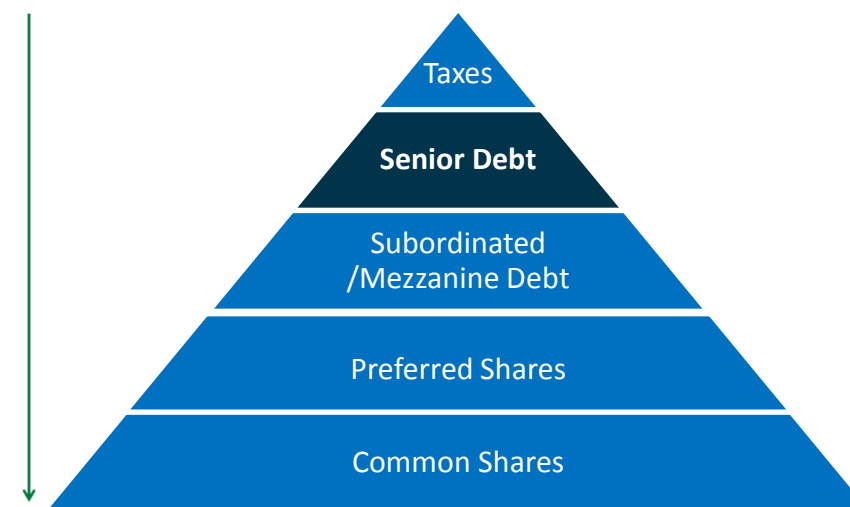
Senior debt is most often secured by first ranking collateral over all the assets of the project company.

Should the borrower go bankrupt, any remaining funds, dissolved assets or other available sources of value must first repay senior debt before other creditors are able to collect.

The following diagram illustrates how senior debt ranks:

#### Repayment priority:

Top



Bottom

## Subordinated Debt

Subordinated Debt ranks below senior debt in terms of security or any claim on a project's cashflow or assets, and usually above equity.

It is at times referred to as *mezzanine*, especially when it has equity components such warrants or options.

Subordinated debt often fills a critical shortfall between senior debt capacity/availability and equity funding.

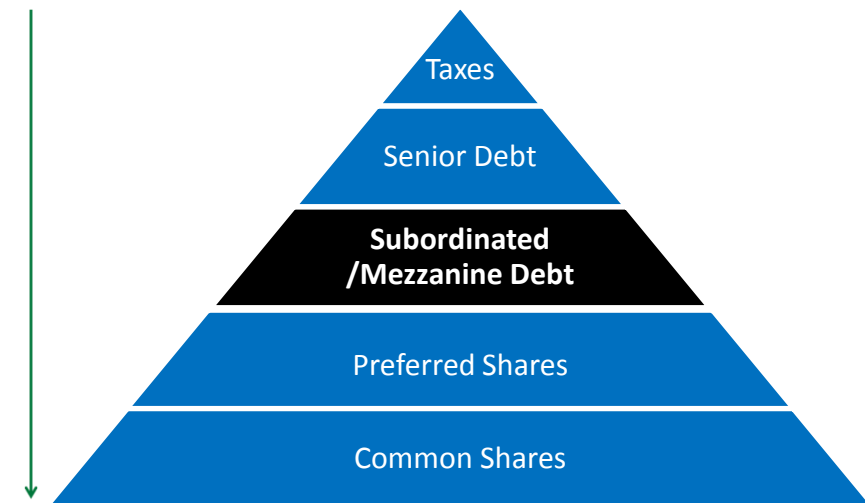
It generally has more flexible repayment terms than senior debt, albeit for a price.

It should be noted that sponsors may prefer mezzanine debt to equity contributions for tax and corporate finance purposes.

The following diagram illustrates how subordinated debt ranks:

## Repayment priority:

Top



Bottom

## Syndicated Debt

A *syndicated loan* is a loan that is granted to a company that wishes to borrow more money than any single lender is prepared to risk in a single loan. A syndicated loan is provided by a group of lenders and is structured, arranged, and administered by one or several commercial banks or investment banks known as arrangers. Loan syndication is a risk management tool that allows the lead banks underwriting the debt to reduce their risk and free up lending capacity.

## Equity

### Definition

*Equity* is a financial instrument representing an ownership interest that can be issued in the form of ordinary shares and preference shares.

Equity holders usually hold voting rights in the decision making of a company.

### When Equity is Used

Equity is used when shareholders wish to dilute ownership of the company to another investor to reduce their exposure to risk and to raise funding for business activities.

### Equity further explained

Strictly speaking, *equity* is the residual claim or interest of the most junior class of investors in the assets of a business after all liabilities are paid.

In common parlance, *equity* is commonly used to denote the share capital of an incorporated entity. The term *share capital* is also often employed but it should be remembered that it may include different classes of shares with different rights. However, in the developing economy context today, a company's share capital most often consists of one class of shares.

Where there are different classes of shares (attracting different rights) they may, for example, be denoted as *Preference Shares* and

*Ordinary Shares (or Common Shares)* or *Class A shares* and *Class B shares*.

Be wary because, in accounting terminology, *shareholders' equity* usually refers not to the residual business value but to the sum of share capital (common stock), retained earnings and other tangible and intangible items (such as reserves and stock options).

In a financing context, raising *equity finance* refers to the issuance by a company of new, additional shares to existing and/or new investors.

*Equity financing* is a strategy for obtaining capital that involves selling a partial interest in a company to investors. The equity, or ownership position, that investors receive in exchange for their funds usually takes the form of stock (shares) in the company. In contrast to debt financing, which includes loans and other forms of credit, equity financing does not involve a direct obligation to repay the funds. Instead, equity investors become part-owners and partners in the business, and thus are able to exercise some degree of control over how it is run.

More detail on equity financing is provided in Section 5.

### The Attraction of Equity

Equity investment is attractive from two perspectives:

- Existing shareholders can raise capital without any commitment to pay interest. Apart from any costs (mostly

legal costs) relating to the issue of shares, there are no further cost commitments.

- New investors can acquire shares in a business they perceive has having potential and can reap the possible benefits of high returns (through capital gains and/or dividends) if the business is successful. Also, ownership of shares is transferrable (in accordance with the rules set out in the company's charter).

## *Mezzanine Finance*

### **Definition**

Mezzanine finance is debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full.

It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

### **When Mezzanine Finance is Used**

Mezzanine finance is used when the borrower requires finance very quickly with little or no collateral and with little due diligence on the part of the lender.

Subject to contractual terms, this financial instrument can be treated like equity on a company's balance sheet.

Mezzanine finance can, in some circumstance, assist in obtaining bank financing.

### **How Mezzanine Finance is Used**

Mezzanine finance is used by companies that are cash flow positive to fund further growth through expansion projects, acquisitions, recapitalisations, and management and leveraged buyouts.

Mezzanine finance comes in many forms but the common features of all mezzanine instruments and products are that they offer a risk/return profile that lies between debt and equity.

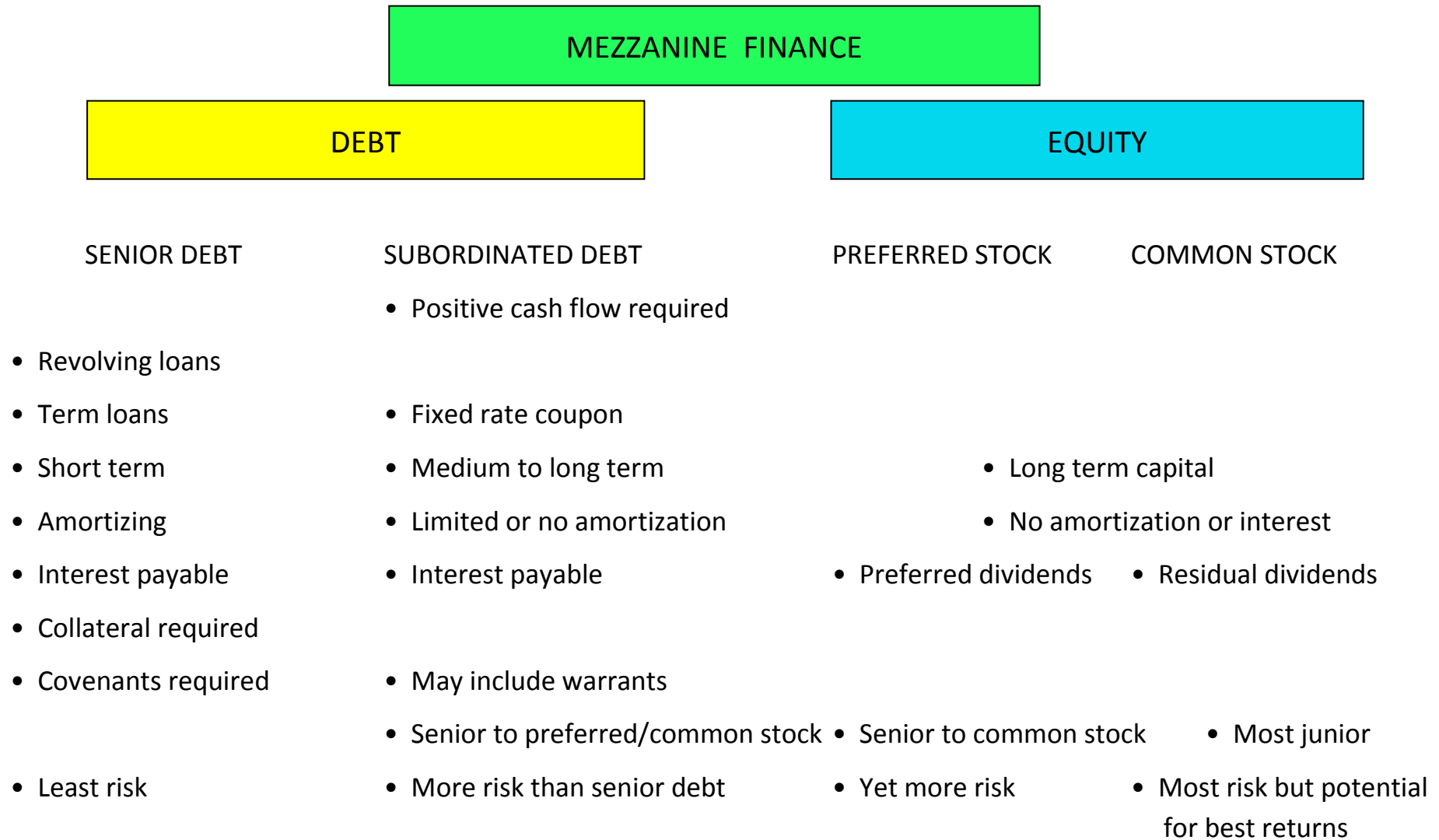
Mezzanine finance is used as an equity substitute to increase the financial leverage of transactions (the ratio of debt to equity) where the senior debt capacity has been maximized and a company's cash flow has sufficient capacity for additional long-term borrowings.

When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in a business. In some situations, equity can be the most expensive form of capital and, in this case, the use of lower cost mezzanine debt along with traditional senior debt lowers a company's cost of capital and improves shareholder return on equity.

## *Comparing Capital Finance Characteristics*

At this point it is useful to compare the different forms of financing discussed so far. A comparison of main characteristics is set out in Chart 3.1 on the next page while Chart 3.2 sets out the varying flexibility of these different financing forms.

### Chart 3.1: Comparison of Capital Financing Characteristics



**Chart 3.2: Capital Sources offer Varying Levels of Flexibility**

|                             | Senior          | Stretch                  | Mezzanine           | Equity          |
|-----------------------------|-----------------|--------------------------|---------------------|-----------------|
| <b>Security</b>             | Secure          | Partial                  | Subordinated        | None            |
| <b>Ranking</b>              | Senior          | First on specific assets | Second              | Third           |
| <b>Covenants</b>            | Tight           | Tight                    | Flexible            | None            |
| <b>Term</b>                 | Demand          | Term                     | Term/patient        | Patient         |
| <b>Coupon</b>               | Coupon-floating | Coupon-fixed             | Coupon-fixed        | Dividend        |
| <b>Amortization</b>         | 5 years or less | Tied to asset life       | Flexible/engineered | Indefinite      |
| <b>Rate</b>                 | Prime           | Prime adjusted           | Risk adjusted       | Market adjusted |
| <b>Equity kicker</b>        | None            | Success fee              | Warrants            | Shares          |
| <b>Prepayment penalties</b> | Yes             | Yes                      | Fixed period        | No              |
| <b>Recovery %</b>           | High            | Medium                   | Low                 | Lowest          |
| <b>Liquidity</b>            | High            | Medium                   | Low                 | Right of sale   |

## *Bonds*

### **Definition**

A bond is a debt security issued by a company that borrows funds for a defined period of time at a fixed interest rate to finance a variety of projects and activities. The bond entitles the holder to repayment of the principal sum, plus interest.

### **When Bonds are Used**

Bonds are used when there is a low risk profile with relatively low returns but provide a relatively predictable stream of income.

The project bond market has been fairly inactive in recent years with bond yields falling substantially.

### **How Bonds are Used**

Bonds are issued to investors in a marketplace when a company (or other institution) wishes to borrow money. Bonds have a fixed lifetime at the end of which the money should be repaid in full.

Interest may be added to the end payment, or can be paid in regular instalments (known as coupons) during the life of the bond.

Bonds may be traded in the bond markets, and are widely used as relatively safe investments in comparison to equity. Bonds are therefore of limited relevance to less developed economies.

## **Key Bond Markets**

The key bond markets are US bond markets, Eurobonds, and local markets.

In the USA, the three main types of bond markets are: Public – SEC registered “Yankee”, quasi-public – 144a not registered, and private placement.

The three Eurobond types are: Eurodollar, Eurosterling, and Euro.

The main market segments in the foregoing and local markets are:

- Sovereign’s, Supra’s, Agencies
- Corporates
- Financial Institutions
- Asset Backed / Structured
- High Yield
- Emerging Markets

## *Insurance*

### **Definition:**

Insurance is a promise of compensation for specific potential future losses in exchange for a periodic payment and it is designed to protect the financial well-being of an individual or company in the case of unexpected loss.



### **When Insurance is Used**

A corporation will wish to engage in an insurance contract to protect itself against unforeseeable losses in the future.

Insurance payout for losses will be capped at an agreed liability as stated in the insurance contract.

Section 10 deals with risks for which insurance is a key mitigant.

### *Guarantees*

#### **Definition:**

A guarantee is a non-cancellable indemnity bond that is backed by an insurer or corporate in order to guarantee investors that principal and interest payments will be made.

It can lower the cost of financing for issuers because the guarantee typically earns the security a higher credit rating and therefore lower interest rates.

#### **When a Guarantees are Used**

Guarantees are used to reduce the risk to loans and liabilities and typically improve the credit agency ratings of bonds.

Loans for projects in developing countries typically require guarantees (section 7 deals with some available guarantees).

### *Swaps*

#### **Definition**

A swap is the exchange of one security for another to change the maturity (bonds), quality of issues (stocks or bonds), or because investment objectives have changed. Recently, swaps have grown to include currency swaps and interest rate swaps.

#### **When Swaps are Used**

Swaps are used to facilitate borrowing at a lower cost and for hedging risk.

If firms in separate countries have comparative advantages on interest rates, then a swap could benefit both firms.

### *Hedge*

#### **Definition**

A hedge is an investment made to reduce the risk of adverse price movements in an asset.

Hedges can be in the form of futures, forwards and options that take an offsetting position in as related security.

#### **When Hedging is Used**

Investors use this strategy when there is uncertainty in the market. A perfect hedge reduces the risk to nothing (except for the cost of the hedge) which can be expensive.

## Export Finance

### Definition

Export credits are government finance, direct financing, guarantees, insurance or interest rate support provided to foreign buyers to assist in the financing of the purchase of goods from national exporters.

Non payment is generally capped at 80-90% of capital expenditure.

### When Export Finance is Used

Used to move financial risk from the exporter by shifting it to an export credit agency (ECA) or another export finance lender, for an agreed premium.

Alongside export finance, an ECA may underwrite the commercial and political risks associated with an investment in an overseas market which is deemed to be typically high risk

## Project Finance

The rationale for project financing is that it enables a company or entrepreneur to secure long-term debt (typically for an infrastructure or industrial project) based on project cash flow projections in an evaluation report and not on past performance and balance sheets of its sponsors.

Project financing is complicated and usually involves the creation of a special purpose entity that shields the other assets owned by the

sponsor(s) from the detrimental effects of project failure. This topic is covered in section 4.

## First Loss Investment

A term, first coined by the US mortgage industry, for a form of long-term equity investment which was considered sound but, in the event of a downturn in a company's fortunes and value, the equity holder expects to bear the loss.

This type of investment does not apply to a commercial trading business but has applicability to economic development institutions providing financing facilities (see section 8).

## Main Sources of Debt Finance in Emerging Markets

Due to the repayment duration, interest rates and risks, substantial corporate debt finance or finance for projects are generally not available in many developing economies. Consequently, the main sources of debt finance in emerging markets are:

- Multilateral development banks
- Regional multilateral development banks
- Bilateral and other development institutions

followed by:

- National development banks
- Global and national private commercial banks
- Global and national investment banks

- Global and national investment funds

### **Multilateral Development Banks**

The multilateral development banks that provide loan finance to the private sector in developing economies are:

African Development Bank  
 Asian Development Bank  
 European Bank for Reconstruction and Development  
 European Investment Bank  
 International Finance Corporation (World Bank)  
 Inter-American Development Bank  
 Islamic Development Bank

### **Regional Multilateral Development Banks**

The regional multilateral development banks that provide loan finance to the private sector in developing economies include:

Africa Finance Corporation  
 Black Sea Trade and Investment Bank  
 Caribbean Development Bank  
 Central American Bank for Economic Integration  
 East African Development Bank  
 Latin America Development Bank  
 Pan-African Infrastructure Development Fund  
 West African Development Bank

### **Bilateral and Other Development Finance Institutions**

Bilateral and other finance institutions that provide loan finance to the private sector in developing economies include:

Belgium Investment Co. for Developing Countries (BIO)  
 Commonwealth Development Corporation (CDC)  
 European Commission  
 French Development Agency (AFD)  
 German Investment Corporation (DEG)  
 Japan International Cooperation Agency (JICA)  
 Netherlands Development Finance Company (FMO)  
 Nordic Investment Bank  
 OPEC Fund for International Development  
 Overseas Private Investment Corporation  
 PROPARCO.

## Section 4

# Project Finance

### Introduction

Project financing is common in developing economies but is often complex and time-consuming. This part therefore considers:

- why project financing is important;
- the difficulties of project financing, and
- a typical project finance structure.

We begin with a comparison of corporate finance with project finance – see Table 4.1

### Recourse and Non-Recourse Financing

Recourse financing gives lenders full recourse to the assets or cash flow of the shareholders for repayment of the loan in the case of default by the SPV. If the project or SPV fails to provide the lenders with the repayments required, the lenders would then have recourse to the assets and revenue of the shareholders, with no limitation. Recourse financing is rarely used because of the level of risk that the shareholders would bear, a risk they would prefer to limit.

Project financing is therefore usually non-recourse (i.e. It is “limited” or “non-recourse” to the shareholders).

**Table 4.1: Comparing Corporate with Project Financing**

|                                     | Corporate Finance                                                                            | Project Finance                                                                   |
|-------------------------------------|----------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|
| <b>Entity</b>                       | Permanent multi-purpose company/organisation                                                 | Single special purpose vehicle (SPV)                                              |
| <b>Capital</b>                      | Permanent equity plus other forms                                                            | Loans and other forms for the life of the project                                 |
| <b>Evaluation for credit</b>        | Financial performance, position and prospects                                                | Technical and financial feasibility                                               |
| <b>Focus</b>                        | Balance sheet and cash flows                                                                 | Project’s assets, cash flows and contractual arrangements                         |
| <b>Investor/ lender base</b>        | Broad participation, deep secondary markets                                                  | Small group, limited secondary markets                                            |
| <b>Finance amounts</b>              | Varies over time                                                                             | Fixed to cover agreed transaction costs                                           |
| <b>Credit investment decision</b>   | Opaque to creditors                                                                          | Highly transparent to creditors                                                   |
| <b>Cost of capital</b>              | Relatively lower                                                                             | Relatively higher                                                                 |
| <b>Financial structure</b>          | Standard forms and readily duplicated                                                        | Unique to the project                                                             |
| <b>Financing transactions costs</b> | Low costs due to: competition from providers, standard mechanisms, and short turnaround time | Relatively higher costs due to level of documentation and longer gestation period |

In the case of non-recourse financing, the project company is generally a limited liability SPV, and so the lenders' recourse will be limited primarily or entirely to the project assets (including completion and performance guarantees and bonds) in the case of default of the project company. A key question in any non-recourse financing is whether there will be circumstances in which the lenders do have recourse to part or all of the shareholders' assets. The type of breach of covenant or representation which gives rise to this would typically be a deliberate breach on the part of the shareholders. Applicable law may also restrict the extent to which shareholder liability can be limited, for example liability for personal injury or death is typically cannot be limited.

### **Main Characteristics of Project Finance**

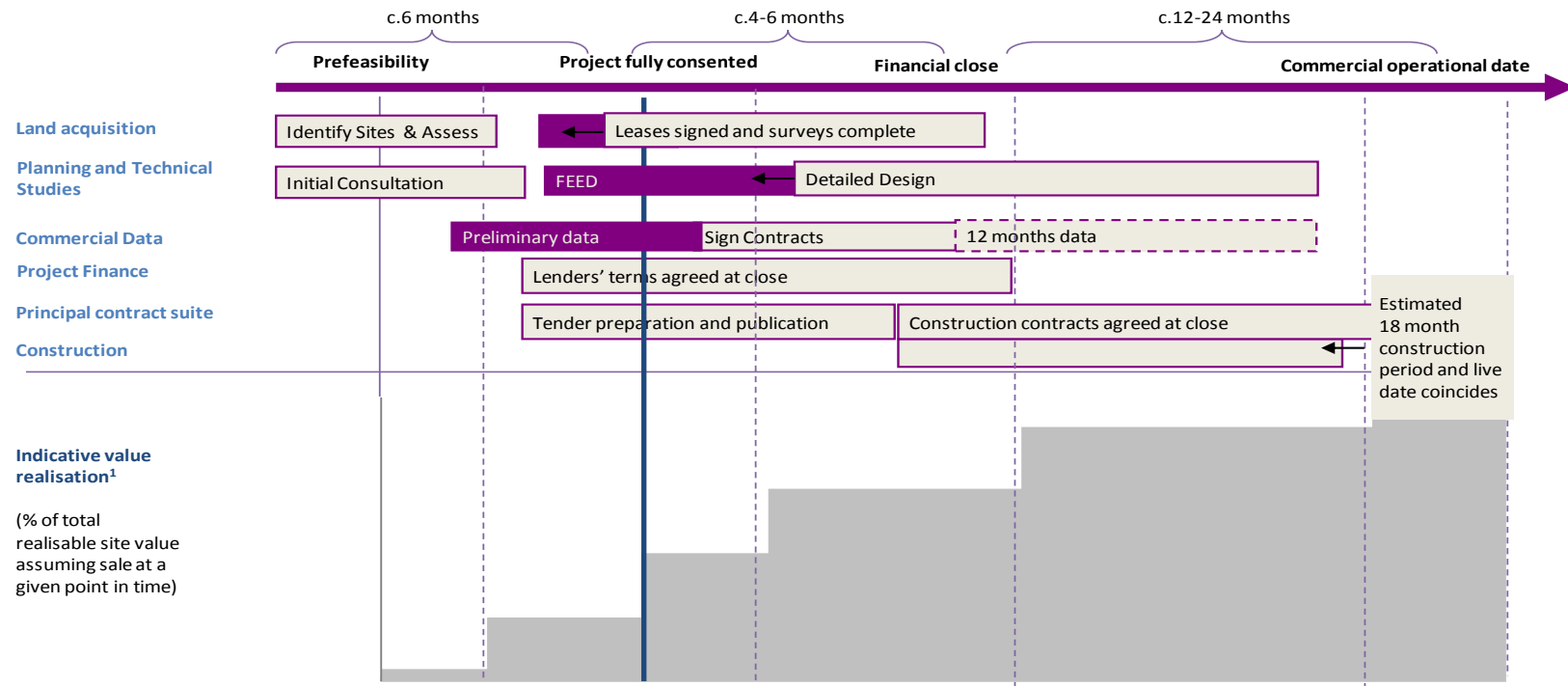
The main characteristics of project finance are:

- Non-recourse lending;
- A special purpose vehicle (SPV) for the project;
- Borrowing is repaid entirely from project cash flows;
- The is usually a high debt to equity ratio; and
- The value of the project increases during its development cycle, a feature of interest to potential financiers (see Chart 4.1)

### **Why Project Finance?**

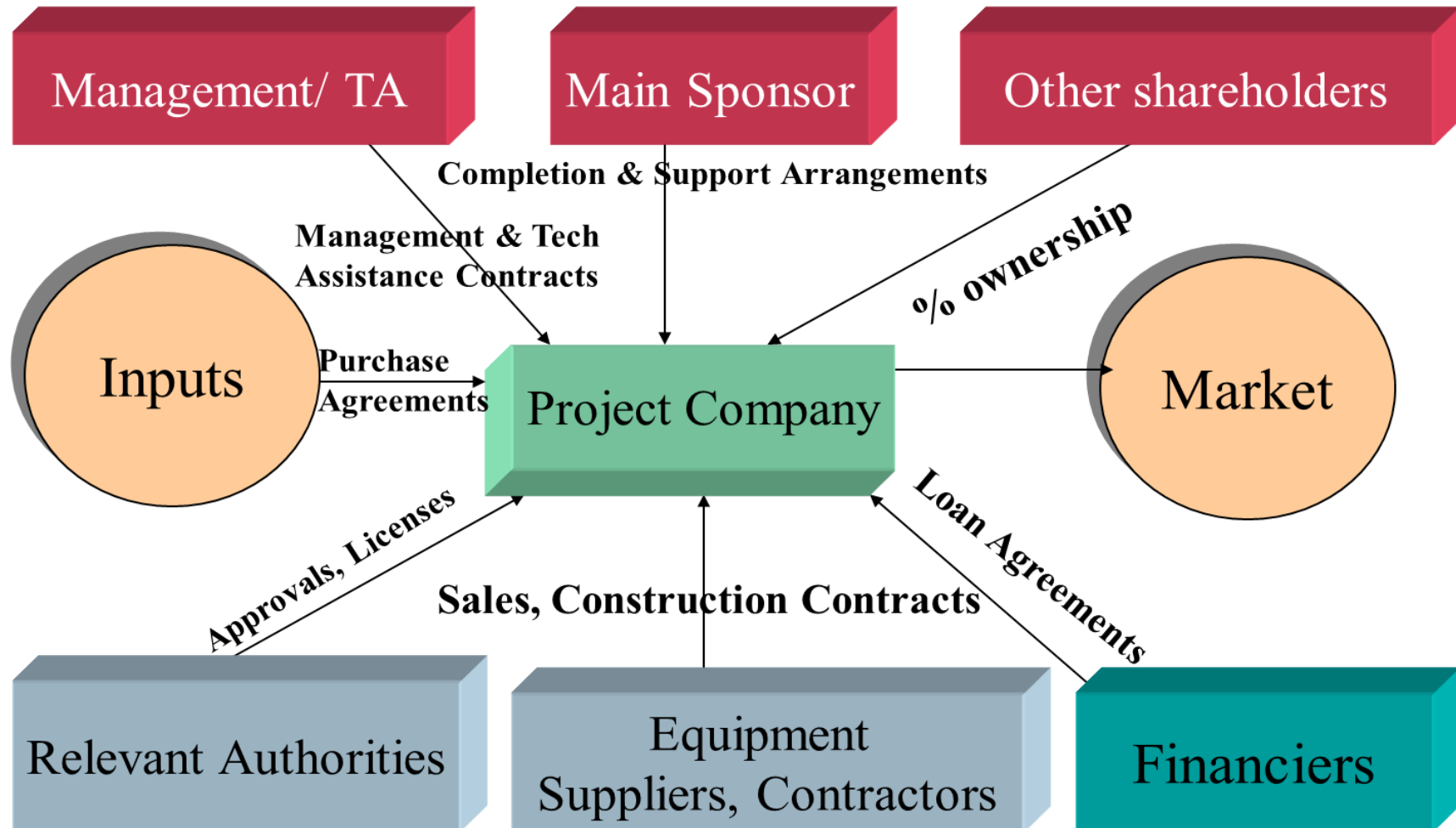
- One of the primary advantages of project financing is that it provides for off-balance sheet financing of the project, which will not affect the credit of the sponsors/shareholders, and it shifts some of the project risk to the lenders in exchange for which the lenders obtain a higher margin than for normal corporate lending. At the same time, it maximises equity returns by allowing for high leverage with interest as a tax deductible expense.
- Project finance is usually made available not to the sponsors but to a separate company, known as a “special purpose vehicle” (SPV), set up specifically to administer the project.
- Lenders know that their recourse is to the project assets.
- **Disadvantages of Project Finance**
- Arranging project finance is time consuming due to the relationship structure of the parties and the due diligence required to proceed. The complex structure and relationships also contribute to more time on governance issues. The typical parties and relationships are depicted in Chart 4.2.
- It is also relatively expensive due to the time, transaction costs and interest.
- A project company is restricted in its scope of activity and often has a defined lifetime.

# Chart 4.1: Value is increased throughout the Project Development Cycle



Note: Based on a limited number of UK transactions and Ernst & Young experience working with leading developers in the field who tend to apply these percentages to estimate value once set milestones are achieved

**Chart 4.2: Typical Project Parties and Relationships**



## Typical Features of a Project Financing Structure

Every project has its unique financing structure but certain features are typical (see also Chart 4.3):

- A separate SPV (or special purpose company – SPC) is set up for the project;
- Repayment of this SPC debt is based primarily on cash flows generated by the future activities made possible by the investment;
- The project is expected to be profitable and its long-term cash-flow projections indicate that it will meet the debt servicing costs under all conditions;
- The project must have a security package that can be shared between lenders on a *pro rata* and *pari passu* basis;
- There should be a minimum equity portion of the project;
- A guarantee should be in place to provide coverage for a minimum amount of the debt associated with the project;
- Export credit agencies and credit institutions should agree to share the risks associated with the project;
- A feasibility study should have been conducted for the project and the document made available to interested investors, lenders and related parties; and
- Lenders may also require additional guarantees from the project's sponsor(s).

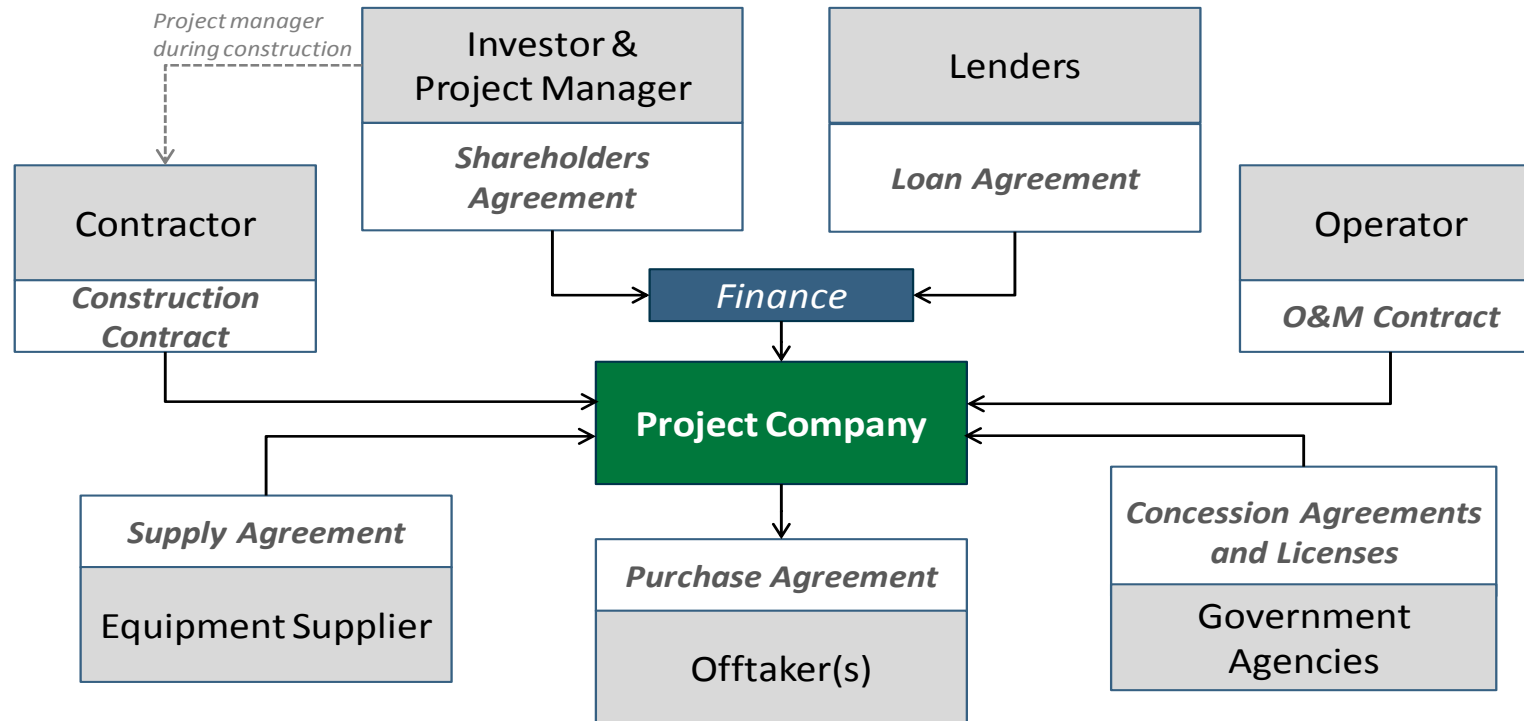
## Main Project Players/Stakeholders

There may be wide range of players/stakeholder in a project. Typically they include:

- **Project Company:** an SPV, incorporated in the country of intended operation, for the construction and operation of the project.
- **Contractors for Project Construction:** Perhaps in international company or a consortium of local firms responsible for transportation, installation and construction under various contract agreements.
- **Plant and Equipment Supplier:** Providing the key assets pursuant to a Supply Agreement.
- **Operator:** Possibly the project company but more likely a qualified international that will operate the plant pursuant to an operation and maintenance contract.
- **Offtaker:** A key buyer who undertakes to purchase all or a sizeable proportion of the project's output, thus providing some sales stability.
- **Government / Public Sector Authorities:** including the relevant sector ministry, other ministries that provide licenses and permits, and relevant regulatory authorities.
- **Lenders:** Banks and other institutions pursuant to the loan agreements.
- **Others:** Local communities, civil society, trade unions.



**Chart 4.3: Example of a Typical Project Financing Structure**



## Project Financing Applicable to DFID

DFID would not of itself consider financing an individual private sector project but it can, through an appropriately designed programme, support private sector projects in target sectors. A good example is India's Infrastructure Debt Partnership Programme (see Annex 4A).

## Typical Steps in Developing a Project

The example in Annex 4A shows just some of the features of lending to support projects. Due to the unique properties of every project (location, infrastructure, timing, local politics, etc.), it is not possible to state exactly the steps involved in a project. However, typically, they do include:

- A pre-feasibility study including initial data gathering;
- Search for potential technical partners and financiers;
- Verification of licensing and other governmental permissions required;
- Review of the availability of land, inputs and skills requirements;
- Review of the market for products/services;
- A full feasibility study with evaluation of options and projections;
- Negotiations with potential partners and suppliers;
- Negotiations with potential financiers;

- The selection and appointment of technical specialists and lawyers;
- Tenders for the supply of capital goods and construction;
- Due diligence;
- Reworking of designs and forecasts/projections;
- Obtaining the necessary licenses/permissions;
- Acquisition of the land required;
- Negotiating the financial covenants;
- Concluding contracts with lenders;
- Concluding contracts with suppliers;
- Commencement of project; and
- Project review and sign-off (completion).

## Project Development Duration

Project development takes time. Firstly, Pre-project development work can take many years. Then the time between project development and commissioning will depend on the nature of the project but, where construction is involved, it will take a lot longer.

Meanwhile, the project will not generate any revenue until after commissioning. This means that finance will be required during project development, with the sponsor(s) funding pre-development costs and the lenders providing a grace period between any loan drawdown and an agreed date after project commissioning.

## Annex 4A

### DFID India's Infrastructure Debt Partnership Programme<sup>2</sup>

The programme is for a total of £38m of which £36m is available as a line of credit and £2m is for technical assistance.

The programme is expected to result in increased investor interest in pro-poor infrastructure sectors in eight low-income states. Initially the programme is focusing on the dairy industry in four states in East India.

The key terms of the line of credit are: Tenor, rate of interest, grace period, credit risk, credit appraisal, ESG standards etc.

The programme is expected to directly result in:

- At least 10 new private sector-led (including PPP) projects;
- At least £120 million of additional private investment mobilised for pro-poor infrastructure services;
- An estimated 280 000 people get access to new/improved infrastructure services such as electricity, sewerage, and transport; and
- An estimated 1,500 long-term jobs and 3,000 short-term jobs generated directly.

#### The Dairy Industry in India - Numbers

<sup>2</sup> Please note that this is for illustrative purposes only as reviews and negotiations are under way and the deal may or may not come to closure.

India is the world's largest producer of dairy products by volume (13% of world's share) and has the world's largest dairy herd although milk production, which was an estimate 17MT in 1951 had only risen to 110 MT by 2009 and the demand-supply gap is increasing due to changing consumption. Key statistics in the four focus states are given in Tables 4A.1, 4A.2 and 4A.3.

