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PRACTICAL INFORMATION

HERMES COVER SPECIAL

Project finance – the essentials

EXPORT CREDIT GUARANTEES OF THE  
FEDERAL REPUBLIC OF GERMANY

► **Hermes Cover**

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## Project finance – the essentials

The Export Credit Guarantees of the Federal Republic of Germany are an instrument for the promotion of German exports and react flexibly to the constantly changing developments in the export and finance world. In fact, this is the only way in which they can retain their effectiveness in fulfilling this remit. That is especially true in the specialised segment of project finance, which has been offered by the Federal Government since 1988. The Federal Government, with Euler Hermes Aktiengesellschaft, which is commissioned to handle the export credit guarantees, was one of the first state export credit insurers to become involved in this field of finance.

In the intervening period, the requirements stipulated by the Federal Government in connection with this business have become increasingly more precise and differentiated, especially with regard to collateral. On the other hand, it has become apparent that transactions of this type must be approached flexibly on a case-by-case basis. The description of the Federal Government's requirements for project finance cover set out on the following pages can therefore often only sketch a theoretical ideal of this type of business.

### WHAT DOES THE FEDERAL GOVERNMENT REGARD AS BEING PROJECT FINANCE BUSINESS?

The term project finance is firmly established in the financing world, even though there is no generally agreed definition for it. Starting from the normally accepted features, the Federal Government defines a project financed transaction as being an investment project made by a **legally and economically independent special purpose company (SPC)**, which **exclusively generates the operating costs and services the debt repayment out of the proceeds of the project**. It is thus a form of finance which focuses on the direct revenues of the project (cash flow-related lending) which, as off-balance sheet financing, does not appear in the financial statements of the investor.

### WHAT ARE THE ADVANTAGES OF PROJECT FINANCE?

Investments in the project finance field often have a large volume. If the investor were to borrow the necessary funds via a normal buyer credit, it would have a **negative impact on its balance sheet ratios**, and this would have an adverse knock-on effect on its creditworthiness. This aspect is a crucial one, especially when we consider the minimum capital adequacy rules for banks' credit risks under the Basel II Convention.

In order to realise such a project **off their own balance sheet**, investors therefore set up an SPC as a project company, which is the sole borrower in its own right. The borrowed funds needed for the project thus only appear on the balance sheet of the SPC. The shareholders of this SPC are the investors, which, on the one hand, supply the equity and, on the other – on a secondary level – share in the proceeds of the company via the dividends they receive.

The investors are liable to the lenders, and thus also towards the Federal Government, with the equity they have contributed to the SPC. If the investors have no further liability beyond this, we have a case of non-recourse financing. Under normal circumstances the Federal Government does, however, expect the investors to undertake further commitments with regard to the project (e.g. through an obligation to make additional contributions in the event of construction-cost overruns). This type of scheme is known as limited-recourse financing.

#### WHAT PROJECT FINANCE RISKS ARE COVERED BY THE FEDERAL GOVERNMENT?

The entire palette of Federal Government cover is available for project financed business. The exporter will first of all think here of **cover of manufacturing risks** as well as the **risk of non-disbursement of the loan** under a (similarly covered) buyer credit. The financing bank can get buyer credit cover to insure against the **risk of the loan amount being uncollectable** for commercial or political reasons.

The Federal Government is also prepared to carry the risk of completing the plant in project financed transactions. This willingness is of crucial importance, since the risk that the plant is not completed on time or at all is one of the central risks of the project, which far transcends the pure initial construction schedule for the project.

In line with normal procedures, the Federal Government also does not accept any **documentation risks**, i.e. the policyholder bears the risk that the underlying contractual agreements concerning payment obligations and collateral may not be legally valid. The Federal Government insists on this position even in cases in which the experts of Euler Hermes are involved in negotiations concerning the financing scheme. Examining contractual documents or taking part in site visits in this context are also undertaken solely with the purpose of coming to a

swift decision on cover. And in fact it has proved very helpful in the past to involve Euler Hermes in negotiations at an early stage.

