

RESTRUCTURING PROJECTS IN FINANCIAL DISTRESS

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Abstract

The recent paradigm shift in financing capital intensive projects by private and public entities from traditional corporate finance schemes with project finance schemes has witnessed massive surge in the corporate world. However, a number of such projects are either plunged into financial distress at preliminary phases or operational phases. To address this issue, this paper examined the general overview of financially distressed project by reviewing adequate literature regarding project finance and financial distress, outlining the major signs of financial distress associated with projects and recommend suitable solution to projects engulfed in financial distress. To achieve this goal, capital structural reforms in the area of increasing equity capital requirement is advisable in view of the existing arrangement which allows equity investment of 10% to 20% in most cases. Ascertaining optimal capital structure that would enable the avoidance of finance distress requires further research.

Keywords: Financial distress, Project finance, Equity, Optimal structure, Reforms.

1. Introduction

The considerable surge in the application of project finance schemes to develop and execute large-scale projects in recent times leaves much to be desired in contemporary corporate governance (Pranowo et. al, 2010; Igor, 2012). Over the years project finance has been the panacea for developing capital intensive projects in western and developing countries (Yescombe, 2002). In 2001 alone, whopping \$217 million was spent on project finance culminating from a cumulative surge of 20% in the 1990s (Esty, 2004). In the US, over \$500 million spent on capital intensive projects annually are project finance schemes (Morrison, 2012). The year 2010 witnessed the signing of over 200 project finance schemes worth \$130 billion across China, Russia, Brazil and other emerging economies in Africa, Asia, Europe, Latin America and the Gulf (Thompson, 2012). Eventually, project finance is emerging as the major source of funding capital-intensive projects. The only occasion project finance recorded a reduction was in the mid 2000 due to the downturn in global economy activities. It was estimated that, total project finance reduced by approximately 40% in the year 2002 (Esty, 2005).

Notwithstanding the tremendous contribution of project finance in most economies, most projects encounter financial distress leading to bankruptcy or restructuring. In fact project finance is susceptible to a number of risks capable of frustrating the entire execution of the project (Fight, 2005). The famous Eurotunnel distress is a practical example of risks associated with project finance. In his study, Vilanova (2006), revealed that apart from financial distress most project finance schemes encounter structural distress, managerial distress, organizational distress and general corporate governance distress. However, the extent to which these distresses impact on the fortunes of a project is not as severe as the impact financial distress have on projects (Morrison, 2012). Financial distress generally impacts on the entire success of a project due to the non-recourse nature of project finance schemes (Esty, 2005; Fight, 2005 & Igor, 2012). Considering the sensitive nature of financial distress to success of projects, it is imperative on the part of parties engaged in project finance schemes to always initiate measures aimed at sustaining its financial viability through adequate provision of mitigating tools (Igor, 2012).

The main aim of this paper is to examine the general overview of financially distressed project by reviewing adequate literature regarding project finance and financial distress, outlining the major signs of financial distress associated with projects and recommend suitable solution to projects engulfed in financial distress. To achieve this objective, this paper will explore existing and suitable restructuring strategies to turn around the fortunes of a distress project. The paper discusses the achievement of a desired sound financial health of a project under project finance schemes. The study will further discuss the findings and recommend suitable conclusions. In view of this study objective, parties engaged in project finance schemes will benefit from the findings and recommendations.

2. Literature Review

To conceptualize the restructuring of a financially distressed project, fund providers and sponsoring companies must have insight into the probability of a possible borrower default (Brown et al, 2004). In this regard, both parties will make provision for possible mitigation of losses. In the case of a distressed project, borrower default is high therefore both parties will have to decide either to restructure or exercise the foreclosure on the assets to manage the assets or dispose-off the assets to external investors (Igor, 2012; Brown et al, 2004). In view of this hypothesis, the literature framework will discuss the general overview of project finance, financial strength of projects, financial distress of projects, suitable feasibility of a project prior to commencement and design an antidote for eliminating financial distress.