**Table 4A.1: Estimated Milk Production in '000 Tonnes**

|        | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 |
|--------|---------|---------|---------|---------|---------|
| Bihar  | 5,451   | 5,783   | 5,934   | 6,124   | 6,517   |
| Odisha | 1,431   | 1,625   | 1,598   | 1,651   | 1,671   |
| UP     | 1,8094  | 18,861  | 19,537  | 20,203  | 21,031  |
| WB     | 3,983   | 4,087   | 4,176   | 4,300   | 4,471   |

**Table 4A.2: Co-operative Sector Achievement 2010-11**

|        | Co-op Societies Nos | Member Farmers '000 | Procurement / Day in '000 Kg | Liquid Milk Sales in '000 L/D (in the state) |
|--------|---------------------|---------------------|------------------------------|----------------------------------------------|
| Bihar  | 9,425               | 523                 | 1,090                        | 464                                          |
| Odisha | 3,256               | 187                 | 276                          | 290                                          |
| UP     | 21,793              | 977                 | 504                          | 380                                          |
| WB     | 3,012               | 213                 | 273                          | 41                                           |

**Table 4A.3: Dairy Plants and Capacity in '000 L/Day - March 2011**

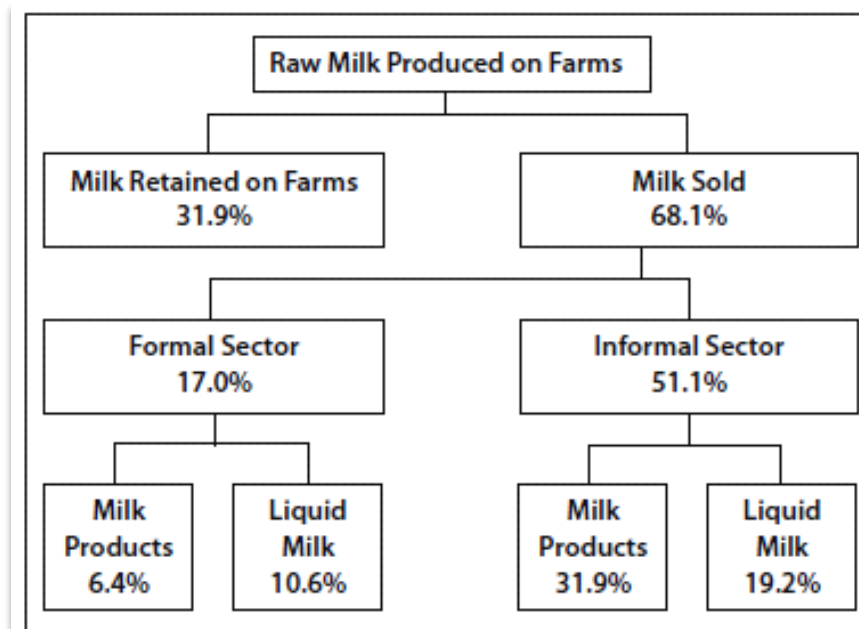
|        | Co-op |          | Private |          | Total |          |
|--------|-------|----------|---------|----------|-------|----------|
|        | No    | Capacity | No      | Capacity | No    | Capacity |
| Bihar  | 6     | 575      | 2       | 400      | 8     | 975      |
| Odisha | 4     | 294.5    | 0       | 0        | 4     | 294.5    |
| UP     | 7     | 1560     | 37      | 13179    | 44    | 14739    |
| WB     | 3     | 816      | 2       | 650      | 5     | 1466     |

Note: State Governments do not have any dairy plants.

## The Dairy Industry in India - Market

An overview of the dairy industry in India is shown in Chart 4A.1:

**Chart 4A.1: Milk Production to Output in India**



Adapted from Nestle.

The industry faces challenges in four main areas:

- Procurement;
- Sales and marketing;
- Quality, given the perishable nature of the products; and
- Finance.

However, opportunities exist to:

- Assist this capital intensive business;
- Make a direct impact for farmers;
- Assist in becoming a more organized sector; and
- Produce better quality products.

The market gap that exists in the dairy industry value chain is depicted in Chart 4A.4. The value added and value capture is shown in Chart 4A.5.

#### **The Transaction: Summary Term Sheet**

Borrower: Aggregator

Amount: Asset backed with LTV 60%. Post operations: 80% upfront post securitization of receivables

Tenor: 7 years

Repayment: Grace period before COD, thereafter amortizing over the unexpired tenor (i.e. no tail end risk as in a bullet payment)

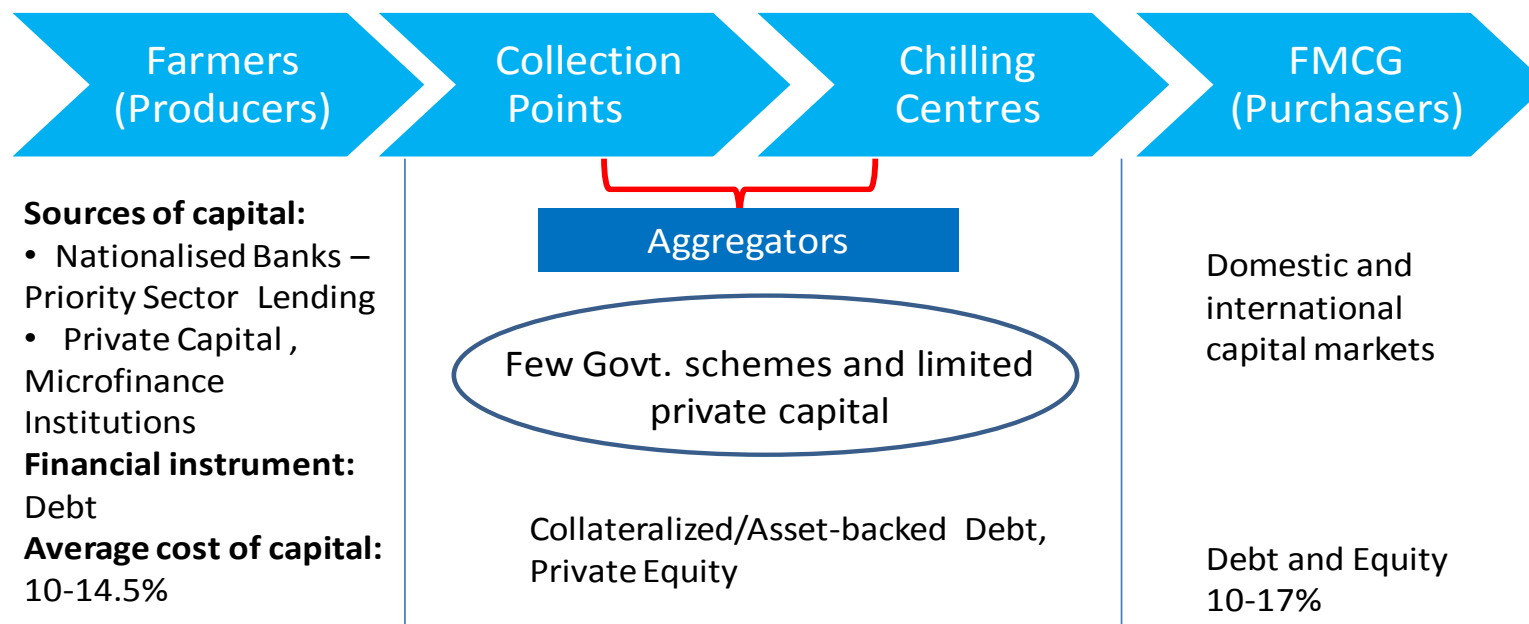
Facility Type: Amortizing, revolving credit facility

Rate: *[transaction in progress]*

Security: Pledge over assets and promoter guarantee (during build out period); pledge over receivables (during commercial operations)

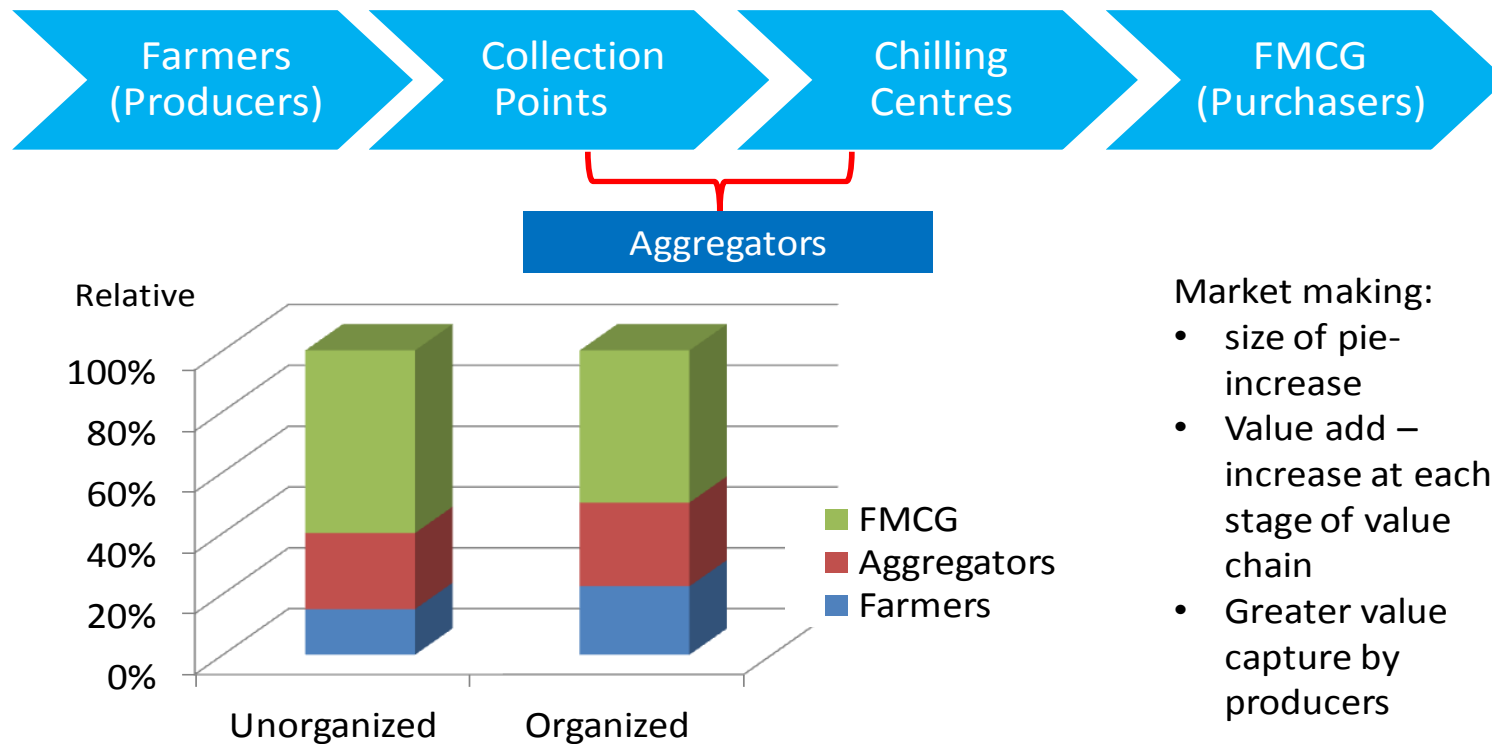
Financial Covenants: (1) Minimum Tangible Net Worth. (2) Ratio of total liabilities to tangible net worth  $\leq 1.2x$ .

## Chart 4.A4: Indian Dairy Industry Value Chain: Market Gap



Current Value Chain: low input-low output system, in which individual producers and households typically own less than five cattle

## Chart 4A.5: Indian Dairy Industry: Value Added and Value Capture



Market making:

- size of pie-increase
- Value add – increase at each stage of value chain
- Greater value capture by producers

# Section 5

## Equity

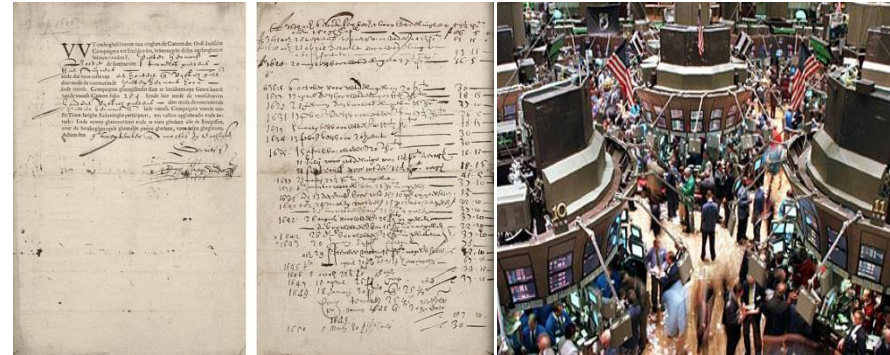
### Key Features of Equity

There are five key features of equity:

- 1) It is an **ownership stake** in a business through **shares**.
- 2) It is **subordinated** in the capital structure and therefore **higher risk** on the downside.
- 3) But it can also be **higher return** with usually **no limit on the upside**.
- 4) Unlike a loan there is no fixed payback – returns are generated through **dividends** and, ultimately, **sale of shares** at “exit”.
- 5) It can come with increased **governance rights and responsibilities** depending on the size of the stake.

### Ownership

Owning equity is the owning of shares in a business:

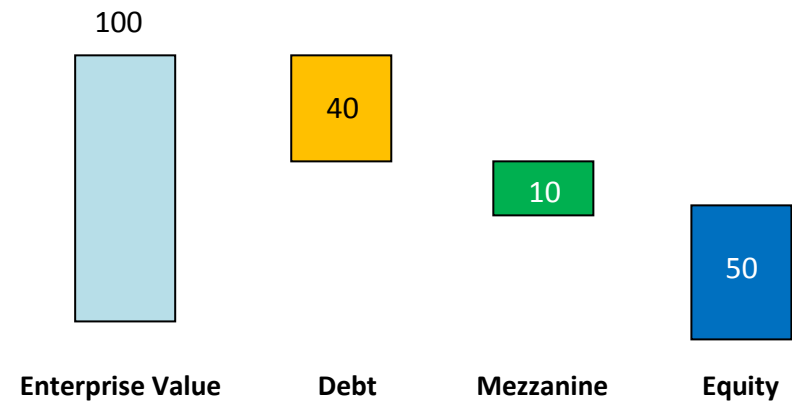


Amsterdam, 1606

New York, 2013

### Equity is Subordinated

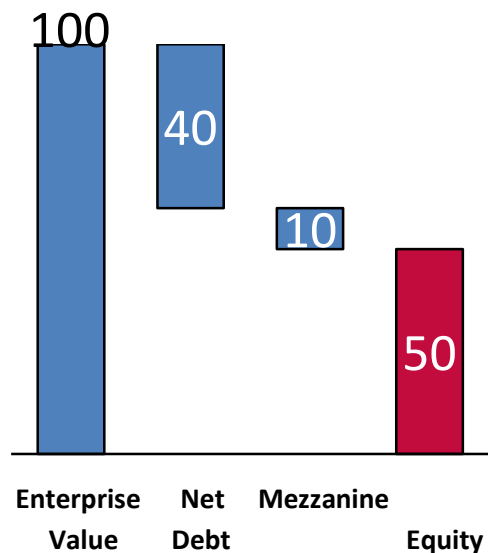
Equity is the value that is left in a business when all debt has been subtracted, for example:



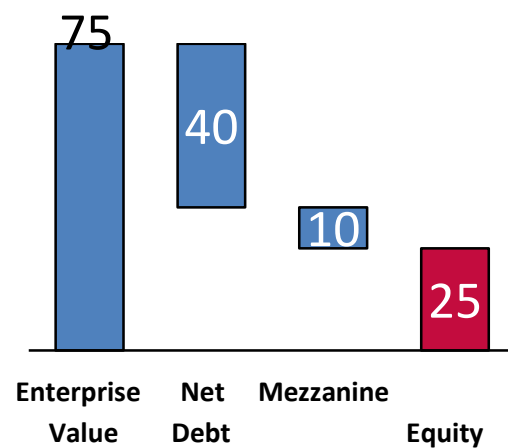


If the value of a business is hit, equity takes the brunt – hence it is higher risk:

This:

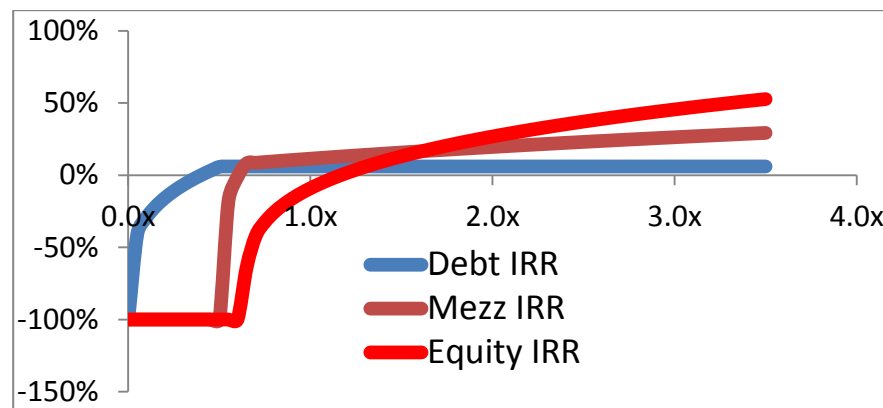


could change to this



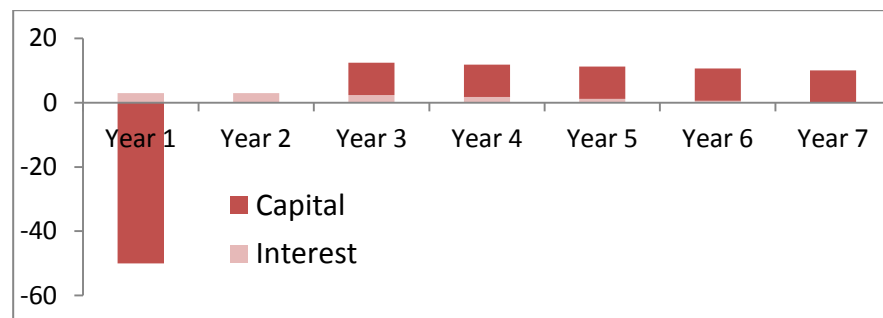
Unlike debt, there is no cap on returns – equity returns grow strongly with underlying company growth:

**Increase in Company Value over a 4 year period**



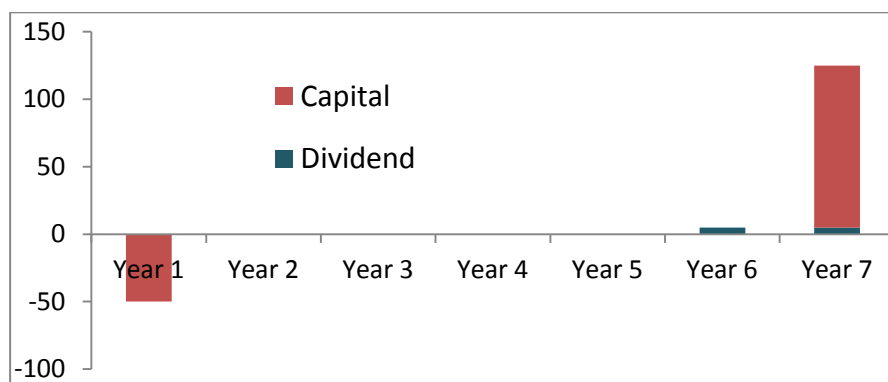
While debt has a relatively certain repayment profile, equity does not – and may be weighted towards exit. Compare:

**Debt Cashflows with Loan Fully Repaid in Year 7 per Agreement**



With:

**Possible Equity Cashflows if exit were achieved at end of Year 7**



## Shareholders' Role in Governance

As owners of the business, shareholders have a role in governance depending on the size of their stake:

| Equity Stake                  | Role / Rights                                                                                                                                                       |
|-------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Minimal (0–5%)                | <ul style="list-style-type: none"> <li>• Right to vote in shareholders meetings</li> <li>• Basic information rights</li> </ul>                                      |
| Minority (5-25%)              | <ul style="list-style-type: none"> <li>• Usually a board seat</li> <li>• Veto rights (shared?) over key decisions</li> <li>• Enhanced information rights</li> </ul> |
| Significant Minority (25-50%) | <ul style="list-style-type: none"> <li>• Potentially two or more board seats</li> <li>• Increased veto rights (e.g. appointment of management)</li> </ul>           |
| Majority (50%+)               | Board majority<br>Right to appoint and remove management<br>Operational control only inhibited by minority shareholders (if they exist)                             |

## Raising Equity: The Company Perspective

Early stage or high-risk businesses can usually only raise equity because no-one will lend. In emerging and frontier markets debt may be non-existent anyway.

Raising too much debt increases the level of risk to existing investors – and lenders will limit the possible ratio of debt:equity.

Equity is more flexible than debt – it does not have a fixed payback period and so is especially useful when there is uncertainty.

## Raising Equity: The Investor Perspective

There is potential for a bigger role in governance and management to shape the business.

There is also the possibility of accessing higher returns.

It is more suitable for many companies that are in a period of rapid growth because of flexibility.

It is sometimes possible to “crowd-in” additional debt on the back of equity investment.

## Issues in Negotiating and Structuring an Equity Transaction

There are generally six key issues to be addressed in negotiating and structuring an equity transaction:

- Valuation
- Downside protection

- Corporate governance
- Minority protections
- Exit
- ESG and impact

### **Determining the Value of Equity**

How the value of equity in a company is determined depends on the prevailing circumstances of the business as well as the industry, market and socio-economic environment. The methodologies for valuing a business are outlined in Annex C.

### **Downside Protection by Structuring Equity**

There are two broad types of equity structure:

- “Common” or “straight” equity – where all shareholders have the same economic rights; and
- “Preferred” or “Structured” equity – where some investors have better rights under some or all circumstances.

“Structured” equity is common either in early-stage businesses (where investors want more protection if things go wrong) or in situations where valuation is difficult to agree on and an investor will trade some of the “upside” for protection on the “downside”.

Some forms of structuring include:

- Liquidation preferences;
- Preference shares with a coupon (having equity participation but debt-like interest);

- “Guaranteed IRRs”;
- Ratchets; and
- The promoter providing contingent equity.

Among the key considerations for a potential investor are:

- Many structures are possible but the more complicated they are the more likely they will not work.
- There needs to be full alignment between the promoter and management (who have a keen vested interest) and other investors.
- Because structured equity deals can be complicated, they take time and may require considerable legal advice.
- Thorough due diligence is more important than the structure.
- Inclusion of veto rights.

### **Corporate Governance**

Companies and project sponsors seeking to raise finance are often used to working in an environment where decision-making has been narrowly-based and without reference to other shareholders.

Improving corporate governance and creating broad-based decision-making will be in the interests of all shareholders. This will involve ensuring:

- Transparency of information through high-quality and regular management information; and

- Solid corporate governance with effective use of non-executive directors and board committees.

Section 12 deals more fully with the subject of governance.

### **Use of Vetoes**

Despite improving board governance, promoters typically continue to control the board and management of a company, hence negotiated “vetoes” are critical for an incoming minority investor. The circumstances when vetoes might apply and how they would apply are often difficult points of negotiation that arise when the transaction legal documentation is near completion. To avoid delay, it is better to table the subject of vetoes at as early a stage as possible.

There are two key types of veto: (1) constitutional vetoes; and (2) operational vetoes.

A constitutional veto relates to the structure of share classes and the rights of a shareholder (e.g. to protect a minority investor’s interest by preventing changes to his disadvantage, borrowing in excess of agreed limits, or appointment of external auditors).

Operational vetoes relate to decisions made about the running of the company (e.g. to limit capital expenditure to the approved budget level and appointments of senior management personnel).

For vetoes to be used constructively and effectively, co-investors should agree which vetoes will be exercised collectively and which independently.

## **Equity Examples**

Two real examples of equity financing are included in the following annexes:

**Annex 5A**      **DFID Climate & Environment Department**

**Annex 5B**      **The Neev Fund in India**

## Annex 5A

### Equity: Examples from DFID Climate and Environment Dept

Britain spearheaded a new drive to bring major private investment to help tackle the global threat of climate change and help boost economic. Two newly established commercial funds within the Climate Public Private Partnership (CP3) are expected to bring in at least £30 of private capital for every pound provided by the British taxpayer. CP3 was established in recognition in climate negotiations that substantial amounts of money are needed to build low carbon infrastructure in developing countries.

#### Climate Public Private Partnership (CP3)

At meetings in Copenhagen and Cancun it was agreed that it was necessary, in the context of meaningful climate change mitigation actions and transparency, to achieve the goal of mobilising \$100bn a year by 2020. While developed countries have made some commitments, finance will be required from a wide variety of sources, public and private, including alternative sources of finance. However, it looks increasingly likely that most of the finance will have to come from the private sector.

UNFCCC donor governments must report on progress in meeting this target.

CP3 is designed to:

- Drive new types of private money into climate investments e.g. pension funds, sovereign wealth funds.
- Speed up the development of private equity market in climate-related investments.
- Show climate investments are profitable by building network of sub-funds with good investment track records.

#### Evidence Base

Sources of information used to determine requirements and to formulate CP3 were:

- Castalia report with IFC (Nov 2011) – How private equity markets work:  
<http://documents.worldbank.org/curated/en/2012/01/15796985/public-private-equity-partnerships-accelerating-growth-climate-related-private-equity-investment>
- Catalysing low-carbon growth in developing economies – Public finance mechanisms to scale up private sector finance solutions (UNEP):  
[http://unepfi.org/publications/climate change/Ps](http://unepfi.org/publications/climate%20change/Ps)
- Research on pipeline returns SDCL, fund managers.
- Interviews with pension funds P8, P80.

#### How and Why the Model

The rationale behind CP3 is that:

- Equity is the driver (and MDBs' traditional focus is on debt; and debt is passive);

- PE funds are well-known, established, replicable model;
- Discussions with G8 pension funds showed that:
  - DFIs reduce developing country risk; and
  - DFIs/MDBs have bankers on the ground;
- Professional fund managers need to attract institutional investors; and
- SEC regulated entity needed but the UK Government cannot and should not promote investments to investors. There is also an **FCA** risk.

Negotiations resulted in two different funds and, while there is a slight overlap/competition, each fund has a different focus:

- 1) The Catalyst Fund, which has a global focus; and
- 2) CP3 Asia, which focuses on emerging Asia.

The structure of the two funds is depicted Chart 5A.1 and a summary of the present position of the funds is provided in Table 5A.1.

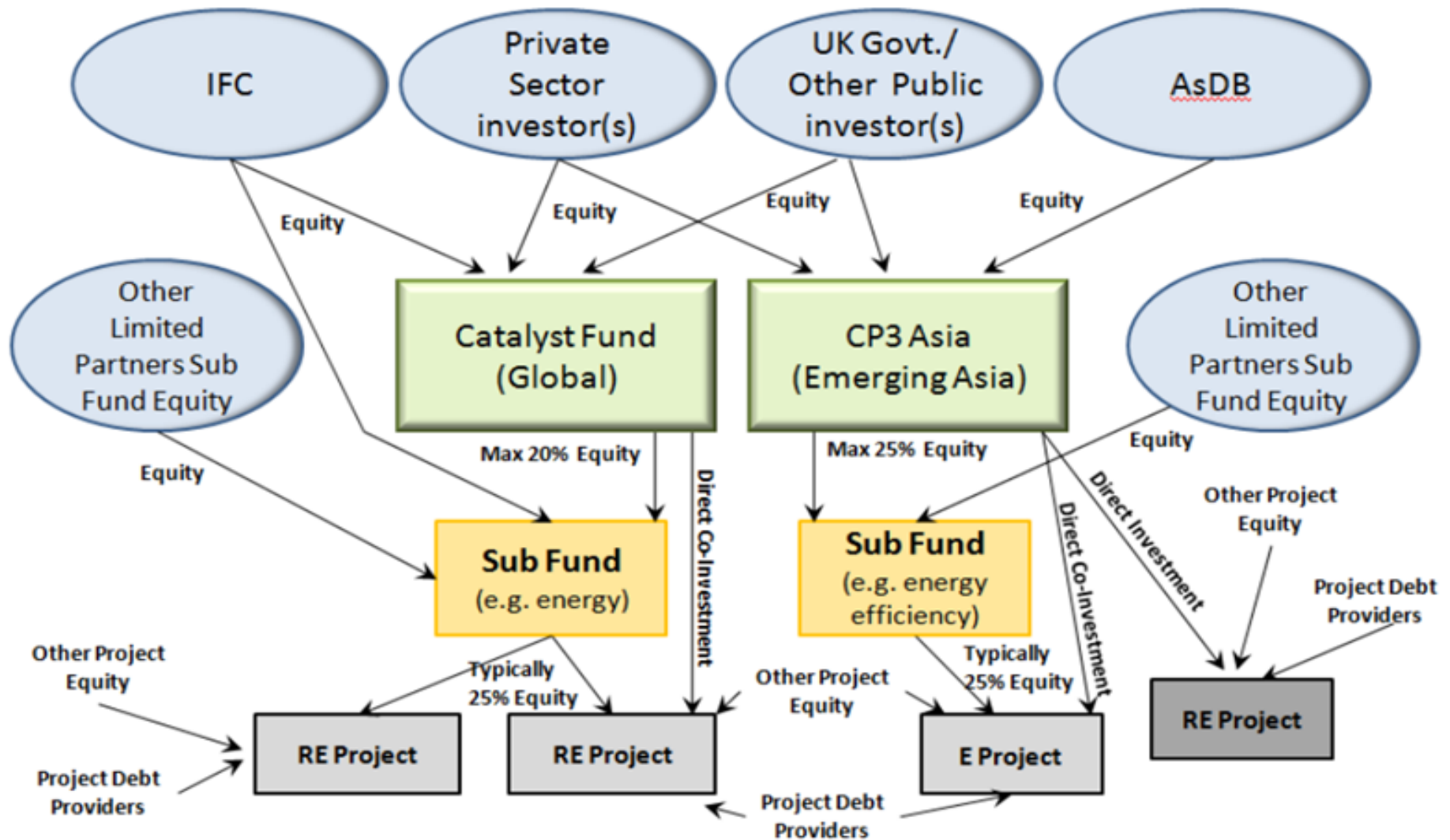
### Things to Note

The following are important points to note that may be relevant to establishing funds for other developmental purposes involving the private sector:

- Upfront definition of “climate” – then UK steps back and the market does the work.
- Compared to Climate Investment Funds or Challenge Funds, the UK Government’s “management” role is very limited.

- The anchor investor provides a signalling effect.
- There was a large DECC contribution (£75m).
- The funds aim at commercial returns. Hence there is a need to include middle income countries because low income countries alone would render them non-commercial.
- Pensions are highly regulated and restricted in investments (5% rule). Pensioners are relatively old in Europe; and this makes fund-raising hard.
- The funds flow will follow “returns”, hence there is an Asia bias for CP3.
- The UK investment is not a subsidy and it is not first loss but “pari passu”.
- This a long term project, with governance implications for managing the funds as well as a long-term financial outlook.
- Funds are 12 years + (up to 15 years).
- Evaluation will look at pension fund attitudes over circa 10 years.
- It will take a long time to change a market.
- Quarterly accounts from the PE fund and trust fund will assist with valuing asset for non fiscal Del.

Chart 5.A1: The CP3 Structure – Two Funds



## Table 5A.1: CP3 Funds – Summary of Present Position

UK investment of £110 million + up to £19 technical assistance

### IFC Catalyst Fund

### CP3 Asia

|                                                                                                                                                      |                                                                                            |
|------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|
| IFC AMC as fund managers                                                                                                                             | CFIG + Asian Development Bank as fund managers                                             |
| Global focus                                                                                                                                         | Asia only (33% India, 33% China, 33% rest of Asia)                                         |
| 70% sub funds (with a focus on first time fund managers)                                                                                             | 70% direct investments<br>30% sub funds                                                    |
| First close Dec 2012: USD \$281.5 million (UK \$80, IFC \$75 , Azerbaijan \$50, Canada \$76.5)<br>July 2013 private sector German pension fund \$65m | First close: expected Spring 2014<br>Delayed – mostly due to sale of CFGI by Credit Suisse |



## The Risks

Significant risks that were recognised are:

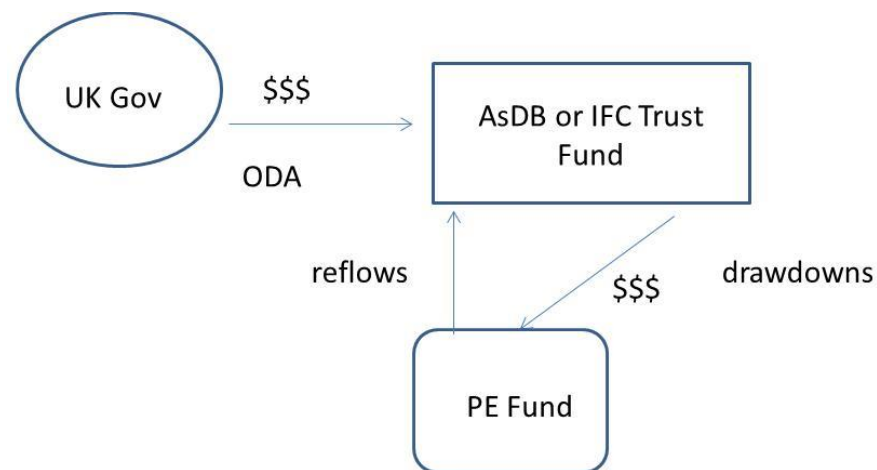
- Private sector may not respond or agree to join.
- Returns may be too low, so the demonstration effect is lost.
- Delays occur, so the welfare benefits are limited.
- Inadequate pipeline of projects (considered a low risk).
- NGOs argue insufficiently pro-poor.
- Developmental benefits may be slow to appear.

## ODA and Non-Fiscal Del

Important aspects related to development assistance, especially ODA compliance –see Chart 5A.2) are:

- Returnable grant to MDB is equivalent to non-fiscal Del.
- A Promissory Note counts as spend immediately and not as a disbursement in advance of need.
- Trust fund will manage drawdowns to the fund capture reflows (it will “manage” negative ODA).

## • Chart 5A.2: ODA Compliance and Non-Fiscal Del



## Negotiation Lessons

The following lessons have been drawn from the negotiations to establish the CP3 Funds:

- It is important to appoint a good, specialist commercial funds lawyer early on.
- First run a mini tender with input from the Treasury Solicitor's Department input.
- Bargaining power stronger early on. Hence draft Heads of Terms as was done for CP3Asia.
- Fees should be set by tender early on but care must be taken to avoid a cost leakage.

- It is important to sound out HMT's view to avoid any jurisdictional problem.
- It is necessary to impose and enforce ESG standards throughout, even at the sub-fund investment level; but this is not easy to achieve in practice.

#### Fee Issues in Private Equity

Issues should be foreseen regarding the determination of fees:

- The setting of a basic management fee and any "carry" for managing the fund
- Management fees can vary widely (2% and 20%) depending on the fund complexity and other factors that could affect fund management.
- A hurdle rate might be set. If so, it is usually of the order of 8%.

#### Lessons of Fee Issues in Private Equity

Determining fees for CP3 highlighted the four following lessons:

- It is important to distinguish between:
  - sub-Funds;
  - Co-investments; and
  - Direct investments (time intensive).
- Investment in infrastructure tends to be safer than other ventures.

- Venture capital in the earlier stage is riskier and management therefore attracts higher fees.
- Dispersed geography of activities also means higher fees.

#### Management Fees

Management fees are usually negotiated for an investment period of, say, 4 to 5 years. The management fee, which will be levied on "commitments", is expressed as an annual percentage, and usually levied quarterly.

It should be noted that the fee may reduce in the post investment period as there is less work involved.

Lastly, it will be important to watch fees during wind-up period.

#### Typical Fees \*

Table 5A.2 shows the typical levels of management fees.

**Table 5A.2: Typical Management Fees\***

|                                  | Typical<br>Management Fees | Typical Carry (profit<br>share to manager) |
|----------------------------------|----------------------------|--------------------------------------------|
| Lead role, active<br>management: | 1.25 - 2.5 % pa            | 15 - 20 %                                  |
| Co-investment:                   | 0.75 - 1.25 % pa           | 7.5 - 15 %                                 |
| Fund of fund<br>investment:      | 0.5 -1.0 % pa              | 5 - 10 %                                   |

\* Findings of a GBRW and Prequin survey for DFID

### Other Cost Issues

Other cost issues to watch include:

- Administration fees;
- Organisational costs (cap and “scope”);
- Charges for services to portfolio companies;
- Revenue from portfolio companies e.g. for sitting on boards (which should go back to the fund); and
- Deal/transaction costs.

### Other Points

Other matters that must also be considered include:

- Removal of the Fund Manager (for default);
- Controlling the end of the fund;
- Allocation of investments if the Fund Manager has competing funds;
- Key man/team clauses;
- Change of control (this issue occurred with CP3 Asia); and
- Placing a limit on the Fund Manager investing in the fund: say 0.5% for subfunds and 1% co/direct.

### Technical Assistance – SCAF UNEP

The Seed Capital Assistance Facility implemented through the United Nations Environment Programme will provide technical assistance:

- Works with PE funds, which addresses first mover disadvantage and aims to encourage investments in more difficult countries or sectors.
- Loans to first time fund managers whilst fundraising. Repaid by investors out of organisation costs.
- Loans for higher transaction costs, feasibility studies etc.
- Commences Dec 2013.

### Funding for Climate Change – Stages of Development

Different levels of funding are required at different times for the various stages of development of a climate change business project. These are depicted in Chart 5A.3

### Investments in Forests and Sustainable Land

Proposals are under consideration to establish a Forest Fund for investment in forests and sustainable land. Such a fund is needed as sustainable investments are perceived to be more expensive; and thus there has been a market failure.

The aim is to demonstrate viability and to “top up” costs of, say, obtaining forest certification with:

- Up to £300m Business Case (DFID, DECC, DEFRA) Africa, Latin America and Asia;
- 50% TA and 50% equity and debt investments;
- The setting up of a separate UK entity and tendering for fund managers; and
- Revolving capital but
- No third party investor money joining.

It is expected that, there would be, in addition to the management fee and carry, a “performance” fee for development outputs.

As with CP3, GAP and the Flexible Fund, consultants have been engaged to prepare a full financial model (which in turn drives economic model).

