



FIRST NATIONS
MAJOR PROJECTS
COALITION

Capital Markets 301

Financial Structuring for Major Projects Handbook

HANDBOOK FOR LEARNING MODULE #3



Project
Leaders

About Us

The First Nations Major Projects Coalition (FNMPC) is a national 140+ Indigenous nation collective working towards the enhancement of the economic well-being of its members. We understand that a strong economy is reliant upon a healthy environment supported by vibrant cultures, languages, and expressions of traditional laws. With a project portfolio exceeding a combined total cost of over \$45 billion, our key area of focus at the FNMPC is to support our members in making informed decisions about their participation in major clean energy, natural resource, and infrastructure projects.

Colliers Project Leaders is a *Sustaining Partner* of the First Nations Major Projects Coalition. Our organizations prioritize the relationship between them, and seek out ways to leverage their two sets of resources to advance mutually beneficial outcomes that contribute to true, lasting, and meaningful First Nations reconciliation in Canada, including economic reconciliation. Colliers Project Leaders supported the Major Projects Coalition in the development of this learning module handbook: *Financial Structuring for Major Projects*.



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Foreword

First Nations are increasingly becoming involved in major industrial projects that require large-scale financing. There are major barriers to First Nations working on financing major projects, including the constraints of the *Indian Act*, remoteness, variable experience in securing large-scale financing for projects, and in a vast majority of cases a limited economic resources.

The FNMPC supports its First Nations members across Canada on many elements of commercial deal-making, including securing financing for major projects for First Nations acquiring equity ownership in a major projects.

This paper is the third in a series of modules aimed at supporting First Nations' navigation of financing of major projects. To accomplish this, this handbook seeks to build on previous modules pertaining to financial structuring for First Nations participation in major projects for anyone with or without a financial or legal background. The module is grounded in industry standards of practice, leveraging current market information and expertise from major credit rating agencies, (i.e., Moody's Investor Services).

The modules of this handbook will support First Nations in financial structuring engagements and discourse. Specifically, it points to elements of a constructive dialogue and negotiation with major project proponents, financiers, lawyers, or governments that often accompanies the financing of major projects.

As First Nations expertise on project financing grows, First Nations governments and businesses will be better equipped to the negotiate terms in agreements with major project proponents that address the unique circumstances of First Nations.

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Executive Summary

1. Why do Projects Need Financing?

Project finance is a tool used to fund and deliver large-scale infrastructure projects using financing with limited or no recourse (no collateral beyond the project's own assets and cashflows) to the project owners. Project finance is characterized by the creation a standalone commercial legal entity, also called a Special Purpose Vehicle, whose project revenues support profitability on their own merit. Project finance is often used for infrastructure projects with significant capital requirements, long construction periods, and cash flow generation that depends on the project's success. The financing process considers the risks facing the project, the creditworthiness of the project, and an optimized debt to equity balance to ensure a successful infrastructure project. Project finance can be used as a mechanism to achieve First Nation own source revenue, creating the opportunity for First Nation equity ownership access the economic benefits of major infrastructure projects.

2. Working with Lenders

Engaging with lenders (for example banks, insurance companies, pension funds) is a critical step in securing the necessary financing to execute any major projects. Working effectively with lenders creates transparency and added certainty on projects by allowing effective allocation of project risks and greater certainty forecasting project cash flows. Lenders are integral to project finance, because they play a vital role in structuring financing and conducting thorough project analysis. They evaluate projects across various dimensions, including financial, technical, legal, and market aspects, ensuring alignment with cash flows and risk profiles. They also examine contractual arrangements and equity investments, culminating in a lending approval process. First Nations should take a pro-active and informed role engaging with lenders to ensure financial agreements align with First Nations and their membership's interests. Professional financial and commercial advisors can enhance First Nations' negotiating positions and understanding of the lending process and how risks are allocated.

3. Creditworthiness

The decision and degree to which lenders contribute loans to projects hinges on the project's creditworthiness, specifically the project's ability, and likelihood to meet operational cashflows and corresponding debt repayment obligations. Evaluating creditworthiness of a project involves a thorough assessment of the project financial statements, industry, and operations. Lenders examine the project's financial feasibility through a variety of lenses including business profile, operating risk, and the nature of cashflows that support a project's ability to meet it's loan repayment obligations.

4. Financial Structuring

The capital (financial) structure of a project plays a pivotal role in achieving financial stability and strategic goals of those invested in the project. Capital structuring is the mix of funding sources that organizations use to finance their operations and projects, typically involving debt (e.g., bank loans) and equity.

Debt-to-Equity Ratio

The allocation of debt financing and the corresponding amount of equity required is called the debt-to-equity ratio, or gearing ratio. The gearing ratio (proposed financial leverage) represents the risk profile of a project. Projects that are perceived as riskier will require a higher equity portion compared to the debt whereas ‘safer’ projects will supporter greater debt proportions, and as such have a higher creditworthiness.

Creditworthiness

Due diligence is essential when making capital structure decisions, involving careful evaluation of industry dynamics, risk tolerance, viability, and market conditions. The risk perception and resulting creditworthiness can be based on things such as a proponents experience in the market, the novelty of the project, and market or political stability. The specific composition of debt and equity in a capital structure provides insight into lender’s perception of a project. Often, the greater the proportion of debt, the stronger the creditworthiness the project.

First Nations involvement in projects can include additional factors that influence risk and capital structure, most notably the availability of the First Nation’s own-source revenues/investment or the existence of government support (e.g., loan guarantees). Project equity owners are expected to contribute at-risk capital (e.g., a downpayment on a home purchase) to de-risk a lender’s view on project financial risk. Governments hold a pivotal role in First Nations equity participation because governments can provide grants, loan guarantees, and tax incentives to First Nations to compensate for First Nations generally not having access to their own sources of at-risk capital.

Private (non-government) equity involvement is occasionally an option in raising at-risk capital. However, it is important to note that private equity involvement in First Nations project finance can present conflicting objectives. First Nations’ priorities and worldviews on ownership, control, and cultural values, can diverge from the profit-focused goals of private equity. Further, private equity investors often pursue their own equity positions in projects that would otherwise go to First Nations under a traditional lending model. In some scenarios, inviting private equity to invest alongside First Nations can provide some additional at-risk capital to make an otherwise unviable deal become viable. On the other hand, the unique risks associated with Indigenous projects often deters private equity investors, who often seek short investment horizons with high return on equity.

5. Conclusion

Project finance is a valuable tool that can support First Nations in achieving economic development, and own-source revenues. The cash flows arising from equity participation in major infrastructure projects can equip First Nations with funds to address critical infrastructure needs, establish sustainable businesses, and strengthen nation membership priorities. These types of benefits to First Nations certainly transcend economic wealth, and encompass the reinvigoration and continuation of culture, way of living, and rights and responsibility to the land. In this way, project finance is not merely a financial instrument, it represents a pathway to self-determination and economic reconciliation. This report aims to bolster First Nations’ expertise in project finance and equip decision makers with key information and considerations to take an active role and successfully implement major infrastructure projects.

1. Why do we Need Financing?

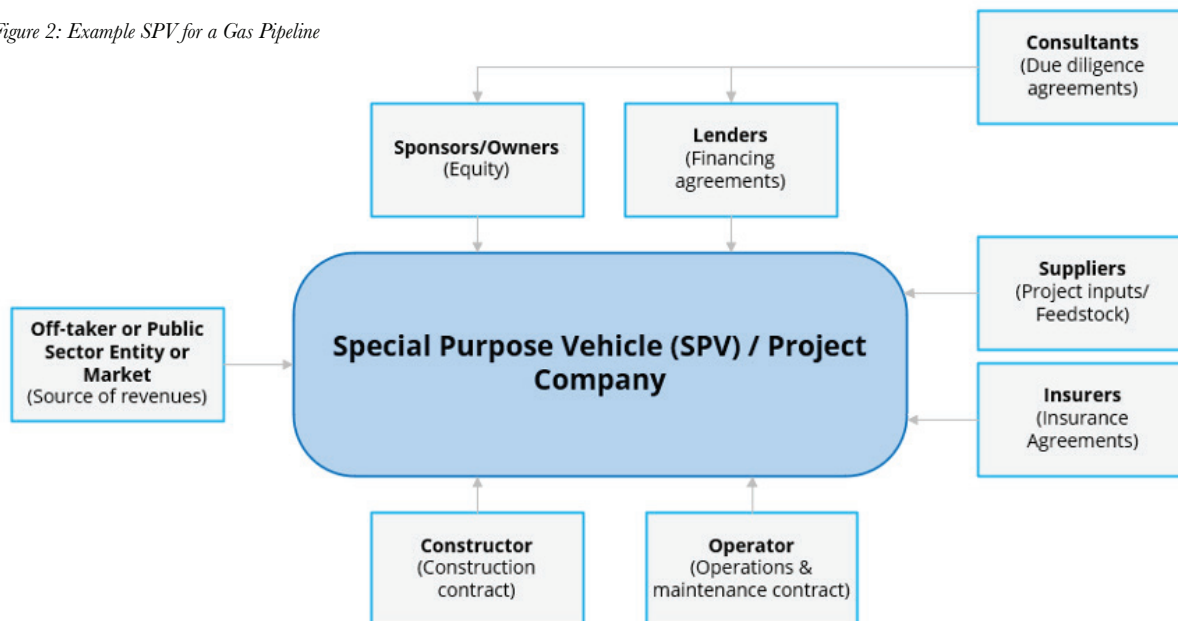
Project Finance Structures

What is Project Finance?