#### HOW DOES THE FEDERAL GOVERNMENT CHECK THE ECONOMIC VIABILITY OF PROJECTS?

Since the project only has a chance of success if the project company has sufficient funds available for operating costs and to service the loan, an in-depth forecast of the expected cash flow (**financial model**) is crucial. The Federal Government therefore expects to be provided by the applicant with a financial model drawn up according to best practice rules. A formal audit of the model is not compulsory. It is also not in itself a problem if the model is drawn up by the project company. It is, however, absolutely essential that the model is delivered to the experts of Euler Hermes in electronic form which enables stress tests to be carried out on the calculations.

Based on this financial model, the specific **sensitive aspects** are then investigated to determine the robustness of the project with regard to changes on the cost and the revenues side. The focus for the Federal Government here is whether sufficient funds are generated at all times from cash flow to service debt repayment. The crucial element here is the debt service cover ratio (DSCR).

## WHAT IS THE FRAMEWORK FOR THE FEDERAL GOVERNMENT GIVING COVER FOR PROJECT FINANCE?

In principle, cover for project finance is subject to the **standard national and international framework** applying to all export credit cover. Project financed transactions are, however, frequently handled with particular flexibility where the cover policy for a specific country imposes restrictions, such as ceilings, limits on the size of individual transactions and the like. Provided that the project risks are externalised to the greatest degree possible, cover can be given on a case-by-case basis even when the country concerned is off cover for other types of business.

In view of the international framework, it should be stressed that the **OECD Arrangement on Officially Supported Export Credits** also applies without restrictions to project financed business. This is the agreement among the countries of the OECD to observe common guidelines on the granting of cover by officially supported export credit schemes. It stipulates, for instance, that advance payments of at least 15% of the covered order value must be made. The OECD arrangement further contains regulations applying to the repayment profile and maximum credit horizons.

## WHAT ENTITIES INVOLVED DOES THE FEDERAL GOVERNMENT PAY PARTICULAR ATTENTION TO?

A project finance construction consists as a rule of an extremely complex and intricate structure of contractual relations among a large number of participants in the project. The relative importance of these participants varies according to the type of project concerned; notwithstanding, certain participants are typically involved:

The investors in the project (generally also called the **sponsors**) are crucially important in assessing the pro-

ject's chances of success. Two types of sponsors are normally distinguished: financial investors that want to realise a project out of primarily financial motives, without having any roots in the sector of industry concerned, and strategic sponsors that are already active in business in the sector or a closely related one. Each of these groups of sponsors can bring different strengths to the development, construction and operation of the project and are therefore acceptable in principle to the Federal Government.

The main duty of the sponsor is first of all to contribute a sufficient level of equity to the project. From the perspective of the Federal Government, it is an absolutely essential priority to ensure that this requirement is fulfilled. The equity will normally be in place prior to the first disbursement of borrowed capital, or there will be appropriate security for the obligation to pay in the equity funds.

The primary source of borrowed capital for the project are the **banks** which provide the long-term financing for the project (the **senior lenders**), as well as any other lenders that may be involved, e.g. suppliers (**vendor financing**) or mezzanine lenders. As the Federal Government sees it, the circle of banks eligible for cover includes not only all banks domiciled in Germany, but also, in principle, foreign banks.

Although the loan contract exists between the bank and the foreign borrower, it is important for the Federal Government that the conditions of the contract take due account of the interests of the German exporter. After all, the export credit guarantee scheme is intended primarily to promote German exports, and therefore to support German exporters. Mezzanine finance, on the other hand, is not suitable for export credit guarantee cover; the Federal Government may, however, be able to give a direct investment guarantee on it (you can find further details of this type of cover on the Internet page [www.investitionsgarantien.de/en](http://www.investitionsgarantien.de/en)).

**The administrative authorities of the country concerned** (host government) play an important role, especially in infrastructure projects, which are frequently realised on the basis of a public-private partnership (PPP). Involving the Federal Government here can often positively influence the willingness of the administrative authorities in the host country to issue a letter of comfort or similar declarations of support, to the benefit of the project.