### Forests

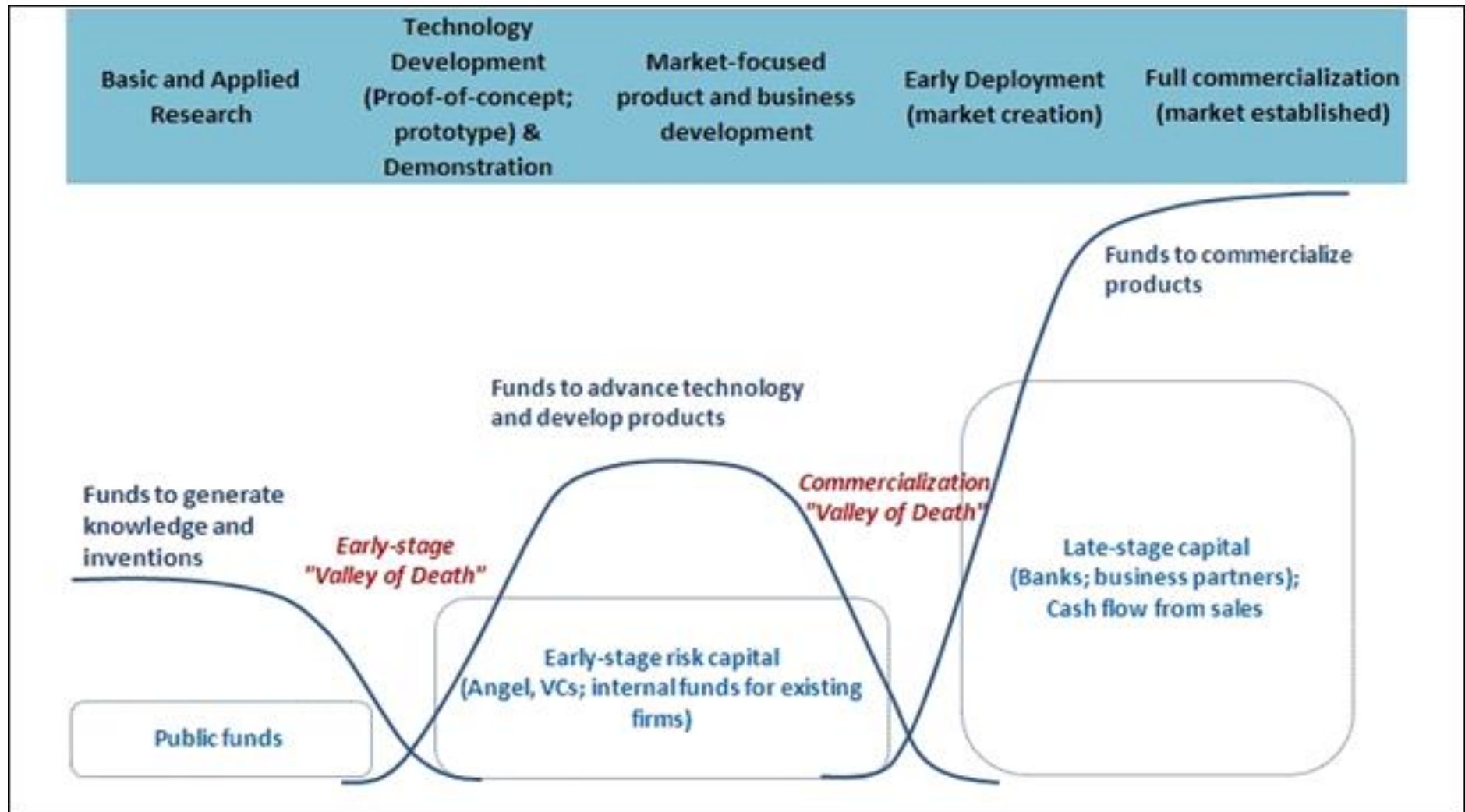
Investments will only count as ODA when they are made and not when transfers are made to the fund as there is no ODA accredited entity in the middle.

The fund will need managers to value the fund quarterly for non-fiscal Del.

Investment policy will be critical, so careful attention will have to be given to geographic spread as well as investment types (brownfield, greenfield).

Further consideration will have to be given to decisions as to the roles of UK staff on various committees (e.g. investment committee, steering committee) and the independent board.

**Chart 5A.3: Climate Change Business – Stages of Development**



### Flexible Fund

The Flexible Fund (FF), for which DFID has a £99,000 budget, has been set up to support businesses to get renewable energy innovations to scale in developing countries.

The FF, needed to meet the financing gap for low carbon companies (e.g. mini-grids, solar home systems, low carbon), particularly the lack of working capital, has been designed on the basis of considerable consultation with businesses interested in renewable energy and the issues in Monitor report:

<http://www.mim.monitor.com/blueprinttoscale.html>

As with the forest fund, the Flexible Fund will have a separate legal entity, then Fund Manager, so same ODA issues.

The flexible Fund will have no carry arrangement: any bonus will be base primarily on impact outputs e.g. CO<sub>2</sub>te, energy access for poor.

Procedures for tendering have been negotiated so that flexibility is built into the various rounds of tendering.

Two evidence studies have been commissioned: (1) Lion's Head on costs and governance of funds; and (2) ECA Financial model using 10-20 real businesses to model costs and exit. The findings of the studies will drive the economic model.

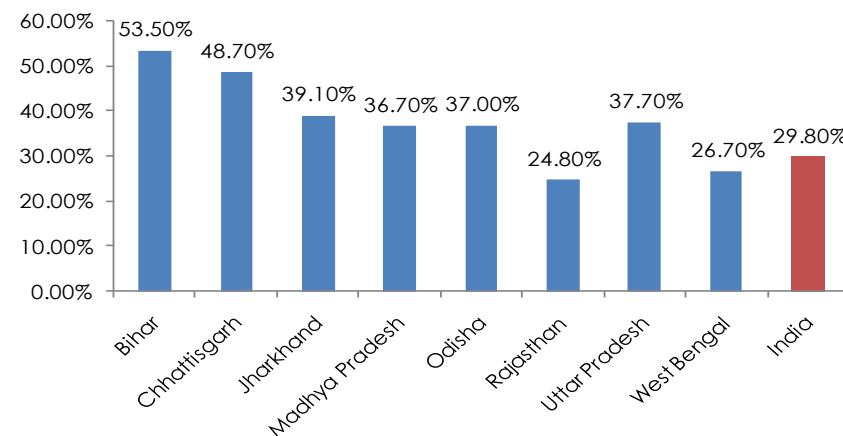
## The Neev Fund in India

### The Need for Neev

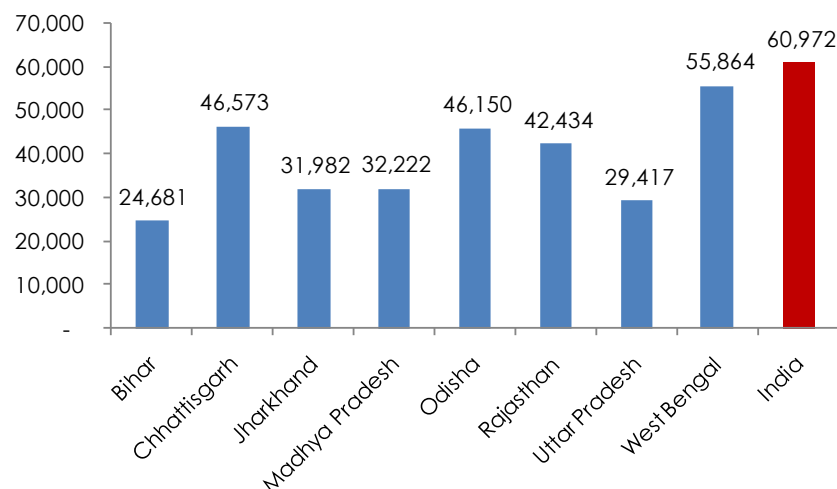
The Neev Fund is DFID India's Infrastructure Equity Partnership Programme targeted at the country's poorest states.

The target states lag behind the country's average with greater proportion of poor people and lower per capital income levels (see Charts 5B.1 and 5B.2).

**Chart 5B.1: Percent of Population Below Poverty Line (BPL) 2009-10**



**Chart 5B.2: Per Capita Net SDP (in Rs.) in 2011-12 at current prices**



### Options and Considerations

The following financial instruments were identified as possible choices:

- Line of credit;
- Establish a New Fund Manager (GP);
- Fund of Funds Investment (established GP); and
- Blended investments through PIDG Facilities, through Multi-laterals or via CDC.

The key parameters in deciding the most appropriate instrument(s) were:

- DFID India's bilateral aid framework agreed with the Government of India;
- Through a supported institution offering sustainability in the long term;
- Twin bottom-line objectives in DNA; and
- The potential for a demonstration effect.

### Neev Fund – Basic Data

Budget: £37.5 m (£36m Equity + £1.5m TA) in Bihar, MP, UP, Orissa, Rajasthan, Chhattisgarh, Jharkhand, West Bengal

Expected Results: – at least 12 investments, £120m private capital leverage, 280 000 women and men with improved services, 1 500 long term and 3 000 short term jobs

Co-investors: SBI Group, SBI Capital Markets

Investment Manager: SBICAP Ventures Limited (SVL)

#### Key Terms:

- Term: 8 (+ 2) years
- Target Investments: Greenfield SME Infrastructure
- Ticket size: £1 - 12 million
- Management Fee: cumulatively under 10% but with development incentives built in
- Carry (Profit Share of Managers): 20%.

### **Neev Fund Structure and Management**

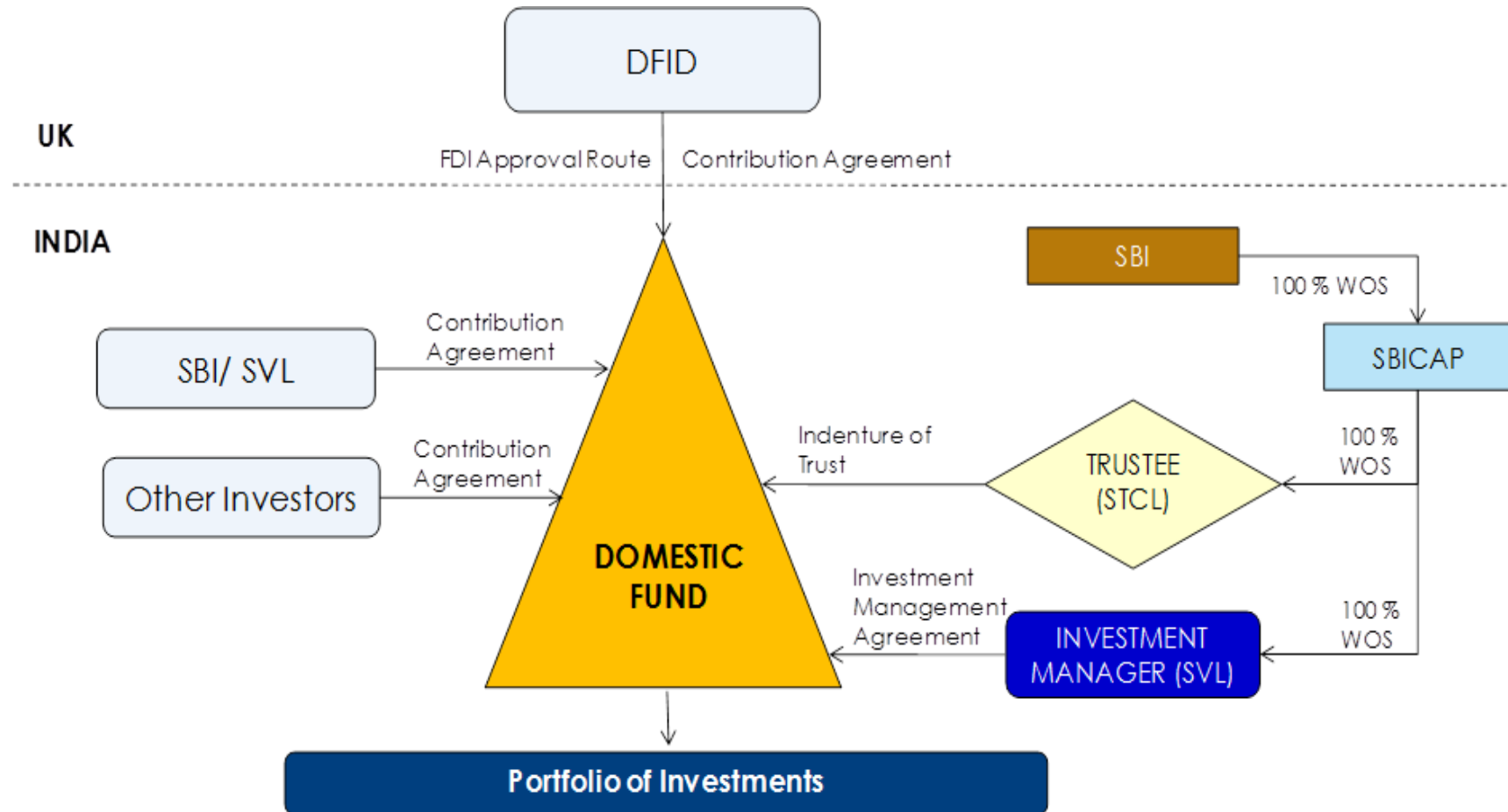
The Neev Fund was set up in India as an Infrastructure Fund under the Alternative Investment Fund (AIF) Regulations 2012. The fund structure is depicted in Chart 5B.3.

Chart 5B.4 provides an overview of the Fund's governance and management.

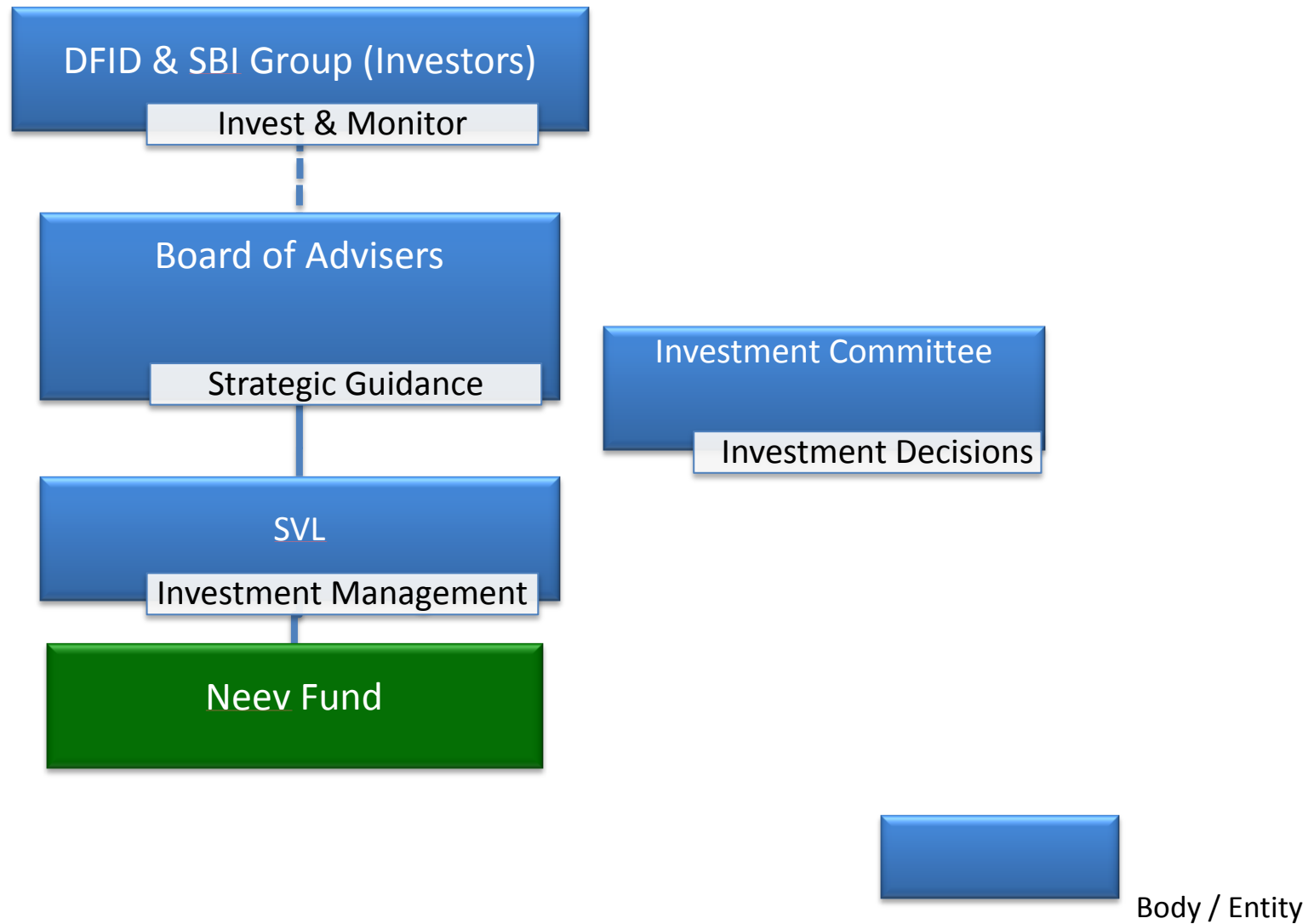
The Neev Fund investment cycle is depicted in Chart 5B.5.

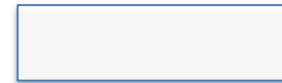


**Chart 5B.3: Neev Fund Structure**



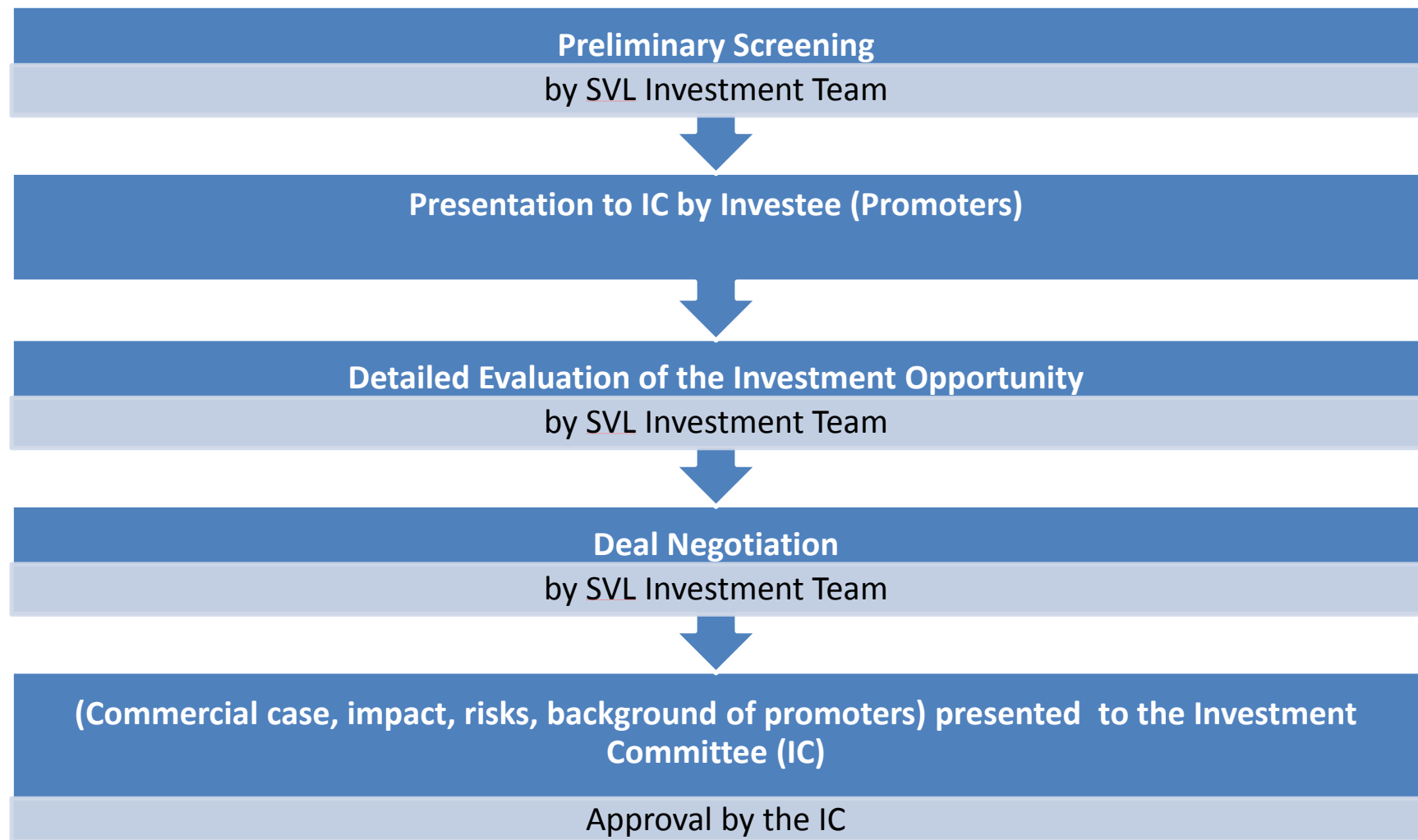
**Chart 5B.4: Neev Fund Governance and Management**



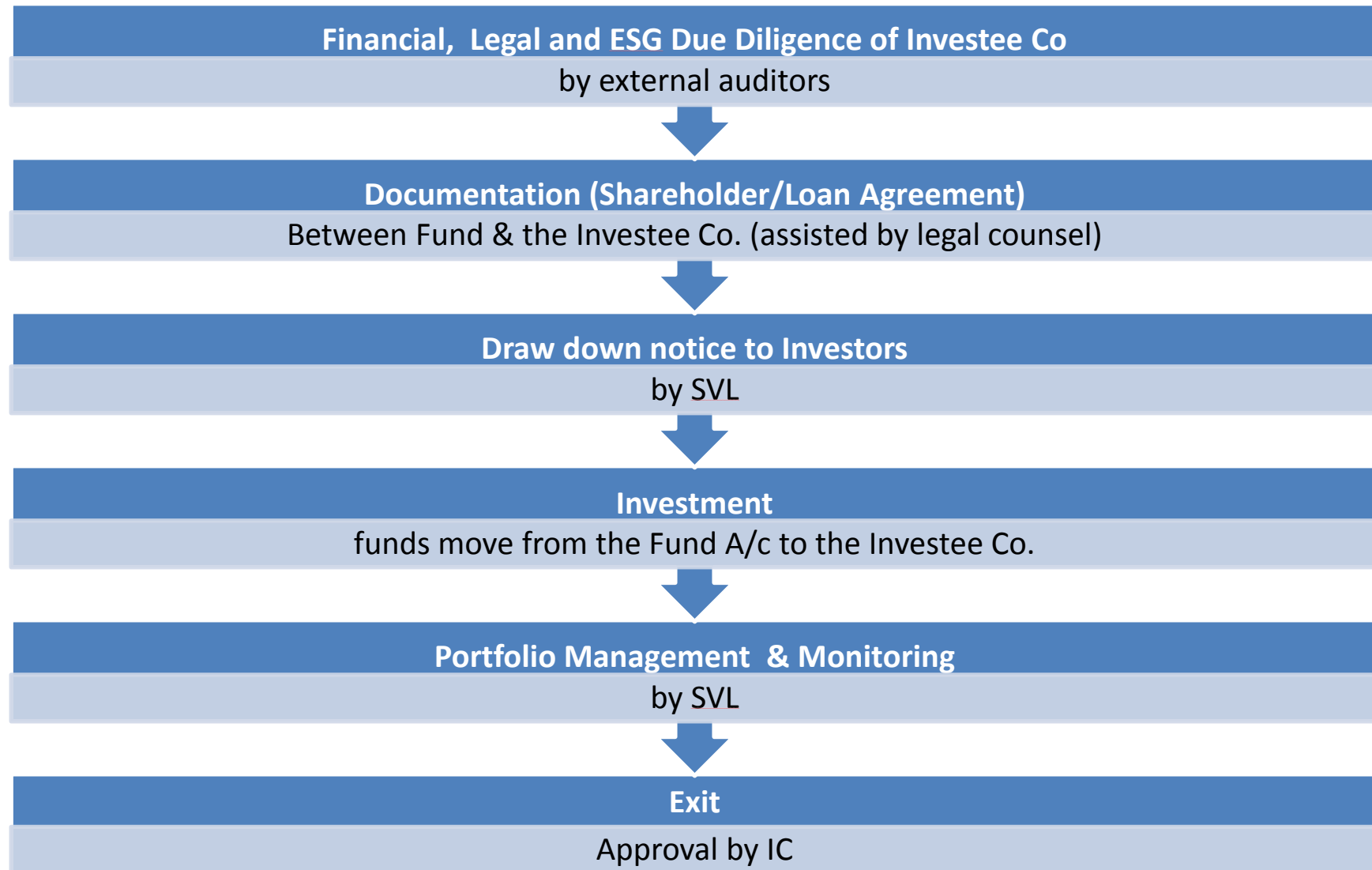


Role / Function

## Chart 5B.5: Neev Fund Investment Cycle (p.1)



**Chart 5B.5: Neev Fund Investment Cycle (p.2)**



# Section 6

## Guarantees

### Introduction

Guarantees can play an important role in securing finance for investment in businesses and projects. This part deals with:

The need for guarantees

Who issues guarantees?

What can be guaranteed?

Types of guarantees; and

How guarantees work.

### The Need for Guarantees

Guarantees are needed because lenders usually require guarantees from sponsors or other parties, especially for major project finance where business uncertainty is present.

Sponsors, shareholders and lenders alike want to feel assured that their financial resources are protected from potential risks.

Investment in developing economies generally means facing higher risks. Guarantees help mitigate some of those risks and, in so doing, facilitate financing that might not otherwise be made available and/or lower the cost of borrowed capital.

### Risks Covered by Guarantees

The following are typical risks that can be covered by guarantees:

- Breach of Contract
- Availability and convertibility of foreign exchange
- Expropriation and nationalization
- Commercial risks (such as buyer's, borrower's or guarantor's insolvency or unwillingness to pay its debt; and plant and equipment breakdowns)
- Default
- Political Force Majeure.

### Political Risks

Political risks include:

- Corruption (affecting access (to supplies, markets or premises), licensing, payment, etc.);
- Change of government/policy (affecting licensing, pricing, employment, etc.);
- Civil commotion;
- Civil or other war;
- Intimidation (due to factional interests and/or corruption);
- Restrictions imposed on the availability and movement of foreign exchange; and
- Restrictions imposed on imports/exports.

Depending on the prevailing circumstance, some or all of these types of political risks can be covered by guarantees.

## Principal Benefits of Guarantees

From a government's perspective, guarantees help catalyze private financing, Improved financial terms, provide access to capital markets, and support sector reform and growth.

The private sector benefits from guarantors' safeguards, which help mitigate some lending risks, improve a project's viability and help reinforce government undertakings.

## Partial Risk Guarantees (PRG)

### Definition

A PRG is a financial guarantee which covers debt service defaults on commercial debt, normally for a private sector project, when such defaults are caused by a government or government owned entity's failure to meet its specified contractual obligations to the project.

### Coverage

A PRG usually only covers sovereign / political risk, with obligations clearly defined *ex ante* in a contract between the government and the private sponsor who is responsible for the implementation of the project. Among such obligations, PRGs typically cover all types of undertakings that are under government's control, but not genuine commercial risks.

## Counter Indemnity

Institutions, such as the African Development Bank and the Multilateral Investment Guarantee Agency cannot normally extended a guarantee unless the relevant member country provides an indemnity under which it agrees to reimburse the bank/agency for any payments the bank/agency makes under the guarantee.

## Sovereign Risk Coverage

Breach of Contract: A PRG protects against loss arising from breach or repudiation of a project agreement (e.g. infrastructure and power projects) including:

- Government contractual obligations such as termination payments;
- Contractual performance of public counterparties such as failure by state-owned entities to make payment under an off-take agreement or input supply agreement;
- Regulatory risk and change of law such as negation or cancellation of license and approval or non allowance for agreed tariff adjustment formula or regime; and
- –Frustration of arbitration.

Currency Inconvertibility and non-transferability: A PRG protects against losses arising from inability to:

- Convert local currency into foreign exchange within host country; and
- Transfer funds out of the host country; but note that:

Currency depreciation and devaluation are not covered.

Pre-existing restrictions on conversion or transfer are not covered (unless the government has expressed to undertake cover).

Conversion / transfer has to be lawful in the host country at the time when coverage is issued.

Expropriation, Confiscation, Nationalization and Deprivation: A PRG protects a foreign investor against a host government's interference with the investor's fundamental ownership rights.

Political Force Majeure Risks: This normally include damages to assets resulting from politically motivated strikes, riots, civil commotion, terrorism, sabotage, war and/or civil war.

#### **A PRG with a Letter of Credit**

Under the PRG Letter of Credit (L/C) structure (see Chart 6.1), the PRG provides risk mitigation through a standby L/C facility opened by a governmental entity in favour of a project company.

The project company is entitled to draw under the L/C upon a cash shortfall resulting from government noncompliance with contractual undertakings to the project as set out in the project agreements backstopped by the PRG.

In the event of drawing under the L/C by the project company, the government's repayment obligation to the L/C bank of the amounts drawn is guaranteed by the PRG under a guarantee agreement concluded with the L/C issuing bank.

A PRG with an L/C is suited to projects in which easy access to a source of pre-allocated liquidity is critical to project sustainability, for example: power or water distribution privatisations or concessions.

#### **A PRG with a “Deemed” Loan Structure**

Under the “Deemed” Loan Structure (see Chart 6.2), the PRG is designed to provide risk mitigation to lenders directly, and indirectly to private investors/project companies, through a shareholder loan facility (“deemed loan”) from the project company/concessionaire to the government or government entity.

The “deemed loan” would consists of amounts owed by the government to the project company resulting from government non-compliance with its contractual undertaking.

Repayment of the “deemed loan” by the government to the company/concessionaire is guaranteed by the PRG.

This structure is more suited to the backstop of termination risks where the government would have a one-time termination obligation, instead of ongoing obligations.

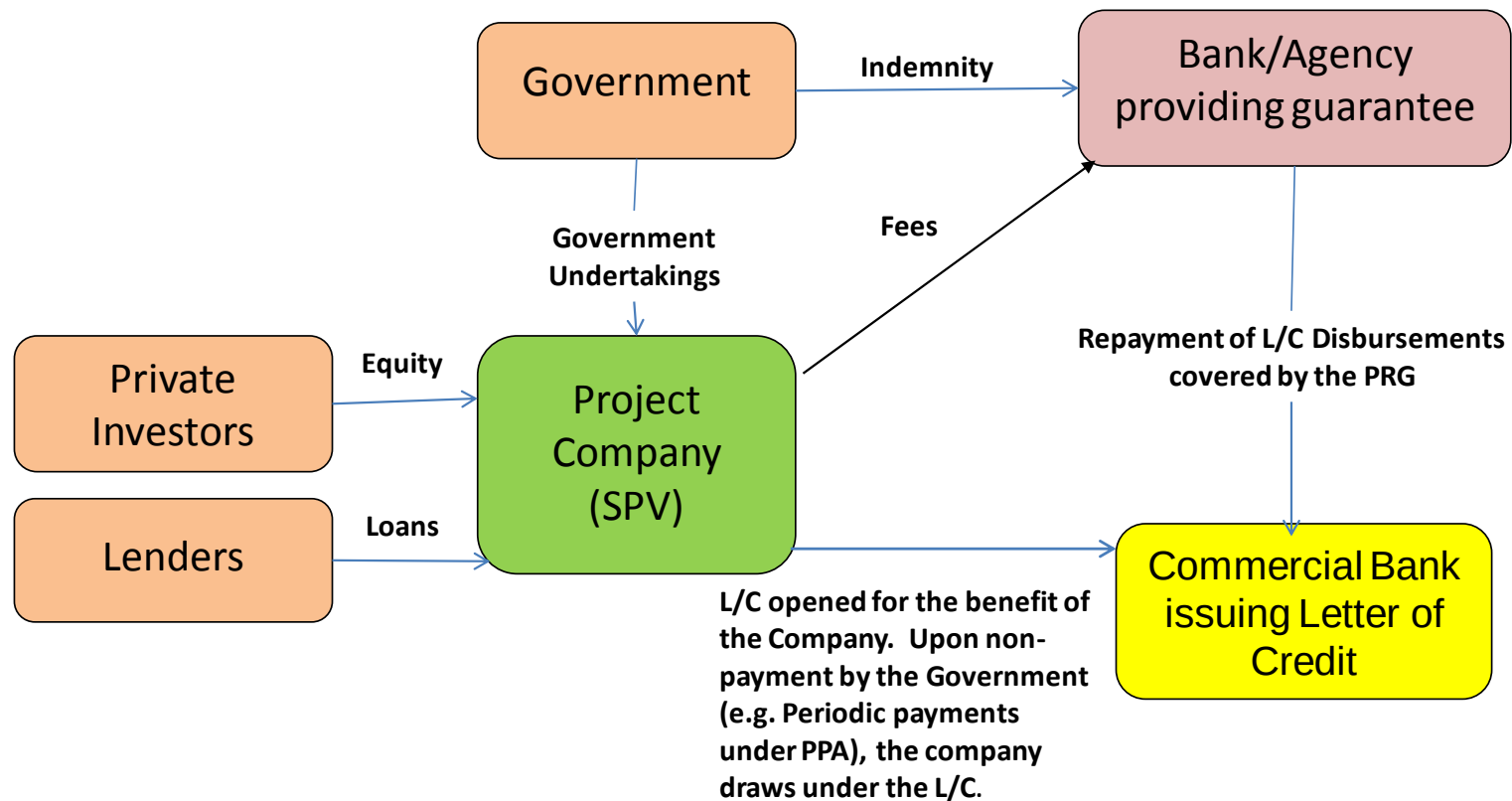
The structure has the advantage of PRG support being provided for the entire term of the concession, which enables the project company to mobilize finance from lenders at any stage of the concession, as required.

#### **Example of a Partial Risk Guarantee**

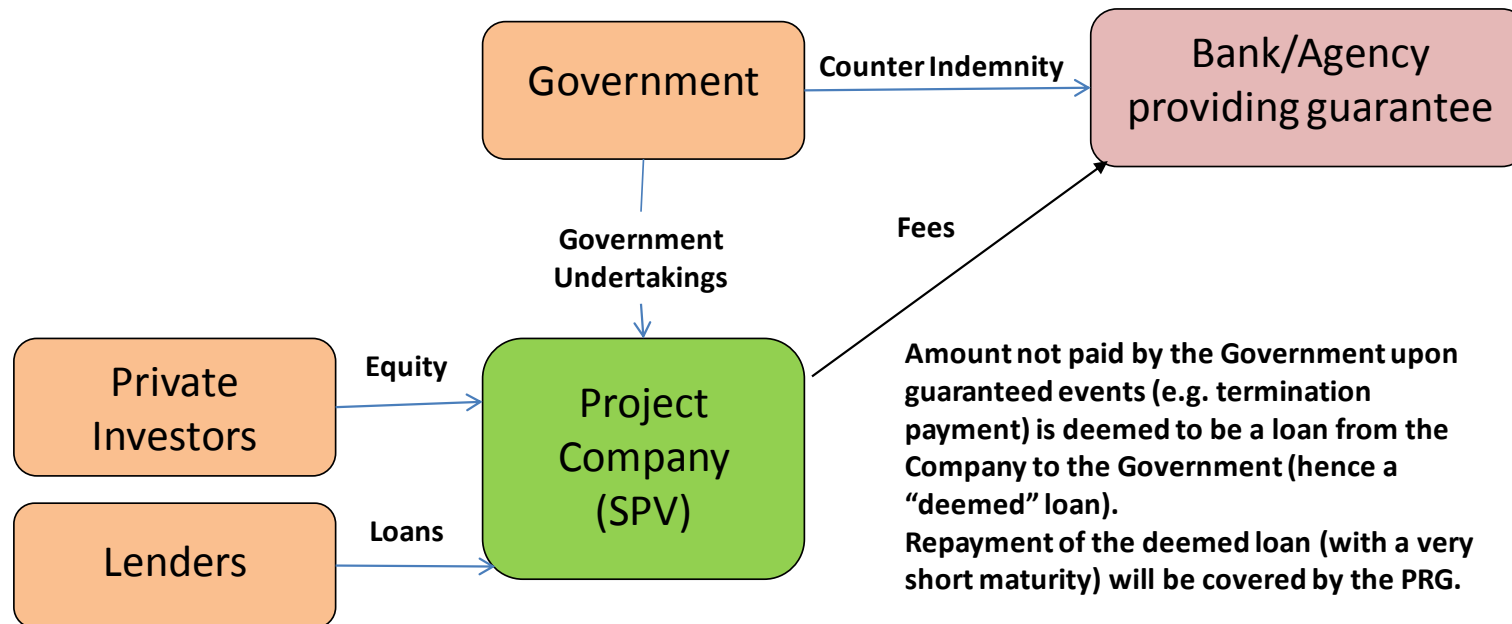
An example of PRG is provided at Annex 6A.



**Chart 6.1: Example of a PRG with a Letter of Credit**



**Chart 6.2: Example of a PRG with a “Deemed” Loan**



**Note:** The provision of the PRG will *indirectly* benefit equity investors and lenders, facilitating the mobilization of financing for the project.

## **Partial Credit Guarantee**

A partial credit guarantee (PCG) is a financial guarantee which covers a portion of scheduled repayments of loans or bonds against the risk of non-payment by the obligor.

A PRC helps lengthen the maturity of both public and private debt financing beyond that available in private markets.

The theoretical structure of a PCG in relation to a project is shown in Chart 6.3 and the theoretical structure for the financial intermediation is shown in Chart 6.4.

Annex 6B provides an example of a partial credit guarantee.

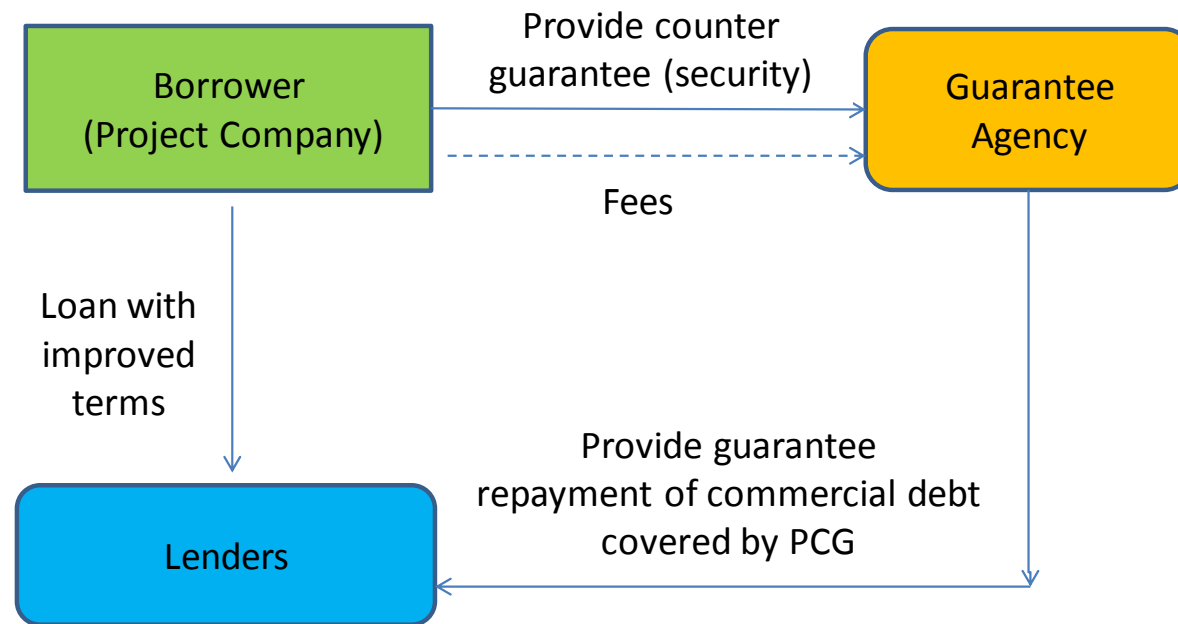
## **Policy Based Guarantees**

Policy based guarantees (PBGs) are examples of PCGs which can be structured to cover the full risks of portions of sovereign borrowings from private creditors.