Project finance is a financial structure used to fund and organize large-scale infrastructure projects using financing with limited or no recourse to the project owner(s). It is characterized by its focus on creating a business-specific legal entity, also called a Special Purpose Vehicle (SPV), for each project. Financing for an SPV is often secured through the project's revenues and assets. Project finance is often used for ventures with significant capital requirements, long construction periods, and cash flow generation that depends on the project's success. It is an effective mechanism to successfully deliver infrastructure projects with tailored risk-allocation, optimization of debt financing, and responsible use of free cash flows.

SPVs, a distinguishing feature of project finance, are legal entities and they can be part of subsidiary companies created for a specific, limited purpose, often to isolate financial and operational risk of a project. The diagram below illustrates a standard structure of a SPV.

Figure 2: Example SPV for a Gas Pipeline



This financing structure can be applied to infrastructure projects encompassing a wide range of project/asset types. In Canada, project finance projects are most prevalent in transportation, healthcare, energy, and natural resource projects and have also been used to deliver for education, renewable energy, government services, and other public infrastructure projects¹.

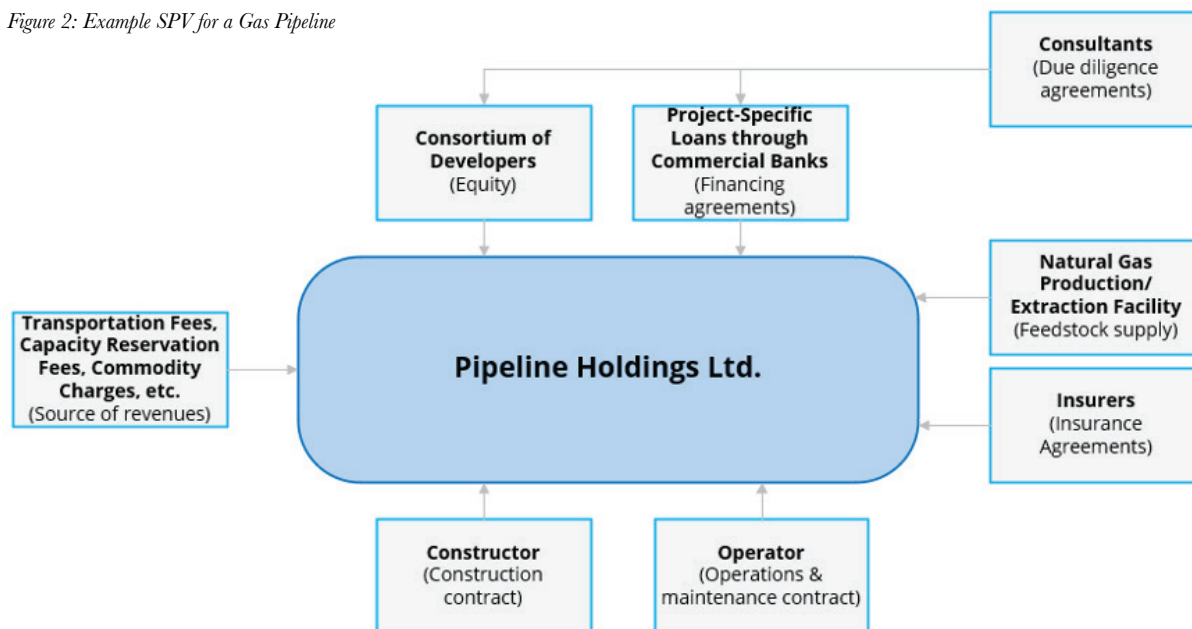
¹ Han, Julie & Mirza, Ahsan (2023), Project finance Comparative Guide. Retrieved from: <https://www.mondaq.com/canada/finance-and-banking/1109172/project-finance-comparative-guide>

Special Purpose Vehicles in Practice

This section is intended to identify the inception of and key players in a SPV, to improve readers' insight into the SPV formation process. Creating an SPV can arise from a variety of project types, in this case we will walk through a consortium of companies creating an oil/gas pipeline SPV.

A consortium of experienced companies plan to finance, construct, and operate a gas pipeline. The consortium structures an SPV as displayed in the diagram below forming, an example company 'Pipeline Holdings Ltd' where consortium members share the SPV equity, and raise debt financing as long-term debt loans held by the SPV.

Figure 2: Example SPV for a Gas Pipeline



Outside of financing, several other parties are involved in the SPV including due diligence consultants, insurers, operators, constructors, off-takers, and suppliers. The parties contractually engaged are experienced professionals involved to undertake a specific, explicitly defined role. In essence, these parties are included to manage defined project risks they are specialized to handle. Risk is allocated to project parties by entering contractual agreements over the project's expected term. Due to the complexity of project finance, the project sponsor must be careful to ensure that contracts are structured to be complimentary of one another. Avoiding conflicting interests and achieving the highest creditworthiness is a key priority.

Example company Pipeline Holdings Ltd. enters into a construction agreement with a contractor to design and build the pipeline, an operations and management contractor for day-to-day management, maintenance and operations of the pipeline, and insurance agreements that are often structured to meet debt lender requirements. The SPV would also establish input supply agreements as this is directly related to the revenue generating capacity and greater certainty; consistent and reliable supply results in more credible, strong revenue forecasts. In this case, securing a reliable natural gas supplier ensures a defined volume gas passing through the pipeline which underpin pipeline toll agreements. Pipeline toll agreements provide for a fee to be paid to the pipeline owner in exchange for the use of the pipeline. The fee translates into the revenue generated for use of the pipeline along with a return on monies invested to build and operate the pipeline.

There are also several parties that are involved beyond those contractually engaged during the project lifecycle including consultants performing financial due diligence to determine adequate financing structure and terms, and legal advisors to provide contract drafting support. When the roles and responsibilities are assigned in formal contracts, Pipeline Holdings Ltd. defines the project’s forecasted sources and uses of funds, which are used to secure the financing through equity and debt.

Why Project Finance Matters for First Nations?

Project finance is a well-developed market in Canada and globally, supporting infrastructure development, resource extraction, renewable energy transition, urbanization, and commitments to sustainability and economic growth. It leads to successful execution of essential projects that stimulates economic development and benefit communities.

Canada’s public and private sectors are increasingly recognizing the benefits from the inclusion of First Nations as business partners and equity holders in economic development opportunities. First Nations can benefit through these project partnerships and capitalize on economic opportunities and infrastructure development, with First Nations as leaders in meaningful roles in major projects. The financing structure creates the opportunity for First Nation equity involvement to redeem economic benefits as well as control at the board and operational level which ultimately strengthens First Nations being able to achieve the benefits outlined below.

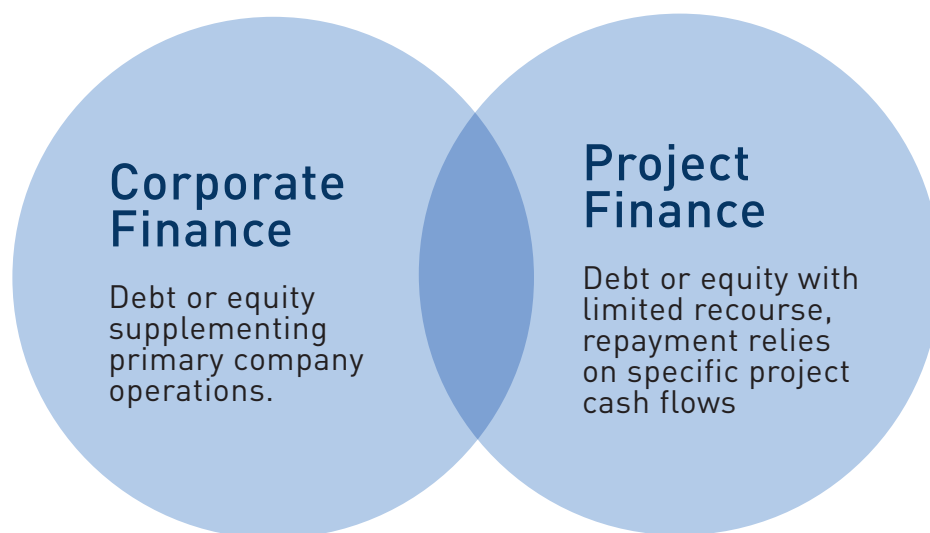
Figure 3: First Nation Benefits of Project finance



Project finance Versus Corporate Finance

There is an important distinction between project finance, and corporate finance approaches to raising capital. Corporate finance debt is typically used to fund on-going operations, investments, and working capital needs of a company and the use of the funds raised by debt is at the discretion of the company. Alternatively, project finance has a precise scope, objective, and revenue stream(s) for net-new projects that have a clear start and end point. The funds raised by debt in project finance must be used specifically to support the delivery and operations of the project. For clarity, this document focuses on project finance in a Canadian context.