2.1 Project finance

Unlike traditional corporate finance, project finance scheme is a non-recourse loan facility and equity created by a legally independent project company to develop and execute capital intensive project (Esty, 2005). It is normally used to fund capital intensive projects inter alia in the energy industry, mining and railway industry, telecommunication industry, and the transportation sector (Morrison, 2010). India, China and Hong relied on project finance to 3,960

Krishnapatnam Ultr Mega power plant, Gansu Guazhou Ganhekou Wind farm and the waste energy project. These projects costed these countries US\$3.6 billion and US\$5.6 billion respectively (Morrison, 2010).

In a typical project finance scheme, a Special Purpose Vehicle (SPV) also known as the sponsoring company is created to develop independent projects with a team of financial entities and individuals. The SPV is a consortium of investors, shareholders and contractors created to enter into negotiation with governments and syndicated financial institutions to develop a particular capital intensive project. Fight (2005), identified parties to project financing schemes as the project company, the sponsor, borrower, financial advisers, lenders, technical advisers, lawyers, construction firms, regulatory agencies, export credit agencies and equity holders. Depending on the financing structure, sponsoring company in most cases becomes the borrower of funds while the financial institutions and individuals become the lenders under this scheme. In view of this arrangement, the sponsoring company has limited obligation and responsibility to lenders in case of any financial distress (Gherzi & Sabal, 2006). For instance, given the limited recourse nature of project finance schemes, the sponsoring company is not directly responsible to the lenders in the event of any default instead; the lenders only have a claim on the assets of the sponsoring company and the future cash flows of the project company (Yescombe, 2002 & Fight, 2005). Critical to the success of the project is the lenders ability to provide funds to complete the project (Igor, 2012). This particular party to a project finance scheme revolves around the syndication of financial institutions to provide funds for the execution of the project. In most cases one bank usually referred to as the arranger or lead manager arranges and leads the loan syndication from the host country or other foreign countries. In the case of the Eurotunnel project, over 220 financial institutions were involved in the syndication of over \$5 billion (Fight, 2005 & Vilanova, 2006). To protect their interest in the project company, the lenders normally require and conduct series risk assessment prior to construction, at construction stage and operational stage apparent; preliminary risk assessment is major assessment conducted prior to construction (Kreydieh, 1996). This assessments aims at identifying, mitigating any potential risk associated with the project and how they are distributed to the parties involved in the scheme (Mensah, 2012). Nevitt (1989), identified the major cause of project depression as the failure on the part of sponsors and lenders to identify and allocate risk to projects. At the preliminary phase of risk assessment, risks susceptible to derail the successful completion of the project are identified, allocated, qualified and quantified (Ayano, 2010). In connection with risk identification phase, efforts are made to outline the threats associated with the project at the design phase, operational and the probability of not commencing the project on time (Farrell, 2000).

At the construction stage, lenders are particular about the execution of the project in consonance with the laid-down procedure (Walker, 1995). Farrell (2001), identified the risk associated with this stage as the start-up risk. The major concern of the syndicate at this phase is the probable construction of the project at the costs and specification agreed upon (Yescombe, 2002; Fight, 2005). The major risk at this level is a possible conflict of interest that may emanate from the sponsoring company apparently in their quest to commence commercial activities at the expense of completing the project to plan. In view of this, while the syndicate is interested in insuring that all tests performances have being carried, the sponsoring company may be compelled to persuade the engineers to compromise their report (Gherzi & Sabal, 2012). A breach of this project requirement is eminent to a possible accumulation project depression. The consequence being the inability of the project to exhaust its estimated useful-life and projected cash inflows but rather permeates excessive cost overruns (Ayano, 2010).

Eventually, the depression of a project is normally evidenced at the operational stage once the project is completed (Fight, 2005). In view of the non-recourse nature of project finance, the loan syndicate relies solely on the cash flows generated from the project to service their loan principal and interest therefore any difficulty encountered at this stage is very detrimental to the possible retrieval of lenders' investment (Brigham, 2006). The major risk associated with the operational phase of projects is the probable failure of operations to generate sufficient cash flows necessary to run the project and service the loan obligation (Igor, 2012). To protect themselves against this risk, lenders normally require project companies to maintain healthy operating, solvency, efficiency and working capital ratios through their loan covenants (Andrews, 2010). The aforementioned risks associated with project finance schemes clearly

shows the necessity of using loan covenants to mitigate the possible risk of the project in the event of a default by the borrower.