The entire plant, or parts of it, are delivered by a German exporter, which also provides the work and services connected with erecting it. This German exporter is also frequently the general contractor (perhaps as a member of a construction consortium). This means that it is not only responsible for its own part of the material and work, but that the obligation to fulfil the contract he has taken on also encompasses the engineering, procurement and construction for the entire project (EPC contract). This is often a turnkey contract, which obliges the contractor to deliver a fully functioning plant to the project company. The Federal Government prefers turnkey EPC contracts, wherever possible at a fixed price, since they reduce the risk of non-completion. The existence of such a contract is not, however, a compulsory condition precedent for Federal Government cover. The decisive factor is that the non-completion risk is adequately taken account of. Thus there could be, for example, a completion guarantee from the sponsor. In addition, it is also an important aspect for the Federal Government whether the exporter or the consortium of exporters has sufficient experience to bring the export transaction to a successful conclusion. In cases where the plant or individual parts of it consist of innovative new technology, the Federal Government expects the exporter in its turn to shoulder its responsibility by taking adequate precautions to offset the additional risk involved.

Especially in projects realised by financial investors, an operating contract covering the operation, maintenance

and servicing of the plant is concluded with a company specialised in the operation of such plants (the operator). If, on the other hand, the sponsor is a strategic investor, it will often also be the operator of the plant, either directly or indirectly. It is an essential prerequisite for granting cover that the Federal Government is given proof of the expertise of the operator, since only the successful operation of the plant – like its completion – can ensure sufficient cash flow to cover the operating costs and debt service. On top of this, it contributes towards stabilising the project if the operator is involved in the risks associated with the project as a sponsor in addition to its operating contract.

With regard to the supply of raw materials, it is important that there is a sufficiently secure supply of **feedstock**. If long-term procurement contracts are standard practice in the sector concerned, the Federal Government expects the project company to conclude a supply contract of adequate volume, which should cover, wherever possible the entire repayment period. In order to reduce the price risk, the Federal Government in addition favours fixed-price agreements, as far as such a pricing agreement fits the market conditions and makes economic sense.

The sale of the project products to the **offtaker** is, of course, the crucial factor which determines the success of the project. Where market conditions permit it, such as in projects in the energy sector, the Federal Government expects long-term offtake agreements covering the entire output of the project, if possible at fixed prices. If such an agreement is not possible, or is not customary in the sector concerned, cover can still be given if the market risk appears acceptable to the Federal Government in the context of the overall project structure. This is particularly the case for projects producing commodities.

## WHAT DISTRIBUTION OF THE RISKS DOES THE FEDERAL GOVERNMENT EXPECT IN PROJECT FINANCE?

The Federal Government expects a fair distribution of the risks between those involved in the project (**fair burden sharing**). Against this background it is important that the sponsors first of all make an adequate financial contribution to the project. The Federal Government does not, however, stipulate a particular minimum equity holding. Neither does it demand that the banks should share in the default risks with an unsecured loan (commercial tranche). Should such a tranche be present, however, it would be regarded by the Federal Government as a significant point.

What is absolutely indispensable is that there should be a **typical project finance security package**. This not only includes the typical security taken over loans (e.g. charges over assets and assignment of receivables) but also all the agreements between, and obligations of, the entities involved in the project in respect of the overall project structure, the construction, supply and operation of the plant, offtake of the products and cash flow, as well as the overall financing scheme.

The details will always depend on the individual facts of the project. The project security should also be available to all the senior lenders equally (*pari passu* clause). The details of this are typically regulated in an inter-creditor agreement. The important aspect for the Federal Government here is that due account is taken of the status and the interests of the individual lenders and the individual ECAs, especially with regard to voting rights.

## WHAT SPECIAL ASPECTS NEED TO BE OBSERVED IN MULTI-SOURCING PROJECTS?

With increasing globalisation, more and more major projects are being realised by exporters from a number of different countries. The state export credit agencies have developed cooperation models for the support of such

transactions (parallel insurance, coinsurance and re-insurance) to accurately reflect the involvement of the individual exporters (see here the brochure “**Multi-sourcing projects**”). In the case of transactions on the basis of corporate risk, considerable importance is attached here to reinsurance agreements.