Figure 4: Corporate Finance versus Project Finance



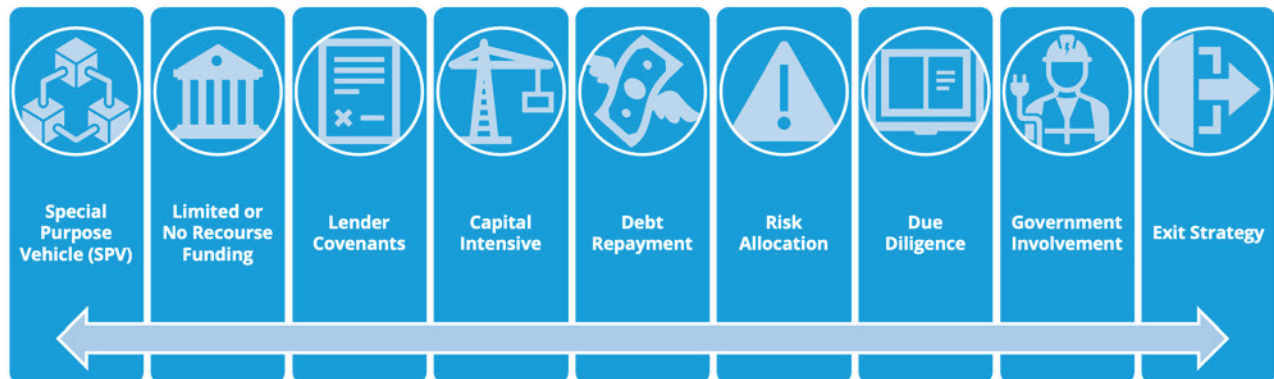
Project finance is structured with the intent to manage and de-risk a project to the point it is feasible for the public sector and marketable to the private sector.

Some project life phases present greater risks than others. Particularly, construction is often the riskiest phase requiring major capital expenditure requirements and no operating cash inflows; meticulous planning is required to ensure the SPV can deliver through construction efficiently (i.e., on-time and on-budget) prior to the project generating revenues. Mitigating construction risk can be facilitated by strong contractual obligations with contractors, enforcing financial penalties for underperformance.

Distinguishing Characteristics of Project finance

Project finance has several characteristics that distinguish it from other financing mechanisms as follows:

Figure 5: Project Finance Characteristics



Special Purpose Vehicle (SPV)

The SPV is a legal entity, established solely for the purpose of owning, operating, and financing the project. The structure helps isolate or “ring-fence” the project’s assets and liabilities from any other assets owned by the sponsors. Creation of a new legal entity separates the project from the sponsor so neither have claim to the other’s assets in the event that the project experiences a interruption in cashflow due to an adverse event (e.g., reduced worldwide demand in a product like natural gas), recourse (collateral) is limited only the assets of the project.

Limited or No Recourse Financing

Lenders provide financing with limited recourse to the sponsors (e.g., owners or investors) of the project. If the project encounters financial difficulties, the lenders’ claims are primarily restricted to the project’s assets and cash flows rather than the sponsors’ general assets.

Lender Covenants

In order to maintain the creditworthiness of the project, lender covenants may be applied to the SPV. Lender covenants are contractual requirements or restrictions on the SPV’s actions, dictating things they can’t or must do. Covenants can influence operating, investing, and financing activities. Particularly, covenants may restrict issuing additional senior debt during the operating cycle, specify how net income is distributed, and constrain operations to a single mandate. Project finance requires a precise business plan that defines the core, and often sole, operating purpose which the SPV will pursue. These entities are created with a mandate to operate in one business line or revenue generating unit, thus limiting the project’s operating activities to strictly what is defined, ensuring the project investors do not need to reevaluate creditworthiness based on new activities.

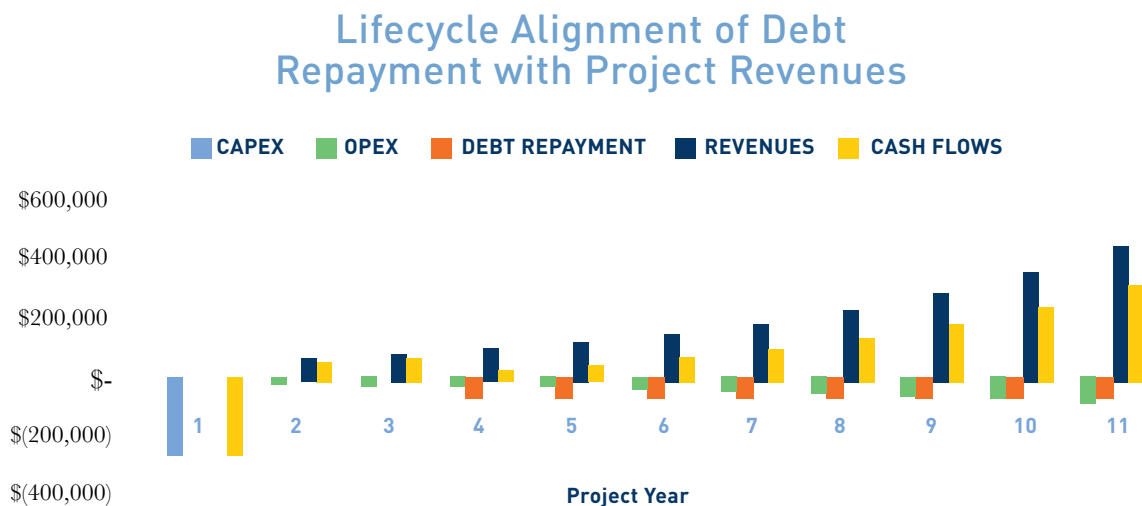
Capital Intensive

Project finance typically involves capital intensive projects requiring significant upfront capital investment that may not be feasible through traditional financing.

Debt Repayment

Repayment of debt is based on cash flows generated by the project itself. These cash flows often come from offtake agreements, such as the sale of electricity, tolls from a pipeline, or from a user base such as tolls on a toll road or resource road. These project finance loans are often long-term in duration, designed to align with the project's revenue generating capacity lifecycle. The figure below illustrates how debt repayment is structured to align with when project revenues grow to a level sufficient to service the interest and principal payments. Note the grace period, debt repayment doesn't begin until year four, allowing the project time to scale up revenues through two years of operations.

Figure 6: Lifecycle Alignment of Debt Repayment with Project Revenues



Risk Allocation

Project finance involves a detailed identification, assessment, and allocation of risks among the parties involved, including the sponsors, lenders, contractors, and government entities. Risks can include construction delays, cost overruns, revenue shortfalls, and regulatory changes. SPVs allocates risk to different, specialized parties (e.g., lenders, operators, constructors) to optimize risk transfer by decreasing the likelihood and impact of a costly risk event.

Due Diligence

Lenders conduct extensive assessments of the project's technical, financial, legal, and environmental aspects to understand and mitigate risks and assess creditworthiness. Each project is unique, requiring tailored financing structures that consider the project-specific characteristics, risks, and objectives.