3. State of Financial distress

In fact, the probable failure of projects can occur at the various stage of the project life-cycle. Villanova (2006), revealed that, financial distress can occur at the construction and operational stages. Various bodies of literature have conceptualized financial distress in a number of categories however; Outecheva (2007), conceptualized financial distress into three categories. The concept stratified financial distress into event-oriented concepts, process-oriented concept and technical-oriented concepts. The event-oriented concept postulates the financial distress of a project as the failure of the borrower to meet its financial obligations as and when they fall due (Gordon, 1971). The concept assumes that the occurrence of financial distress is incumbent on events such as loan default, and non-payment. Eventually, this event may result into a project's failure or bankruptcy (Beaver, 1996). Vilanova (2006), in his "Eurotunnel study" identified the main cause of financially distressed projects to emanate from wrong governance structure, agency conflicts, huge cost overruns, and external governmental conflicts. Eurotunnel is one of the famous projects that encountered financial distress prior to commencement of commercial activities. At the initial stages of this project, the project company raised an IPO of \$770 million and a syndicated loan of \$5 billion from over 200 lenders however; the project began to experience difficulties at the construction stage due to cost overrun and other specifications (Kleimeier & Megginson, 2002). The unexpected cost overruns resulted in requirement of additional estimated cost of \$4.9 million (Vilanova, 2006). Due to this additional cost, the project company was forced to raise new cash from equity shareholders in 1990 and 1994 (Esty, 2004). Few months after commercial commencement of the tunnel in 1994, the

impact of the projects' high leverage positions resulted in their inability to service their loan interest in September, 1995. As a result, Eurotunnel suspended the payment of interest on existing debt representing 96% of the total debt (Kleimeier & Megginson, 2002). This action triggered serious financial crisis for the Eurotunnel project apparently; causing a standstill between the project company and the creditors. During the period 1995 to 1997, the project undertook financial distress restructuring to turn around the fortunes of the project (Kleimeier & Megginson, 2002).

Paramount among other reasons to a project running into financial distress is the failure to meet projected cash flows at the construction and operational stages (Igor, 2012). Apart from structural and governance crisis that might trigger a project's distress, the main causes of financial distress are credit and political distress (Vilanova, 2006). During the construction phase of a project, the potential risk capable of running the project into financial distress is the failure of the financiers to extend credit to the project company thus meeting the required cash outflows flow to complete the project. Notwithstanding this reason for failure at the construction stage, wrong governance structure in the form of the required optimal capital mix for the project (Luciano, 2006). An unfavourable capital mix may trigger serious financial distress (Altman, 2000).

In view of the need to meet the future cash flows aimed at servicing the financial obligation of the project, Paranowo et al. (2010) identified profitability, liquidity, efficiency, solvency and macro-economic crisis that account for credit distress. Considering the expectation of the syndicate after resuming commercial operations, the main determinants of meeting their (lenders) needs is to generate returns on the project (Luciano, 2006). It is only when the company generates adequate cash flows that it can service its financial obligation (thus both loan interest

and principal). In addition, a project's profitability depends on its capability to operate efficiently by avoiding waste but rather add value to operations. In the Eurotunnel case, the company continued to incur extra capital expenditure even after the commencement of the project. This among many other reasons accounted for the company's financial distress (Vilanova, 2006).

Considering the non-recourse nature of project finance, where the lenders' collateral is tied to the cash flows generated from the operations of the project, the company's liquidity position is paramount to the success of the project (Jane, 2003). A firm is usually said to be liquid if it is capable of meeting their immediate obligation. Wood (2006), further reiterate on the need to always assess firms' liquidity position before transacting business with them. It suggested a favourable liquidity position of a firm to be 2:1 thus with every, one (1) currency unit owed lenders, the company has two (2) currency units to settle them. A worsened liquidity position of a project company simply confirms the company's assumption into financial distress. The firm's liquidity and profitability position is therefore critical to the servicing of loan interests and the principal (Altman, 2000).