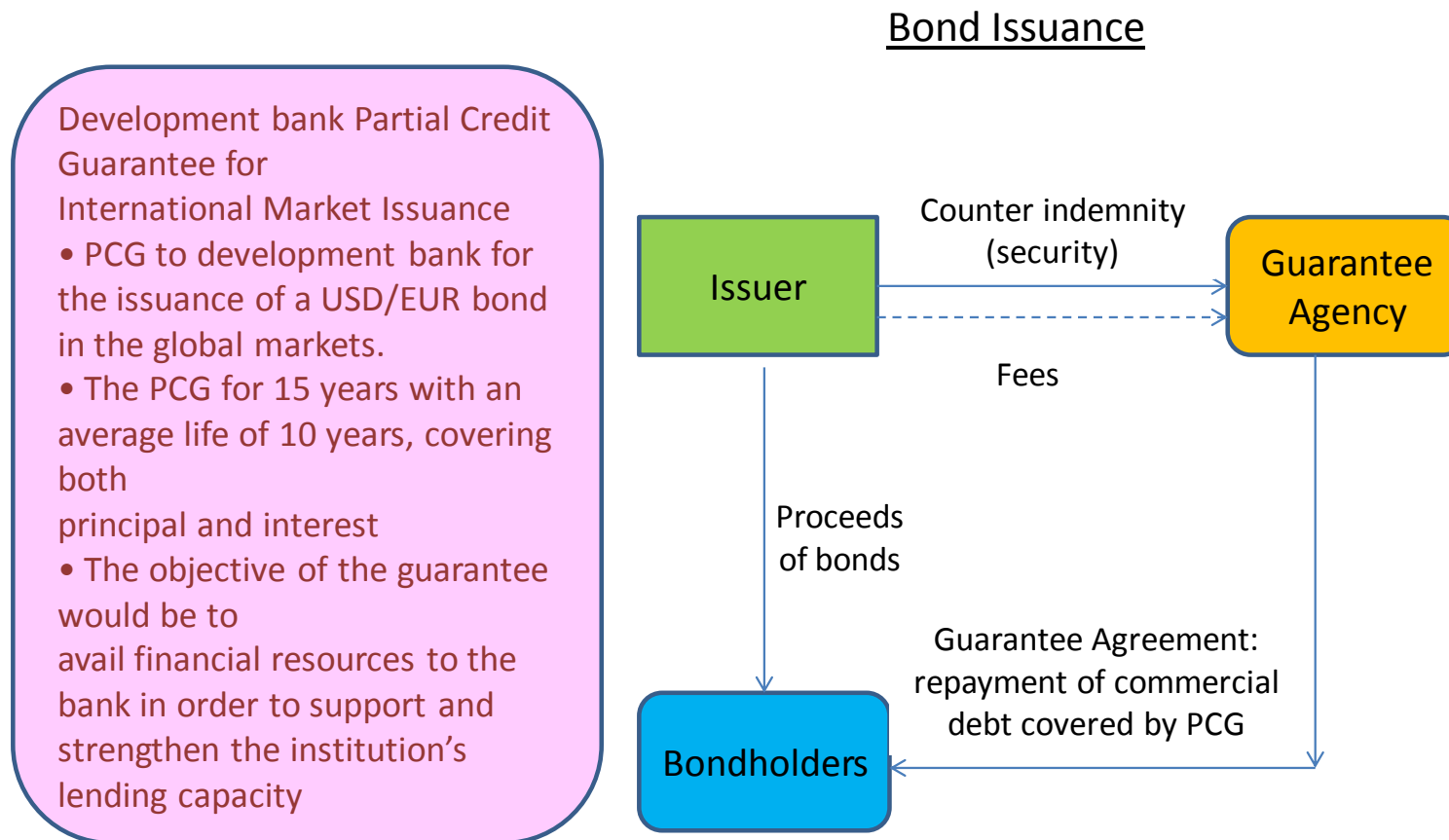
PBGs help improve sovereign governments' access to capital markets and support agreed social, institutional, and structural policies and reforms.

**Chart 6.3: PCG for Project Finance: Theoretical Structure**

Loan to a private sector entity:



**Chart 6.4: Financial Intermediation: Theoretical Structure**



## Annex 6A

### Lake Turkana Wind Line Transmission Line Project

#### Project Description

The project was identified in 2007. AfDB acted as lead arranger and co-developer to fully structure the project, syndicating over EUR 100 million of senior debt and sub-debt. The Government of Kenya (GoK) had several obligations vis-à-vis the Lake Turkana Wind Project (articulated in a Letter of Support), including the delivery of a Transmission Line (T-Line). Lenders needed the comfort that political risks would be mitigated, and that underlying financial obligations will be met. A delay in the T-Line would have meant that revenues required for debt servicing would not be available when the Lake Turkana Power Project was already generating power.

#### Lake Turkana: The PRG Applied

The PRG will back stop the payment obligations of the transmission line construction company and the Government of Kenya in case of a delay in commissioning of T-line.

Implementation of the PRG mitigates the risk to the project developers and the providers of debt to the LTWP project for the construction of the T-line and associated substation needed to connect the LTWP project to the Kenyan national grid.

#### Lake Turkana: Alternative Solution

At this point it is worth noting the alternative solution that was explored, which was for the sponsor to build the T-Line as part of the project. This would have meant additional project costs of EUR 142 million versus guarantee fees of 75bps; and there was another important consideration: security would have been outside the responsibility and control of the private sector as KETRACO is a national transmission company.

#### Key Project Finance Component

Project Components: 428km T-line between Loyangalani and Suswa with 2 substations

Financing: Total: EUR 142 million, of which:  
Government: EUR 32 million  
Government of Spain: EUR 55 million  
ECA: EUR 55 million

Structure: Payment security in the form of an L/C to meet the DGE payments in case of delay.  
L/C bank will be covered against any payment default from KETRACO and GoK.

Beneficiaries: 1) LTWP as it will recover up to 4 months worth of DGE payments.  
2) Lenders to LTWP.

Tenor: Up to 2 years

Guaranteed Amount: UA 17.4 million (equivalent to EUR 20m)

GoK Contribution: UA 4.35 million

## Example of a Partial Credit Guarantee

### MTN Cameroon Partial Credit Guarantee



## MTN Cameroun PCG

### Description

MTN purchased CAMTEL Mobile in February 2000 as part of the privatization process in Cameroun, and planned to upgrade the infrastructure, extend coverage, and put in place a new and more modern GSM cellular network.

Under the acquisition, MTN obtained a GSM license which was for a period of fifteen (15) years, renewable for periods of ten (10) years.

The project was to design, finance, build and operate a modern GSM network of about 400,000 subscribers. In the first year of operation, MTN was to roll out its network infrastructure in Douala, Yaounde, Bafoussam and Bamenda, in addition to 8 other secondary cities, for a combined coverage of 63% of urban areas. Coverage was to increase gradually to include all towns above 50,000 people in the fifth year of operation.

### MTN Cameroun: Alternative Solutions

Two possible alternative solutions were explored:



**Syndicatio**

**DFI operating**

### PCG Financing: Debt Package

The lenders syndicate was led by Citibank and included Standard Bank, Société Générale and Crédit Lyonnais.

The financial instruments selected are in line with MTNC's stated objective of maximizing local currency funding to match its revenue stream.

Local currency component is CFA 23 billion of which CFA 9 billion is guaranteed by AfDB, CFA 9 billion is guaranteed by FMO and CFA 5 billion non-guaranteed.

The projected sources of funding are set out in Table 6A.1.

### The AfDB PCG Financing Product

There is a guarantee of EUR13.7 million for MTNC to mobilise a local currency loan of up to FCFA 9 billion from local banks (6.5% of total costs).

The duration: of the guarantee is 5 years with a 2 year grace period.

The loan repayment will be in six semi-annual instalments but the local loan interest payments are not covered by the guarantee.

The guarantee is secured by the project's comprehensive security package.





**Chart 6B.1: MTN Cameroun PCG Financing: Sources of Funding**

| <b>Sources of Funding (EURO)</b> | <b>Year 0</b> | <b>Year 1</b> | <b>Year 2</b> | <b>Total</b> | <b>%</b>    |
|----------------------------------|---------------|---------------|---------------|--------------|-------------|
| Capital issued                   | 0.3           |               |               | 0.3          |             |
| Shareholders' Subordinated Loans | 62.8          | 28.0          | 18.0          | 108.8        |             |
| <i>Equity and Quasi Equity</i>   | <i>63.1</i>   | <i>28.0</i>   | <i>18.0</i>   | <i>109.1</i> | <i>52%</i>  |
| International Senior Debt        | -             | 48.3          | 16.7          | 65.0         | 31%         |
| of which: Citibank               | -             | 5.6           | 1.9           | 7.5          |             |
| Standard Bank                    | -             | 11.1          | 3.9           | 15.0         |             |
| Other Banks                      | -             | 31.6          | 10.9          | 42.5         |             |
| Local Senior Debt                | -             | 27.4          | 7.6           | 35.1         | 17%         |
| of which: guaranteed by ADB      | -             | 10.7          | 3.0           | 13.7         |             |
| guaranteed by FMO                | -             | 10.7          | 3.0           | 13.7         |             |
| non-guaranteed                   | -             | 6.0           | 1.7           | 7.6          |             |
| <i>Senior Loans</i>              | <i>-</i>      | <i>75.7</i>   | <i>24.4</i>   | <i>100.1</i> | <i>48%</i>  |
| <b>Total Funding</b>             | <b>63.1</b>   | <b>103.8</b>  | <b>42.3</b>   | <b>209.2</b> | <b>100%</b> |

# Section 7

## Mezzanine Finance

### Introduction

Development finance institutions, bilateral agencies and export credit agencies can play an important role in providing mezzanine financing to projects, notably to support investment in infrastructure in developing countries. Due to their mandates, experience and connections, these mezzanine finance providers are prepared to take more risk than traditional lenders.

This part explains mezzanine finance and debt, provides examples of types of mezzanine capital structure, when it is applicable and its advantages.

### What Is Mezzanine Debt?

Mezzanine debt capital generally refers to that layer of financing between a company's senior debt and equity. Structurally, it is subordinate in priority of payment and security to senior debt, but greater in rank to common stock or equity (Chart 1).

The term covers many financial instruments (generally hybrids of pure debt and pure equity financial instruments) and may take various forms.

It is sometimes referred to as “quasi-equity”.

### Examples of Typical Mezzanine Debt Instruments

Among the different instruments that can be termed “mezzanine” are:

- Junior or subordinated debt ;
- Subordinated debt with upside sharing features;
- Convertible debt;
- Debt with warrants ;
- Redeemable preference shares (accounting-wise part debt part equity) ;
- Cumulative convertible redeemable preference shares (also accounting-wise part debt part equity) ;
- Zero coupon bond instruments; and
- Contingent convertibles.

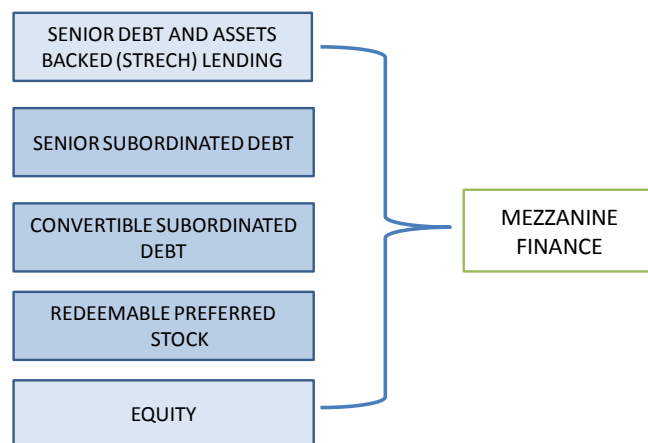
Chart 7.1 illustrates how mezzanine finance fills the gap between senior debt and equity.

### How Mezzanine Finance is Viewed

From a senior debt perspective mezzanine finance ranks below in rights, and hence is seen as equity by senior debt holders. It improves senior debt service coverage.

From an equity perspective mezzanine is debt and, while it has priority over common stock, it has less strict covenants than other debt and is more flexible, particularly on repayment terms. Thus it provides the opportunity to increase or preserve equity returns.

**Chart 7.1: Mezzanine Finance Fills the Gap between Senior Debt and Equity**



### The Mezzanine View of Debt and Equity

From a mezzanine viewpoint debt typically takes lower returns for higher security/safety while equity seeks or receives higher returns for taking more risk.

Equity typically controls or wants to control and proactively makes decisions. Hence there is typically active sponsor equity versus more passive/financial equity.

Management also controls and makes decisions but tends to be accountable to the sponsor/active shareholder(s), although the influence of management varies by profile of other stakeholders.

Debt typically does not make direct decisions but seeks to restrict the decision making of equity holders via financial instrument (loan/bond, etc.) covenants.

The risk/reward profile for debt and equity is typically reflected in: the

- order of priority of payment in the cash flow waterfall;
- order of priority of payment in liquidation (when it has gone wrong);
- contractual language concerning rights and legislation; and
- timing of entry (early stage, late stage or in restructuring old money versus new money).

### Typical Uses of Mezzanine Capital

Mezzanine capital is typically used: (a) to fund corporate growth opportunities, such as an acquisition, new product lines, new distribution channels or plant expansions; (b) for company owners to take money out of the company for other uses; or (c) to help finance the sale of a business to management or another third party.

Although it makes up a smaller portion of a company's total available capital, mezzanine financing is an important capital source, filling in the gap between debt and equity.

## The Funding Gap

The gap in funding between senior debt and equity is common for the following reasons:

- Accounts receivable, inventories and fixed assets are being discounted at greater rates than in the past for fear that their values will not be realized in the future;
- Senior lenders are reluctant to lend using goodwill or intangible assets as collateral;
- Senior lenders may wish to limit their exposure to any one company or industry; and,
- Equity may be limited or unavailable, prohibitively expensive, or highly dilutive.

## When Mezzanine Finance is Used

Mezzanine finance is used when a borrower requires finance very quickly with little or no collateral and with little due diligence on the part of the lender. Subject to contractual terms, this financial instrument can be treated like equity on a company's balance sheet. I may also assist in obtaining bank financing.

## How Mezzanine Finance is Used

Mezzanine finance is used by companies that are cash flow positive to fund further growth through expansion projects; acquisitions; recapitalisations; and management and leveraged buyouts.

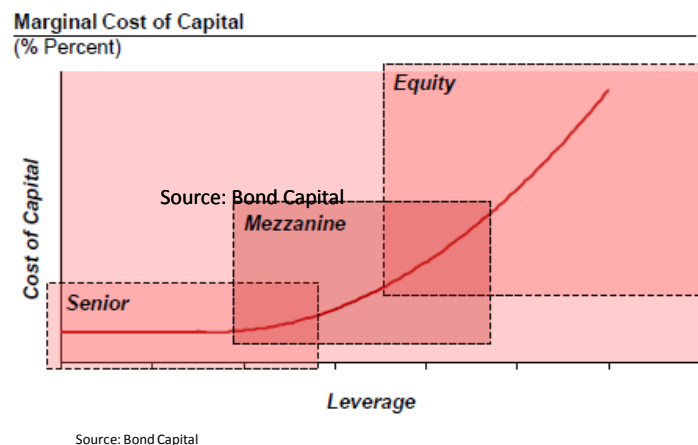
Mezzanine finance comes in many forms but the common features of all mezzanine instruments and products are that they offer a risk/return profile that lies between debt and equity.

It is used as an equity substitute to increase the financial leverage of transactions (the ratio of debt to equity) where the senior debt capacity has been maximized and a company's cash flow has sufficient capacity for additional long-term borrowings.

When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in a business. In some situations, equity can be the most expensive form of capital and, in this case, the use of lower cost mezzanine debt along with traditional senior debt lowers a company's cost of capital and improves shareholder return on equity.

A mezzanine provider will generally seek a risk profile between that of senior debt and equity with corresponding pricing. Mezzanine debt can often be thought of as borrowing equity, as senior banks will treat it as such, while the cost of mezzanine debt will be less than equity because of the interest paid and security preference it takes ahead of equity as illustrated in Chart 7.2.

**Chart 7.2: Cost and Leverage of Mezzanine Finance**



## Why Mezzanine Finance?

While capital can be obtained from equity, equity is usually the most expensive and most dilutive source of capital. Shareholder dilution with mezzanine investments is up to 90% less than with equity investments because much of the mezzanine return is from the loan repayment (interest and principal) rather than from capital gains. Additionally, it is common for a company to repurchase any equity issued to a mezzanine investor and revert back to its pre-financing equity structure.

## Mezzanine Capital Structure

There are no hard and fast rules for optimising a company's capital structure. In developed economies, companies use an efficient combination of senior debt, mezzanine debt, and equity capital to minimize their weighted average cost of capital in order to boost shareholder return on equity. In developing economies, companies have less choice due to the difficulty of accessing finance, with available debt finance at prohibitively high cost.

### Basic Principle for Sound Mezzanine Financing

In structuring a mezzanine investment, the shareholders and mezzanine investor should work together to match the business' future free cash flow with any repayment obligation.

A well structured mezzanine investment will leave excess free cash available to the company as a margin of safety, for asset replacement, and growth of the business.

### Usual Forms of Mezzanine Financing

Mezzanine financing can be completed through a variety of structures based on cash flow, the specific objectives of the transaction and the existing capital structure in place at the company. The basic forms used in most mezzanine financing are subordinated notes with warrants for private companies, and high yield debt (junk bonds) or convertible / preferred shares for public companies.

## Cost of Mezzanine Finance

Mezzanine lending includes both subordinated debt and an equity component. Mezzanine lenders, typically specialist mezzanine investment funds, look for a target rate of return which can be earned through two basic components: current payment and deferred payments.

Mezzanine lenders will also often charge an arrangement fee, payable upfront at the closing of the transaction and ongoing administration fees to cover administrative costs and as an incentive to complete the transaction.

### Current Payments

Current Payments are paid monthly, quarterly or annually:

- *Cash interest* - a periodic payment of cash based on a percentage of the outstanding balance of the mezzanine financing. The interest rate can be either fixed or floating.
- *Principal* - scheduled repayments a portion of which may be deferred until maturity and /or yearend cash sweeps based on a formula.
- *Royalties* – variable payments based on a prescribed formula usually related to revenue, gross margin, EBITDA or net income.

### Deferred Payments

Deferred payments are paid upon maturity of the mezzanine facility or later:

- *Payable in Kind interest* — a periodic form of payment in which the interest is not paid in cash but rather by increasing the principal amount through capitalization of the interest payment then due.
- *Bonus Payment* – a negotiated fixed or variable payment, with variable payments often calculated as a proxy for the change in business/company value over the duration of the mezzanine facility.
- *Equity Ownership* — mezzanine capital will often include an equity stake in the form of attached warrants, a debt for shares conversion feature, or common shares of the company.

## Advantages of Mezzanine Financing

The principal advantages of mezzanine financing are that it:

- Helps a company secure more total capital;
- Reduces the amount of equity required in a transaction;
- Secures more long-term financing; and
- While mezzanine finance may be more expensive than traditional bank debt, it is longer-term, not nearly as strict and offers flexibility.

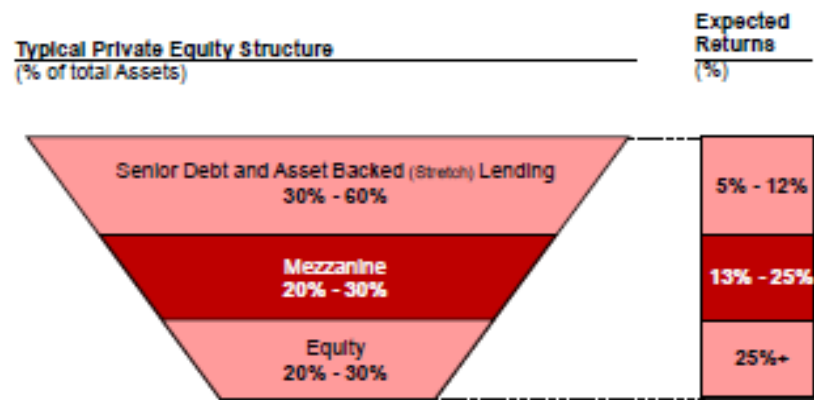
## Mezzanine Debt in a Commercial OECD Country Environment

In an OECD country environment mezzanine capital is more typically used for companies with existing cash flows when the companies /equity holders seek to lower the weighted average cost of capital and to increase shareholder returns (ROE) (see Chart 7.3).

Senior lenders seek comfortable debt service coverage and collateral levels and the mezzanine capital providers seek cash current payments and (deferred) upside.

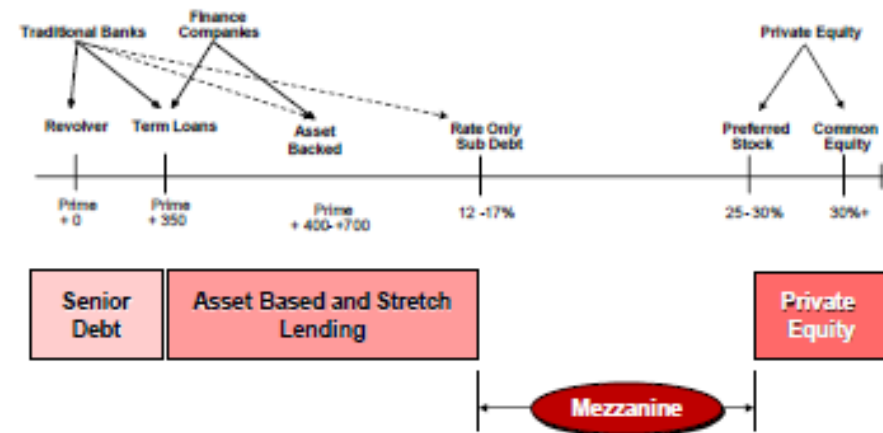
**Chart 7.3: Typical Use of Mezzanine Capital in OECD Country**

COMPANIES WITH EFFICIENT CAPITAL STRUCTURES EMPLOY A NUMBER OF CAPITAL SOURCES



Mezzanine debt increases total capital available, where insufficient equity is present (Chart 7.4).

**Chart 7.4: Mezzanine Debt Increases Total Capital**

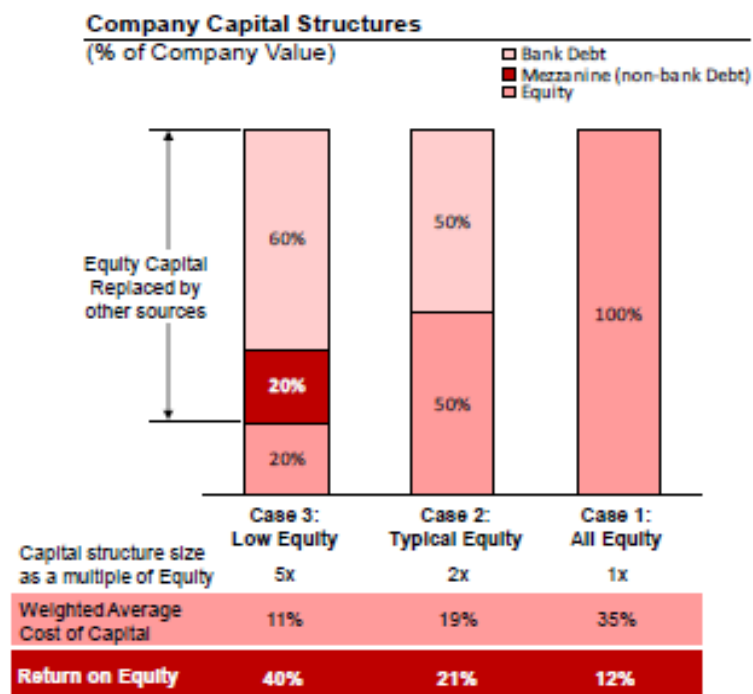


The engagement of mezzanine lenders is often perceived by lenders as risk reducing, as mezzanine lenders tend to pay close attention to risk and corporate governance. Meanwhile the equity holders may see an improvement in returns as well as the increased availability of capital (Chart 7.5)



Chart 7.5: The Effect of Mezzanine Capital

## LEVERAGE IMPROVES RETURN ON EQUITY AND AVAILABILITY OF CAPITAL



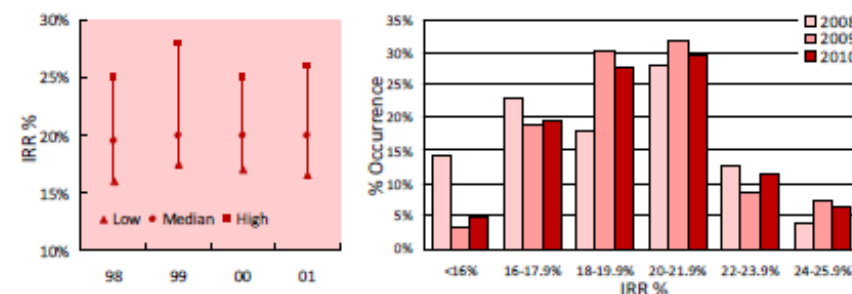
Source: Bond Capital

Over the years mezzanine investments have earned reasonable returns and, importantly, have been fairly consistent (Chart 7.6).

Chart 7.6: Consistency of Mezzanine Returns

## TARGETED MEZZANINE RETURNS HAVE REMAINED RELATIVELY CONSTANT AT ABOUT 20%<sup>1)</sup>

### Mezzanine Targeted Returns (Internal Rate of Return IRR %)



Source: Fleet Securities Inc., PNC Mezzanine Capital

## Uses of Mezzanine Finance for Development

In developing countries private capital tends to gravitate to low hanging fruit, seeking high returns for relatively low risk. Lenders – through their institutional equity investment and credit committees – prefer to avoid combinations of risk (e.g. high country risk, high

market risk, weak sponsor, poor customers, early project development stage, etc.). Senior debt therefore seeks high coverage ratios, low or moderate financial leverage and large contingencies for high risk projects in high risk countries.

With institutional private equity requiring high returns to justify engaging in a typical developing economy, mezzanine capital can help bridge the gap. Hence, development finance institutions (DFIs) do make frequent use of mezzanine finance for investment purposes because:

- Frontier markets and fragile states have particular difficulty attracting private sector capital, due to risk perceptions (and, frankly, reality);
- Large, well capitalised private sector sponsors tend to avoid such markets until they can acquire a developed asset in a maturing environment
- Projects in such markets are typically developed by smaller, less well capitalised private sector sponsors, seeking a good return for their capital and “sweat equity” and without the funds to fully complete or finance a project themselves; and, consequently,
- There is a lack of equity, a gap that must be filled if development is to be accelerated.

## Uses by DFIs

DFIs, because of the balance of constraints imposed on them, often have the same risk concerns as other investors, and have to off-set/balance their development goals by:

- Not losing money but remaining viable. They must therefore reduce/minimize risk (incl. via deal selection);
- Attracting and leveraging private sector funds;
- Maintaining credit ratings, therefore limiting their portfolio risk; and
- Not crowding out private sector investment, which means they must therefore aim to achieve non-subsidized or commercial returns.

Care has to be taken when making investments but work-outs are time, staff and monetary resource intensive. Most DFIs find that the right staff resources are scarce; yet they still have to meet regular deal/monetary targets.

DFIs should leave the private sector broadly in charge of projects/equity – but there have to be limits on pro-activity from the perspectives of both the private investors and the DFIs.

Finally, there are, In every transaction design, many other goals/constraints (environment, social, corporate governance, etc.) to consider.

## Annex 7A

### Example of a Mezzanine Investment: Green Africa Power (GAP)

GAP was designed to deal with the market failure caused by the lack of cost reflective tariffs, with climate externalities not factored in; high upfront costs and low project returns in early years; and specific risks e.g. frequent construction delays and cost over-runs.

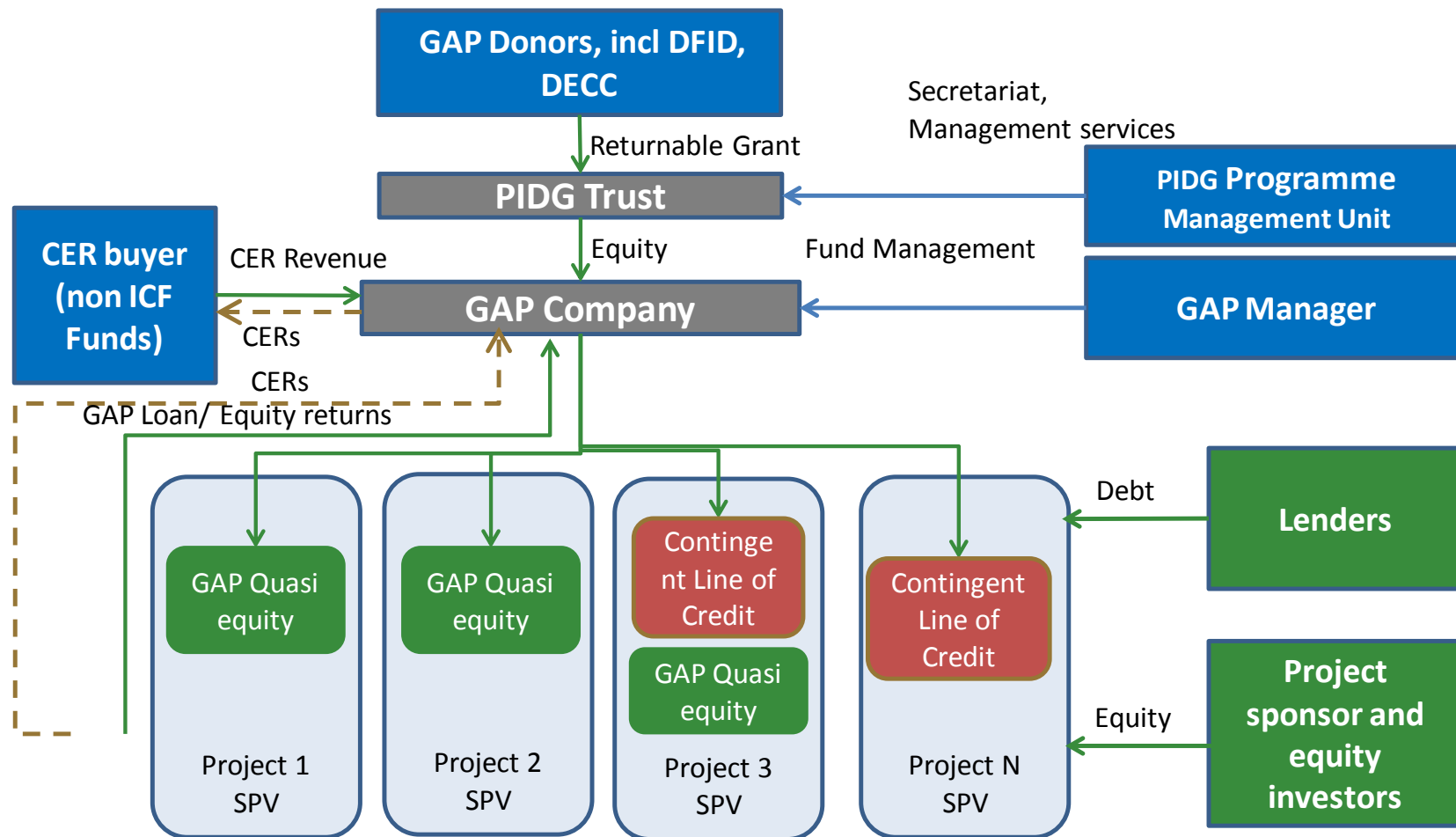
GAP was designed to tackle these issues by providing:

- Quasi equity/ mezzanine capital: a minimum coupon in early years, with capital repayment after threshold equity IRR to “back-end load” cash-flows received by GAP;
- A contingent line of credit to drawn down in case of delays or cost over-runs in construction; and
- Policy dialogue support to encourage host countries to move towards cost-reflective tariffs.

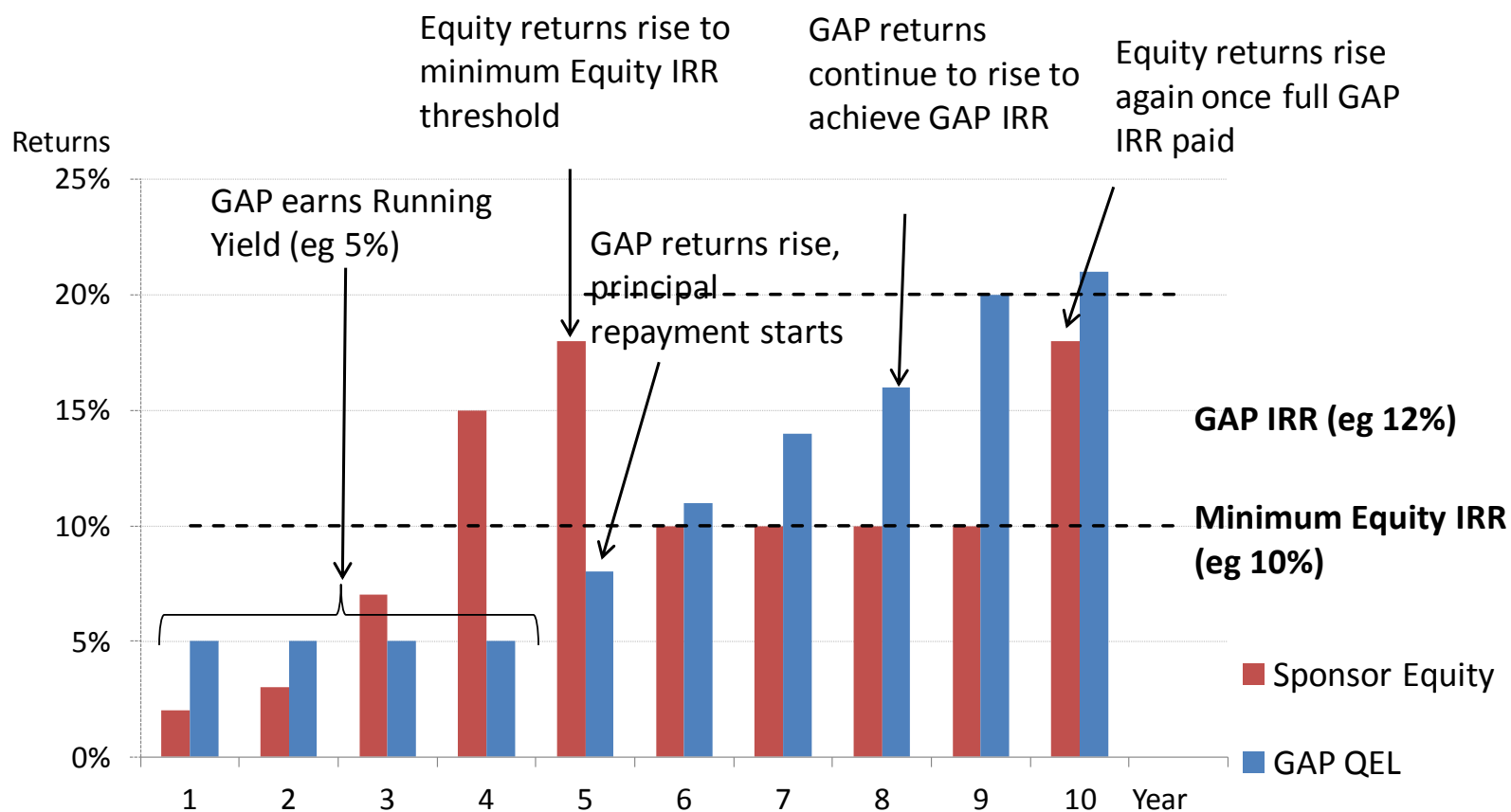
A UK funding contribution of £98m has been approved from DFID’s Climate and Environment and Private Sector Departments and from DECC via the International Climate Fund.

The stakeholder structure and relationships for FAIR are depicted in Chart 7A.1. Chart 7A.2 shows the expected payments and payments waterfall for GAOP. The capital structure and expected rates of interest are shown in Chart 7A.3, and Chart 7A.4 illustrates the projected risks and financing costs.

