

# Moving towards hybrid project financing

By Christopher Czarnocki, Gide Loyrette Nouel

Earlier this year the South African petrochemical group Sasol secured debt financing for its US\$1.2bn development of gas fields in Mozambique and its construction of a connecting 865 km pipeline to South Africa. As one of Africa's largest infrastructure projects to date, the financing attracted commercial banks, development funding institutions, multilateral institutions and export credit agencies. Driven by the need to achieve financial close in a short period of time, and by a bouquet of diverse needs and requirements of the various financial institutions, the resulting financing structure is an innovative combination of corporate and traditional project finance lending, interwoven with a supporting web of political risk insurance.

This article discusses the resulting hybrid financing structure, the factors and pressures which drove and determined the structure, and its possible application as a model for other projects in emerging markets where a sponsor has sufficient resources to initiate the project on its balance sheet and has the capacity to continue to hold commercial risk on its balance sheet, but wishes to ultimately mitigate any political risks.

## Framework considerations

The key factor which drove and, ultimately, facilitated the Sasol financing was the borrower's willingness to initiate this ambitious project on its balance sheet,

assisted by limited bridge financing provided by the Development Bank of Southern Africa. In fact, construction of the project commenced two years before Sasol and its financiers put pen to paper in an effort to negotiate the long term financing documentation. Financial close was reached approximately 12 months later and, in fact, within days of the pipeline being completed and the gas flowing!

While Sasol was financially able to undertake the project on its balance sheet and was willing to take on the commercial risk of the project and, initially, any associated political risk, it also wanted to structure its debt in such a way as to subsequently displace political risk. As a company listed on the Johannesburg and New York stock exchanges, this strategy reflected the company's desire to lay off the political risks viewed by the markets as inherent in a financing of this size in a jurisdiction such as Mozambique.

Accordingly, the challenge for the company, its financiers and their respective legal teams was to structure a financing which fulfilled the following criteria: a financing which could be put into place in a much shorter period of time than is the norm for large projects of such nature; a financing which laid off any political risk from the company; a financing which, given the commercial risk being undertaken by the Sasol parent company under the financial support it was providing, granted the Sasol project companies everyday operational freedom which was more akin to that typically found under a corporate loan structure rather than a project financing.

## Hybrid financing structure

To facilitate the above mentioned needs of the Sasol

group, but to also adequately address the needs and concerns of its financiers, the final financing structure delivers to Sasol and the lenders benefits inherent in both a typical corporate financing and a more complex project financing. As such, the structure adopted is very much a hybrid animal – as detailed below, depending on prevailing circumstances, the financing reflects either typical corporate financing or project financing characteristics.

On its face, the Sasol financing comprises a number of large, but fairly standard, corporate loans, tied together by a common terms agreement. The financing breaks down into three tranches, each with a notional tenor of 12 years. The first tranche (the 'commercial tranche') was arranged and underwritten by South Africa's Standard Corporate and Merchant Bank. The commercial tranche totals approximately R1.46bn, split between the upstream gas fields' development and production project company and the downstream cross-border pipeline operating company. The two project vehicles' payment obligations under the commercial tranche are guaranteed by Sasol, by way of debt service support agreements issued in favour of the lenders. The commercial tranche benefits from political risk insurance from MIGA (reinsured by the export credit agencies SACE of Italy and EFIC of Australia), the Export Credit Insurance Corporation of South Africa (ECICSA) and the World Bank. The commercial tranche is structured to be syndicated after financial close.

The second tranche (the 'agency tranche') was arranged and underwritten by the Development Bank of Southern Africa. The agency tranche totals approximately R1.47bn, and is also split between the upstream and downstream Sasol project companies. The participating development finance institutions, split between the upstream and downstream projects, include African Development Bank, Germany's Deutsche Investitions- und Entwicklungsgesellschaft (DEG), Holland's Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (FMO) and France's Societe de Promotion et de Participation pour la Cooperation Economique (Proparco).

Like the commercial tranche, payment obligations under the agency tranche are guaranteed by Sasol. Unlike the commercial tranche however, the agency tranche does not benefit from any third party political risk insurance. Effectively, the development finance

institutions 'self-insure' all political risk.