Apart from these internal causes of a project's financial distress, macroeconomic factors such as interest rates, inflation rates, foreign exchange rates and political risks accounts for the failure of projects (Yescombe, 2002 & Fight, 2005). Most often, these type of risk are outside the control of the project company therefore any negative impact they have on the project can easily lead to financial distress (Hoffman, 2008; Fight, 2006; Finnerty, 2007 & Vilanova, 2006). A negative impact of foreign currency in a particular country will mean that in the event of servicing loans external to the project company, the company will require additional cash different from their initial projections to meet this obligation. By inference, variation in exchange rates between currencies will result in liquidity crisis (Wood, 2008). In the case of interest rates,

an increase will negatively impact on the project's company to settle their debts as and when it

falls due (Hoffman, 2008). For instance, the unexpected hike in interest rate as a result of the severe economic recession in Europe was identified as the main cause of Euro Disneyland Project (Finnerty, 2007). This had a significant unfavorable impact on the cash flow of the project leading to serious financial distress.

Political risk is another factor that accounts for a project's financial distress in the sense that governments' participates in most project finance schemes (Andrews, 2005). This crisis normally arises when governments withdraws from the project or pass laws that will infringe on the success of the project (Finnerty, 2007). In fact, political risks possess significant catastrophe of projects. For instance, defunct Enron and General Electrical Corporation lost significant amount in the Dabhol Power Project estimated in the region of \$28 billion in India following the withdrawal of the government from the project. (Esty & Sesia, 2010). In most developing countries where governments are major participants in project finance schemes, political instability in a particular country will account for financial distress. Apart from these occurrences, frequent passage of laws regarding tax rates will also negatively impact on the project's cash flow especially in high tax regimes (Sangree, 2010). The combination of these factors among all other factors will account for default or bankruptcy of projects.

4. Restructuring Financially Distressed Projects

Empirical evidence shows that some projects under project finance schemes have failed due to financial distressed however, most of these distressed firms are either restructured or disposed off. In their study on "restructuring distressed projects" Brown et. al (2004) revealed that in the event of a default by borrowers, lenders will either decide on restructure or

foreclosure. In view of their findings, it is eminent to note that project restructuring can be conducted at the construction stage and operational stage. In any of these instances, the decision to restructure or liquidate in the event of default will depend on the position of the stakeholders (Finnerty, 2007 & Altman, 2000). A decision on exercising the lenders' foreclosure on the project assets will require that the assets are disposed of immediately or at a later date to (Brown et. al, 2004). According Brigham & Houston (2007), liquidating a distressed company is only favourable in the event the stakeholders are better-off than restructuring. If all the stakeholders/lenders can recover all or substantial portion of their investments and debts, then it is reason to decide on selling the foreclosure of the project's assets. This will depend on the situation where the pool of the buyer is very strong. In their study Brown et. al (2004) revealed that a substantial number of distressed companies are sold when the pool of the outside buyer is very strong. The study further revealed that during the period 1993 to 1994, the real estate lenders sold 12% of their foreclosure assets in their quest to recover from the downturn that had engulfed the industry. In critical analysis of project foreclosure and project restructuring in the event of default, foreclosure loans normally occur sharply in the era of serious downturn (Brown, 2000).

The choice to restructure financially distressed project depends on numerous factors other than just considering the pool of the outside buyer (Stromberg, 2000). In most cases where the fortunes project is financially stressed up that it will be very difficult for the lenders to recover their debt in the event of liquidation, the final resort is to reorganize the operations of the project (Brown et.