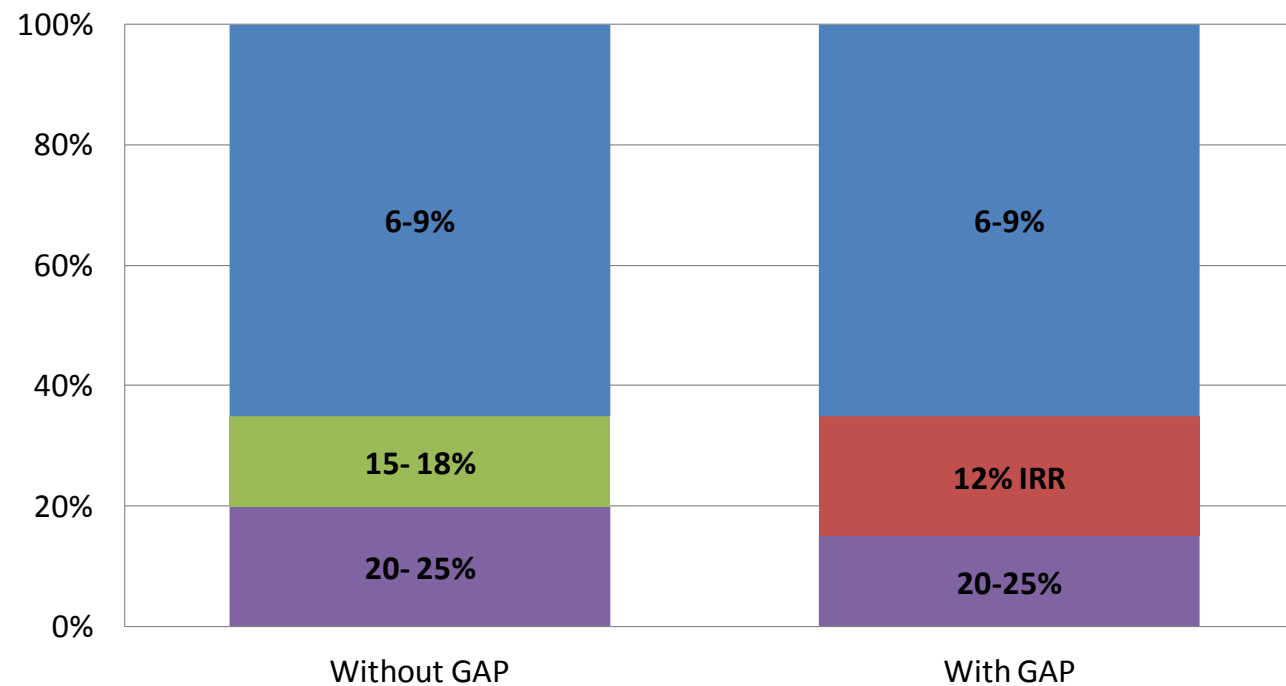
## Chart 7A.1: Green Africa Power: Structure



## Chart 7A.2: GAP Expected Returns/ Payments Waterfall

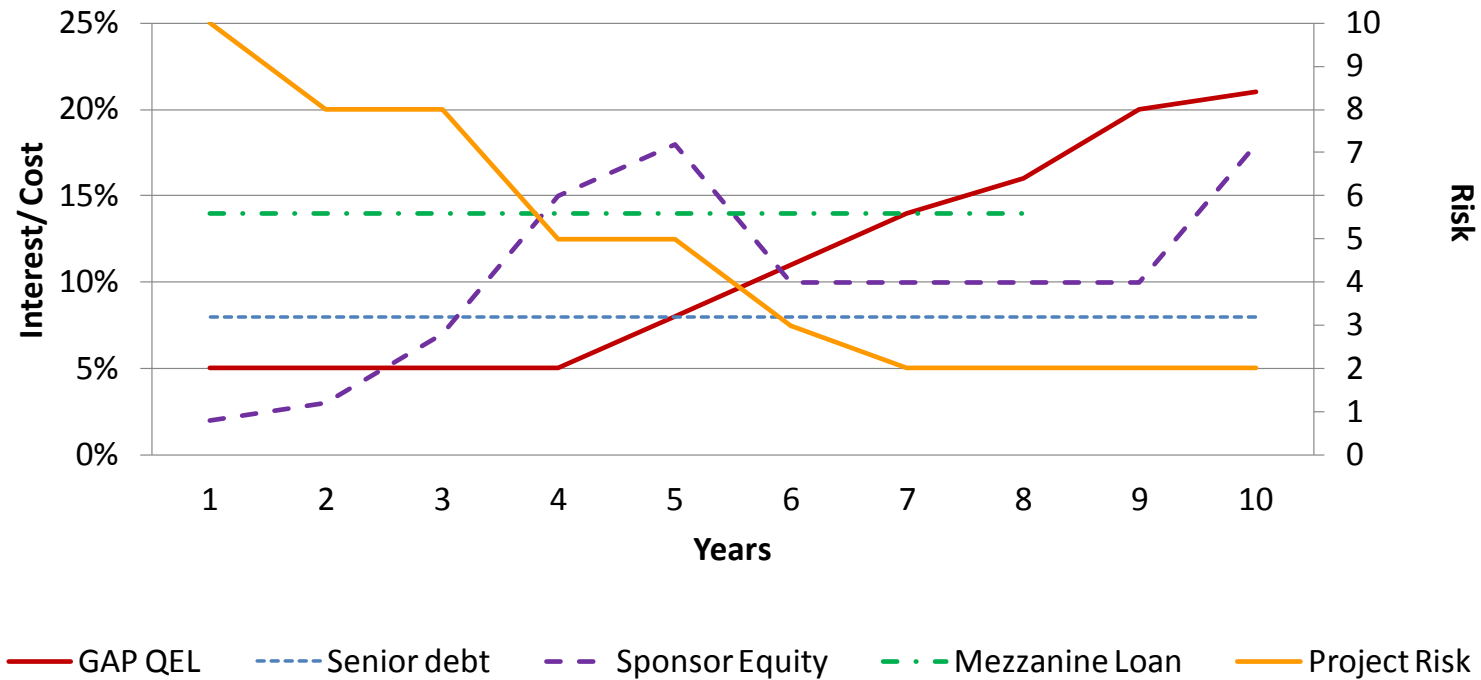


### Chart 7A.3: Project Capital Structure and Interest Rates



■ Sponsor Equity ■ GAP QEL ■ Mezzanine Loan ■ Senior debt

## Chart 7A.4: GAP Risk and Financing Costs



# Section 8

## First Loss Investment

### First Loss - History

The concept of first loss is relatively new. In a capital structure that element thought of as being “junior” or “last to recover”, as opposed to a “senior” debt holder or “subordinated” debt holder, is generally known as equity. *First loss* is a structured finance term taken from the pooled mortgage obligations first structured in the US.

The primary creator of these obligations historically was the US Government via its agencies Fanni Mae, Freddie Mac and Sallie Mae whose loans were collated and tranced as: senior, mezzanine and equity/first loss.

### First Loss Applied

Chart 8.1 compares a classic corporate financing structure to meet the capital cost of a project with a company structure where its debt has been converted into rated securities (the process known as *securisation*).

The securitisation portfolio structure shown in Chart 8.1 shows the corporate credit ratings published by a selected credit rating agency. Charts 8.2 and 8.3 show lists of the corporate credit ratings

of three well-known agencies. These ratings are used by financiers to make investment decisions and to determine appropriate interest rate and other loan and investment terms.

### Types of First Loss Investment

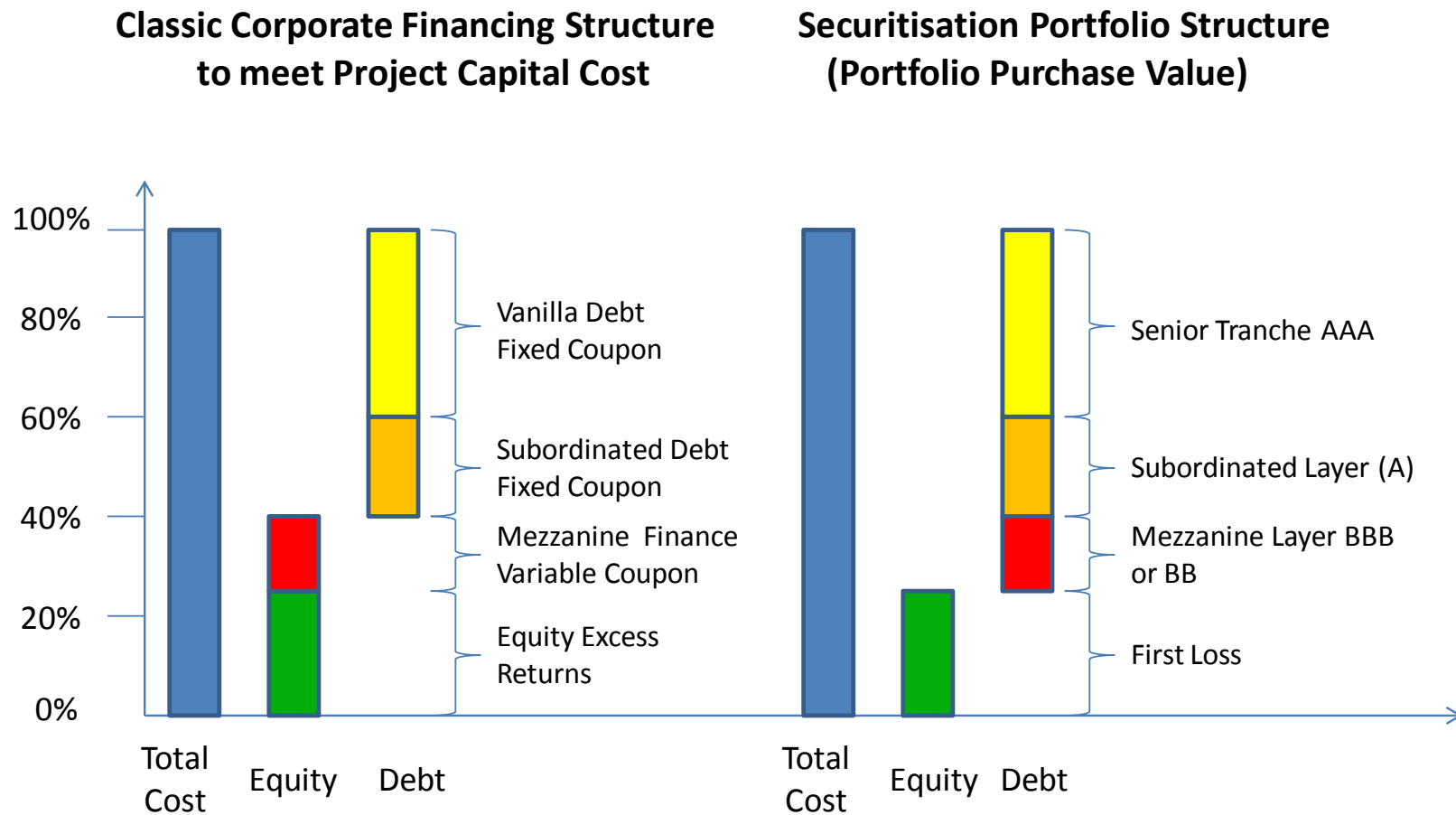
There are four types of first loss investment:

- Paid-in (see Annex 8A)
- Paid-in over time (see Annex 8B);
- Callable (see Annex 8C); and
- Paid-in and callable.

These are best explained through the real examples provided in the annexes.



## Chart 8.1: First Loss – Securitisation



## Chart 8.2: Corporate Credit Ratings (less risky)

| Fitch     |            | Moody's   |            | S & P     |            | Rating Description |     |
|-----------|------------|-----------|------------|-----------|------------|--------------------|-----|
| Long-term | Short-term | Long-term | Short-term | Long-term | Short-term |                    |     |
| AAA       | F1+        | Aaa       | P-1        | AAA       | A-1+       | Prime              |     |
| AA+       |            | Aa1       |            | AA+       |            | High Grade         |     |
| AA        |            | Aa2       |            | AA        |            |                    |     |
| AA-       |            | Aa3       |            | AA-       |            |                    |     |
| A+        | F1         | A1        | P-2        | A+        | A-1        | Upper Medium Grade |     |
| A         |            | A2        |            | A         |            |                    |     |
| A-        | F2         | A3        |            | P-2       | A-         |                    | A-2 |
| BBB+      |            | Baa1      |            |           | BBB+       |                    |     |
| BBB       | F3         | Baa2      | P-3        | BBB       | A-3        | Lower Medium Grade |     |
| BBB-      |            | Baa3      |            | BBB-      |            |                    |     |

### Chart 8.3: Corporate Credit Ratings (more risky)

| Fitch     |            | Moody's   |            | S & P     |            | Rating Description                                 |
|-----------|------------|-----------|------------|-----------|------------|----------------------------------------------------|
| Long-term | Short-term | Long-term | Short-term | Long-term | Short-term |                                                    |
| BB+       | B          | Ba1       | Not prime  | BB+       | B          | Non-investment grade speculative                   |
| BB        |            | Ba2       |            | BB        |            |                                                    |
| BB-       |            | Ba3       |            | BB-       |            |                                                    |
| B+        |            | B1        |            | B+        |            | Highly speculative                                 |
| B         |            | B2        |            | B         |            |                                                    |
| B-        |            | B3        |            | B-        |            |                                                    |
| CCC       | C          | Caa1      | Not prime  | CCC+      | C          | Substantial risks                                  |
|           |            | Caa2      |            | CCC       |            | Extremely speculative                              |
|           |            | Caa3      |            | CCC-      |            | Default imminent with little prospect for recovery |
|           |            | Ca        |            | CC        |            |                                                    |
|           |            |           |            | C         |            |                                                    |

## Annex 8A

### Example of a Paid-In First Loss Investment

FAIR is a new \$100 million facility to target the current funding gap for developmental projects, perceived “too risky” for a variety of reasons.

Many “frontier” projects are commercially viable and could have high developmental impacts. In spite of this, these projects often suffer from a lack of interest and support from lenders (and equity) in the crucial stage between initial early stage equity investment and final round equity and senior debt.

The provision of financial expertise and an early commitment (but not early disbursement) to provide capital to a frontier project will increase its attractiveness to third party investors (equity and debt). This will facilitate the financing of frontier projects and take more of them across the “finishing line”.

FAIR will be managed by the Emerging Africa Infrastructure Fund (EAIF) which was established in 2002 by the Private Infrastructure Development Group (PIDG).

#### PIDG

PIDG was established as a coalition of partners, focused on overcoming obstacles to private sector involvement in infrastructure development such as:

- Lack of suitable projects for investment;
- High upfront costs of project development;
- Shortage of long-term debt;
- Lack of local currency investment; and
- Inadequate capacity and expertise in public and private sectors in some of the world’s poorest countries.

The main aim of PIDG is to mobilise private investment in infrastructure, in order to increase service provision for the poor, boost economic growth and alleviate poverty in the world’s poorest countries.

The PIDG members are vital to the success of its work. The original members were: DFID, the Swiss State Secretariat for Economic Affairs (SECO), the Netherlands Ministry of Foreign Affairs (DGIS), the Swedish International Development Cooperation Agency (Sida) and the International Finance Corporation (IFC)/World Bank. In 2006, PIDG membership expanded to include the Austrian Development Agency (ADA) and Irish Aid; in 2009 KfW joined and in 2011 AusAid (now the Australian Department for Foreign Affairs and Trade (DFAT)).

#### EAIF

In 2007 EAIF appointed Frontier Markets Fund Managers Limited (“FMFM”) as the Fund Manager under an exclusive long term Fund Management contract.

FMFM is a private limited company established in Mauritius by its shareholders: Standard Bank Group (as the lead sponsor) and FMO of the Netherlands and Emerging Markets Partnership (“EMP”) of the USA (as joint venture partners).

The scope of FMFM’s core responsibilities under the Fund Management contract include *inter alia*:

- Identification of investment opportunities that comply with EAIF's Investment Policy (including environmental, social, health and safety standards);
- Making investment proposals to the New Business and Credit Committees of EAIF;
- Performing due diligence investigations on investment opportunities which the Securities Industry and Financial Markets Association determines are appropriate for review by EAIF's Credit Committee;
- Negotiation of investment documentation, and ongoing monitoring and management of EAIF's investments; and
- Administrative services for EAIF with regard to debt service, cash management, maintenance of records and reporting.

The Emerging Africa Infrastructure Fund (EAIF) is a good example of a paid-in first loss investment. EAIF was initiated by the Private Infrastructure Development Group (“PIDG”) whose members provide equity to EAIF through the PIDG Trust. The current capital structure of EAIF is depicted in Chart 8A.1.

### Fund Structure and Capital Contributions

Chart 8A.2 shows the EAIF fund structure and the different types of capital contributions.

### PIDG Initiatives

In addition to EAIF, PIDG has set up various funds and investment companies including:

*Technical Assistance Facility (TAF)*, established in 2004, which provides grants to build capacity and to support project preparation and delivery.

*InfraCo (infraCo Africa)*, established in 2005, which develops commercially viable infrastructure projects in sub-Saharan Africa.

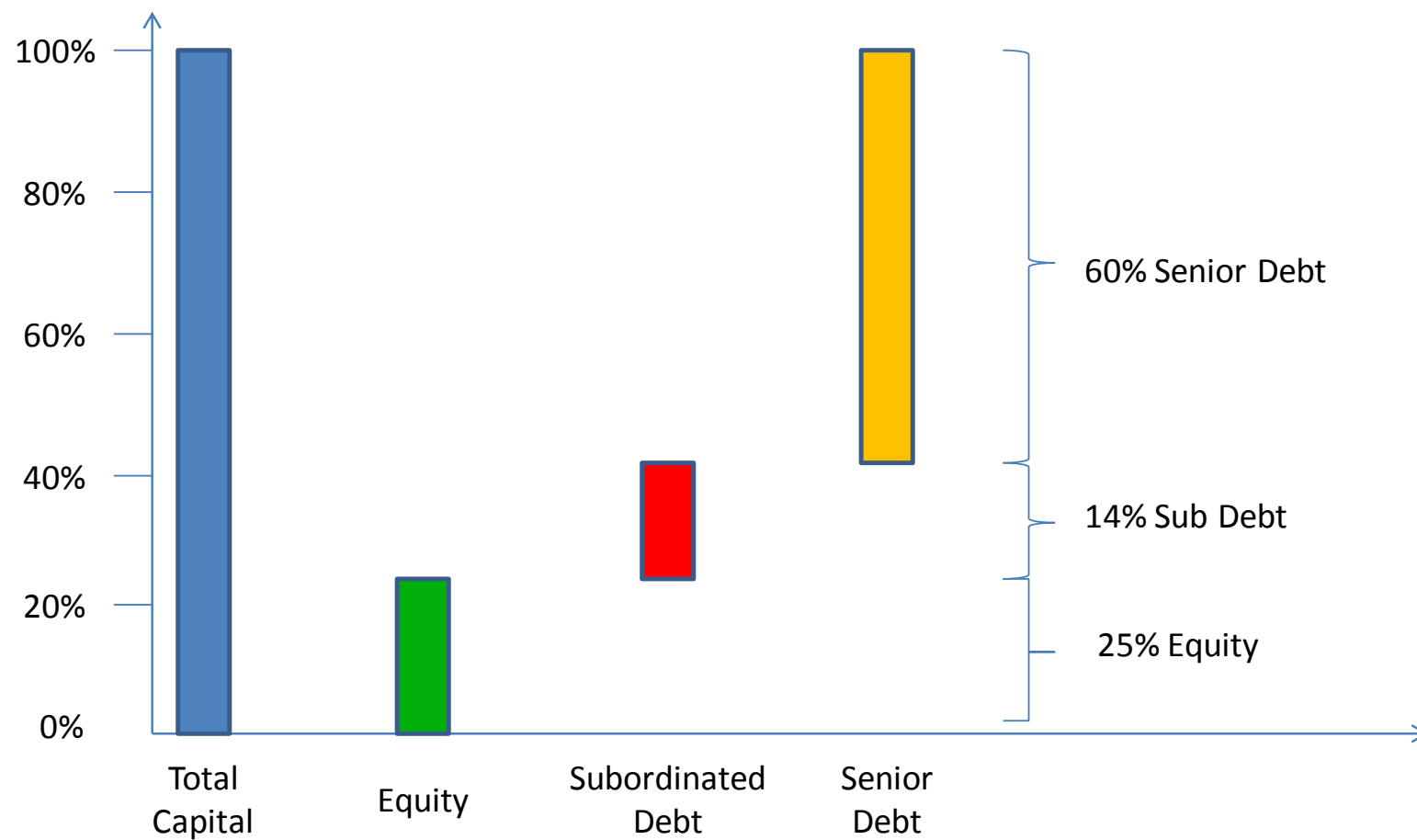
*GuarantCo Ltd*, established in 2006, which provides local currency guarantees to avoid exchange rate risks and stimulate local capital resources.

*InfraCo Asia Development Pte. Ltd (InfraCo Asia)*, established in 2010, which develops commercially viable infrastructure projects in sub-Saharan Asia.

*Green Africa Power*, established in 2013, which provides financing and policy support to projects to demonstrate the viability of renewable energy on Africa.

The above PIDG bodies will support FAIR in different roles (see Chart 8A.3).

## Chart 8A.1: Current Capital Structure of EAIF

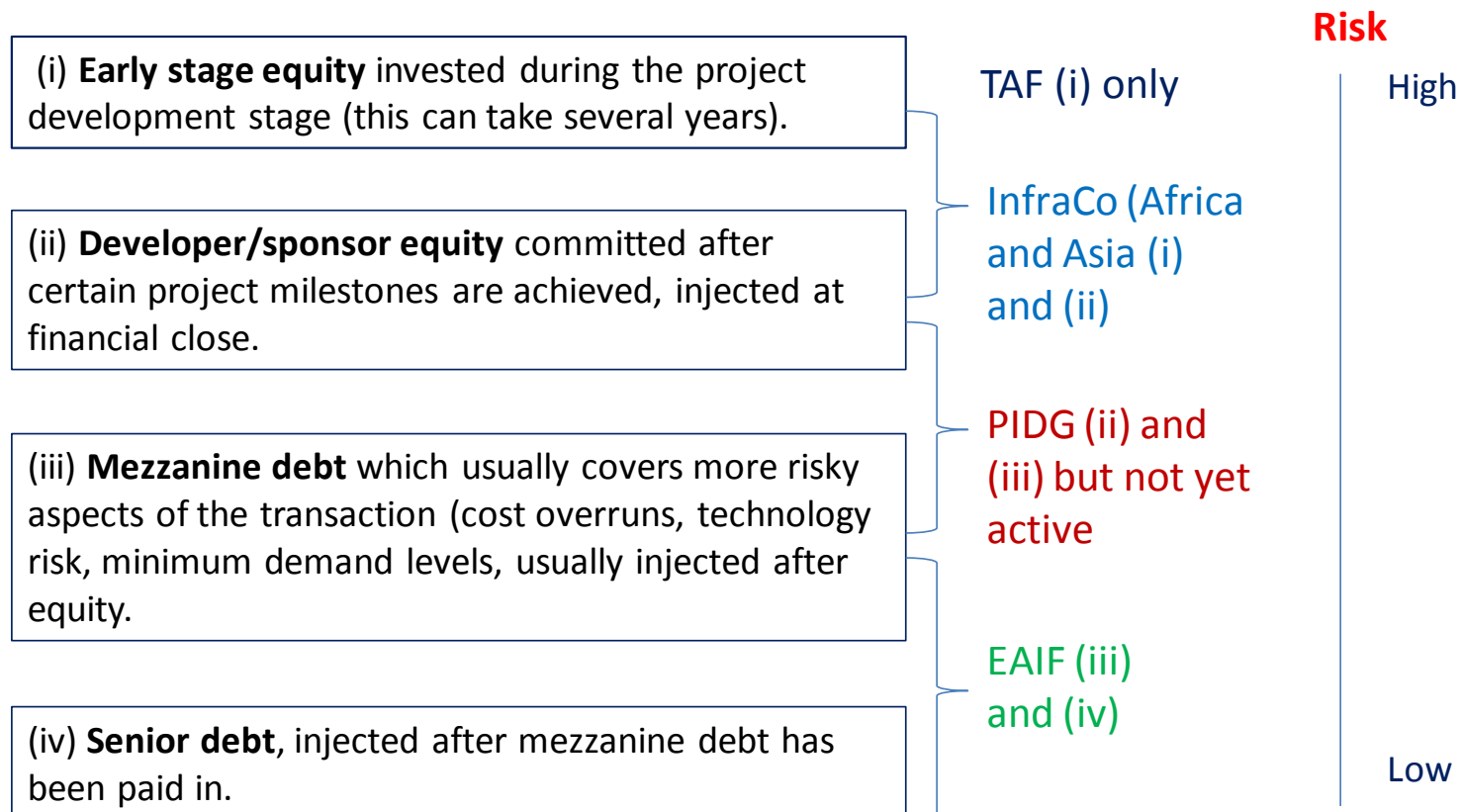


## Chart 8A.2: EAlF Fund Structure

|                                                                            |                     |
|----------------------------------------------------------------------------|---------------------|
| <b>Equity (provided by the PIDG group)*</b>                                | <b>US\$ 202.1 m</b> |
| <b>Subordinated debt (provided by DFIs)</b>                                | <b>US\$ 85.0 m</b>  |
| Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V. (FMO) | 40.0 m              |
| Development Bank of Southern Africa (DBSA)                                 | 25.0 m              |
| Deutsche Investitions – Und Entwicklungsgesellschaft mbH (DEG)             | 20.0 m              |
| <b>Senior debt (provided by private sector lenders)</b>                    | <b>US\$ 466.1 m</b> |
| Barclays Bank Plc                                                          | 100.0 m             |
| Kreditanstalt fur Wiederaufbau (KfW), Germany                              | 95.0 m              |
| Standard Bank of South Africa Ltd (SBSA)                                   |                     |
| 87.5 m                                                                     |                     |
| International Finance Corporation (IFC)                                    | 81.25 m             |
| African Development Bank (AfDB)                                            | 76.25 m             |
| Oesterreichische Entwicklungsbank AG (OeEB) (equivalent of EUR 20m)        | 26.1 m              |
| <b>Total</b>                                                               | <b>US\$ 753.2 m</b> |

\* Excludes retained earnings

## Chart 8A.3: The 4 Levels of Intervention among the PIDG Facilities





### Decision Background to FAIR

A PIDG Strategic Review identified two specific “market failures” where EAIIF could play a role if an appropriate structure were put in place to:

- focus on the “frontier” of private sector participation in infrastructure, prioritising demonstration effects over scale; and
- increase investment in the early stages of the infrastructure value chain at the project level.

FMFM was encountering these “market failures” in EAIIF’s current funding activities and saw an opportunity to expand work within these areas. “Frontier projects” have some or all of the following characteristics: They

- lack a major international sponsor (no “deep pockets” and experience);
- are located within challenging or extremely challenging environments;
- provide a significant contribution to the development of that environment;
- suffer from a lack or perceived lack of sponsor capital; and
- display sufficiently robust project economics, taking account of the above factors.

### Funding under the FAIR Initiative

Fair is to provide long term capital or a high risk tranche within the overall financing available to frontier projects.

Investments will take the form of mezzanine capital or quasi-equity, with FAIR providing between US\$10 million and US\$15 million of proposed investment per project, depending on the size and overall financing structure of the project.

The return for each investment will be tailored to the project’s specific needs and characteristics, though risk adjusted returns would be market priced (i.e. not subsidised). In addition, FAIR capital deployed will not include early stage equity or patient equity.

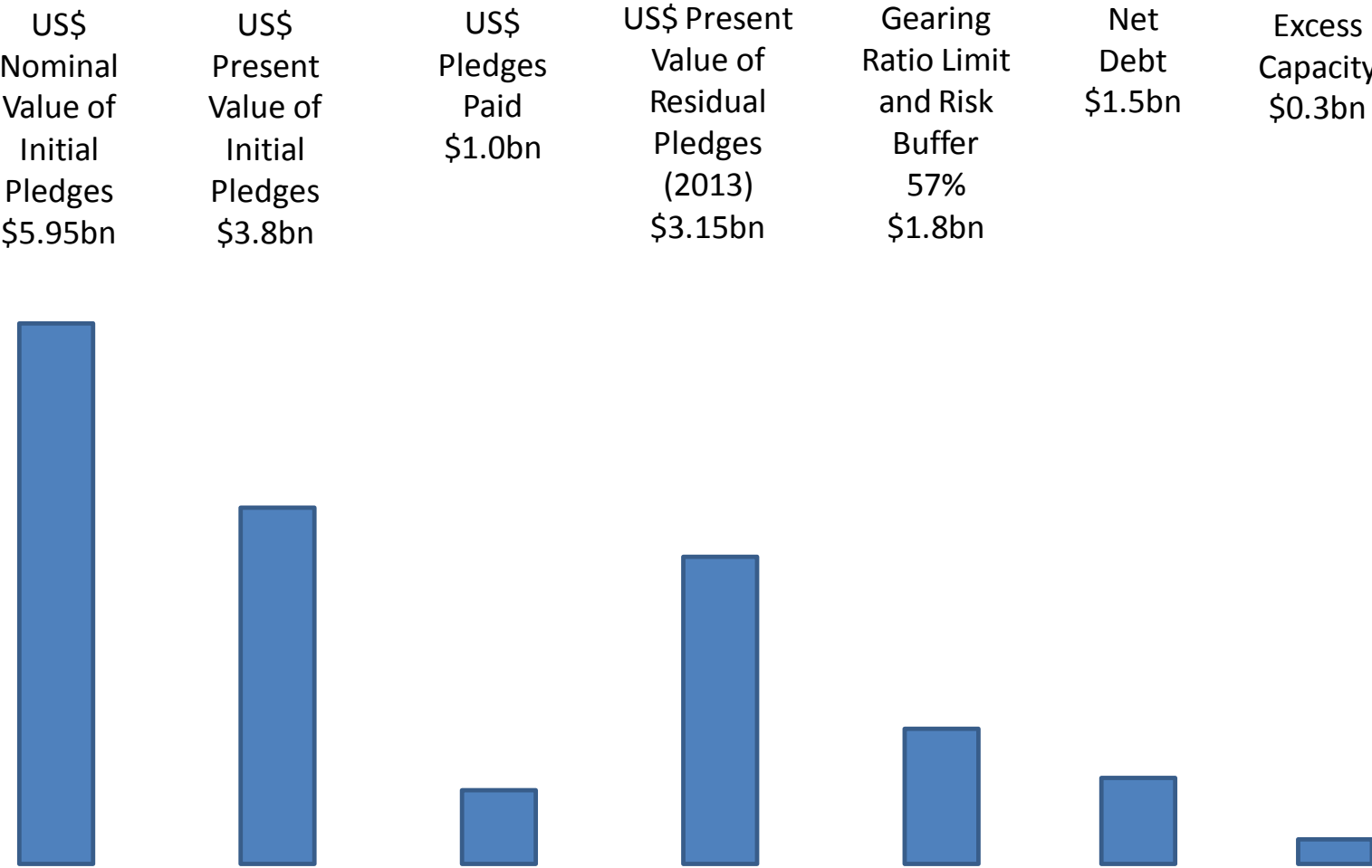
Funds from FAIR will not be injected prior to financial close, but will be approved at an early stage. This is to signal to the market that FAIR believes the project is viable.

## Annex 8B

### Example of a First Loss Investment Paid-in Over Time

The International Finance Facility for Immunisation (IFFI) set up under the Global AIDS Vaccine Initiative (GAVI) is an example of a first loss investment paid-in over time. See Chart 8B.1.

Chart 8B.1: First Loss Investment Paid-in Over Time : IFFI



## Annex 8C

### Example of Callable First Loss Investment

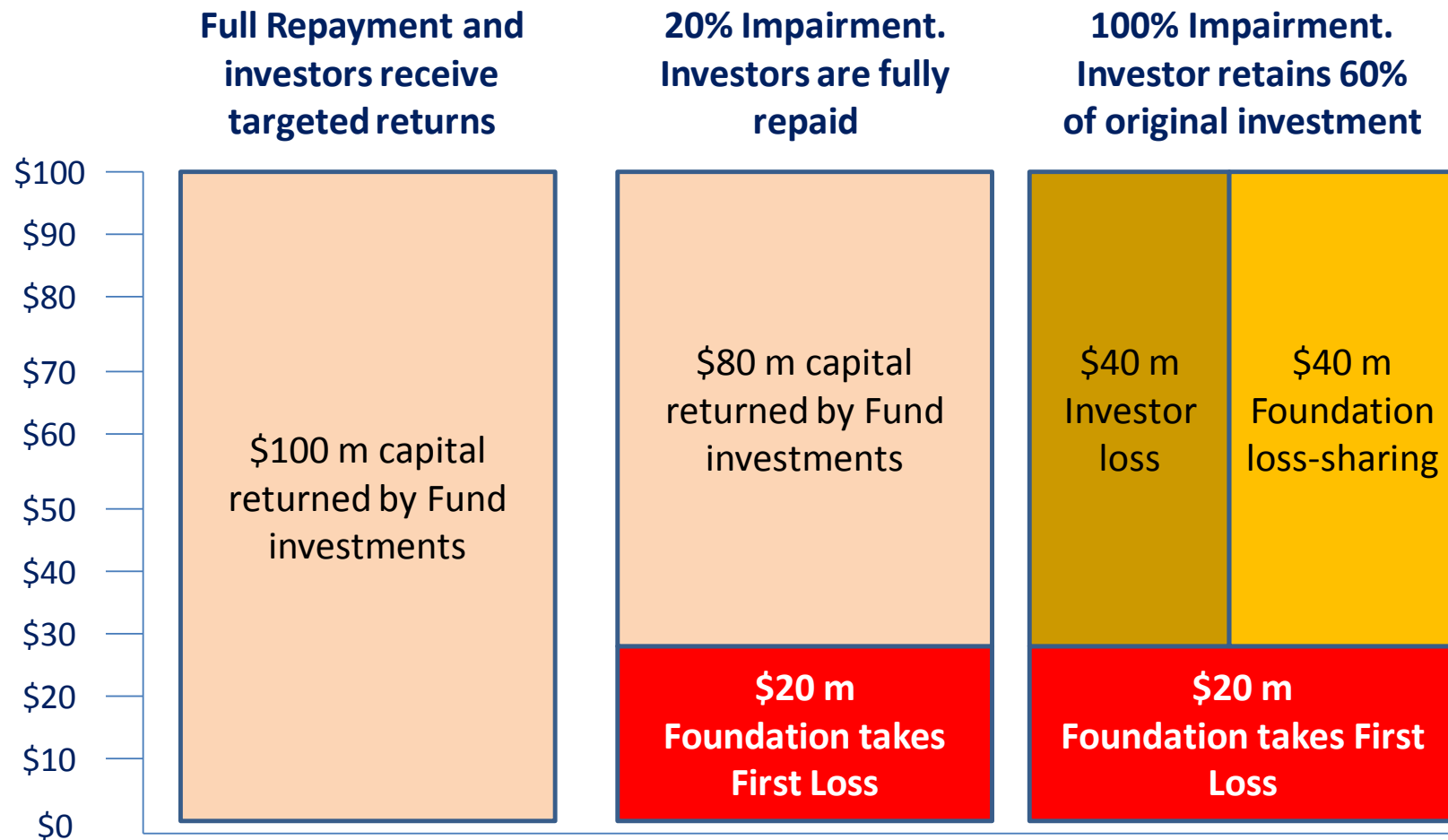
The Global Health Investment Fund founded in 2013 is an example of a callable first loss investment. The Bill & Melinda Gates Foundation together with SIDA of Sweden committed to cover aggregate first losses of the Fund to up to 20% of invested capital. Any further aggregate losses are shared between investors and the Foundation on a 50/50 basis.

Chart 8C.1 illustrates the loss protection scenarios assuming \$100 million of contributed capital<sup>3</sup> to the Fund.

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<sup>3</sup> \$94 m had been committed by its pioneering group of investors at the announcement of the fund launch on 23 Sep 2013.

## Chart 8C.1: Global Health Investment Fund – Callable First Loss



## Section 9

# How Financing Works

### Structures for Financing

As we have seen in earlier sections, finance is required for either corporate financing or for a project. In both cases the transaction(s) will involve legally documented contractual arrangements linking the various parties to the transaction.

“Structure” is the term often used to denote the linkages between these parties and the sum of the legally documented arrangements.

Structuring entails:

- Identifying the parties, purpose, sources of finance, use of the finance provided, repayment, and risks;
- Identifying and selecting appropriate financial instruments;
- Determining risks, risk allocation and mitigation; and
- Preparing the necessary legal documentation.

Chart 9.1 depicts a typical project financing structure. In addition to the structure, note that projects sometimes require support of an export credit agency.

Chart 9.2 depicts how corporate finance processes typically work.

### Project Finance with ECA Support

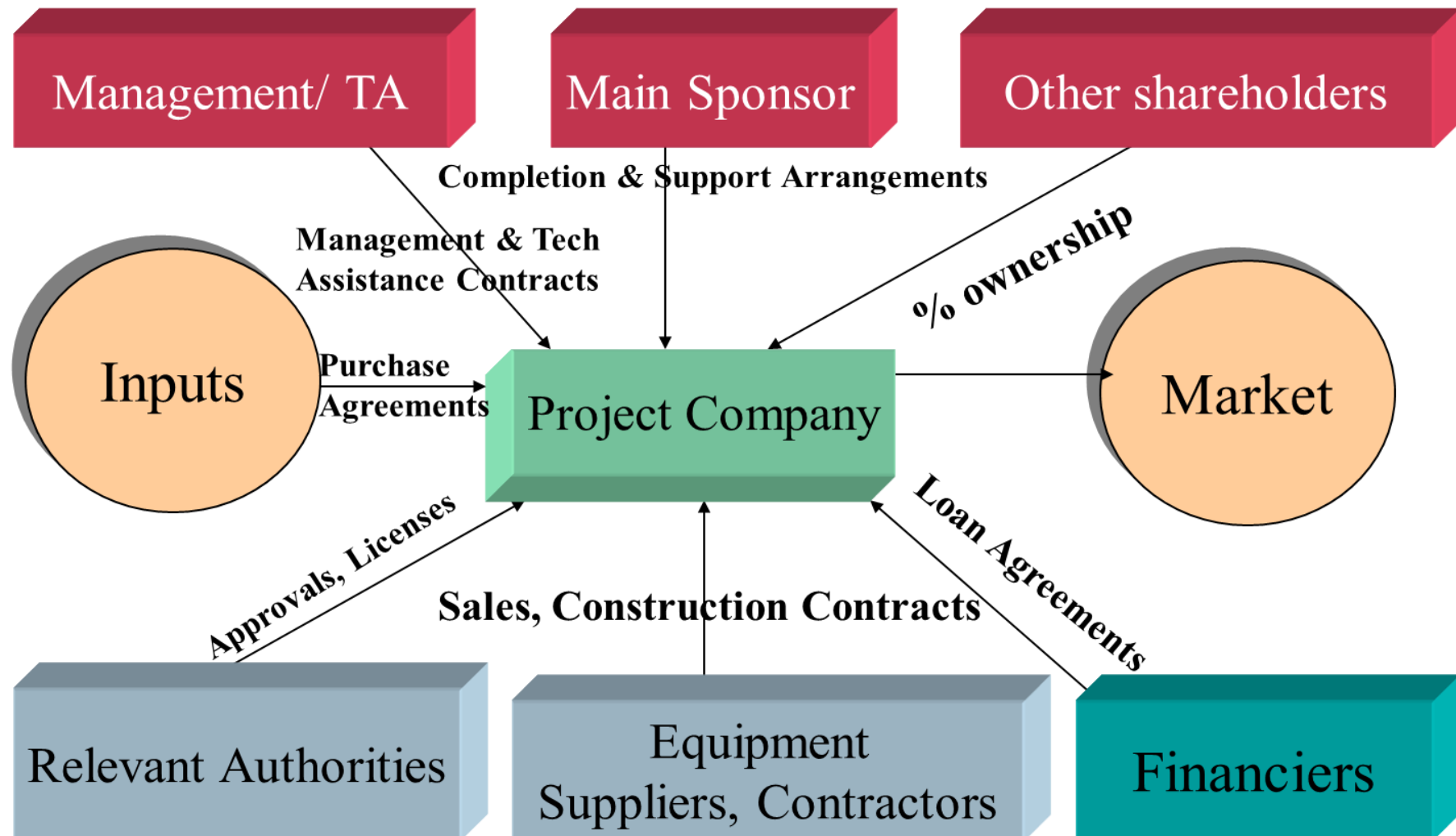
Projects are often supported by export credit agencies (ECAs) who use three methods to provide funds to an importing entity:

- Direct lending: The structure whereby the loan is conditioned upon the purchase of goods or services from the organizing country.
- Financial intermediary loans: The ECA lends funds to a financial intermediary, such as a commercial bank, that in turn loans the funds to the importing entity.
- Interest rate equalization: Under an interest rate equalization, a commercial lender provides a loan to the importing entity at below market interest rates, and in turn receives compensation from the ECA for the difference between the below-market rate and the commercial rate.

