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# FINANCING OF INFRASTRUCTURE PROJECTS IN AFRICA

**By Bruce Johnston and Helena Guidolin**

Financing infrastructure projects in Africa would undeniably help to unlock the economic potential of the continent. Finance for investment in African infrastructure is hindered however, by various factors relating to the complexity, size and viability of infrastructure projects generally.

In energy-related infrastructure projects, there are continuing challenges in project planning and preparation that need to be surmounted to ensure a bankable proposal that is attractive to investors.

Local financial markets are less developed, which means more cross-border lending in US dollars. National oil companies sometimes lack the expertise and financial resources to develop some projects. Undoubtedly, there is a need to accompany physical infrastructure development with other required elements such as upskilling of labour, regulatory adaptation and streamlining of administrative requirements. Projects can take longer to develop, which may lead to early decisions that impede a later financing.

Determining viable processes by which funds for project development can be raised is pivotal and requires a clear understanding of the options available for financing, taking into consideration the specific nature of differing projects. In time, however, the methods and sources of financing oil and gas projects worldwide will be used in Africa.

The basic premise of this article is that commercial decisions made early in an oil or gas project in Africa often preclude certain types of financing at later stages. This is often because decisions about financing are not made at the start of the oil or gas project.

This article examines the financing options for upstream oil and gas projects in Africa and to set out the criteria for the availability of such finance. Only then, can developers of oil and gas projects in Africa ask, at the start of a project, "from where will the project get its funding?" and use the answers to structure the project properly in order to enable the funding to be raised. The financiers of an upstream project will also require insurance against damage to physical assets and political insurance.

**Upstream**

Since 2008, increased regulation of banks (including under Basel III) has meant that fewer banks are willing to lend to oil or gas projects in Africa and long-term lending is less freely available. This has resulted in more finance coming from private equity and from non-bank lenders and more trade-based lending.

Recent growth in African economies has also meant increased interest from investors in both debt and equity for African projects (not only oil and gas). As a result, there are many new investors, including many Africa-focused debt and equity funds.

**Equity**

The exploration phase in an oil and gas project is the most risky. The risk/reward ratio therefore needs to be as high as possible. Equity is the most appropriate tool for financing the exploration phase.

Equity is also more expensive than debt and operates to dilute the ownership of the sponsors.

The traditional model is distorted because big international oil companies can raise equity from the stock markets more cheaply than an oil project can raise debt. International oil companies therefore have a strong preference to finance oil and gas projects in Africa using equity rather than debt.

Despite this, taxation systems in many countries operate so that interest is tax deductible but dividends are not. This often means that there is debt financing of oil or gas projects in Africa which, in economic terms, is really an equity financing.

Sources of equity finance include:

***Private placement***

Many start-up exploration companies will raise finance by issuing shares on a private placement basis. This involves the issue of shares to the management of the start-up exploration company, to friends and family, to investors in previous businesses connected with the management, and to specialist private equity funds and family offices.

***Private equity***

Private equity funds and sovereign wealth funds are increasingly looking at investments in Africa. Oil and gas projects with proven reserves are ideal targets for private equity.

***Stock exchange***

Most of the large international oil companies are listed on one or more of the major stock exchanges. They can raise debt and equity on those stock exchanges relatively inexpensively. An IPO is, however, a time-consuming and expensive mechanism. There is a need for the company to meet certain standards of corporate governance and to prepare a prospectus. Ongoing compliance with the listing rules, together with investor relations, are also onerous for a small company.

***Joint ventures***

The most common means of financing an oil and gas project in Africa is a joint venture with a larger company, such as an international oil company. Joint ventures are undertaken by smaller exploration and production companies or by national oil companies.

**Debt**

Debt is an important feature of all oil and gas projects. Due to its risk/return nature, however, it may be inappropriate to the exploration phase of African oil or gas projects. In addition, debt raised with recourse to the oil or gas project only, will be expensive when compared to the financing that can be

raised by an international oil company. As a result, many oil and gas projects do not have project-specific debt financing.

There are, however, many significant benefits of external debt finance, which include the following: the leverage associated with debt finance can enhance the return on equity. Debt finance is usually cheaper than equity finance; the discipline that comes with debt finance often means that the project assumes a lower risk profile; and the involvement of major banks, development finance institutions or export credit agencies may encourage governments not to interfere in the oil or gas project.

Typical types of debt finance used include:

***Project finance***

The lenders' primary recourse is to the cash flow of the oil or gas project, rather than project assets or the assets of the project's equity investors. There is usually some form of recourse to the equity investor (ie, 'limited recourse'). Once the oil or gas project is operational, its revenues are used to: pay the cost of operating and maintaining the project; pay principal and interest to the lenders; and pay distributions to the equity investors.

***Reserve based lending***

Reserve based lending involves loans made against the net present value of future cash flows projected to be generated from certain identified oil or gas reserves. In Africa this tends to be limited to oil reserves which can be exported to the international markets (i.e., the oil can be valued in US dollars using international market prices).

***Carry loans***

Many oil and gas projects in Africa are financed by international oil companies. Such financing often takes the form of a carry loan. In law, this is a debt, but commercially it is equivalent to equity. The usual terms require that the loan is only repaid from the cash flow of the project and, if there is insufficient or no cash flow, there is only repayment of principal or interest in part (or not at all).

***Corporate loans and bonds***

Due to the creditworthiness of the large oil and gas companies, they are able to borrow money using their corporate balance sheet in a more cost-effective manner than an oil and gas project in Africa could borrow

money. As a result, the typical joint operating agreement structure often involves a large oil company financing its share of the exploration and production costs through a general issue of corporate bonds.

***Islamic finance***

Islamic finance is increasingly common in the development of projects in the Middle East and has featured in the financing of some African oil or gas projects. It is most commonly used where the finance comes from banks or investors in the Middle East.

***Prepayment facility***

Prepayment facilities are increasingly being used to finance oil and gas projects in Russia and are also suitable for use in financing of oil projects in Africa. A prepayment facility is commonly provided by a trader in oil products and is structured so that the trader prepays for the oil to be supplied by the project under an export contract between the project (as seller) and the trader (as buyer). The oil may be delivered to the trader for onward delivery to the end buyer, or delivered directly to the end buyer. The sale proceeds received by the trader from the end buyer repay the loan.

***PXF finance***

A pre-export financing arrangement involves a loan to the project company taking security over cash flows due to the borrower, under confirmed orders from pre-agreed offtakers under export contracts. The cash flows under the export contracts are sufficient to repay the loan, and there is a mechanism which allows the lenders to use the cash flows to repay the loan in a default situation.

**Derivatives**

One of the biggest risks for lenders and investors in oil or gas projects in Africa is the fluctuation of prices in the oil or gas. This can be hedged by over-the-counter derivatives or exchange-traded derivatives.

The financing of African oil and gas projects is not too different from the financing of these types of projects worldwide. There is, however, a perception of greater political risk, which requires more political risk mitigation and different lenders.

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