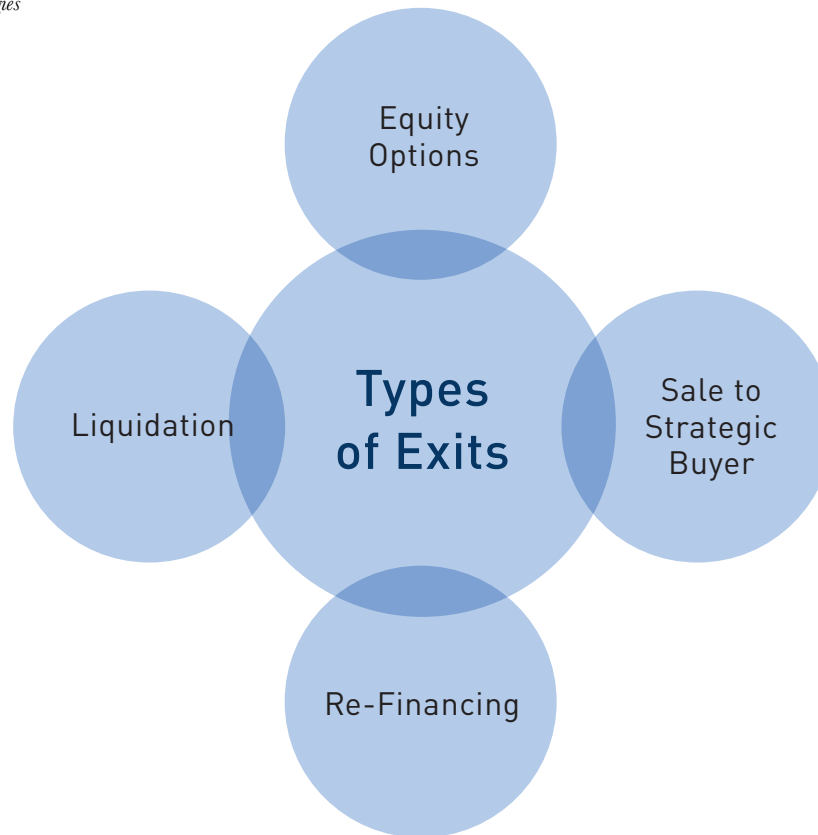
Government Involvement

Many project finance deals involve significant government involvement, including regulatory approvals, permits, and sometimes government guarantees or support to mitigate certain risks.

Exit Strategy

Project finance transactions often have a well-defined exit strategy, which may involve the sale of the project or refinancing once it reaches a certain stage of maturity or completion. The residual value of projects is often difficult to assess, and is not included in the project's cash flow or revenue analysis.

Figure 7: Exit Strategies



What are the Common Mechanisms to Finance an SPV?

The analysis that follows in the report demonstrates the principles of debt facilities applied to most projects, and the role of equity.

Equity Financing - Equity ownership in a project is purchased through the sponsors/owner's own funds, which can sometimes come through government funding (e.g., grants and subsidies), or commercial loans that are guaranteed by government entities or other security. Equity investment in major natural resource infrastructure projects can range from as low as ~20% of construction costs for low-risk projects to as high as 50% for riskier projects.

Debt Financing - Borrowing senior debt loans through financial institutions is the primary avenue through which an SPV secures project finance debt. The debt financing is usually the largest financing tranche, committing all financing not satisfied by equity contributions. Occasionally, more than one debt positions might

be used (e.g., senior and junior debt). Senior debt is often the largest portion of debt, is typically secured by some collateral, and gets paid ahead of other subordinate loans. These subordinate, or junior debt positions carry a greater risk to those lenders, as they are paid after senior debt and may not always have collateral security. Accordingly, they require higher rates of return to accept that additional risk.

Tax Increment Financing - Public funding can sometimes be secured by earmarking future property tax revenue generated through increased property values resulting from the project. This is essentially pledging future revenues from one asset to finance another.

Land and Natural Resources - Project sponsor or partnerships can leverage natural resources and land through leases, timber rights, and resource royalties to earn an ownership interest in a project, or to secure a right to distributions.

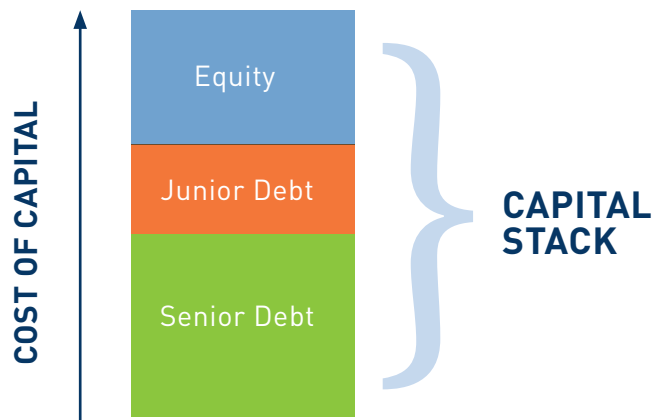
Project Finance Best Practices

Figure 8: Project finance Best Practices



Credit Facilities and the Capital Stack

Figure 9: Credit Facilities



Each credit facility, or tranche of the capital stack, carries a different risk profile and anticipated rate of return for the investor depending on the collateral associated with their investment, and the repayment priority. In terms of seniority of repayment and payments to financing parties, senior debt is paid first, followed by junior levels of debt (if applicable), and finally equity shareholders receive distributions of remaining cash flows.

Figure 10: Waterfall Repayment



Senior debt

Senior debt typically takes the form of a long-term loan, which is the first in line for repayment. It is secured by the project revenues and by the first lien on the project asset(s), which can be used as collateral in the event of default. As a result, senior debt carries a relatively low interest rate, which is why it typically makes up the largest portion of financing for a project in order to increase economic profitability.

Junior debt

If the majority equity holder cannot or will not secure all the required debt as a senior debt facility, project sponsors may be required to take on junior (subordinated) debt facilities that have a lower repayment priority and therefore come at a higher interest rate. Of the three facilities described in this analysis (senior debt, junior debt, and equity), junior debt is the least frequently used facility.

Equity

Equity is a financial investment made in exchange for an ownership stake in the project. To source debt for a project, lenders will require that developers invest their own capital in a project company as a form of collateral to ensure that they are incentivized to successfully deliver the project. Equity investors are at the top of the capital stack (implying highest risk exposure) as they are the last of the project's investors or lenders to receive repayment. In the event of default, equity holders will only be repaid after all other investors (e.g., debt holders) have been repaid in full. Accordingly, equity investments carry the highest risk of non-repayment, and require the highest rate of return.

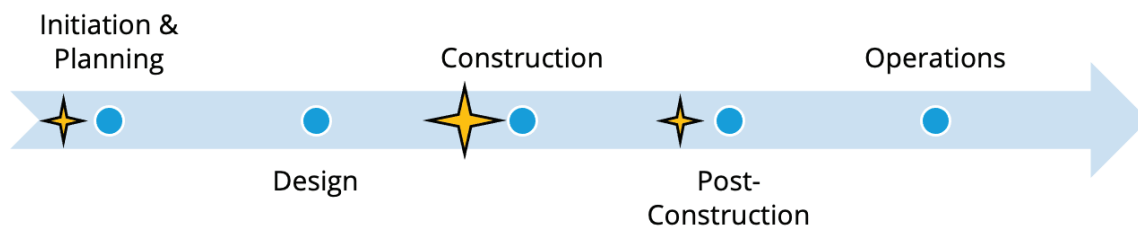
Weighted Average Cost of Capital

Collectively, the various debt facilities and equity that comprise a project's capital stack are what determine the weighted average cost of capital (WACC). If the project WACC increases, meaning the net cost of financing increases, then the return on investment (ROI) or the net profit to project owners, decreases. If the majority shareholder is forced to resort to more expensive debt facilities to finance the project, this erosion of the project's ROI can push the project beyond its viability as revenues may be insufficient to service debt obligations and provide owners with their required rate of return.

When and How Debt is Drawn Upon?

Structuring how funds are allocated and used through a project's duration are carefully planned in project finance. Drawing upon debt and equity during project construction, has a specific set of rules and parameters that inform when and how debt and equity are used. Typically, a structured process is followed to ensure that funds are disbursed efficiently and used for their intended purpose. The graphic below illustrates debt drawdown timing and magnitude over the traditional project lifecycle (yellow star icons), the largest drawdown often occurring prior to construction. Equity injections into the project often follows a similar pattern of debt drawdowns.

Figure 11: Debt Drawdown through Project Lifecycle



Before construction begins, financing is earmarked for various purposes with contracts that outline terms and conditions for the disbursement of funds. This specifies procedures, conditions, and requirements for drawing against financing. Primarily, milestones or other triggers like earned value² act as stage gate, that upon achieving, permit financing to be drawn upon. These payment triggers are tied directly to project progress such as completion of a construction phase, passing inspections or other operational performance standards.

Upon completion of a stage gate or milestone, the SPV requests additional funds from their lender (a drawdown); lenders will require certification and other documentation to provide evidence to the lenders that the construction is on time and on budget, and not expecting any bad surprises. Often, this information package will consist of progress reports, certificates and compliance statements, and schedules. Lenders may then pursue due diligence to validate that the progress claims are accurate and are aligned with contractual agreements; this includes site reviews, assessment of project risks, and review of construction documentation. If conditions are satisfied, the lenders will continue to distribute the funds accordingly. If the construction is not meeting expectations and cost or date overruns are anticipated, the project owners will need to identify the plan forward and convince lenders that their investment(s) will be recovered before they release additional funds or increase the borrowing limit(s).