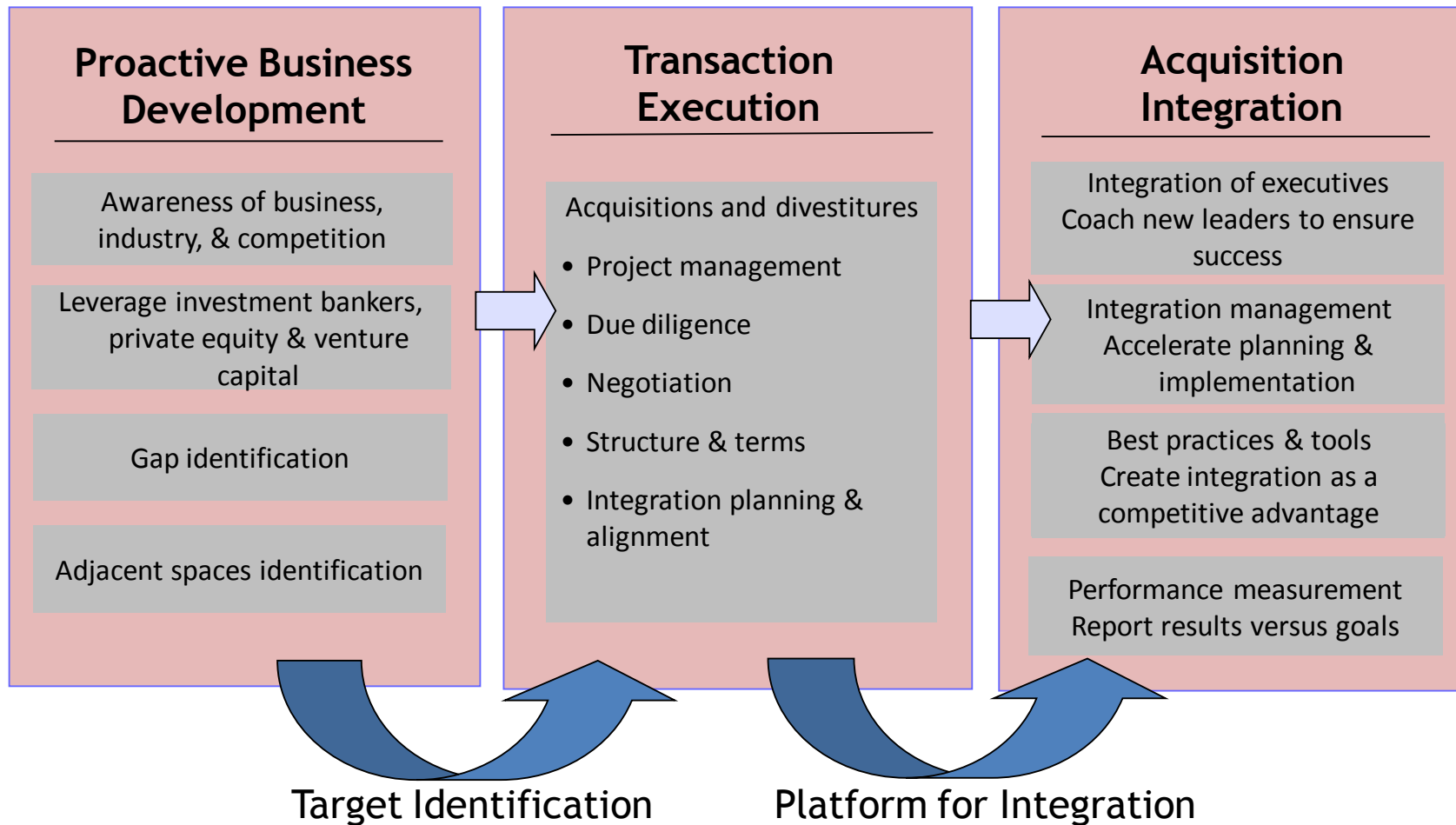
### Steps in a Typical Finance Transaction

Due to the different parties and different risks and/or levels of risk, every transaction is unique. The steps to be taken will therefore vary. Charts 9.3, 9.4 and 9.5 show three examples that outline the steps in some typical finance transactions; but, be wary, the next transaction could be simpler or, more likely, more complex.

## Chart 9.1: A Typical Project Structure



## Chart 9.2: How Corporate Deal Processes Work





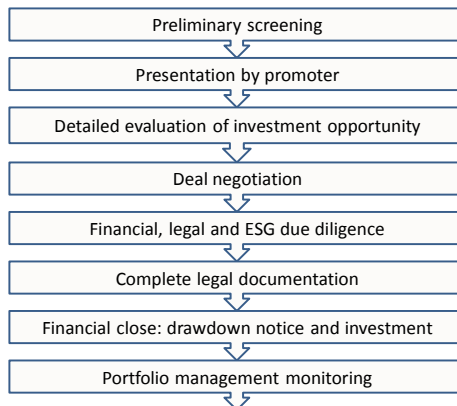
**Chart 9.3: A Financial Transaction Process: Example A**



**Chart 9.5: A Financial Transaction Process: Example C**



**Chart 9.4: A Financial Transaction Process: Example B**



## Evaluating the Key Levers for Success

Potential investors and lenders will look to identify and assess the key levers for success. Depending on the transaction, these might include:

- The promoter's reputation for integrity and record of achievement;
- The promoter's use of professional advisers;
- A business plan that provides clear evidence of demand and an innovative approach to meeting that demand;
- A capable and enthusiastic management/project team that will ensure that the business attracts/recruits top quality people;

- Transparency through the ready provision of high quality financial and other management information that indicates the future availability of regular and reliable information for monitoring and evaluation; and
- Solid corporate governance in place with effective use of non-executive directors and board committees.

## Due Diligence

“Due diligence”, which appears in each of the examples shown above, is a necessary process in any financial transaction.

It is of critical importance to any potential investor, lender or guarantor. It is time consuming and requires the input of appropriate specialists. The cost of due diligence is therefore usually borne by the sponsor or company until a decision to proceed is taken.

An investor, lender or guarantor will proceed only if due diligence discloses sufficient and satisfactory information to provide confidence that the investment, loan or guarantee would be prudent in the context of the business plan, risk assessment and proposed safeguards.

Due diligence will cover the following key areas but more may be required depending on the business/project under review:

- Commercial;
- Industry;
- Financial;

- Tax;
- Legal;
- Economic, social, and governance (ESG); and
- Forensic.

### Due Diligence: Commercial Review

The commercial review will cover inter alia:

- The actual and potential competitive position of the company or project products and services;
- Projecting supply and demand;
- Historic drivers of performance;
- Mapping key personnel and any gaps; and
- Benchmarking the business-plan.

### Due Diligence: Industry Review

The industry review will include:

- Assessing equipment against manufacturing and operational standards;
- Assessing systems against published standards; and
- Assessing outputs against regulated standards.

### Due Diligence: Financial Review

The financial review will include:

- Historic financial performance;
- Verification of balance sheet items;

- An analysis of current trading;
- A critical review of projection assumptions and projected results;
- A critical review of projected cash flows; and
- Identification and assessment of any off balance sheet liabilities.

#### **Due Diligence: Tax Review**

A tax review is necessary in order to determine:

- Any outstanding tax liabilities of the company;
- The current tax regime and allowances as they apply to the industry and company; and
- Any tax risks in the proposed investment.

#### **Due Diligence: Legal Review**

The legal review, often time consuming especially when several parties and/or legal jurisdictions are involved, will include:

- Major supplier contracts;
- Key personnel contracts;
- Verification of corporate structure and shareholdings;
- Verification of ownership of key assets (e.g. land title);
- Confirmation of compliance with key social, environmental and corporate laws;
- Verification of major assets (e.g. property) including planning compliance; and

- Identification of any claims or litigation.

#### **Due Diligence: ESG Review**

The ESG review will cover:

- Compliance with the investor's/lender's requirements;
- Compliance with any relevant investment code(s);
- Compliance with labour regulations;
- Compliance with international and local health, safety and environmental standards;
- Compliance with local laws and requirements; and
- The sponsor's governance record.

#### **Due Diligence: Forensic Review**

The forensic review will include any other items that the investor/lender considers important to have comfort in the level of potential risk. Typically it will include:

- The sponsor's reputation in the market;
- The sponsor's reputation in the community;
- A public record search for any "red flags" on key individuals involved with the business;
- Interviews with current and former employees to check reality of business practices; and
- Interviews with key community figures to understand reputation, key relationships and reaction to proposed investment.

## Legal Covenants in a Financing Contract

Every financing contract contains certain legal covenants; these typically include:

- Conditions precedent (i.e. the matters to be completed prior to disbursement).
- Financial covenants. These are to ensure that the borrower maintains financial prudence. They also impose restrictions on further debt, use of cash for unrelated expansions, asset disposals, etc.
- Business covenants that restrict the activities of an SPV.
- Lender's rights to: timely information, monitor construction progress, approve the appointments of independent specialists, suspend disbursements in default, etc.

## Timing

Due to the many steps, parties and risks involved, financial transactions tend to take many months – and sometimes several years – to complete.

The example in Chart 9.6, which shows part of a financing timetable, gives an idea of some of the steps and the time involved.

Experience shows that the financing process takes a good deal longer than most people imagine. The two transaction preparatory steps that tend to take many weeks, sometimes months, are: (i) due diligence (which should therefore commence as soon as practicable); and (ii) legal documentation, in particular changes

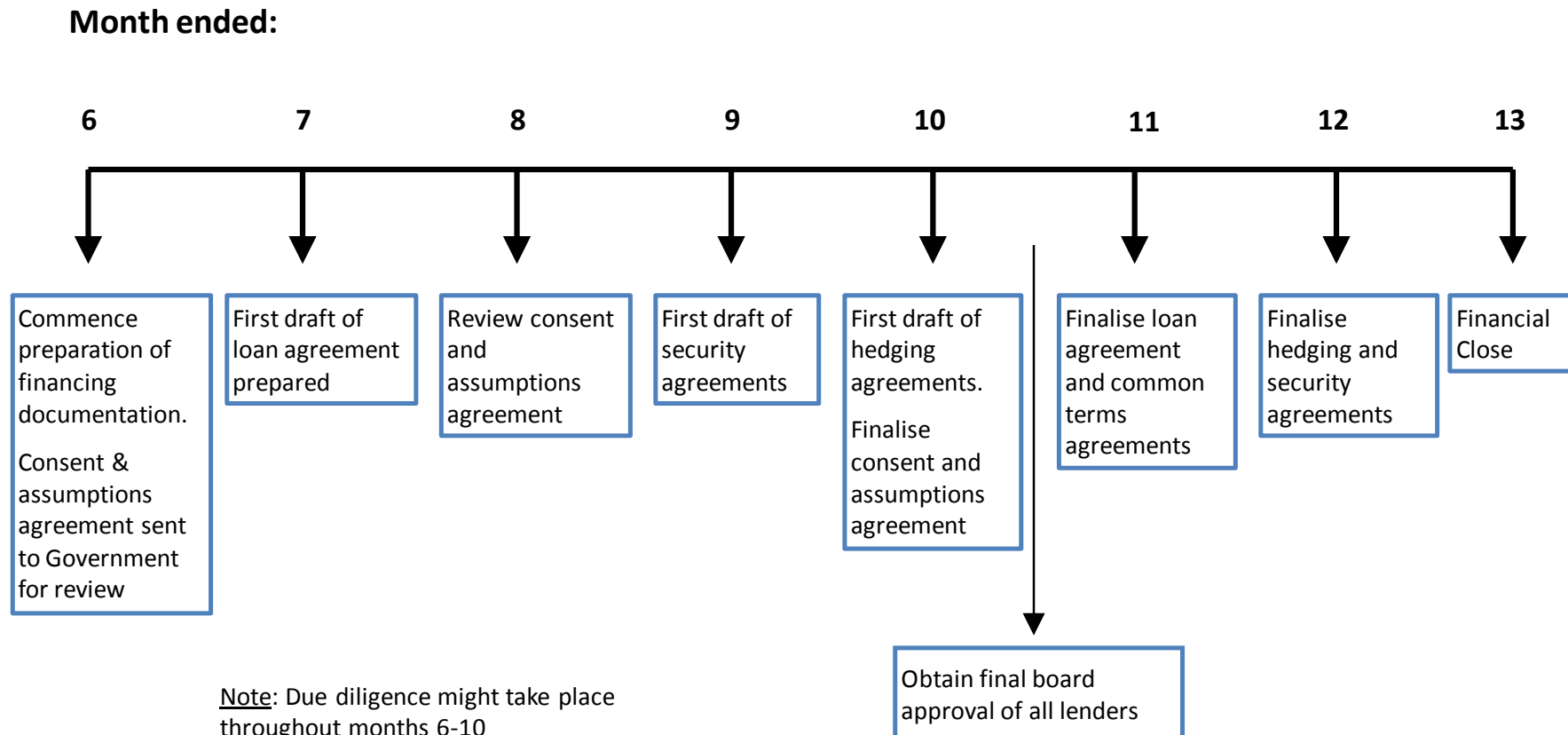
needed as result of review of draft documents and subsequent renegotiations. Further delay can also be expected when EPC contracts are involved.

Further delay may occur at the lending institution. Once all due diligence and legal documentation is satisfactorily completed, the transaction has then to receive the formal approval of the investor/lender.

In the case of a loan, it will require the approval of a credit or loan committee; and a very substantial loan may require board approval. Submissions for approval often have to be placed on an agenda many weeks in advance.

Lending institutions, who by the nature of their business must manage funds effectively, plan many months ahead for tranches of loan disbursements and set dates for approval of loans in the pipeline. If a delay occurs in preparing/finalising documentation for a transaction, it could therefore mean that approval for the loan is delayed, sometimes for many months (even up to six months). Such delays inevitably increase project transaction costs.

## Chart 9.6: Example of a Financing Timetable



# Section 10

## Risk Assessment and Management

### Risks are Ever Present

Financiers are always concerned about risk: risks to the borrower and thus risk of non-repayment; and occurrences in the financial markets in recent years have increased the emphasis on identifying, assessing and managing risks.

Compared with other regions of the world, doing business in developing economies, especially low income countries, is perceived by investors (local and foreign) as riskier (and much riskier in some situations). This means that an equity investor or lender will require an additional risk premium (as much as 15%) to cover the higher risk. The perceived higher risk thus makes the cost of capital much higher in developing countries and, in turn, this deters straightforward commercial business

Undertakings that involve sovereign exposure carry an additional risk premium as they are subject to political risks, including government failure to honour commitments.

Because borrowers and lenders alike will identify and assess risks during appraisals and due diligence work, it is important to have a

good understanding of the range of risks, their possible incidence, and actions to mitigate their potential impact.

Every business faces risks. Mitigating risks makes sense but incurs cost and, with the pressure to contain costs (to maximise profit) and complacency that can develop because adverse events have not occurred to date, risks are ever present.

### The Array of Business Risks

Different risks apply to different types of businesses and projects; and different financial instruments bear a greater or lesser degree of risk.

Some risks are external (i.e. they are factors external to the business over which its management has no control). Others are internal in the sense that the board and management have a measure of control and, if vigilance and early corrective actions are taken, those risks can to a large extent be avoided.

The choice of appropriate financial instruments can also help to mitigate risks.

Before considering any transaction, investors and lenders in international markets tend to first consider *country risk*.

An investor or lender looking at a business or project will consider the business risks, often referred to as *commercial risks*.

Rating agencies attribute *corporate credit ratings* (see section 9).

## Country Risks

Countries are classified by banks, export guarantee agencies and other financial institutions according to risk categories. For example, those used by Finnvera are:

|                        |                         |
|------------------------|-------------------------|
| 0 Advanced economy     | 4 Intermediate risks    |
| 1 Very low risks       | 5 Relatively high risks |
| 2 Low risks            | 6 High risks            |
| 3 Relatively low risks | 7 Very high risks       |

Financing costs, both for investment and transactional purposes, is relatively low in advanced economies (category 0) and relatively high in countries with very high risks (category 7).

### Countries with Intermediate Risks \*

- Aruba
- Bahrain
- Bulgaria
- Colombia
- El Salvador
- Latvia
- Romania
- Tunisia
- Turkey

\* According to Finnvera 20 March 2014

### Countries with Relatively High Risks \*

- Angola
- Azerbaijan
- Croatia
- Dominican Republic
- Fiji
- Gabon
- Ghana
- Guatemala
- Jordan
- Kazakhstan
- Lesotho
- Macedonia
- Mongolia
- Nigeria
- Papua New Guinea
- Paraguay
- St Vincent and the Grenadines
- Vietnam
- Zambia

### Countries with High Risks \*

- Albania
- Antigua and Barbuda
- Armenia
- Bangladesh
- Belize
- Benin
- Bolivia
- Cambodia
- Cameroon
- Cape Verde
- Congo (Peoples Rep)
- East Timor
- Egypt
- Georgia
- Honduras
- Kenya
- Montenegro
- Mozambique
- Senegal
- Serbia
- Sri Lanka
- Suriname
- Swaziland
- Tanzania
- Turkmenistan
- Uganda
- Uzbekistan

### Countries with Very High Risks \*

- Afghanistan
- Argentina
- Belarus
- Bhutan
- Bosnia and Herzegovina
- Burkina Faso
- Burundi
- Central African Republic
- Chad
- Congo (Democratic Republic)
- Cote d'Ivoire
- Cuba
- Djibouti
- Ecuador
- Equatorial Guinea
- Eritrea
- Ethiopia
- Gambia
- Guinea
- Guinea-Bissau
- Guyana
- Haiti
- Iran
- Iraq
- Jamaica
- Korea (Dem Peoples Rep)
- Kyrgyzstan
- Laos
- Lebanon
- Liberia
- Libya
- Madagascar
- Malawi
- Maldives
- Mali
- Mauritania
- Moldova
- Myanmar
- Nepal
- Nicaragua
- Niger
- Pakistan
- Rwanda
- St Kitts and Nevis
- Sao Tome & Principe
- Syria
- Tajikistan
- Togo
- Ukraine
- Yemen
- Zimbabwe
- Seychelles
- Sierra Leone
- Somalia
- South Sudan
- Sudan

### Commercial Risks

Commercial risks (business risks) are generally classified into 5 main types:

- 1) Strategic risks;
- 2) Financial risk;
- 3) Market risk;
- 4) Operational risks;
- 5) Compliance risk; and
- 6) Other risks.

### Strategic Risks

Strategic Risks are associated with the nature and location(s) of a business arising from:

- a) Business Environment: changes in affordability, competitive structures, and introduction of new technologies.
- b) Transaction: Results of the business relocation or mergers and acquisitions, spin-offs, alliances and joint ventures.
- c) Investor Relations: Strategy for communicating with individuals who have invested in the business.

### Financial Risk

Financial risk is the possibility that a business will not have adequate liquidity to meet its ongoing obligations, and this has both short- and long-term implications. Financial obligations include debt repayment, payroll requirements, dividend payments,



government licenses and taxes. Obligations can also include more complex transactions, such as the ability to settle financial transactions in the capital or debt markets. Financial risk encompasses the possibility that external sources of finance, such as debt or the ability to access the capital markets, may not be available when needed. This lack of availability could be due to poor credit ratings or operations in remote locations that are too risky for financial institutions to fund.

### **Market Risks**

Closely linked to strategic risks, market risks include changes in attitudes and taste, demand and supply, price sensitivity, new entrants, and competitors' responses.

### **Operational Risks**

Operational risks tend to be short-term and include losses resulting from (a) failed processes, (b) people and (c) failed systems, or (d) external events." Essentially, operational risk is the possibility that transactions or processes will fail due to poor design, inadequately trained personnel or external business disruptions such as a fire. It also includes the risk of fraud and the possibility that a business will fail to meet a contractual obligation due to operational reasons.

### **Compliance Risk**

Compliance risk is the possibility that a business will not comply with laws and regulations in the jurisdictions where it operates or that the organization will violate a legally binding contract.

Noncompliance can be wilful, or it can result from being unaware of local legal requirements.

### **Other Risks**

Other risks are varied but, if and when they occur, can be devastating. These risks include political risks and natural disaster (such as floods). To consider how the various types of risk can be mitigated, we shall here look at them from the perspective of a business.

### **External and Internal Risks**

A business or project is confronted with a range of risks. Some of them are *external* to the company and the company can do very little to influence/prevent them. Note that most of the external risks (such as economic, political and marketplace) are systemic.

*Internal* risks are those that relate to matters within the specific scope of the company and for which the company has more scope to mitigate.

External and internal risks can be summarised as follows:

| <b><u>External</u></b> | <b><u>Internal</u></b>                                    |
|------------------------|-----------------------------------------------------------|
| Economic               | Compliance                                                |
| Marketplace            | Ethical                                                   |
| Natural                | Financial                                                 |
| Political              | Marketplace                                               |
| Strategic              | Operational                                               |
|                        | People                                                    |
|                        | Strategic                                                 |
|                        | Suppliers (including outsourcers and strategic alliances) |

Table 10.1 lists typical external risks and possible steps for their mitigation.

Table 10.2 lists typical internal risks and possible steps for their mitigation.

## **Risk Assessment**

The risks listed in Tables 10.1 and 10.2 are examples. The lists are not exhaustive; and remember: different risks apply at different times and locations to different businesses, and to different companies in the same business.

From an investor or lender perspective, different risks can apply to different types of financial instruments. For example, while the risk of default and reputational risk apply to all instruments, interest rate risk would be relevant to debt or bond financing and political risk would be of more importance to guarantees.

A potential investor or lender will seek to identify risks and to assess what steps a sponsor has taken to mitigate them. The key indicators of risk mitigation are:

- a risk assessment and mitigation plan in place;
- insurance cover for all normal risks; and
- health, safety and environmental policies and procedures in place

When assessing risks, the following risk management pitfalls should be avoided:

- Box-ticking rather than a business-led approach;
- Failure to prioritise key risks;
- Too narrow a focus on financial risks;
- Not enough attention paid to changes in the internal or external environments;
- Board discussing risk but not integrating it into their own decision-making; and
- Failure to embed risk management into the Company's organisational culture and processes.

**Table 10.1: External Risks and Mitigation**

|                     | <b>Risk</b>                                                | <b>Mitigation Steps</b>                                           |
|---------------------|------------------------------------------------------------|-------------------------------------------------------------------|
| <b>Economic:</b>    | Exchange rate changes                                      | Hedging, swaps.                                                   |
|                     | Interest rate changes                                      | Fixed rate, hedging, swaps.                                       |
| <b>Marketplace:</b> | New entrants                                               | Offtake contracts, monitoring and frequent reviews with customers |
|                     | New competing technology                                   | Research and developments, develop pricing and exit strategy      |
| <b>Natural:</b>     | Environment and social                                     | E&S action plan.                                                  |
|                     | External accidents                                         | Contingency planning, insurance                                   |
|                     | Natural disasters                                          | Monitoring and contingency                                        |
|                     | Unexpected meteorological conditions                       | Monitor forecasts, contingency planning, insurance.               |
| <b>Political:</b>   | Changes in government and/or policies (e.g. protectionism) | Partial risk guarantees                                           |
|                     | International events/tension                               | MIGA/ECA guarantees and insurance                                 |
| <b>Regulation:</b>  | Unexpected onerous/adverse changes                         | Industry association, lobbying, partial risk guarantee            |
| <b>Strategic:</b>   | Judicial and/or regulatory failure                         | Contingency planning.                                             |
|                     | Industry loss of public confidence                         | Industry association.                                             |

**Table 10.2: Internal Risks and Mitigation (p.1)**

|                             | <b>Risk</b>                                                 | <b>Mitigation Steps</b>                                              |
|-----------------------------|-------------------------------------------------------------|----------------------------------------------------------------------|
| <b>Compliance:</b>          | Breach of competition, corporate, employment or tax laws    | Internal controls, audit                                             |
|                             | Failure to protect intellectual property                    | Internal controls                                                    |
|                             | Health, safety and environmental issues                     | Internal controls, audit                                             |
|                             | Litigation risk                                             | Legal opinion                                                        |
| <b>Ethical:</b>             | Failure to enact high standards of ethics                   | Rules and penalties in place, transparency, audit, (i.e. governance) |
|                             | Obtaining contracts(customers, suppliers, etc.) unethically | Internal controls, governance                                        |
|                             | Stakeholder concerns on business/service probity            | Governance                                                           |
| <b>Finance</b>              | Cash flow / going concern problems                          | Stringent treasury management                                        |
|                             | Susceptibility to fraud /accounting problems                | Internal controls, audit                                             |
|                             | Property damage                                             | Property insurance                                                   |
|                             | Security and theft                                          | Security measure, insurance                                          |
|                             | Other uninsured risk                                        | Insurance                                                            |
| <b>Fuel, Raw Materials:</b> | Availability, timely supply                                 | Long term supply contracts                                           |

**Table 10.2: Internal Risks and Mitigation (p.2)**

|                     | <b>Risk</b>                                              | <b>Mitigation Steps</b>                                            |
|---------------------|----------------------------------------------------------|--------------------------------------------------------------------|
| <b>Marketplace:</b> | Missed opportunities and failure to innovate             | Incentive scheme, introduce new blood                              |
|                     | Poor level of customer satisfaction (quality/timeliness) | Incentives, new blood, training                                    |
|                     | Over-reliance on a few key stakeholders/customers        | Target new customers                                               |
| <b>Operational:</b> | Failure to maintain or protect assets adequately         | Maintenance plan, internal controls                                |
|                     | Non-adherence to safety standards                        | Rules and penalties                                                |
|                     | Quality control shortcomings                             | Internal controls and penalties                                    |
|                     | Unforeseen breakdowns                                    | Contingency planning, insurance, suppliers' warranties             |
| <b>People:</b>      | Over-reliance on one person                              | Strengthen management team                                         |
|                     | Over-dominant CEO                                        | Good governance, covenants                                         |
|                     | Fraud and corruption                                     | Internal controls; good external audit                             |
|                     | Poor workmanship (resulting in claims or litigation)     | Manufacturers insurance, indemnity insurance                       |
|                     | Accidents at work                                        | Effective H,S&E safeguards in place, employers liability insurance |
|                     | Inadequate succession planning                           | Frequently review succession plans                                 |
|                     | Internal communications weaknesses                       | Improve intranet and internal controls                             |

**Table 10.2: Internal Risks and Mitigation (p.3)**

|                        | <b>Risk</b>                                       | <b>Mitigation Steps</b>                                         |
|------------------------|---------------------------------------------------|-----------------------------------------------------------------|
| <b>People (cont.):</b> | Leadership inability to drive the Company forward | Contingency plan for leadership replacement                     |
|                        | Loss of key personnel                             | Contingency plan with contacts                                  |
|                        | Poor employee motivation                          | Frequent review of competitive employer position and incentives |
| <b>Strategic:</b>      | Complacency and failure to manage major change    | Regular Board reviews and Board Report to shareholders          |
|                        | Reputational risk                                 | Careful selection of business partners including due diligence  |
|                        | Strategy not aligned with capabilities            | Review plans, training, recruitment                             |
|                        | Unfocused strategy                                | Management changes                                              |

# Section 11

## Governance

### Introduction

*Governance* as it applies to a business is more frequently referred to as *corporate governance*.

In an increasingly competitive and complex world, a business that is going to flourish and maintain its market position must operate – and be seen to operate – to standards that impress its current and potential stakeholders, whether they be shareholders, lenders, employees, suppliers, customers, regulators, or the local communities in which it operates. Indeed, companies are now subject to greater scrutiny and regulation than ever before; and they know that they have to meet corporate governance standards.

As should already have become apparent during this course, governance is important to DFID because: (1) there is the issue of governance as it relates to any proposed transaction and how DFID's ongoing interest in an investment is safeguarded; and (2) corporate governance is important to the success of an existing business or new project that DFID Governance chooses to support financially.

Because good governance is such an important element of success, we look at the subject from the perspective of a potential investor or lender.

### Definition of Corporate Governance

Corporate governance has been defined in many academic books on the subject but the simplest and most precise definition is that found in the 1992 Report of the Committee on the Financial Aspects of Corporate Governance (the UK Cadbury Code) which states "Corporate governance is the system by which companies are directed and controlled."

### Corporate Governance: Essential for Success

History has shown that good corporate governance is a key element in the sustained success of a business.

Strong corporate governance provides clarity, stimulates effective teamwork, encourages innovation, and ensures effective internal controls and quality outputs.

Weak corporate governance, on the other hand, allows inefficiency to creep in, generates discord, leads to ineffective internal controls and poor leadership. It inevitably results in waste and poor results.

Today, a well managed business should have in place a *Company Code of Ethics and Corporate Governance*.

## Company Code of Ethics & Corporate Governance

The publication of its code demonstrates that a company is committed to a high standard of business conduct, whereby it conducts business in accordance with the spirit and letter of applicable laws and regulations and in accordance with ethical business practices.

The basic principle of ethical behaviour is that business must be carried on with loyalty to the interests of the shareholders, fellow employees, persons with whom the company contracts business and the communities in which the company has its operations.

A code helps in this endeavour by providing a statement of the fundamental principles and practices that govern the conduct of the company's business.

### Ethical Behaviour

A code of ethical behaviour should cover: corporate books and records; confidentiality; communications; use of company assets; and, of particular interest to a potential investor or lender:

- Conflicts of interest;
- Bribery and corruption;
- Business policies;
- Human rights standards;
- Societal Interests; and
- Employment protocols.

## Corporate Governance

The following aspects of corporate governance - that should be set out in a company code – are of particular interest to an investor or lender:

- Ownership and management of the business;
- Duties, responsibilities and authority of the board of directors and its individual members;
- The existence and performance of board committees (for example, the Audit Committee);
- Board meetings (attendance, frequency, minutes, etc); and
- Results reporting and accountability.

## Ownership and Management of the Business

### Articles of Association

The transfer of ownership of shares, the selection and election of directors, the appointment of officers, and other rules of a company's corporate governance regime are set out in its Articles of Association (often referred to as the *Company Charter*).

### Register of Shareholders

The Register of Shareholders is maintained by the Company Secretary and should be available for inspection at the Company's registered office. Due diligence will probe into who are the beneficial owners, especially where some shareholders are other companies, trusts or relatives of directors or employees.



### **Selection and Appointment of Directors**

A potential investor will be interested to have board representation, while a lender will be interested in who sits on the board and how effective the board is; both would want to gauge the extent of the independence of the directors (see below).

### **Register of Directors**

The Register of Directors is maintained by the Company Secretary and should be available for inspection at the company's registered office. A potential investor or lender may wish to obtain the opinion of former directors about the company's operations.

### **Company performance**

A well managed business has regular management reporting and reviews of performance.

### **Accountability**

Shareholders expect the Board, within the framework of the company's objectives and business plan, to direct the company such that it performs to expectation. The shareholders – through meetings of the shareholders, the Annual Report, and other reports requested by the shareholders - hold the Board accountable for performance.

### **Bonuses and Dividends**

There should be clarity as to the basis for determining and paying bonuses and dividends.

### **Risk Management**

A potential investor/lender will want to know how the company manages risks, what risk management policies are in place and how the key revenue earning assets are safeguarded and maintained.

### **Disclosure**

When seeking to raise finance, a company/sponsor should follow a policy of full disclosure. However, to protect the company/sponsor's interests (e.g. information being passed to a competitor), it is normal for a potential investor or lender to sign a *non-disclosure agreement*.

### **Organisation**

An investor/lender will, as part of the due diligence process, review: (a) the organisation structure; (b) the composition and capabilities of the senior management team; and (c) the extent of management's autonomy.

### **Audit**

There are four audit aspects of interest to a potential investor/lender: (1) the membership and performance of the board Audit Committee; (2) the selection and appointment of the external auditor; (3) recent audit reports and "management letters" to see what issues have been raised and whether those issues have been dealt with; and (4) the use of internal audit. A question to consider: Should the potential investor/lender insist on a change of external auditor to assure audit effectiveness?

## Independence of Directors

A director may hold shares in the company and may have interests outside the company that are related to the business. A director may also hold directorships in other companies. A director should therefore be required to disclose all such interests and any potential conflicts of interest. But to ensure that the Board acts in the best interests of the company, at least half of the directors should be “independent”.

## Independent Director

An Independent Director is a person who:

- has not been recently employed by the company or its related parties;
- is not, and is not affiliated with a company that is an advisor or consultant to the company or its related parties;
- is not affiliated with a significant customer or supplier of the company or its related parties;
- has no personal service contracts with the company, its related parties, or its senior management;
- is not affiliated with a non-profit organization that receives significant funding or other form of support from the company or its related parties;
- is not employed as an executive of another company where any of the company's executives serve on that company's board of directors;

- is not a member of the immediate family of an individual who is, or has recently been employed by the company or its related parties as an executive officer; and
- is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the company or of a related party.

## Management Information

The availability and quality of management information are useful guides for assessing governance. An investor or lender will want to review and assess:

- the current business plan;
- management accounts (including the application of budgetary control);
- other management information; and
- Board reports.

## Project Governance

Assessing the governance of a project is more difficult because there isn't a history. A potential investor or lender therefore has to:

- Assess governance in the sponsor organisation;
- Examine the proposed project organisation and governance arrangements, with attention to safeguards for ensuring an adequate flow of timely information; and

- Assess the competence and track record of the proposed project manager and his senior team.

## Key Governance Requirements

Whether considering investment or a loan in an existing company or a project SPV, the key governance requirements are:

- A board of directors with representation that: fairly represents the interests of the various shareholders;
- An effective board of directors that: (a) meets on a regular basis (b) makes timely decisions and interventions; (c) holds management accountable; (d) will ensure transparency and compliance with industry best practice; and (e) keeps shareholders informed;
- Safeguards in the company's Articles of Association or in loan agreement covenants that protect the interests of minority shareholders and lenders;
- Ensuring that no one person or small clique has unfettered control. To help in this regard, it is advisable to have a clear statement of the level of autonomy of the company management (including items requiring board approval);
- Keen attention to the avoidance of conflicts of interest. It is becoming common practice to require directors and employees to signed (annual) declarations of interests;
- Regular reporting of results in an agreed format;

- An agreed process for the routine review of performance; and
- To provide confidence that the SPV is complying with approved policies and procedures, the appointment of external auditors of good reputation and who have the necessary experience and resources.

Annex 11A is a case study both of insurance as a financial instrument and of problems associated with governance.

## Annex 11A

### Governance Case Study: Africa Risk Capacity

ARC is a novel mechanism to pool the risk of severe drought across Africa (see Charts 11A.1-11A.9).

DFID has been supporting the design of ARC since 2010:

- £2.5 m over 3 years to explore how to put the concept into practice (along with SDC, SIDA, Rockefeller et al);
- ICF approved capitalisation in 2012 (originally for £25m, 2013 agreed up to £100m). Potentially non fiscal CDel.

KfW is also looking to help capitalise ARC through an equity instrument. SIDA has committed to provide a guarantee (of fund or PS investors). Other donors are also interested but have concerns about governance.

The ARC Board was established in November 2012:

- Strong African ownership but limited consultation with donors;
- It has set contingency plan standards and approval process (PRM); and
- Decisions have been taken on ARC Ltd. structure (mutual), jurisdiction and dissolution rights.

Six countries have been the early movers and have developed contingency plans; but there are issues with those plans.

### Contingency Planning Issues

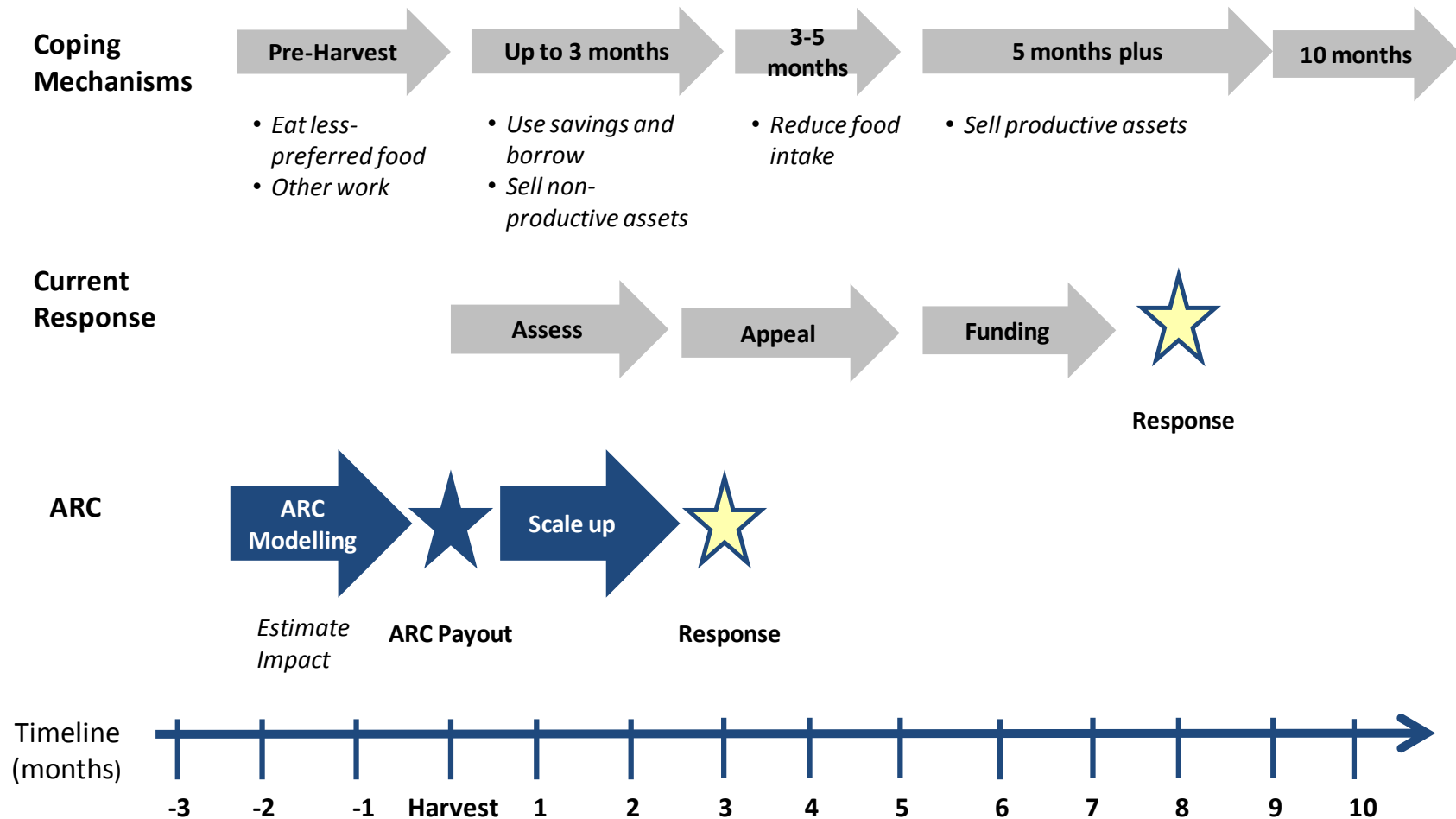
The matters that have been of concern to the development agencies are:

- The quality of contingency planning standards and support for due diligence, monitoring and audit in-country;
- The approval process, with a peer review by the ARC Agency Board and political versus technical priorities;
- The technical skills of the ARC Secretariat; and
- Conflicts of interest with the ARC Secretariat currently staff by World Food Programme personnel.

