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Project Finance – A Primer

Financing for specific projects and assets

Home › Resources › Knowledge › Finance › Project Finance – A Primer

Project Finance – A Primer

Project finance is the financial analysis of the complete life-cycle of a project. Typically, a cost-benefit analysis is used to determine if the economic benefits of a project are larger than the economic costs. The analysis is particularly important for long-term projects of growth CAPEX. The first step of the analysis is to determine the financial structure, a mixture of debt and equity, that will be used to finance the project. Then, identify and value the economic benefits of the project and determine if the benefits outweigh the costs.

Breakdown of the Definition

Now let us break down each of the components of this definition to get a detailed understanding of what it incorporates:

#1 Financing of long-term infrastructure, industrial projects, and public services

Project finance is generally used in oil extraction, power production, and infrastructure sectors. These are the most appropriate sectors for developing this structured financing technique, as they have low technological risk, a reasonably predictable market, and the possibility of selling to a single buyer or a few large buyers based on multi-year contracts (e.g. take-or-pay contracts).

#2 Non-recourse/limited recourse financial structure

Project finance is the structured financing of a specific economic entity – a Special Purpose Vehicle (SPV) – created by the sponsors using equity or debt. The lender considers the cash flow generated from this entity as the major source of loan reimbursement.

Hence, if the borrower has a debt default, the debt-issuer has the right to seize the assets of the said SPV. However, they do not have the right to any further assets that are not part of the SPV, even if the liquidating assets of the SPV are not sufficient to cover the value owed due to default.

#3 Payment from cash flow generated by the project

Cash flows generated by the SPV must be sufficient to cover payments for operating costs and to service the debt in terms of capital repayment and interest. Because the priority use of cash flow is to fund operating costs and to service the debt, only residual funds after the latter are covered can be used to pay dividends to sponsors undertaking the project.

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Why Do Sponsors Use Project Finance?

A sponsor (the entity requiring finance to fund projects) can choose to finance a new project using two alternatives:

1. The new initiative is financed on the balance sheet (corporate financing)
2. The new project is incorporated into a newly created economic entity, the SPV, and financed off-balance sheet (project financing)

#1 Corporate Finance

Alternative 1 means that the sponsors use all the assets and cash flows from the existing firm to guarantee additional credit provided by lenders. If the project is not successful, then all the remaining assets and cash flows can serve as a source of repayment for all the creditors (old and new) of the combined entity (existing firm plus new project).

#2 Project Finance

Alternative 2 means instead that the new project and the existing firm live two separate lives. If the project is not successful, project creditors have no (or very limited) claim on the sponsoring firm's assets and cash flows. The existing shareholders then benefit from the separate incorporation of the new project into an SPV.

How Is Project Finance Difference from Corporate Finance?

Now that we have a basic understanding of what project finance means, let us understand how it differs from corporate finance. The table below outlines important differences between the two types of financing that need to be taken into account.

Factor	Corporate Financing	Project Financing
Guarantees for financing	Assets of the borrower	Project assets
Effect on financial elasticity	Reduction of financial elasticity of the borrower	None/ Heavily reduced effect for sponsors
Accounting treatment	On Balance sheet	Off Balance sheet
Degree of Leverage utilizable	Depends on borrower's balance sheet	Depends on the cash flows generated by the project
Main variables underlying the granting of financing	Customer relations, Solidity of balance sheet, profitability	Future cash flows

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Who are the Sponsors of Project Finance?

By participating in a project finance venture, each project sponsor pursues a clear objective, which differs depending on the type of sponsor. In brief, four types of sponsors are very often involved in such transactions:

1. **Industrial sponsors** – They see the initiative as upstream and downstream integrated or in some way as linked to their core business

2. **Public sponsors** – Central or local government, municipalities, and municipalized companies whose aims center on social welfare

3. **Contractor sponsors** – Who develop, build, or run plants and are interested in participating in the initiative by providing equity and or subordinated debt

4. **Financial sponsors/investors** – Invest with a motive to invest capital in high-profit deals. They have a high propensity for risk and seek a substantial return on investments

Project Finance vs Corporate Finance

Summary and Additional Resources

We learned about the basic characteristics of project finance, how it is different from corporate finance, its major uses, and the type of sponsors involved.

To learn more about how to value a business, or to prepare for a career in project finance, we've got all the resources you need! Here are some of our most popular resources related to project finance:

- Due Diligence in Project Finance
- Credit Risk
- Weighted Average Cost of Capital
- Real Estate Financial Modeling

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