² Earned value (EV) is a way to measure and monitor the level of work completed on a project against the plan. Simply put, it's a quick way to tell if you're behind schedule or over budget on your project. You can calculate the EV of a project by multiplying the percentage complete by the total project budget.

When is Equity Injected?

Equity can be injected at several stages in a project's development for various purposes including funding construction, operations, and reserve accounts. Like debt drawdowns, the magnitude and timing of equity injections is a function of accomplishing milestones and stage gates. Accordingly, project finance contracts detail when equity and debt financing can be done; contracts are customizable to maintain flexibility. Injections are frequently structured around the following stages and needs:

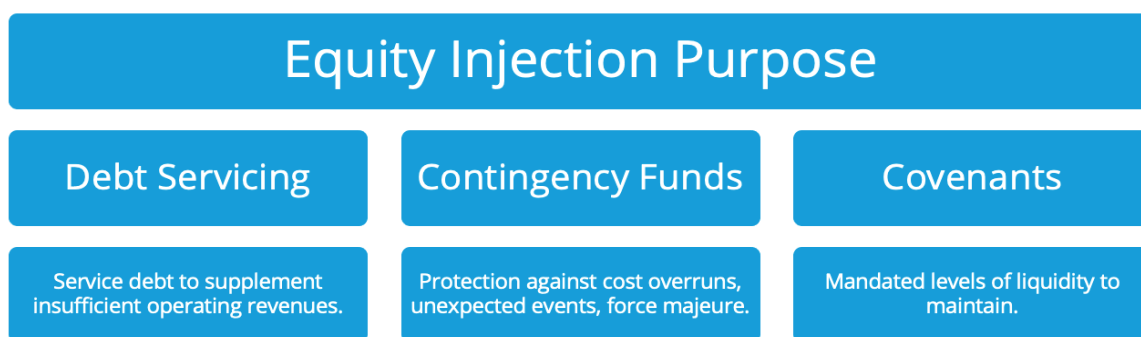
Initial Equity Contribution – Project sponsors make an in-kind equity contribution at the outset of the project, funding project development activities including feasibility studies, permitting, and securing land. The initial contribution is sizeable to allow the project sponsor to establish the SPV and create the groundwork for project success. If and when the project is successful, these costs can be capitalized into the lending package, and the project sponsor retains their ownership of the project.

Construction Phase – Typically the cash equity contribution will be made during the construction phase due to the capital-intensive nature of construction-related costs of materials, labor, and equipment, and to satisfy lender requirements of first-loss capital requirements. Equity can also be injected at the end of the construction phase once debt financing is fully drawn; carries a higher rate of return profile and project owners want to keep costs of financing low. This approach requires lender consent.

Pre-Commercial Operations – Equity injections at this phase act as bridge financing to support the transition from construction financing to operations financing (a refinancing, described in the section that follows, can often also change the debt-to-equity ratio, which is a recapitalization). The equity can be used for construction cost overruns and unexpected expenses, ensuring the project stays on schedule and has sufficient funding to transition to the revenue generating phase.

As operations commence and scale up to peak operating capacity, there is often a need for equity to cover operational expenses, maintenance, and working capital requirements. At this point of the operating phase, the project's revenue streams may have not scaled to be sufficient to cover operating costs, so an equity buffer can be required.

Figure 12: Equity Injection Purposes



Debt Servicing – Equity injections, in the absence of a fully-funded debt service reserve account³ can also be used to service debt obligations during periods when cash flows are insufficient to meet debt payments; these act as a safety net to ensure timely debt servicing and keep lenders from exercising their remedial rights of assigning a lien on the project assets.

Contingency Funds – Equity-financed contingency funds may be used to earmark money to support unanticipated events.

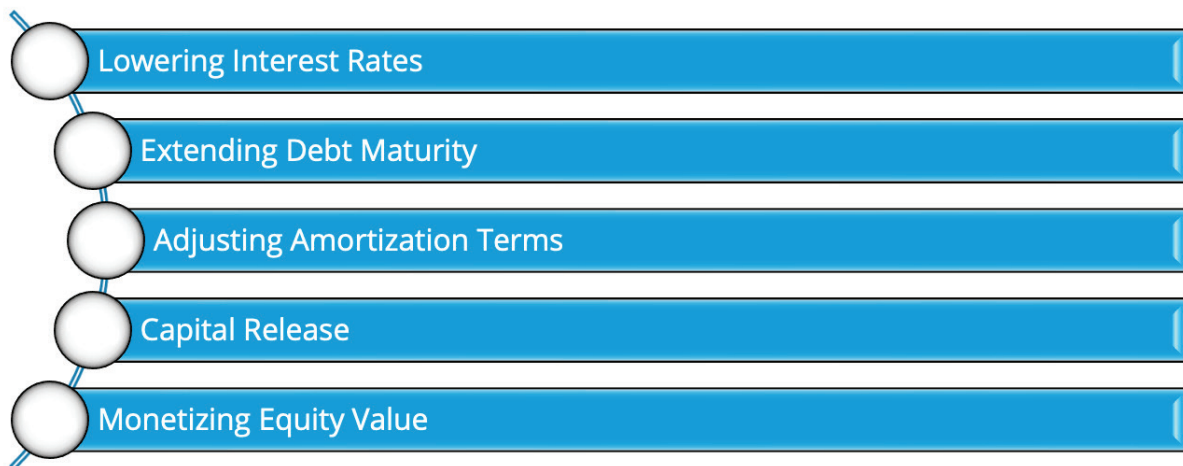
Covenants – In some cases, debt covenants may require maintaining defined levels of liquidity, solvency, or other fundamental ratios. Equity may be injected to maintain the SPV's contractual covenants (e.g., to maintain liquidity to service debt due for 1 year).

What is Refinancing? Why Does it Happen?

Refinancing is the process of replacing or restructuring existing debt with new debt or new financial arrangements to improve project economics. In essence, refinancing often takes place when a major milestone is reached, like shifting from the construction phase debt to long-term operations phase debt, which redefines the terms of a debt agreement. Project risk often diminishes substantially when construction concludes, meaning cheaper debt should be available to projects that have achieved successful operation and corresponding lower risk. Changes can target the interest rate, term of repayment and numerous other factors. Refinancing is a strategy that can be used to improve a project's financial health and position for long-term success but has important considerations.

Objectives of refinancing include:

Figure 13: Objectives of Re-financing



³ Debt Service Reserve Account, also known as DSRA, is a cash reserve account set aside to make debt payments when debt services are not available due to cashflow disruption. It is funded from project revenues, and may not be fully funded in the first year of operations.

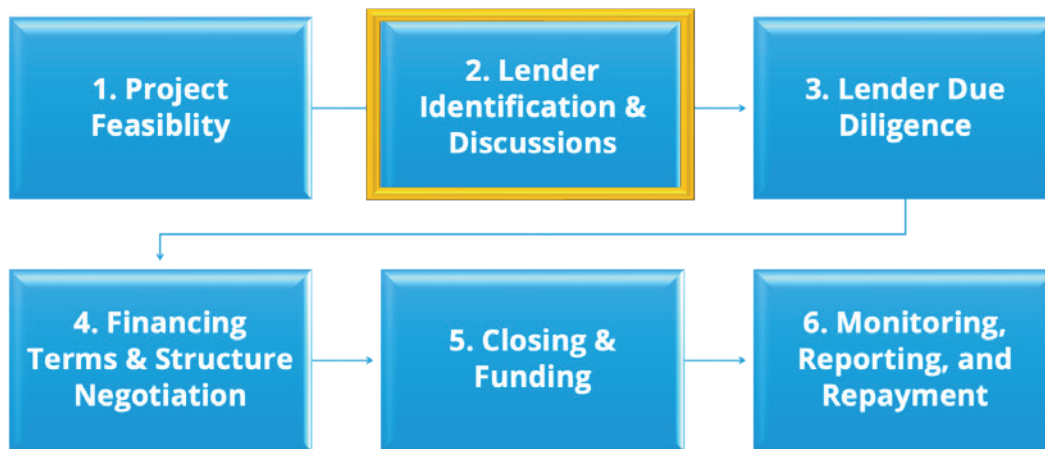
Refinancing can offer several advantages in project finance, including reducing costs, improving cash flow, and accessing higher quality capital. Successful refinancing can help enhance the project's financial sustainability and competitiveness in the market.