The six plans now have “interim approval” but, at the time of writing, the overall quality is low. Negotiations are therefore under way to have:

- Independent technical experts in the peer review;
- Beneficiary feedback, with a whistle blowers’ hotline;
- A comprehensive monitoring framework, including accredited auditors; and
- ARC Agency/ARC Ltd. regularly share reviews to improve standards and support to country programmes.

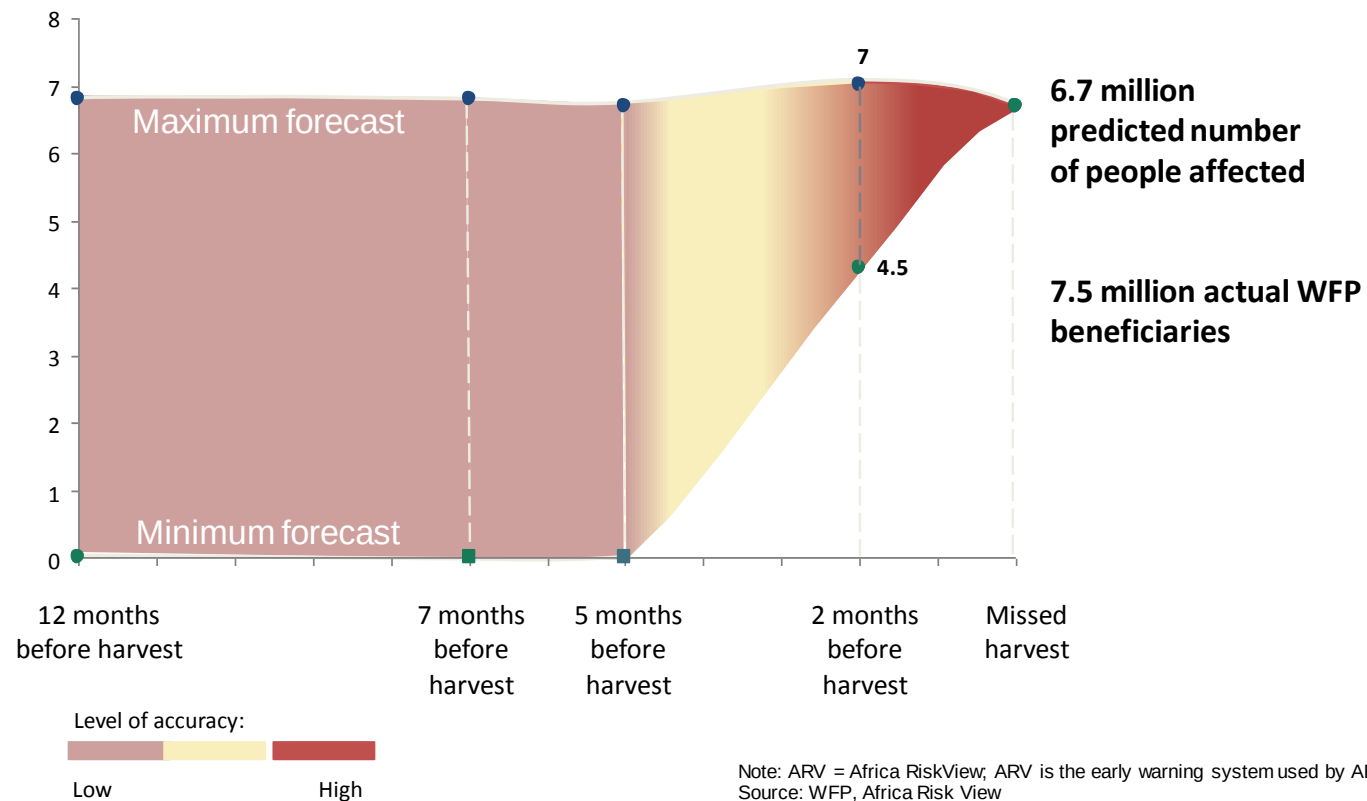
## Chart 11A.1: The ARC Concept



## Chart 11A.2: Predicting droughts - Ethiopia 2002 Example

### ARV early warning system forecast narrows ~2 months before harvest

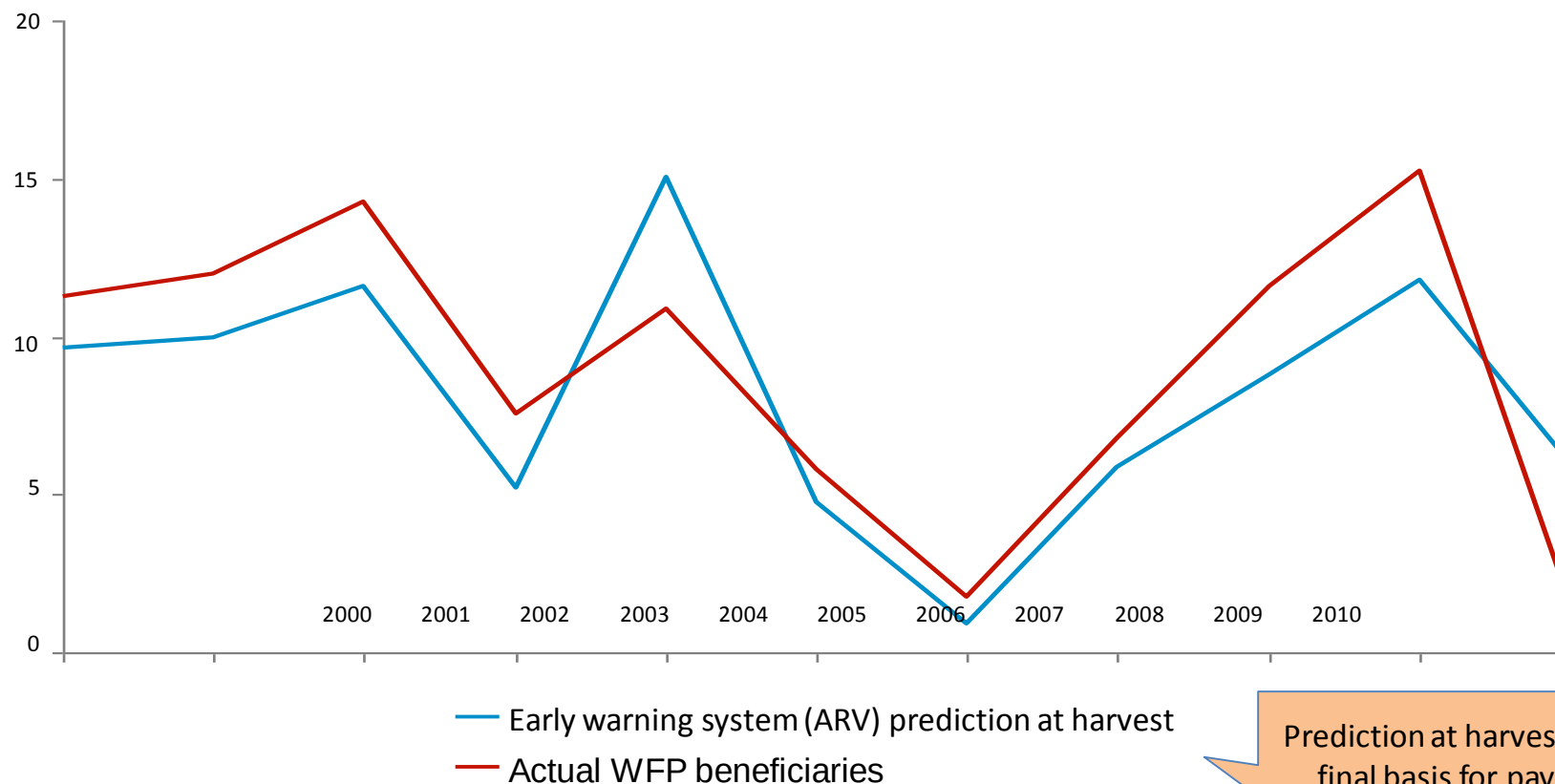
Africa Risk View – Ethiopia 2002  
Estimated no. people affected (m)



## Chart 11A.3: Predicted Droughts with relatively high accuracy

### Comparison of early warning system results and actual WFP beneficiaries

M people affected ARC initial countries

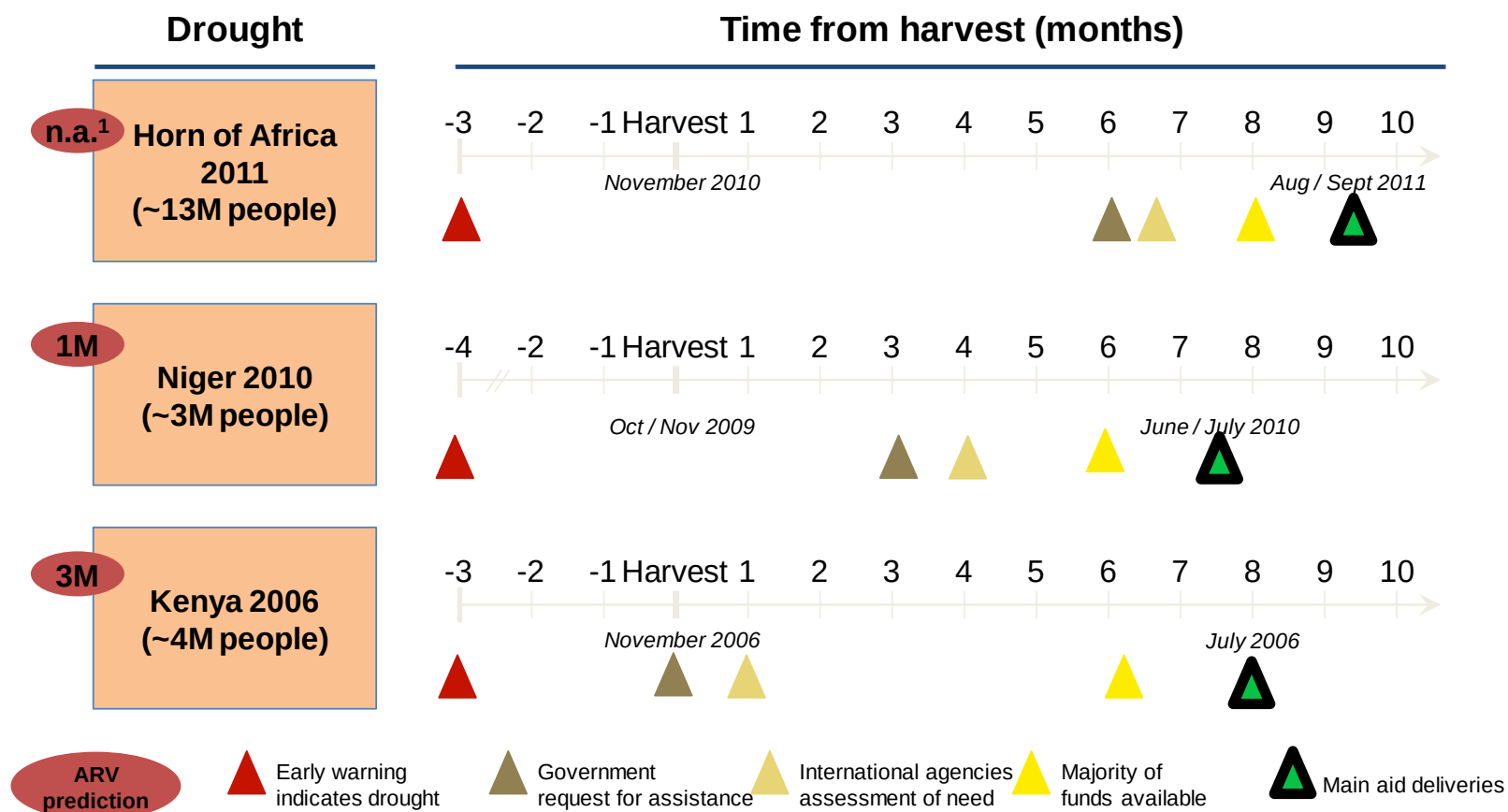


Prediction at harvest is the final basis for payouts

1. Median since 2000

Note: ARV = African RiskView Source: ARC, WFP, BCG analysis

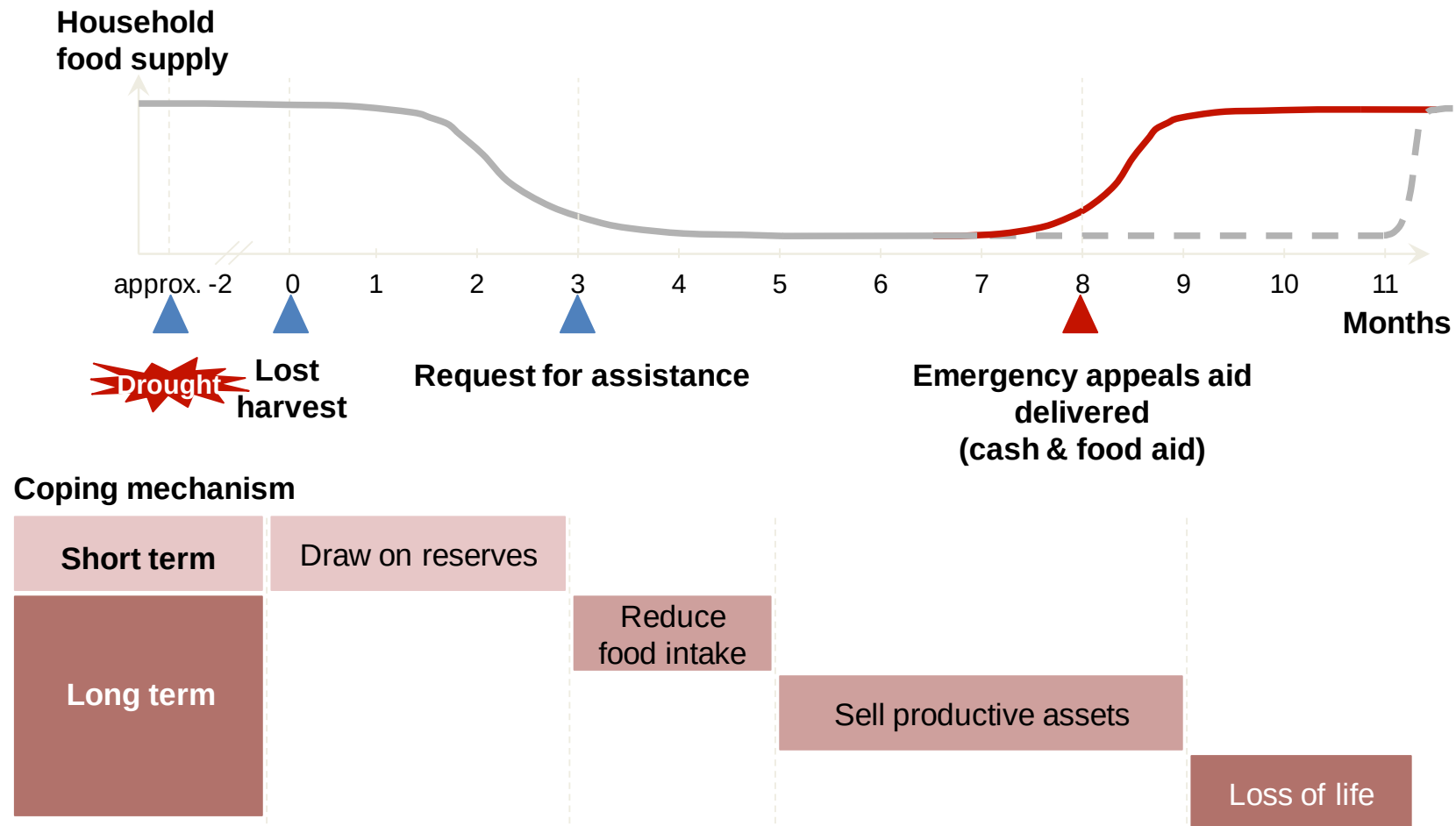
## Chart 11A.4: Emergency appeals aid arrives 7-9 months after missed harvest



1. ARV data only available for Ethiopia Note: Simplified timing capturing operations' main milestones; smaller scale interventions performed along the way – possible through other WFP concurring EMOPs in the area or local immediate support not shown. Also, procurement and food distributions may, under certain circumstances, start before the arrival of funds thanks to internal funding mechanisms and scale up of on-going programme  
Source: WFP timelines, WFP team, "A dangerous delay – The cost of late response to early warnings is the 2011 drought in the Horn of Africa" – Jan 2012 – Oxfam, Save the Children, BCG analysis



## Chart 11A.5: Coping mechanisms have a negative long term impact



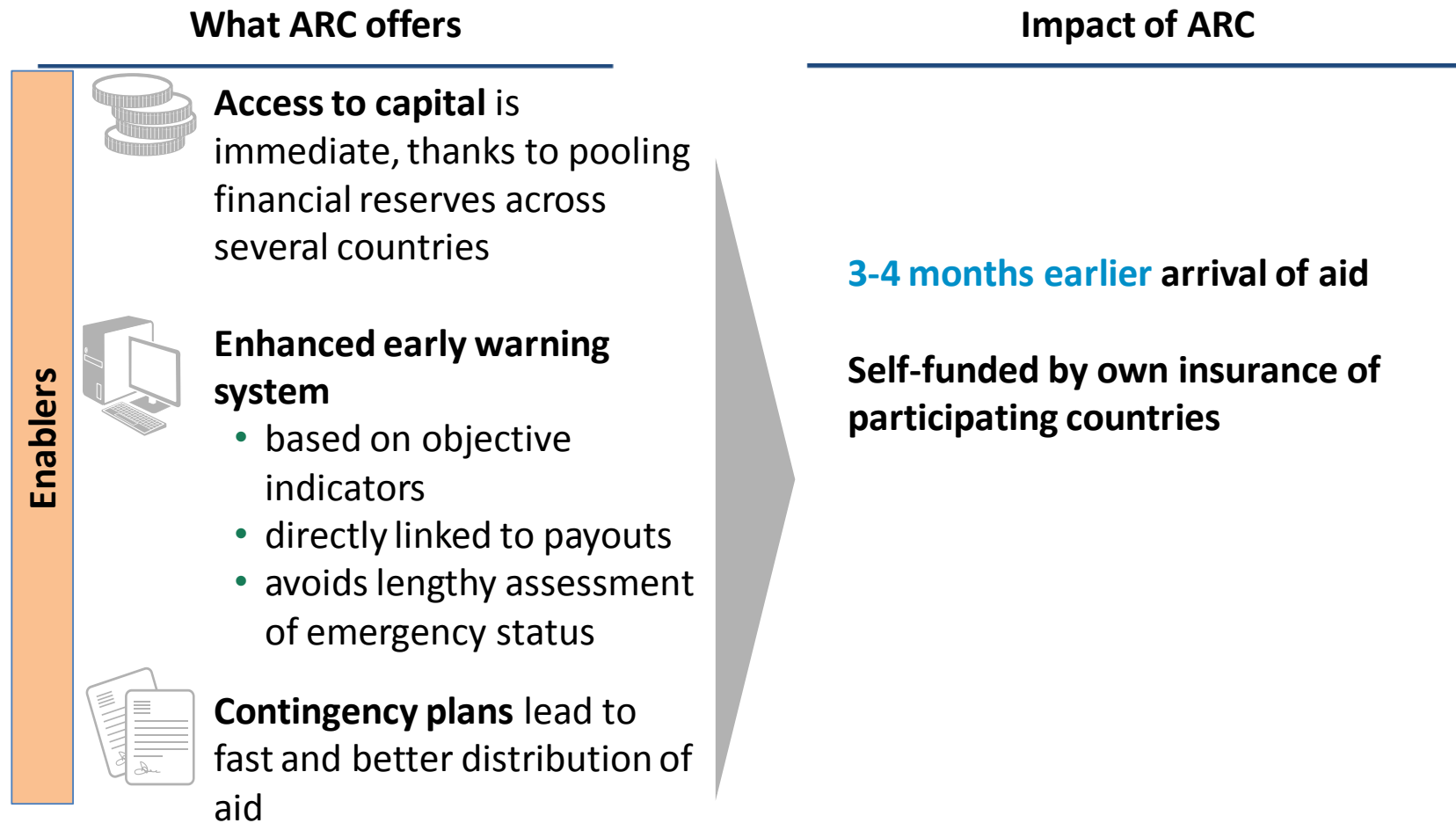
Source: IFPRI Cost-Benefit-Analysis, 2012; BCG analysis

## Chart 11A.6: Significant irreversible long-term consequences of food shortages

| Effects from<br>shortage of food supply<br>(3 -4 months before EMOP) | Long-term consequences                                                                                                                                                                   | Evidence                                                                                                                                                                                                      |
|----------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Malnutrition of<br>children                                          | <b>Irreversible underdevelopment &amp; disabilities, e.g.</b> <ul style="list-style-type: none"> <li>• Lower height</li> <li>• Slowed mental development</li> <li>• Blindness</li> </ul> | <b>14%</b> Reduced lifetime earnings due to health problems and lack of education <sup>1</sup><br><br><b>20%</b> of lost DALYs <sup>2</sup> in developing countries derive from malnutrition during childhood |
| Loss of productive<br>assets                                         | <b>Livestock / machinery sold, impacting next years' harvests</b>                                                                                                                        | <b>30%</b> Reduced cattle holdings even 10 years after drought <sup>3</sup><br><br><b>10%</b> Lower economic growth aggregated over 20 years due to loss of assets <sup>1</sup>                               |

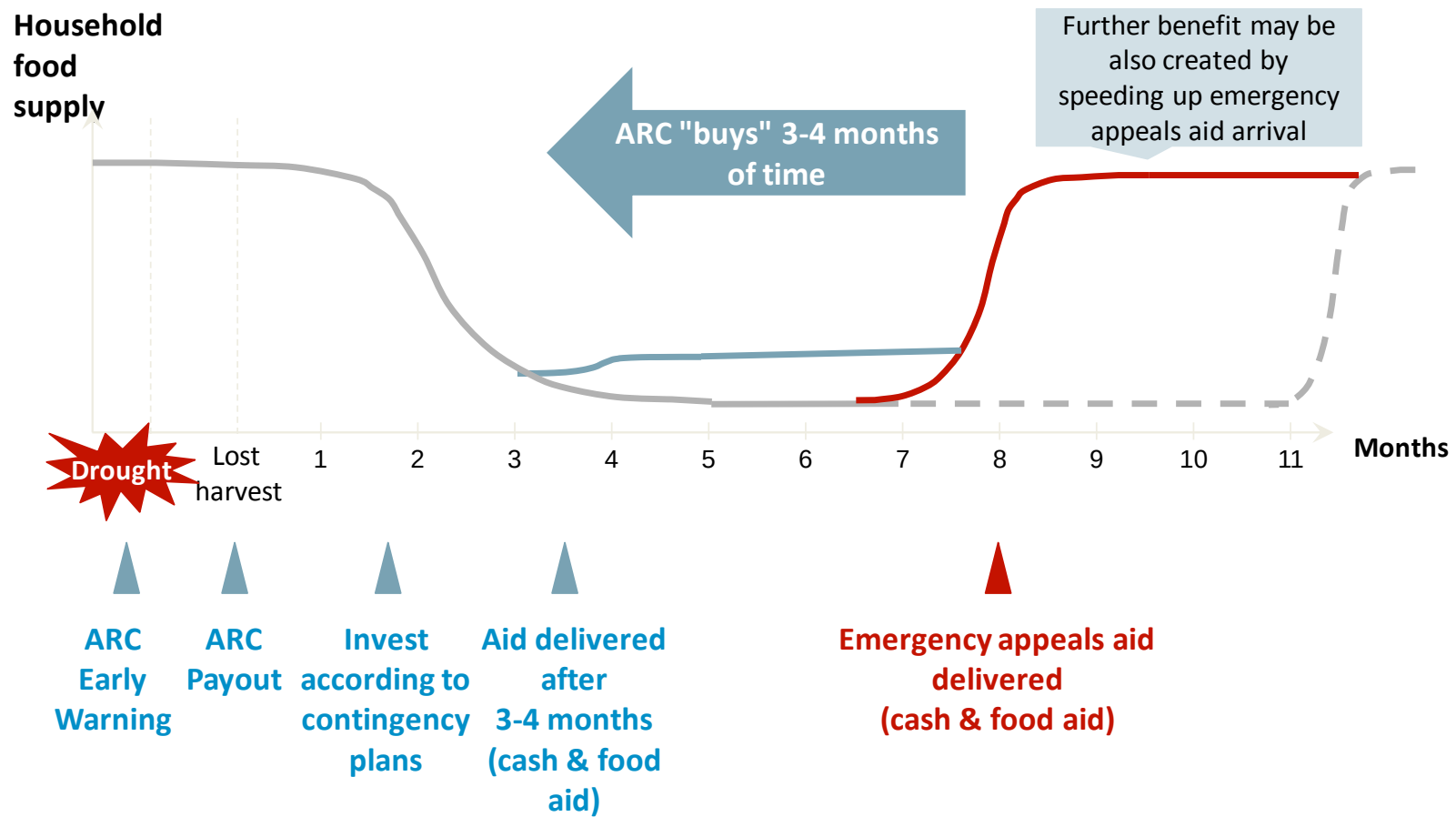
1. Evidence from Zimbabwe 2. DALY: disability-adjusted life years 3. Evidence from Ethiopia  
 Note: EMOP = Emergency appeal Operations  
 Source: IFPRI Cost Benefit Analysis, 2012; BCG analysis

## Chart 11A.7: "Buying" time is ARC's main value driver



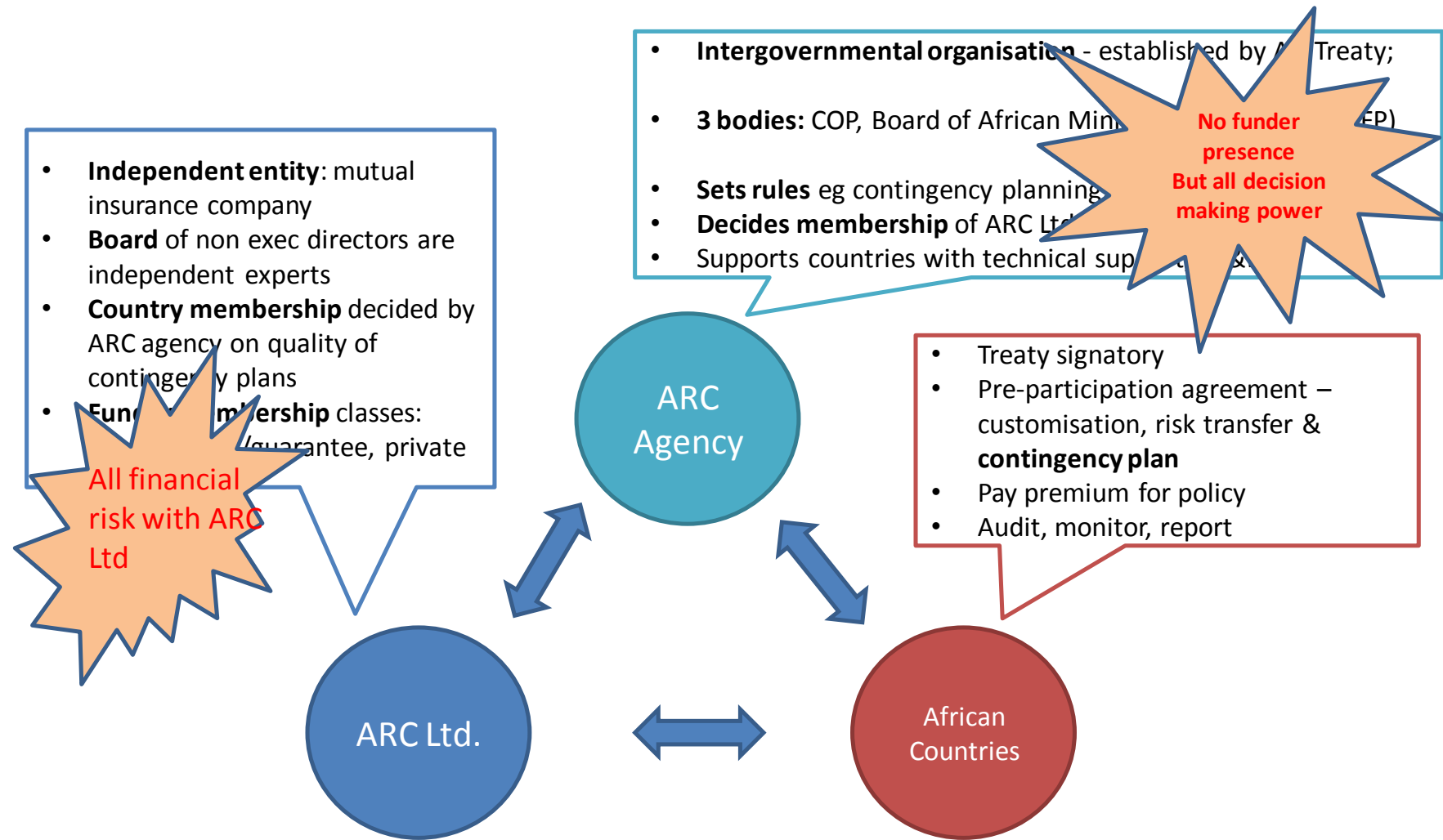
Source: IFPRI Cost-Benefit-Analysis; 2012

## Chart 11A.8: ARC helps fill the food supply gap until traditional emergency appeals aid arrives



Source: IFPRI Cost-Benefit-Analysis, 2012; BCG analysis

## Chart 11A.9: Delivery of the ARC Vision



### ARC Ltd. Structure

In late 2013, there were still issues of concern to DFID and other donors:

- ARC is a hybrid mutual insurance company, an innovative untested structure;
- It has Bermudan jurisdiction, which means managing perception versus flexibility for this novel form;
- There is no African “skin in the game” which, in turn, could mean a high risk donors that pay capitalisation and premiums in a number of countries; and
- There is insufficient protection for investors.

At that time: (a) there was also considered to be a need to provide more equity, probably on equivalent terms to KfW and with a Shareholders Agreement; and (b) it was foreseen that 3 tranches would be needed to scale up, with dynamic financial analysis to define contributions.

Negotiations are under way to have:

- The ARC Agency Board codify the maximum premium subsidy;
- “Proper use” term of insurance policy with sanctions (pay back, barred from ARC Ltd.);
- A proportion of premiums to be used for pay-outs (joint exposure) or kept as collateral against misuse; and

- The right of dissolution for investors and class vote in material decisions.

### Governance of ARC Ltd

The complexity of the ARC governance arrangements is discernible in Chart 12.10. Key governance issues are:

- All risks rest with ARC Ltd while all control appears to be with the ARC Agency;
- Complex governance arrangements with checks and balances poorly defined and accountability to the ARC Agency (COP) and not the funders;
- The ARC Agency - technical skills of the secretariat, time of directors, independence of directors and staff; and
- ARC Ltd. - director recruitment, procuring an insurance manager and legal officer.

Negotiations are under way to have:

- ARC Ltd. nominate independent experts to ARC Agency’s peer review;
- Full transparency of all decisions, plans, accounts, etc.;
- Open, competitive recruitment and procurement, clear terms (vs pro bono);
- Monitoring oversight of pay-outs;
- International accreditation of auditors; and
- An independent evaluation of ARC.

# Section 12

## Designing Structures to Manage DFID's Investments

### Framework

The framework for designing an appropriate structure to manage a DFID investment is set out in Table 12.1.

**Table 12.1: The Framework for Investment Management**

| Objectives         | Constraints                              | Structure Options | Instruments |
|--------------------|------------------------------------------|-------------------|-------------|
| Impact             | International Development Act 2002       | Direct investment | Grants      |
| Value for money    | State aid                                |                   | Loans       |
| Demonstrate value  | Government accounting rules              | Intermediary      | Equity      |
| Protect reputation | DFID Blue Book (currently being updated) | SPV               | Guarantees  |
|                    | ODA eligibility                          |                   |             |
|                    | Regulatory                               |                   |             |

### Objectives

Choice and design of structure impact on the achievement of DFID's objectives – see Table 12.2.

**Table 12.2: DFID Objectives**

|                            |                                                                                                                                                                                               |
|----------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Impact :</b>            | A structure that is attractive to others can leverage DFID's investment and so increase impact. The requirement for the investments to be 'additional' must be hard wired into the structure. |
| <b>Value for money:</b>    | Establishment and on-going transaction costs will depend upon the choice of structure.                                                                                                        |
| <b>Demonstrate Value:</b>  | The managers of DFID's investments must be obliged to assist DFID in demonstrating value, e.g. through results monitoring and case studies.                                                   |
| <b>Protect Reputation:</b> | DFID must allow DFID to ensure good governance and accountability.                                                                                                                            |

Good governance and effective risk management are also a sound basis for innovation.

### Constraints

#### International Development Act 2002

The Secretary of State must be satisfied that the assistance is 'developmental'. For example, it should be noted that the Treasury Solicitor's advice on the establishment of EAIF was that to be within

the Act the leverage ratio must be at least £1 commercial lending for each £1 of DFID equity.

### State Aid

Under Article 107 of the Treaty on the Functioning of the EU: DFID may not grant a selective advantage to any undertaking from state resources that distorts competition in the EU and has a potential effect on trade between EU Member States. Should these regulations be breached then the European Commission has the power to order that the relevant “aid” be recovered by DFID.

However, as DFID is seeking to address ‘market failures’, it could be successfully argued that there is no market to distort but this should be evaluated in relation to each case.

### ODA Eligibility

DFID should consider whether and when its contribution will count as ODA, bearing in mind that different rules apply to different funding instruments.

It is also possible to consider registration of a multi-donor entity with the OECD DAC so that flows count as ODA when invested and re-flows to the entity do not count as negative ODA.

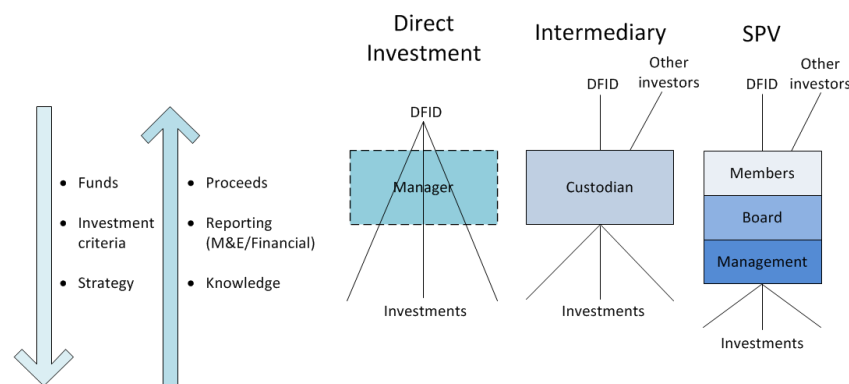
### Regulatory Considerations

The investment management itself and seeking other investment could be regulated activities requiring appropriate approvals.

## Structure Options

The structure options to be considered are shown in Chart 12.1.

**Chart 12.1: DFID Potential Investment Structures**



In the case of a direct investment (such as the Day Chocolate Company Guarantee):

- DFID invests directly or appoints a manager to invest on DFID’s behalf; and
- DFID directly assumes the risk of gain or loss and associated legal and moral liability.

When wishing to use an intermediary, DFID identifies a trusted third party who assumes legal liability. For example:

- Agra in the case of Africa Enterprise Challenge Fund (AECF);
- International Finance Facility for Immunisation (*IFFIm*); and
- Advance Market Commitment (*AMC*).



If DFID is considering establishing a separate vehicle then DFID consults with HMT on its policy towards the establishment of the SPV to house the planned DFID investment(s). Examples of current SPVs are:

- Trade Mark East Africa (*TMEA*)
- Financial Sector Deepening Kenya (*FSD*)
- Private Infrastructure Development Group (*PIDG*).

Pipeline SPV investments are:

- Joint Ventures for Prosperity
- Global Development Innovations Ventures
- Africa Risk Capacity.

## Drivers for Structure Choice

There are six drivers for the choice of the most appropriate structure:

- Managing risk: Does the choice of structure enhance DFID's ability to manage risk e.g. ring fencing liability or intermediaries' use of specialist service providers?
- Value for money: taking full account of the costs involved in establishing and managing the transaction;
- Tax: Use of low tax jurisdictions? Use of charitable companies? Use of tax transparent vehicles?

- ODA eligibility: When does investment become ODA? Treatment of reflows?
- Public body classification: Control could bring the entity within public body classification; control and not just direct control (i.e. contractual control rights); implications (recruitment rules, approval processes) which will depend on classification; and consult with HMT and Cabinet Office as early as possible.
- Impact: Will the choice of structure allow greater leverage?
- What about the views and working relations with other donors? What will be the impact of and on private sector managers and investors?

## Establishing an SPV

For DFID to establish an SPV requires:

- Treasury approval
- Ongoing consultation with Treasury on SPV's, which is easier if multi-donor and not controlled/established by DFID alone;
- Public body status if controlled by a UK government body; and
- Other options to have been considered, e.g. custodian, management contract?

## Location and Structure

Location and structural issues have to be identified and assessed (Table 12.3).

**Table 12.3: Location and Structure**

|                  | Drivers                                                                                                                                                                                                                                                                         | Issues                                                                                                        |
|------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------|
| <b>Location</b>  | <p>Prevailing and predicted situation in location of investment activity.</p> <p>Access to expertise.</p> <p>Location of sponsors.</p> <p>Value for money, e.g. travel costs.</p> <p>Operational – e.g. regulatory, availability of suitable structures, exchange controls.</p> | <p>Use of low tax jurisdictions</p>                                                                           |
| <b>Structure</b> | <p>Not for profit – non-profit distributing – e.g. a UK company limited by guarantee or a trust.</p> <p>For profit – e.g. Limited liability partnership or a company limited by shares.</p>                                                                                     | <p>Charitable purpose?</p> <p>Tax transparency (LLP?)(Sovereign status).</p> <p>Distribution of proceeds.</p> |

## Governance

The governance issues to be considered are summarised in Table 12.4.