The third tranche (the 'EIB tranche') comprises the European Investment Bank, and is for the amount of €100m, split into two sub-tranches of €50m each. The EIB tranche is directed entirely to the downstream part of the project. The EIB benefits from a full recourse Sasol guarantee in respect of one sub-tranche, with Sasol assuming Mozambican political risk. However, the EIB has assumed Mozambican political risk in respect of the second sub-tranche, and its recourse against Sasol is limited to the debt service support agreements in respect of that sub-tranche.

Therefore, ostensibly, the financing can be characterised as essentially a full recourse corporate financing, with Sasol assuming all project related risks, before and after project completion. However, the one item which is carved out from the corporate support given by Sasol is Mozambican political risk (other than in relation to one sub-tranche of the EIB tranche). In the case of the commercial tranche lenders, the political risk is passed on to the political risk providers which are providing the political risk coverage. In the case of the agency tranche lenders, the risk is borne by those agency lenders. In the case of the EIB tranche, the EIB has assumed political risk in respect of the one sub-tranche.

In this way, the commercial tranche lenders have the benefit of, essentially, seamless debt coverage from Sasol in the absence of a political risk event and, otherwise, from the political risk insurance providers. The EIB has total debt coverage from Sasol in respect of one sub-tranche. In respect of its second sub-tranche, the EIB and the agency lenders under the agency tranche, assume Mozambican political risk; in respect of commercial risk, they have recourse to the Sasol balance sheet under the debt service support agreements.

It is worth noting that the Sasol balance sheet support under the debt service support agreements (other than the EIB guarantee), and the political risk carve-out from them, are identical across all tranches, so as to provide for as seamless a regime as possible.

However, uniquely, the Sasol financing is structured such that, upon the occurrence of a defined political risk event, the financing flips into a project finance regime, with its attendant features such as fuller and more onerous, covenant and monitoring regimes. Thus, a structure that starts life as a corporate loan, upon the occurrence of a defined event, triggers the lenders' right

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to unilaterally impose a project financing regime on the borrowers. This hybrid structure was driven by the requirement of the self-insured development finance institutions and the political risk providers to have the ability to attempt recovery of outstanding debt in the event of payment default due to a political risk event occurring.

## Implications of hybrid structure

Thus, in the absence of a political risk event, the hybrid Sasol structure benefits from characteristics typical of a standard corporate financing, including:

- a due diligence which is not as extensive as in the case of project financings, and which does not involve any, or any significant, input into project documents;
- a covenant regime which is less extensive and onerous, and which consequently brings less lender involvement and control in the everyday operations of the project company than under a project financing;
- a project monitoring regime which is not as intrusive as under a typical project financing regime;
- a less extensive suite of default triggers, with emphasis being placed on the credit worthiness of the borrower, rather than the underlying project arrangements;
- a quicker path through the negotiation and documentation of the transaction, with attendant lower advisory fees; and
- lower pricing of debt, in recognition of the lender betting on the borrower, and perhaps the borrower group of companies, rather than the underlying project.

However, as mentioned, upon the occurrence of a defined political risk event, the financing structure automatically flips into project finance mode, rendering the Sasol project companies subject to more onerous, and until then latent, project financing requirements and conditions.

Perhaps surprisingly, in the case of the Sasol financing, the parties did not feel it necessary to fully detail what such an incoming project finance regime would entail. The negotiation and documentation of project finance conditions would undoubtedly have added a considerable period of time to the overall negotiations. Rather, Sasol felt comfortable to agree that the lenders would in such circumstances be entitled to impose additional conditions on Sasol, subject to certain pre-agreed limitations. Such additional conditions

would likely include additional representations, covenants, events of default and would be aimed at, broadly:

- ensuring the continued operation of the project;
- maintaining and preserving the project assets, particularly assets comprising the lenders' security; and
- ensuring control over project revenues, and controlling project expenditures.

In addition, the pricing of the debt would likely reflect the fundamentally changed circumstances.