In contrast, reinsurance very rarely plays a role in project financed business. Here **parallel insurance** is the general rule, i.e. each ECA acts separately. However, the normal process of consultation between the different ECAs in parallel insurance takes on a particular quality in project finance, since as a rule here a **common legal advisor for the ECAs** packages the individual interests of the agencies to ensure that they present one face towards the project company or the sponsor. This approach has proved to be the best way to reach positive decisions on cover from all the ECAs involved swiftly and effectively.

In multi-sourcing projects it may exceptionally occur that the exporters involved only definitively become clear after the conclusion of the loan contract. The Federal Government permits the financing bank to apply for cover here without having to name the German exporters at the time of application.

## WHAT NEEDS TO BE CONSIDERED WITH REGARD TO THE POSSIBLE ENVIRONMENTAL IMPACT OF THE PROJECT?

Granting Federal Government cover to a project financed venture presupposes that it complies with the national and international rules and regulations on environmental impacts, especially the so-called **Common Approaches** agreed by the OECD. These guidelines determine how stringently a project is examined in this respect, primarily by dividing projects into categories A, B or C. Category A projects are those with the greatest environmental impact.

In order to gain a clear picture of to what extent a project affects the environment, an environmental and social impact assessment (ESIA) is normally carried out in connection with project finance deals. Such an ESIA is frequently needed for the environmental audit procedure in the buyer country or is required by the banks, which adopted the Equator Principles. An **ESIA** must be submitted to the Federal Government or Euler Hermes as part of the application procedure at least for **category A** projects.

In addition to this, the Common Approaches stipulate the publication of environmentally relevant information for category A projects at the latest 30 days prior to the final decision on cover. This publication (posting the ESIA on the Internet) can be done either by the applicant or at the request of the applicant by Euler Hermes. You can find further details in the brochure “**Assessment of environmental, social and human rights (ESHR) issues of export transactions: the Common Approaches**”.

#### WHEN DOES IT MAKE SENSE TO COMBINE AN EXPORT CREDIT GUARANTEE WITH A FEDERAL GOVERNMENT INVESTMENT GUARANTEE?

**It is possible to combine an export credit guarantee and an investment guarantee.** This always **makes sense** when a German investor is involved. It should be remembered here that both the object of the cover and the scope of risks covered differ. While a Federal Export Credit Guarantee protects the receivables under a German export contract or the amounts due under a buyer credit tied to it against commercial and political risks, the investment guarantee covers the direct investment (equity participations, endowment capital, loans with an equity character and other financial rights) against political risks (you can find more details concerning this instrument of cover on the Internet page [www.investitions Garantien.de/en](http://www.investitions Garantien.de/en)).

#### ARE THERE ANY REQUIREMENTS AS TO MINIMUM VOLUME FOR FEDERAL EXPORT CREDIT GUARANTEES?

In line with the general principles of the Federal Export Credit Guarantees as an instrument for promoting German exports, there are also **no minimum requirements as to project size** to be fulfilled for project financed deals in order to get cover. However, because of its inherent characteristics project financed business in practice has a significant volume. This is due to the fact that considerable fixed costs are always incurred in this type of business (fees for financial and legal advisors, market consultants, etc.). Against this background, the realisation of a project through project finance schemes is generally only economically viable if the overall investment volume exceeds EUR 30 million.

#### HOW DOES THE PROCESS OF GETTING COVER FOR PROJECT FINANCE BUSINESS WORK IN PRACTICE?

The first contact with Euler Hermes is often made in practice by phone or e-mail. This is generally followed by a presentation of the project at Euler Hermes in Hamburg. The project design has often not crystallised very far at this stage. Nevertheless, the Federal Government offers to assess the project and gives an **indication** as to whether the project financed transaction is, in principle, suitable for cover. If requested by the applicant, the Federal Government can decide, at the same time, whether to issue a **letter of interest**. This consultative process by the Federal Government is free of charge for the applicant.

The further vetting process for the project is then initiated with a formal **application**. Based on the project information memorandum (PIM) and a financial model submitted by the applicant, a so-called **preliminary review** is then made by the experts of Euler Hermes. This primarily involves checking the project design, the use and



sourcing of funds, the entities involved in the project, the market situation and the economic viability. Details of the security package are often still very vague at this stage.