**Table 12.4: Governance**

|                                 | Issues                                       | Considerations                                                                                                                          |
|---------------------------------|----------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|
| <b>Membership</b>               | Should DFID become a member?                 | Limited liability                                                                                                                       |
| <b>Appointment of Directors</b> | Should DFID appoint directors?               | <p>Vicarious Liability</p> <p>Shadow directorship</p> <p>Relevant expertise</p> <p>Nomination rights</p> <p>Adequate representation</p> |
| <b>Management</b>               | In house management team or contracting out? | <p>Service providers can be changed but loss of know how.</p> <p>Public procurement</p> <p>Incentives (vfm)</p>                         |

## Risk Mitigation

All necessary steps must be taken to mitigate risk – Table 12.5.

**Table 12.5: Risk Mitigation**

| Risk               | Impact                                       | Mitigation                                                                               |
|--------------------|----------------------------------------------|------------------------------------------------------------------------------------------|
| Mission creep      | Reduced impact                               | Business Plan<br>Logframe<br>Investment Policy<br>M&E                                    |
| Governance issues  | Reputational risk<br>Reduced impact          | Donor approvals<br>Code of Conduct<br>Operating Policies<br>Audit                        |
| Performance issues | Reduced Impact<br>Reduced value for money    | Results monitoring<br>Periodic reviews<br>(including board direction)<br>Tranche funding |
| Inability to exit  | Loss of investment<br>Reputational liability | Building in exit rights<br>Different instruments offer different options.                |

## Investment Portfolio Management

To minimise the potential adverse affect of an under-performing or failed investment, care must be taken to avoid concentrations of similar types of investments in a specific industry sector or in one country or region. This suggests that, although DFID is not normally in the investment business, when it does invest it should consider diversifying its portfolio.

## Measuring and Assessing Impact

An investor or lender has clear methods for measuring and assessing the impact of financial support, essentially based on financial returns. However, in DFID's case, the impact and assessment must also include the sustainable socio-economic benefits to the ultimate beneficiaries. The latter should be more important than the financial returns to DIFD but may not be easy to determine.

A

## Annex A:

### Definitions of Some Financial Terms

**Basic Point** (appearing as “BPS” or “bps”): A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

**Carried Interest** or **Carry**: In finance, specifically in alternative investments (i.e., private equity and hedge funds), carry is a share of the profits of an investment or investment fund that is paid to the investment manager in excess of the amount that the manager contributes to the partnership. As a practical matter, it is a form of performance fee that rewards the manager for enhancing performance.

**Commercial Risk**: To an ordinary businessman, a *commercial risk* could be any type of risk other than a political risk that could adversely affect a business, most usually the financial risk assumed by a seller when extending credit to a buyer without any collateral or recourse but. However, in the financial sector, it has a narrower definition: the risk that a debtor will be unable to pay its debts because of business events, such as bankruptcy.

**Committed Facility**: A credit facility, available at any time but for which the terms and conditions are clearly defined by the lending institution and imposed upon the borrowing company. Credit under the facility is

available to the borrower if and only if the borrower meets the requirements imposed by the lender; and the requirements are often very strict.

**Commodity Swap**: A swap in which exchanged cash flows are dependent on the price of an underlying commodity. A commodity swap is usually used to hedge against the price variation of a commodity.

**Contingent Convertible**: A security similar to a traditional convertible bond in that there is a strike price (the cost of the stock when the bond converts into stock). What differs is that there is another price, even higher than the stock price, which the company’s stock must reach before an investor has the right to make that conversion (known as the “upside contingency”).

**Credit Facility**: Any type of loan made in a business or corporate finance context. Types of credit facilities include: revolving credit, term loans, committed facilities, letters of credit and most retail credit accounts.

**Coupon**: The interest rate (also referred to as the “coupon rate” or “coupon percent rate”) stated on a bond when it is issued. The coupon is typically paid semi-annually. It is called a “coupon” because some bonds literally have coupons attached to them that represents a sum of interest due and which a bondholder presents to request payment. Coupon payments may be based on fixed or floating interest rates, and coupons are therefore known respectively as fixed or floating coupons.

**DBFO**: Design, build, finance, and operate contract.

**Derivative:** A financial contract which derives its value from the performance of another entity such as an asset, index, or interest rate, called the "underlying". Derivatives are one of the four main categories of financial instruments, the other three being equities (i.e. stocks), debt (e.g. bonds and mortgages), and insurance. Derivatives include a variety of financial contracts, including *futures*, *forwards*, *swaps*, *options*, and variations of these such as *caps*, *floors*, *collars*, and *credit default swaps*. Derivatives are traded over-the-counter (off-exchange) or on an exchange.

**EPC Contract:** The contract for engineering, procurement and construction services needed for infrastructure development projects.

**ECA:** An export credit agency (known in trade finance as ECA) or investment insurance agency, is a private or quasi-governmental institution that acts as an intermediary between national governments and exporters to issue export financing. The financing can take the form of credits (financial support) or credit insurance and guarantees (pure cover) or both, depending on the mandate the ECA has been given by its government. ECAs can also offer credit or cover on their own account. This does not differ from normal banking activities. Some agencies are government-sponsored, others private, and others a bit of both. ECAs currently finance or underwrite about US\$430 billion of business activity abroad - about US\$55 billion of which goes towards project finance in developing countries - and provide US\$14 billion of insurance for new foreign direct investment, dwarfing all other official sources combined (such as the World Bank and regional development banks, bilateral and multilateral aid, etc.). As a result of the claims against developing

countries that have resulted from ECA transactions, ECAs hold over 25% of these developing countries' US\$2.2 trillion debt.

**FCA:** This acronym can mean many things, even in the financial world. The most common uses are: (1) Fellow of the Institute of Chartered Accountants (in various jurisdictions); (2) foreign currency adjustment; (3) functional control audit; and (4) financial conduct authority.

**First Loss Investment:** A financial instrument, usually a grant (which may or may not be repayable) that lowers the risk on returns of other financial providers because they take priority.

**Hurdle Rate:** The minimum return necessary for a fund manager to start collecting incentive fees. The hurdle is usually tied to a benchmark rate such as Libor or the one-year Treasury bill rate plus a spread. If, for example, the manager sets a hurdle rate equal to 5%, and the fund returns 15%, incentive fees would only apply to the 10% above the hurdle rate.

**Interest Rate Cap:** A derivative in which the buyer receives payments at the end of each period in which the interest rate exceeds the agreed strike price. An example of a cap would be an agreement to receive a payment for each month the LIBOR rate exceeds 2.5%. Similarly an interest rate floor is a derivative contract in which the buyer receives payments at the end of each period in which the interest rate is below the agreed strike price. Caps and floors can be used to hedge against interest rate fluctuations. For example a borrower who is paying the LIBOR rate on a loan can protect himself against a rise in rates by buying a cap at 2.5%. If the interest rate exceeds 2.5% in a given period the payment

received from the derivative can be used to help make the interest payment for that period, thus the interest payments are effectively "capped" at 2.5% from the borrower's point of view.

**Interest rate Swap (IRS):** A highly liquid financial derivative instrument in which two parties agree to exchange interest rate cash flows, based on a specified notional amount from a fixed rate to a floating rate (or vice versa) or from one floating rate to another. Interest rate swaps are commonly used for both hedging and speculating.

**Letter of Credit:** A document issued by a financial institution, or a similar party, assuring payment to a seller of goods and/or services provided that certain documents have been presented to the bank. The required documents must prove that the seller has performed the duties under an underlying contract (e.g., sale of goods contract) and that the goods (or services) have been supplied as agreed. In return for these documents, the beneficiary receives payment from the financial institution that issued the letter of credit. Until the letter of credit is presented it serves as a guarantee to the seller that it will be paid regardless of whether the buyer ultimately fails to pay. In this way, the risk that the buyer will fail to pay is transferred from the seller to the letter of credit's issuer. The letter of credit can also be used to ensure that all the agreed upon standards and quality of goods are met by the supplier, provided that these requirements are reflected in the documents described in the letter of credit. Letters of credit are used primarily in international trade for transactions between a supplier in one country and a customer in another.

**Loan (or credit facility) Amortization:** The gradual elimination of a liability, such as a mortgage, in regular payments over a specified period of time. Such payments must be sufficient to cover both principal and interest.

**Loan-to-Value (LTV):** The ratio of the fair market value of an asset to the value of the loan that will finance the purchase. Loan-to-value informs the lender if potential losses due to non-payment may be recouped by selling the asset.

**P8:** The P8 Group brings together senior leaders from some of the world's largest public pension funds to develop actions relating to global issues and particularly climate change. It is an initiative of the Cambridge Programme for Sustainability Leadership and the HRH Prince of Wales's Business and Environment Programme supported by the Environmental Capital Group and the Nand & Jeet Khemka Foundation. The P8 Group involves ten leading global pension funds and sovereign wealth funds, including representatives from Europe, Asia, Australasia and North America. They represent over \$3 trillion of investment capital and, as pension funds, have an inherently long term focus.

**PE Funds:** Private equity funds.

**Revolving Loan (credit):** A flexible loan, usually on a piece of real property, whereby the borrower is able to make loan repayments at will instead of a set repayment schedule. The borrower is also able to use more money from the loan if there are more funds available under the loan ceiling.

**Security:** (1) A tradable asset of any kind. *Equity securities* are usually common stock (shares); *debt securities* include banknotes, bonds and debentures; and *derivative securities* include forwards, futures, options and swaps. Securities may be represented by a certificate or, more typically, "non-certificated", that is in electronic or "book entry" only form. Certificates may be *bearer*, meaning they entitle the holder to rights under the security merely by holding the security, or *registered*, meaning they entitle the holder to rights only if he or she appears on a security register maintained by the issuer or an intermediary.

(2) The pledge over assets and promoter guarantee held by a lender during the development stage of a project.

(3) The pledge over receivables (and often physical assets in addition) held by a lender during the borrower's commercial operations.

**Skin in the game:** A term coined by renowned investor Warren Buffett referring to a situation in which high-ranking insiders use their own money to buy stock in the company they are running. It can also be applied to a situation where a fund manager invests in a fund he is managing.

**Stretch Loan:** A specific type of loan that possesses certain characteristics of both asset-based loans and cash-flow loans. Senior stretch loans are cheaper than straight cash-flow loans since the borrower must have a healthy balance sheet and demonstrate the ability to generate sufficient cash-flows to satisfy their obligations. A stretch loan is usually requires a large proportion of the borrower's cash flows to service the loan on a monthly basis. Often, this benchmark is 50% of the party's gross income or more. Stretch loans are extended to companies that are in dire need of financing. Due to the relatively higher default and financial

risk, lenders may require collateral or a large initial down payment before making a stretch loan.

**Term Loan:** A loan for a specific amount that has a specified repayment schedule and a floating interest rate. Term loans usually mature between one and 10 years.

**Warrant:** A security that entitles the holder to buy the underlying stock of the issuing company at a fixed price until the expiry date.

**Waterfall Payment:** A type of payment scheme in which higher-tiered creditors receive interest and principal payments, while the lower-tiered creditors receive only interest payments. When the higher tiered creditors have received all interest and principal payments in full, the next tier of creditors begins to receive interest and principal payments.

## **Annex B:**

### **Public-Private Partnerships**

#### **Why PPPs?**

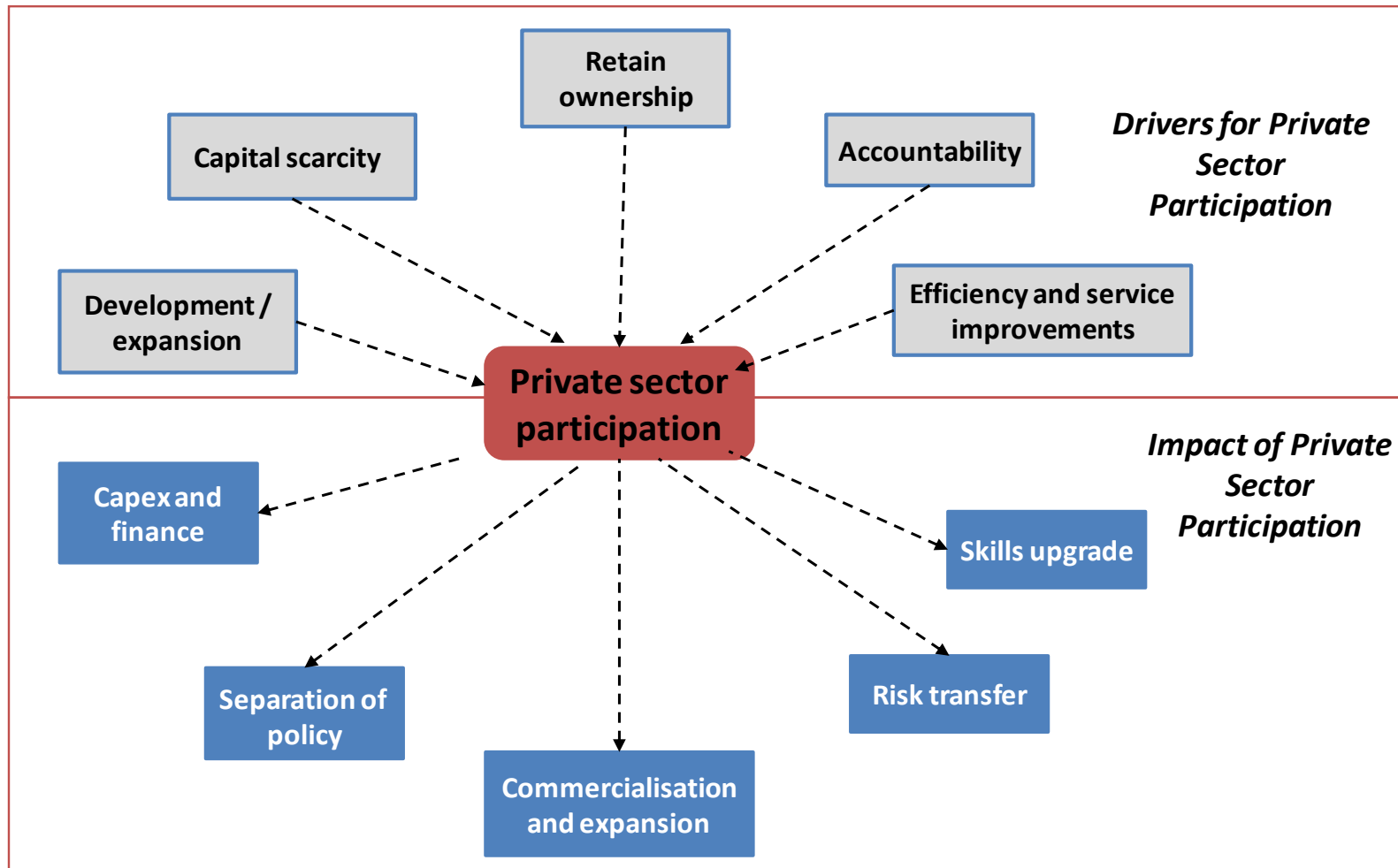
Public-private partnerships are arrangements that in the past were promoted as a form of partial privatisation. More recently, PPPs have been recognised as an important potential channel for private sector development because they offer opportunities for private firms to enter industries and/or markets that are capital intensive and where public institutions have already made substantial investment. Thus PPPs offer private firms the opportunity to “capitalise” on existing major public investment by bringing additional investment, innovation and management capability. The possible private sector objectives and impact of participating in a PPP are shown in Chart B.1.

PPPs can take many forms, with varying levels of private sector control, responsibility and risk sharing; these are shown in Chart B.2. The more usual form of PPP – management contract, concessions/DBFOs, long term leases, and share sales are outlined with examples in Charts B.3-B.6.

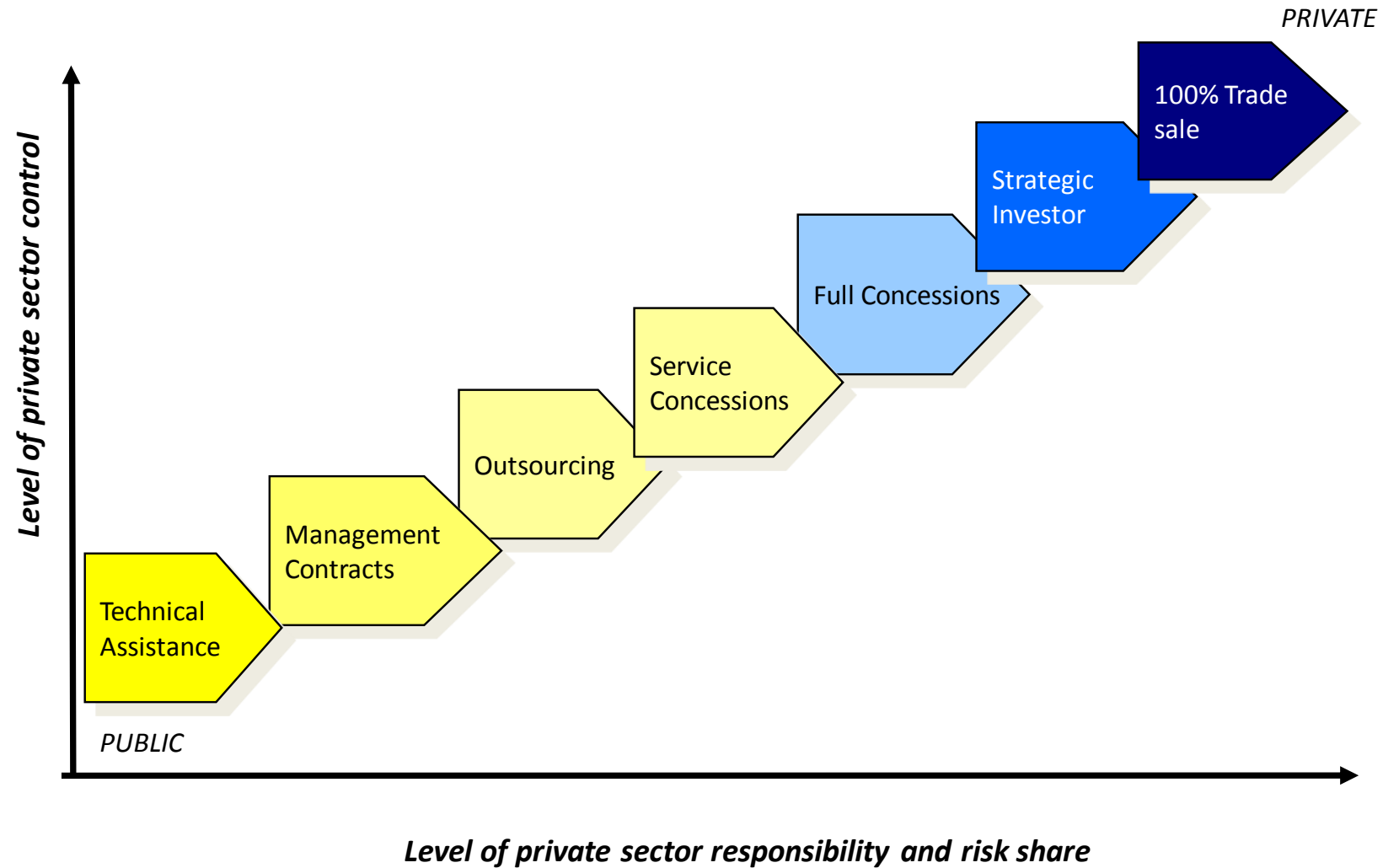
We shall look at two examples of PPPs: (1) St Helena airport; and (2) Healthcare PPPs in India.



## Chart B.1: Private Sector Objectives and Impact of PPPs

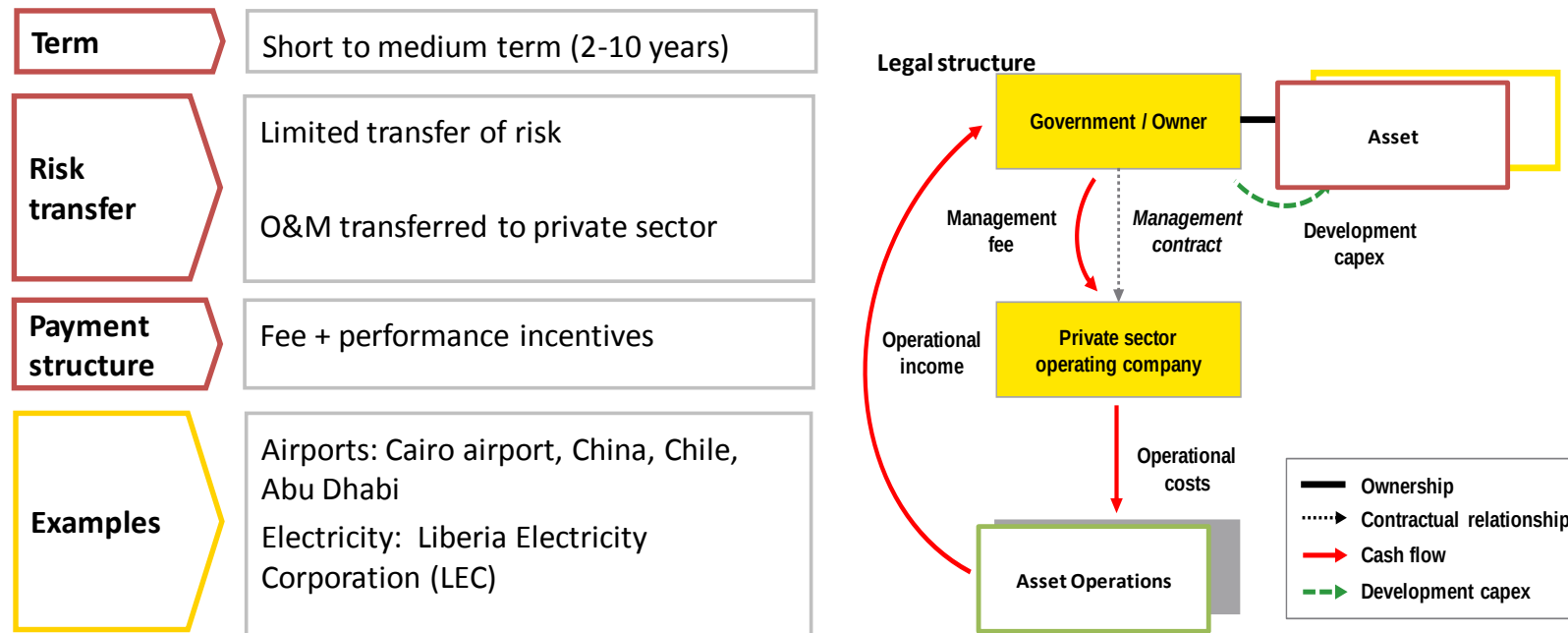


## Chart B.2: Wide Ranging Models for PPPs



## Chart B.3: PPP Structures - Management Contracts

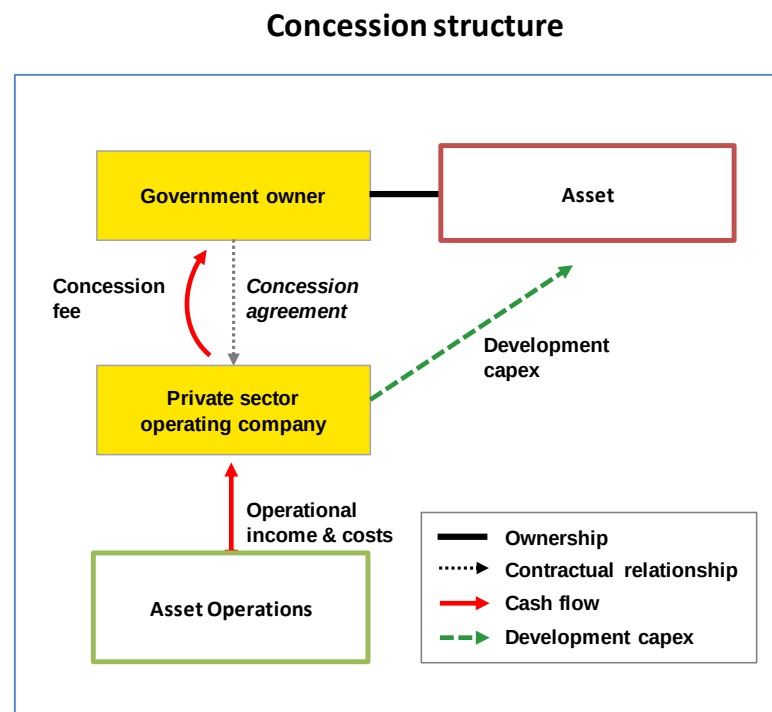
- Third party contracted to operate for an agreed fee
- Introduction of skills to deliver efficiencies and increase operating margins
- Owner retains control
- Improve performance (prior to privatisation)
- Recent developments: Outsourcing as an advanced form of Management Contracts



## Chart B.4: PPP Structures - Concessions / DBFO

- Most widely used PPP structure
- Government retains ownership
- Full business risk transfer to concessionaire
- Often includes significant capital investment obligations

|                          |                                                                                                                                     |
|--------------------------|-------------------------------------------------------------------------------------------------------------------------------------|
| <b>Term</b>              | Typically 25-50 years                                                                                                               |
| <b>Risk transfer</b>     | Significant transfer of risk<br>Concessionaire responsible for business risk                                                        |
| <b>Payment structure</b> | Upfront payment and/or annual concession fee                                                                                        |
| <b>Examples</b>          | Airports: Cyprus, Athens, Jordan, etc.<br>Rift Valley Railway Kenya & Uganda<br>Highways: N-4 Toll Road (South Africa & Mozambique) |

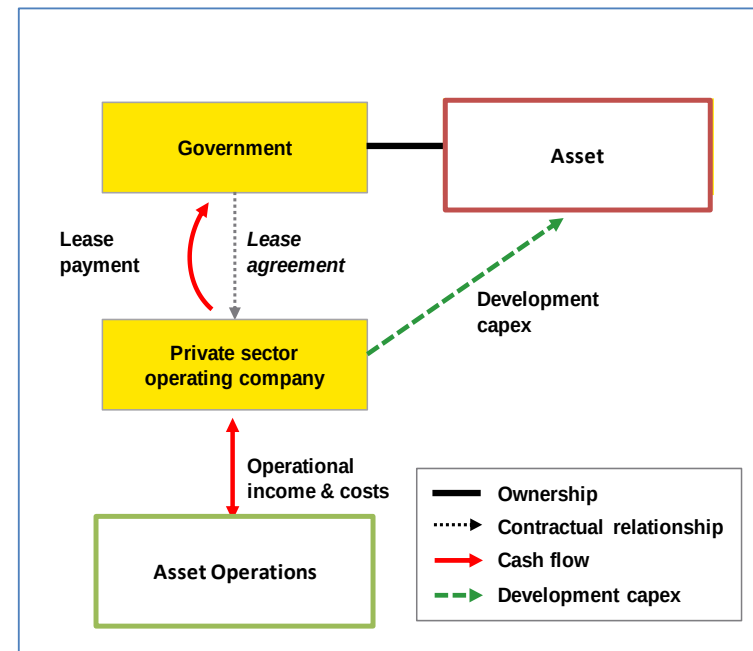


## Chart B.5: PPP Structures - Long Term Lease

- Largely the same characteristics as a concession structure.
- There may be differences in the legal structure due to differences in contractual agreement.
- The key differences are that typically a long term lease is for a longer contractual term compared to a concession and may have less specific development capital expenditure requirements

|                          |                                                                               |
|--------------------------|-------------------------------------------------------------------------------|
| <b>Term</b>              | Typically 50-99 years                                                         |
| <b>Risk transfer</b>     | Similar to concession structure                                               |
| <b>Payment structure</b> | Upfront payment and/or annual lease payment                                   |
| <b>Examples</b>          | Budapest airport (75 year lease)<br>Owen's Falls Facility – Eskom Enterprises |

Long term lease structure



## Chart B.6: PPP Structures - Share Sale

- Majority sale – Investor acquires all (or majority) of the shares in a business and takes over all risks and responsibilities.
- Minority sale – Owner may look to sell a minority stake in order to retain certain controls over the asset.
- Successful sale transactions typically involve little or no commitment from the acquirer to a particular capital investment programme.

### Risk allocation

#### Outright sale

All risks transferred to the acquirer including: ownership, investment, operations and profits.

#### Partial sale

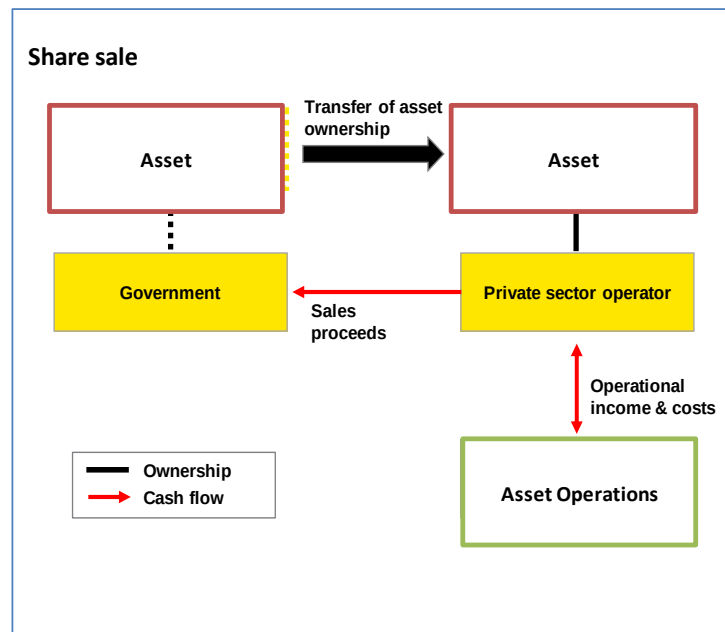
Degree of risk transfer depends on percentage of shares acquired.

### Payment structure

Upfront payment, where the purchase price is determined based on the net present value of forecast cash flows.

### Global precedents

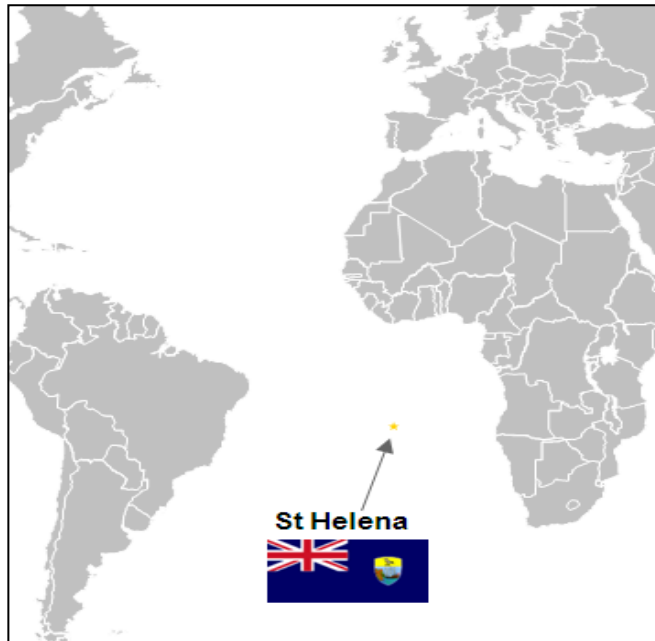
Nigeria: Power sector privatisation  
Phillipines: Power sector PSP  
Cameroon: Power sector partial privatisation



## St Helena Airport

### Initial Phases – up to 2008

St Helena, an overseas British territory, is a remote island of volcanic origin with declining population of around 5,000. Access is by a single ship (RMS St Helena) which operates on a 21-day turnaround and needs replacement.



An airport project was conceived to maintain access, economic development and self reliance:

- 1999 - the UK Govt first considered building an airport on the island of St Helena

- 2003 – Procurement process #1 for PPP – Aborted
- 2008 – Procurement process #2 – Halted
- Cost estimates increased from £100M to £300M in this period.

### Turnaround and Success: Hybrid PPP

In 2010 the process restarted with 2 shortlisted parties. In mid-2011 one bidder pulled out and DFID continued in sole source negotiations with the remaining bidder. A contract was executed for a “Hybrid BOT PPP” transaction: Construction plus 10 years operations.

Significant value for money was achieved through the negotiations:

- Government funding but with the principles of a privately funded project;
- Built to purpose;
- Operate to needs: 1-2 flights a week initially;
- Market testing on costs;
- Community involvement
- Innovative risk sharing (e.g. fuel);
- Comprehensive monitoring regime; and
- Early warning systems to manage risk.

The result was a contract that met DFID preconditions and a price 20% below previous offers.

## Indian Healthcare PPPs

A series of healthcare PPP transactions in India required completion. Initial work was to effectively privatise an Indian State's Health Insurance programme:

- 3 million people registered paying into 2 types of care packages;
- State administered and inefficient (slow payment and slow approval / processing);
- “privatised” effectively to a commercial insurer; and
- Addition of one BOP care package to include people who have traditionally paid “out-of-pocket”.

A range of new healthcare facilities were developed including a hospital and teaching hospital, diagnosis facilities and out-patient treatment facilities. These transactions are on-going; however, effectively:

- All facilities are completed on a DBFO basis, with some absorbing of existing facilities;
- Contractors have bid to build the hospitals in consortia with professional / clinical teams to operate the facilities; and
- Tendering completed on an “international standard” basis, with selection criteria being:
  - Lowest cost, best service (effectively a value for money assessment)
  - Local content
  - Most technically competent (linked to VfM).



## Annex C:

### Valuing Investments

This annex cannot deal comprehensively with this specialised subject but is included with the course notes in order to show the complexity of business valuation and the principal approaches used by specialist advisors.

#### Fair Value

Reference is made in Section 2 to “fair value” with respect to equity and returnable grant investments. A standard definition of “fair market value” is: a value of a business enterprise determined between a willing buyer and a willing seller both in full knowledge of all the relevant facts and neither compelled to conclude a transaction. However, the hypothetical situation set out in this definition does not actually apply when valuing an equity or other form of investment stake in a business at a specific balance sheet.

Fair value is important because it is preferred to “book value” Book value is the value of a business as shown in its latest/current balance sheet; but the book value could be substantially more or less than the real market value of the business.

#### Going Concern Basis

Unless a special situation has arisen, such as a business that is in the process of being liquidated, a valuation is normally made on a *going*

*concern basis*, i.e. the value of the business is based on the assumption that it is an ongoing operating enterprise (not at the balance sheet date but at the time of performing the valuation).

#### Business Valuation Methods

There are four commonly accepted ways to value a business:

1. *Income* approach, which determines the value by calculating the net present value of the benefit stream generated by the business;
2. *Asset-based* approach, which determines the value by adding the sum of the various parts of the business (net asset value);
3. *Market* approach, which determines the value by comparing the subject company to other companies in the same industry, of a similar size and/or within the same region; and
4. *First Chicago* method, which combines the income and market approaches.

There are other valuation methods in use in developed economies but these would not be applicable to a business in a developing economy lacking mature stock and bond markets and/or where political stability is uncertain.

## Discount Rates

A *discount* rate (sometimes referred to as a *capitalisation* rate) is used in some of the above methods to determine the present value of the expected returns of a business. Generally speaking, the discount rate may be defined as the yield necessary to attract investors to a particular investment, given the risks associated with that investment. Discount and capitalisation rates are calculated using the following main methods:

- Capital asset pricing model;
- Modified capital asset pricing model;
- Weighted average cost of capital; and
- Built-up method

The valuation approaches outlined below should yield a *fair market value* of the company as a whole. However, in valuing a minority, non-controlling interest in a business, a valuation professional would consider the applicability of discounts that affect such interests. Consideration of discounts (and also premiums) usually begins with a review of the *levels of value*. There are three common levels of value: (1) controlling interest; (2) marketable minority; and (3) non-marketable minority. In DFID's case, given that it would only engage in programmes supporting developing economies and would avoid a controlling interest, it is likely that the non-marketable minority level of value would be applicable to valuing its equity and returnable grant holdings. This would employ

a discount for lack of control and, in most cases, a discount for lack of marketability.

## Income Approach

The income approach relies on the economic principle of expectation: the value is based on the expected economic benefit and level of risk associated with the investment. Income based valuation methods determine fair value by dividing the benefit stream generated by the subject company times a discount rate. The discount rate converts the stream of benefits into present value.

There are several different income methods, including: (a) capitalisation of earnings or cash flows; (b) discounted cash flow; and (c) the excess earnings method (which is a hybrid of asset and income approaches).

The result of a value calculation under the income approach is generally the fair market value of a controlling, marketable interest in the subject company.

Discounted cash-flow analysis is often used for projects or infrastructure with predictable cash flows.

## Asset-Based Approaches

The asset approach to business valuation is based on the principle of substitution: no rational investor will pay more for the business than the cost of procuring assets of similar economic utility. While it does not apply subjective discount rates, since it uses the

adjusted net book value, it is not the most probative method for determining the value of a going concern business. For example, it does not consider the value of intangible assets, such as goodwill, which are generally impossible to determine apart from the overall value of a business. Hence, an asset-based approach can often yield a lesser than fair market value. For this reason a valuation professional will consider whether the shareholder whose interest is being valued would have any authority to access the value of assets directly.

This approach is used for businesses having a mature or declining growth cycle and is more suitable for capital intensive industries.

Adjusted net book value is most relevant value when: (a) liquidation is imminent or ongoing; (b) a company's earnings or cash flow are minimal, negative or worth less its assets; or (c) it is the standard in the industry in which the company operates.

### **Market Approaches**

The market approach to business valuation is based on the economic principle of free competition whereby supply and demand forces drive the price of business assets to a certain equilibrium. A typical example is the market price of stocks of publicly traded companies of similar size and operating in the same or similar business.

The market approach employs comparable multiples (EV/Revenue, EV/EBITDA, P/E) and used for established businesses.

The difficulty in developing economies is that there typically are few, if any, public companies that can be used for comparison purposes. Note also that the equity of a private company is very likely to be less easy to buy or sell than for a public company and, consequently, its value should be considered to be slightly lower than a market-based valuation would suggest.

When there is a lack of comparison with direct competition, a professional valuer might use a vertical value-chain approach as an alternative.

### **Industry Norms**

It should be noted that certain businesses, notably mining and other extractive industries, employ a standard valuation method adapted for that industry.

### **Financial Information**

It should be borne in mind that a reasonably accurate valuation of a company (and especially if the majority of the company is privately owned) largely depends on the reliability of the firm's historical financial information. Unless operating in a regulated industry, private firms do not have government oversight and may appoint auditors as they choose. For this reason, DFID would place emphasis on governance, including the calibre of the external auditors, to ensure confidence in the timeliness and quality of financial reporting. In particular, the financial statements must be prepared in accordance with generally accepted accounting principles.