However, most importantly for Sasol, as a result of the political risk carve-out, (other than in respect of one EIB sub-tranche) its balance sheet would be insulated from the guaranteed debt, in much the same way as a sponsor would be in a standard project financing. The commercial risks would shift to the lenders (in the case of the agency tranche lenders and the EIB in respect of one sub-tranche) or the political risk insurers (in the case of the commercial tranche lenders).

The above is necessarily very much a simplification of many complex and heavily negotiated provisions. However, it is worth noting that, in a financing thus structured, the most contested and actively negotiated provisions are likely to relate to the regime which would govern in circumstances where an event of default has occurred as a result of a political risk event. Given the varied agendas and motivations of the parties involved, it is likely to be the most challenging aspect of successfully structuring such a financing.

In the Sasol financing, upon the occurrence of an event of default caused by a political risk event, the lenders' recourse to the Sasol balance sheet would have fallen away (other than in the case of the one EIB one sub-tranche). Generally, lenders would naturally wish to be in a position where their ability to, if necessary, accelerate and enforce against security is not limited. However, even between the lenders, there may potentially be a chasm on the level of control they may be willing to surrender in relation to their 'natural' rights.

Thus, in the case of the Sasol financing, the commercial tranche lenders, and the EIB in respect of its guaranteed sub-tranche, are likely to be sympathetic to the sponsor's arguments to limit enforcement rights, given that they benefit from the protection afforded them under the political risk insurance policies, and a full commercial guarantee in the case of the EIB.

In contrast, lenders who themselves bear political risk,

such as the agency tranche lenders, are likely to feel less inclined to in any way qualify their ability to enforce. The position of the political risk insurers is similar; they are all too aware that if they are required to pay out under their policies, they will be subrogated to the rights of the commercial tranche lenders, and would not want their enforcement rights qualified in any manner.

In contrast, Sasol would naturally like to limit or at least delay any enforcement action against it. Importantly, and not surprisingly, Sasol would like to maximise the influence that the political risk providers such as the World Bank and MIGA and institutions such as the EIB bring to the deal their ability to exert political pressure on, in this case, the Mozambican government to prevent or cure a political risk event. Limiting the ability of the lenders, and effectively of the subrogated insurers, to pull the proverbial rug from underneath the project (by limiting the lenders' acceleration and enforcement rights) is arguably the most effective way of ensuring that such institutions actively seek to remedy or mitigate any political risk event, and help bring the project back on to the straight and narrow. In the case of the Sasol financing, the solution lay in a heavily negotiated limited standstill period, during which the lenders benefit from the additional comfort afforded them by the additional project finance conditions, but during which they are subject to certain restraints on their acceleration and enforcement powers.

Unusually, a structure such as the Sasol financing structure is held together to some extent by a degree of faith that is sometimes missing in financings of this size and of many parties the faith of Sasol that, notwithstanding the broad safeguards built into the documents, if the financing flips into project finance mode, the regime imposed upon it will not be reactionary and punitive and will not suffocate the

project; and the faith of the lenders that, notwithstanding the comforting enabling language drafted by their lawyers, the documents will ultimately allow them to impose a stricter regime which will not be mindlessly obstructed by their counterparty.

## In the final analysis

Too often rigid requirements and expectations of what a 'true' project financing entails or how it ought to be structured lead parties down a path which, sometimes unnecessarily, either keeps the project in lengthy negotiations or, worse still, stalls the project.

The Sasol financing is a useful example which has shown that, in certain circumstances, it is possible to structure a financing which, while protecting the interests of both the lenders and of the borrower, nonetheless mitigates and steers away from many of the rigours typically associated with the financing of a large infrastructure project.

Adopting a hybrid project financing structure of the nature discussed in this article is clearly not the answer to every project financing which parties would like to fast track. However, in circumstances where the sponsor is able to offer qualified financial support to a project, the Sasol financing structure does serve as an innovative model for funding and carrying out projects, large or small, in emerging or politically volatile markets quickly and effectively.

**Christopher Czarnocki, Solicitor  
Gide, Loyrette, Nouel, Citipoint,  
1 Ropemaker Street, 20th Floor  
London EC2Y 9HT, UK.  
Tel: +44 20 7826 9732  
Fax: +44 20 7826 9701  
Email: cczarnocki@gide.com  
www.gide.com**