However, there are many factors to consider prior to refinancing and recapitalizing. Refinancing involves a significant process to assess the feasibility, allow lenders to perform due diligence, negotiate updated terms, transition, and retire existing debt. Because of this process, there are corresponding transactions costs to account for. Additionally, refinancing debt may include early repayment penalties amongst other costs, which should be evaluated to determine whether they influence and potentially outweigh benefits of refinancing. Meanwhile if a project has appreciated in value since its inception, resulting in improved cash flows, the SPV can realize this gain by monetizing their equity. Based on the project's increased valuation, owners may be able to secure new debt at more favourable terms (e.g., a lower interest rate, a longer interest-free grace period), increase the overall debt-to-equity leverage, and provide themselves with an increased equity value. Similarly, if the project is able to attract lower cost capital than originally forecast this can increase equity owners return on investment over the long term.

2. Working With Lenders

Engaging with lenders is a critical step in securing the necessary financing to execute a project. Project finance involves complex and interrelated factors that can be simplified in part by early inclusion of lenders in the development phase. Effectively working with lenders creates added certainty, allowing effective allocation of project risks and greater accuracy predicting project cash flows. This process involves several stages, from initial discussions with potential lenders to the finalization of loan agreements.

Figure 14: Working with Lenders



The process of raising capital begins with the project owners leading feasibility studies to assess the project's viability and risks. A significant due diligence package is involved in this phase, yielding a feasibility assessment covering technical, financial, legal, and environmental assessments. The project feasibility assessment creates the framework for the financing negotiation process and the project as a whole. The project owner leverages the feasibility assessment as a framework when identifying target financing terms and gearing, working with financial advisors to identify and engage lenders with a project briefing (or 'teaser'), to gauge interest and progress to a shortlist of potential lenders.

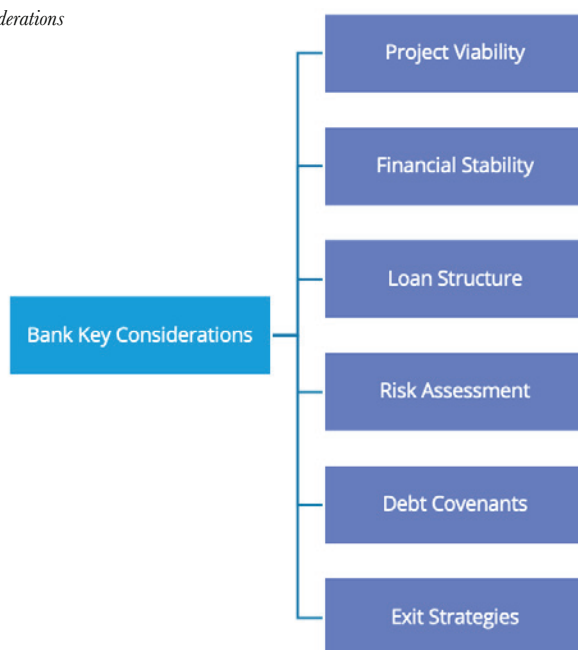
Shortlisted lenders will require the feasibility assessment and will lead their own independent due diligence of the project. These analyses drive their decision to get involved, outlines their preferred financing terms, and initiates the negotiation process. Lenders will submit a financing proposal and term sheet to lead the financing negotiations, and in a competition-style approach, project owners will select their preferred lender. Upon agreement and signature of loan agreements, the financial close will commence with the lender releasing funds based on the defined terms.

Throughout this process, effective communication, due diligence, and negotiation skills are critical. Project finance transactions are complex, and all players need to carefully manage risks and ensure that the project can meet its financial obligations over the long term. Legal, financial, and technical advisors often play vital roles in helping structure and execute successful project finance deals.

Bank Lenders

Banks play an important role in project finance, acting as a key financial intermediary that provide financing (particularly during the construction phase), financial expertise, and risk management services to facilitate the successful execution of infrastructure projects. Banks undertake several different roles when engaged for project finance, most important of which is structuring financing. They are specialists in financial and risk due diligence, helping project sponsors gear financing to align with the project's cash flows and risk profile.

Figure 15: Bank Key Considerations



Banks conduct a robust evaluation of projects to determine their suitability for investment. This comprehensive assessment includes financial, technical, legal, and market aspects. The evaluation process begins with a review of the project's feasibility study, assessing factors such as market demand, financial projections, and risk analysis. Banks scrutinize financial models, examining cash flow projections and key metrics like debt service coverage ratio (DSCR), internal rate of return (IRR), and return on equity (ROE). A thorough risk assessment identifies and quantifies construction, operational, market, regulatory, and financial risks, while legal and regulatory compliance is evaluated alongside technical feasibility and environmental impact. Contractual arrangements, equity investment, and the project team's capabilities are all considered, culminating in a credit approval process. Once approved, banks work on loan documentation and continue monitoring the project's performance throughout its lifespan, ensuring compliance with loan covenants, and assessing evolving risk profiles.

A bank considering a finance stake in a project will consider numerous factors, most of which should be answered in-whole or in-part by the project sponsor's feasibility study. Banks predominantly provide credit facilities with shorter-term horizons, under ten years.

Project sponsors should evaluate the impact of various project scenarios in the following key areas:

- » **Project Viability** – Confidence in business plan, financial projections, market analysis to ensure there is market appetite for the project and generally, the industry or sector. Moreover, analysis could integrate the sustainability of the project regarding legal and regulatory compliance.
- » **Financial Stability** – Ability for the SPV to service the debt in terms of project cash flows as well as any collateral.
- » **Loan Structure** – Alignment of the debt’s repayment term with the project’s revenue generating term or overall project life.
- » **Risk Assessment** – Comprehensive risk assessment of the market, project operations, industry/sector regulatory factors. Historical projects delivered by or in-part by the project sponsors will be evaluated.
- » **Debt Covenants** – If issuing debt, the bank may integrate covenants that aim to improve the likelihood of debt repayment. This may involve enforcing insurance requirements, maintaining cash liquidity ratios, and restricting subsequent debt issuances with senior claims to cash flow.
- » **Exit Strategies** – Banks will be interested in the project sponsor’s exit strategy following completion of the debt repayment and/or project life cycle. For example, the construction loan provided by a bank should be refinanced by debt when the project begins operations.

To ensure First Nations are involved, knowledgeable, and make meaningful contributions to negotiations with banks and other financial institutions, they should include in-house financial expertise or a third-party financial and commercial consultant to act as a representative of the First Nation and/or its development corporation. Regardless of who the responsibility is allocated to, it’s important for the First Nation to be familiar with all the project information evaluated by the bank.

Debt Lenders

Debt instruments are a commonly used financing instrument in project finance and are typically used for long-term financing up to 25 years.

For the sake of discussion, we will discuss two broad types of debt, differentiated based on their priority of claim on cash flows. Senior debt holds a priority position in capital structure meaning that in the event of bankruptcy, senior debtholders have a higher claim to assets and cash flows; these are the first lenders to be paid. Senior debt can be ‘secured’, meaning it is backed by collateral as insurance against default, or ‘non-secured’, meaning there are no pledged assets besides project revenues; based on project finance’s tendency to have limited or no-recourse, non-secured debt will be more common.

Subordinate to senior debt, is junior debt which gets paid after senior debt in priority of claim to cash flows. Debt financing offers several advantages for the SPV including predictable debt servicing costs, lower cost financing, and a wider investor base. Loans are fixed long-term contracts, and are relatively inflexible once assigned. Important considerations when incorporating debt into the capital structure include the structure of loan repayment (e.g., bullet, amortizing, delayed amortizing) to ensure that payments are matched with project revenues. Lenders work closely with owners to engineer the most sensible and cost-effective debt solution(s).

Equity Investors

Equity investors play a pivotal role in project finance by providing capital in the form of equity investments to support the development and execution of the project. Unlike bank or debt financing, equity financing involves the investment of funds in exchange for an ownership position in the project.

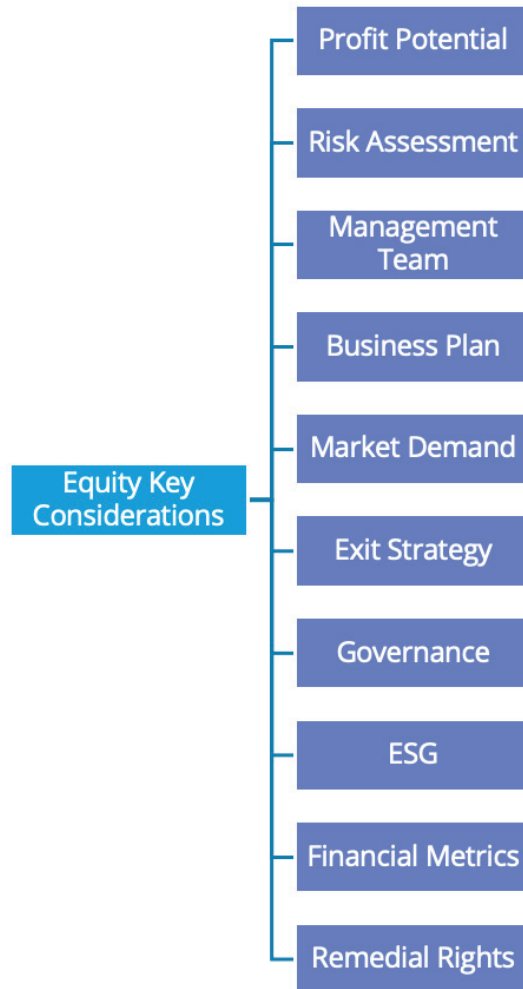
Equity investors expect profit-sharing arrangements that outline their entitlement to a portion of the project’s profits, contingent upon its performance. They play a significant role in project governance, influencing strategic decisions and holding representation on the project’s board of directors.