al, 2005). In the case of the Eurotunnel project, the position of the lenders was far worse off in liquidation than restructuring judging from the volume of debts committed to the project at the time of distressed (Vilanova, 2006). According to Mensah (2012), restructuring

distressed project involves the adoption of strategy (s) transform the dwindling fortunes of the project. This strategy could either involve merger strategies, capital reconstruction strategies and internal capital reconstruction (Brigham & Houston, 2007). If a company decides on mergers, it will involve the combination of additional resources from another company to turnaround the fortunes of the distressed company. However, capital construction entails the total reorganization of the company's capital structure thus total overhaul of the project's capital composition (Altman, 2000). In the case of internal reconstruction, structuring entails the decision by the lenders and shareholders to transform the operations of the business without selling the assets of the business. Altman (2000), identified that for an internal restructuring to be successful, there ought to be scheme of arrangement that are fair and equitable among the various stakeholders; adequate provision must be made for additional capital from the existing lenders and or the shareholders; lenders and shareholders are willing to waive losses to put the project on sound footing. In addition to these, the company must further conduct feasibility studies to project cash flows to be generated after restructuring. Paramount among these strategies is the determination of optimal capital composition after reorganization (Finnerty, 2007).

Gati (2008), identified that the substitution of existing capital structure with another structure is one of the effective arrangements of restructuring distressed projects that can operate into the foreseeable future. This approach to project restructuring has been considered by numerous academic authors as very advantageous for borrowers with many lenders (Yescombe, 2002). Under this structure, capital composition of the project is varied where a number of existing short-term loans are replaced with long term debts to prolong cash outflows (Tebogo, 2011). The approach will offer the borrower to generate enough cash flows from the project as a

result of the moratorium that this structure offers (Vilanova, 2006). This is evidenced in the Eurotunnel case where a number of junior debts were suspended and later replaced with long term debts.

In his study Vilanova (2006) discovered that the restructuring of non-financial crisis such and managerial, and project re-engineering must be considered. A financially distressed company cannot restructure without a realistic scheme of arrangement. According to Lucey (2002), a scheme of arrangement entails a strategy to vary the interest and liabilities shareholders, debt holders and creditors. This scheme requires some amount of capital waiver by providers of capital in restructuring the operation of the project. This can effectively be designed by ascertaining the total loss of the company. After ascertaining the total loss, the lenders and other stakeholders must accept a reduction in their waiver in proportion to this loss to put the prospect of the project on sound footing. In the case of Eurotunnel, this action resulted in the suspension of interest on junior loans (Penati & Zingales, 1998). In the event of requiring additional funds to meet the working capital requirement of the restructured project, the project company can float additional shares and debts to the existing stakeholders (Gilson, 1997). The project managers of Eurotunnel ensured that additional equity was raised from existing shareholders to meet their capital requirement of \$10.1 billion before completing the project.

The critical stage in restructuring financially distressed project is the ability to project realistic cash flows and decide on the optimal capital mix. Igor (2011), identified the two main forms of financial distress as negative NPV and negative cash flow. It was argued that negative cash flows and negative NPV's can be rectified by the additional influx of cash flows at the construction and operational phases of the restructuring. At the initial phases of the restructuring

exercise, the projects generate negative cash flows however, the situation improves as a result of the positive cash flows until the desired NPV and cash flow is achieved.

5. Conclusion

To develop and construct capital intensive projects, the assembly of number of investors cannot be over emphasized. In this regard, the contribution of project finance schemes in most capital intensive projects both in the private and public sector were developed using project financing. Projects developed under this scheme have not been invulnerable to number of challenges and difficulties in their life-cycle. Considering the substantial proportion of debts inherent a distressed project under a project finance scheme, it is quite evidenced that such huge debts land those projects into financial distress therefore the high incidence of financial distress among projects provides basis for reconsideration of a project's capital structure with the aim of enhancing the project's project to mitigate financial distress. A high leverage capital structure raises issues of moral hazards among sponsors and lenders. According to Bigus (2003), in view of the benefits derived by sponsors in a giving project, lenders normally carry substantially all the risk thereby making the sponsor insensitive to mitigate risk. As a result, it is prudent to reconsider the capital gearing ratio of a financially distressed project (Myers, 1977). To achieve this goal, capital structural reforms in the area of increasing equity capital requirement is advisable in view of the existing arrangement which allows equity investment of 10% to 20% in most cases. This will inculcate a sense of control and ownership from all the parties to mitigate potential risks within the scope of the project. As a virtue of fact, it is prudent for parties in project finance schemes to conduct and review feasibility studies at all the stages of the project and also to decide on the optimal composition of their capital structure to improve on their ability to mitigate any potential distress.

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