If the Federal Government concludes as a result of this preliminary review that the project is to be assessed positively, the applicant is requested to commission an **expertise** on the economic viability of the project from an auditing company (you can find further details in the brochure “**Expert opinions for project financing and structured finance**”). As soon as this expertise has been submitted to Euler Hermes it draws up and submits a recommendation for a decision on cover by the Federal Government.

All **decisions on cover** by the Federal Government are made in the **Interministerial Committee** (IMC), on which, in addition to the Federal Ministry for Economic Affairs and Energy, which has the lead function, the Federal Ministry of Finance, the Federal Foreign Office and the Federal Ministry for Economic Cooperation and Development are also represented. Besides the ministries, experts from industry and the banking sector as well as the experts of Euler Hermes also take part in the meetings of the IMC.

For reasons of effectiveness and to avoid taking up too much of the time at the IMC meetings, every project finance-related decision in the IMC is preceded by a discussion dealing with the project in the **Project Finance Working Group**. All four ministries are also represented in this body, which always meets two weeks in advance of the IMC meetings. Besides preparatory work on the actual cover decision in the IMC, the Project Finance Working Group also oversees the contents of the project from its inception up to the discharge from liability of the Federal Government for the risks connected with it.

## WHAT COSTS WILL BE INCURRED?

There are no special rules for project finance as regards the costs for Federal Government cover, so that the normal premium system applies. The costs therefore comprise the **handling fee** and the **premium**. The handling fee depends on the order value or the loan amount in connection with the project.

The **premium** is mainly dependent on the creditworthiness of the country and the **economic stability of the project**, as well as on the **risk horizon**. The minimum premium rates for the **country risk** are fixed here by multilateral agreements within the OECD. The so-called buyer surcharge, which takes account of the economic stability of the project, is then – as also in other cases – determined on a case-by-case basis by Euler Hermes. For this, the classical project finance risks (the non-completion risk, supply risks, market risks) are assessed and allocated to risk groups. There are five risk groups in all, category 1 being the best. The premium is then calculated on the basis of the country category, buyer category and the risk horizon as a percentage of the insurable loan amount. No insurance tax is payable.

If cover in favour of the exporter is taken out in addition to the buyer credit cover, there is no double charging of the premium. This means that a separate additional premium is only payable when additional risks are covered to protect the exporter (e.g. manufacturing risk cover). You can find an interactive calculation tool on our Internet website to calculate your individual premium rate. Further information can be found in the brochure “**Fees and premium rates**”.

Due to the application procedure described above, which normally involves commissioning an expertise on the economic viability of the project from an auditing

company, there will be additional costs for the expertise, which must be borne by the applicant. The fee for this is a matter for negotiation between it and the auditing company.

## CONTACT

If you have any queries, please do not hesitate to contact the Department Project Finance.

Export Credit Guarantees and Untied Loan Guarantees: instruments to promote foreign trade and investment provided by the



Federal Ministry  
for Economic Affairs  
and Energy

Commissioned to implement the federal  
funding instruments Export Credit Guarantees  
and Untied Loan Guarantees:



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### Cover from the Federal Republic of Germany for foreign business

Export Credit Guarantees and Untied Loan Guarantees as well as effective foreign trade promotion instruments of the Federal Government have been established for decades. Export Credit Guarantees (so-called Hermes Cover) protect German exporters and banks financing exports against political and commercial risks. Untied Loan Guarantees are to support raw material projects abroad regarded as eligible for promotion by the Federal Government. Both promotion instruments play an important role in fostering economic growth as well as in protecting and creating jobs. The Federal Government commissioned Euler Hermes Aktiengesellschaft to manage the federal funding instruments Export Credit Guarantees and Untied Loan Guarantees.

Information on other foreign trade promotion instruments of the Federal Government can be found at [www.bundeswirtschaftsministerium.de/en](http://www.bundeswirtschaftsministerium.de/en) under the heading Promotion of Foreign Trade and Investment.

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