It is essential to consider the impact of equity investors on ownership and decision-making autonomy. In scenarios where First Nations seek loans to leverage as their equity investment, they must be diligent ensuring that their lenders are not receiving their own equity position.

Private equity investors do not provide equity loans to project owners, rather they purchase equity for themselves. They can be excellent project partners, especially on very large projects, but in principle they do not lend or offer support to other equity investors. First Nations should be mindful in aligning with private equity, which may necessitate negotiations to safeguard cultural and community interests.

Equity investors share some common interests and considerations as debt investors when considering investment in a project including:

Figure 16: Equity Key Considerations



- » **Profit Potential** – Equity investors are motivated by the potential for significant returns on their investment. They seek projects with strong profit potential, usually evidenced by robust financial projections and a clear path to profitability.
- » **Risk Assessment** – Conduct thorough risk assessments to understand the project’s vulnerabilities. They want to identify and mitigate risks that could impact the project’s financial performance. This includes market risks, operational risks, and regulatory risks.

- » **Strong Management Team** - A capable and experienced management team is crucial. Equity investors want confidence that the project is led by individuals with a track record of successful project execution and a deep understanding of the industry.
- » **Business Plan & Market Demand** – Equity investors expect a well-defined and comprehensive business plan that outlines the project’s objectives, strategies, revenue generation model, and cost management. The business plan should be grounded and supported by market research. Moreover, equity investors seek projects in industries or markets with high demand for the product or service being offered, and they want assurance that the project can capture a significant market share.
- » **Exit Strategy** – Some equity investors can be interested in the project’s exit strategy. These equity investors want to understand how and when they can realize a return on their investment. This may involve a strategy to develop a project with the objective of a secondary market transaction to sell some or all of their equity stake when the project is either in construction or is operational (or achieves certain financial milestones).
- » **Governance** - Equity investors seek governance rights or participation in decision-making processes. They want to ensure that their interests are represented in the project’s governance structure and that they have a say in key strategic decisions.
- » **Environmental & Social Considerations** – Equity investors may assess environmental and social impact. Projects that adhere to sustainable and responsible practices may be more attractive to equity lenders.
- » **Financial Performance Metrics** – Equity investors typically evaluate financial performance metrics such as return on investment (ROI), internal rate of return (IRR), and payback periods. They seek projects that offer favorable financial performance prospects.
- » **Remedial Rights** - Equity investors may seek protective clauses and mechanisms that allow them to step into project operations or Equity otherwise protect their investment in adverse circumstances, such as project delays or underperformance.

First Nations should approach equity financing with a clear understanding of the implications for ownership, governance, and long-term project success. Particularly, private equity (PE) is uncommon for project financing of First Nation projects because PE have competing interests, they seek a majority ownership stake, greater return on investment, and greater board and operational control. These competing priorities make it challenging to integrate PE partners without creating adverse and potentially detrimental effects on the project profitability and success.

Lenders' Due Diligence and Advisors

Due diligence stands as a critical phase in project finance, serving as the cornerstone for informed investment decisions. This process ensures the technical, financial, and legal components of a project are subject to thorough examination. This section introduces the due diligence process lenders undertake financing a project. Additionally, we will explore the invaluable role of financial and legal advisors in guiding First Nations through this complex and demanding process, underscoring their significance in risk assessment, regulatory compliance, and the careful structuring of financing agreements.

Lenders are primarily concerned with the allocation of risk, viability of a project, and protection of their capital in the event of default. Lenders may prefer to have a project be majority controlled by a reputable and experienced private sector entity with a strong credit profile. In the absence of this, lenders can be concerned with the organizational capacity of a newly formed SPV.

The due diligence typically proceeds as displayed below:

Figure 17: Due Diligence Process



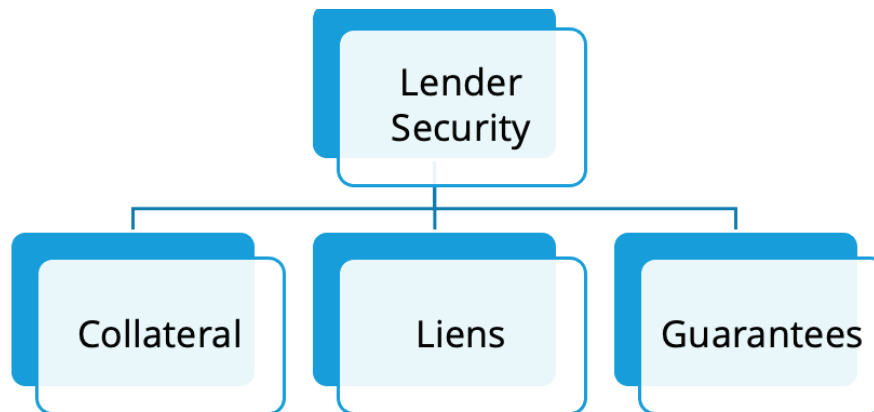
Financial and legal advisors play a pivotal role in supporting First Nations through due diligence intricacies. Financial advisors conduct comprehensive risk assessments, dissecting financial records and market dynamics to unearth potential pitfalls. They navigate the cash flow models, scrutinizing revenue projections and cost estimates to confirm a project's financial viability. Concurrently, legal advisors ensure adherence to laws and regulations. Their scrutiny extends to environmental compliance, land use permissions, and Indigenous rights protection, safeguarding First Nations from potential legal issues.

The roles extend far beyond assessments and examinations. These advisors are architects of sound financing agreements, skillfully negotiating terms with lenders that align with First Nations' financial objectives. They serve as strategic partners, guiding project owners through the intricate terrain of project finance with unwavering dedication to risk mitigation, regulatory compliance, and the creation of robust financial structures. Their expertise and partnership are the beacons illuminating the path toward successful project development.

Lender Security

Lender security serves as a protection for the interests of financial institutions that inject capital into project finance. This section introduces lender security, exploring the unique mechanisms used by lenders to safeguard their investments, including collateral, liens, and guarantees. Furthermore, we will explore how First Nations can navigate lender security requirements while concurrently upholding their own interests. Primary forms of lender security include:

Figure 18: Lender Security Overview

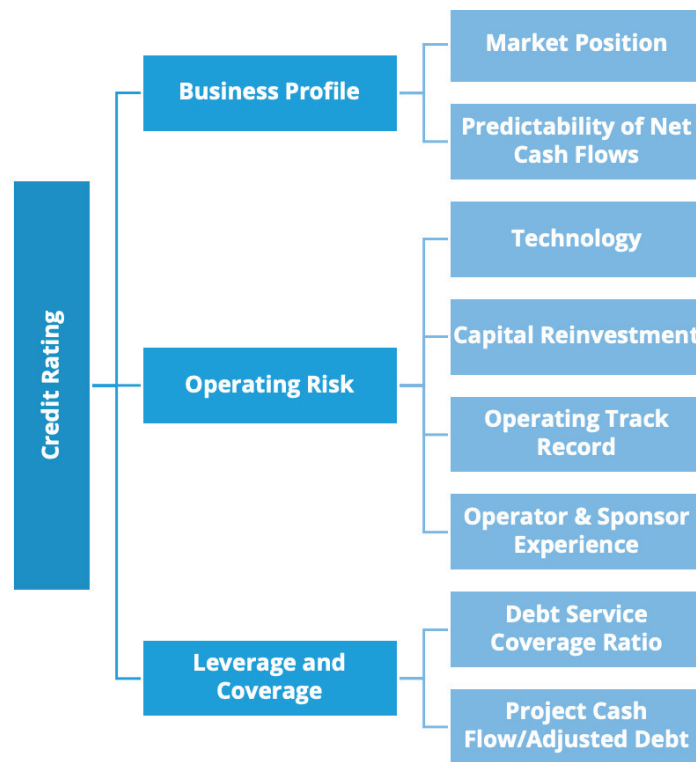


- » **Collateral** – Collateral is a tangible or financial asset provided by the project or borrower to secure the loan. It serves as a safety net for lenders, enabling them to claim and sell the collateral if the borrower defaults on its obligations. Collateral can encompass real estate, equipment, accounts receivable, or project revenue streams, depending on the nature of the project and the lender’s preferences.
- » **Liens** – Lenders often secure their position by placing liens on project assets. A lien grants the lender a legal claim or interest in specific assets, preventing their sale or transfer without satisfying the lender’s claims first. Liens can be particularly relevant in construction projects or infrastructure development.
- » **Guarantees** - Personal or corporate guarantees provide an additional layer of security. In this scenario, individuals, or entities, such as project sponsors or guarantors, pledge to repay the loan if the borrower defaults. Guarantees materially improve the creditworthiness of loan facilities.

3. Creditworthiness

The decision and degree to which lenders fund projects hinges on the project’s creditworthiness, the project owner’s ability, and the asset’s likelihood to meet financial obligations particularly in terms of repaying borrowed funds. Evaluating creditworthiness of a project involves a thorough assessment of the financial, industry, and operational aspects. Banks and other lenders examine the project’s financial feasibility through a variety of quantitative and qualitative measures to evaluate its ability to meet debt obligations. Banks and other institutions pursue a variety of methods to evaluate creditworthiness, typical evaluation criteria used to score credit are displayed in the figure below:

Figure 19: Credit Rating Framework⁴



Business profile, operating risk, and leverage and coverage metrics are key components that influence a projects risk profile. However, there are often features that introduce new risks that are not captured by these three overarching categories, and which can impact a projects creditworthiness upwards or downwards. Factors include liquidity, debt structural features, need for refinancing, construction risk, priority of claim (senior vs junior).

⁴ Medina, John & Sabatelle, Angelo & O’Loughlin Tomas & Maddick, Kevin & Segars, Douglas & Govindia, Kunal (2022) Generic Project finance Methodology, Moody’s Investor Services.

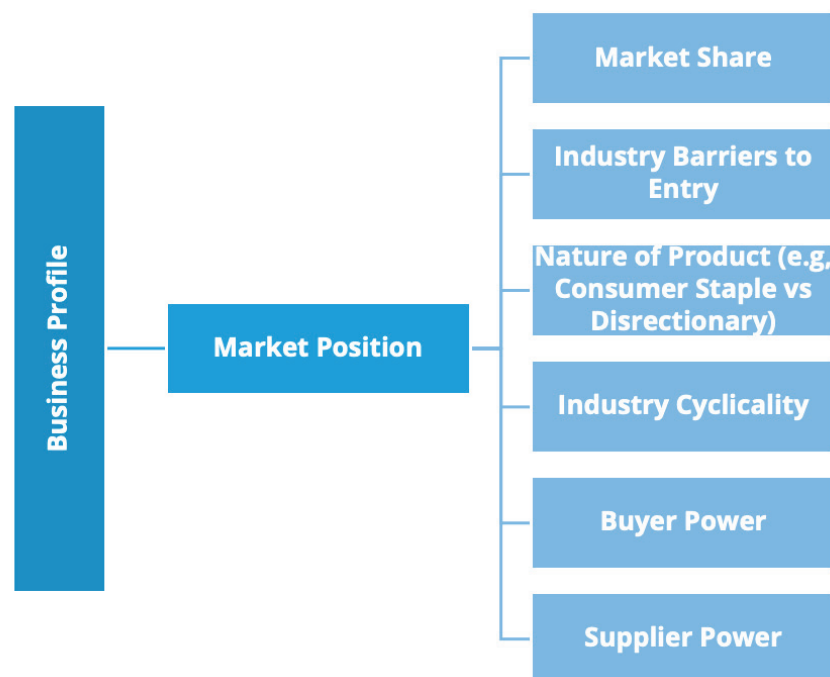
Business Profile

Business profile pertains to the project's competitive position within an industry or sector and its ability to generate sustainable cash flows over the duration of the project. The degree of business profile risk directly reflects the confidence in the sustainability of earnings based on the ability to grow and maintain market share.

Market Position

Market position evaluates the asset's pricing power held in the industry, which is driven by competitive forces. In essence, it is an assessment of the competitive environment the project operates within, and its likelihood to succeed. The emphasis is the nature of competition and the stability of the project's competitive position. It is important to emphasize that projects are often are reliant on some sort of supply chain. As such, projects part of an industrial supply chain is evaluated based on the competitive environments of their dependencies (e.g., input material costs or offtake market prices). Factors that determine competitive position include:

Figure 20: Market Position Drivers

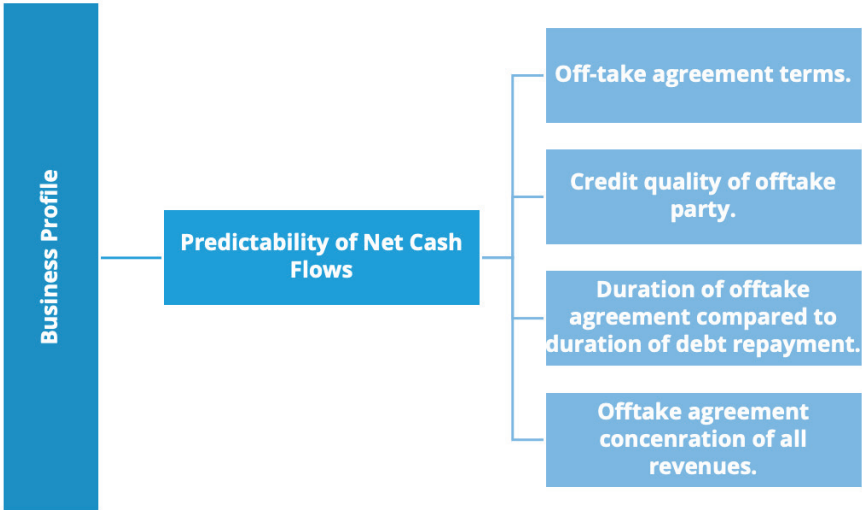


Predictability of Net Cash Flows

Future cash flows are the generated cash flow from project operations the SPV has available to pay back creditors and shareholders; free cash flow is the residual cash available for distributions to equity owners after all business and debt expenses.

Assessment of the relative predictability of a project’s future cash flows accounts for exposure to demand, volume, price, and costs over the debt re-payment term. The volatility of cash flows is evaluated under several scenarios (e.g., strong, average, and weak performance) to examine the expected range that cash flows may vary and the corresponding impact on the ability to service debt. Factors that determine predictability of net cash flow include:

Figure 21: Predictability of Net Cashflows



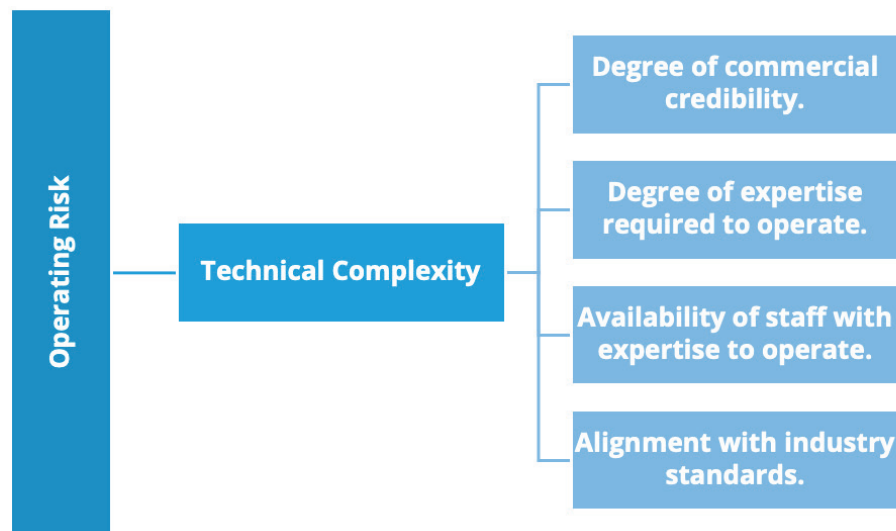
Operating Risk

Operating risk pertains to the project's day-to-day operations and business model. Asset operating performance is essential to evaluate as off-take agreements often have contractual payment tied to assets performance achieving or surpassing a defined standard (e.g., quality of output or availability). Failure to operate (e.g., missing inputs or closures) or to meet defined standards forces the SPV to rely on cash reserves, other cash flow, or sponsor equity to service debt which is a costly alternative.

Technical Complexity

Assessment of the project's technological complexity in terms of how commercially proven, and how long the technology has been in use within the industry and jurisdiction. Acknowledging that projects often involve a complex supply chain, analysis of this factor may extend to the interdependencies of markets and stakeholders the project relies upon (e.g., Off-taker's market). Factors that drive technical complexity:

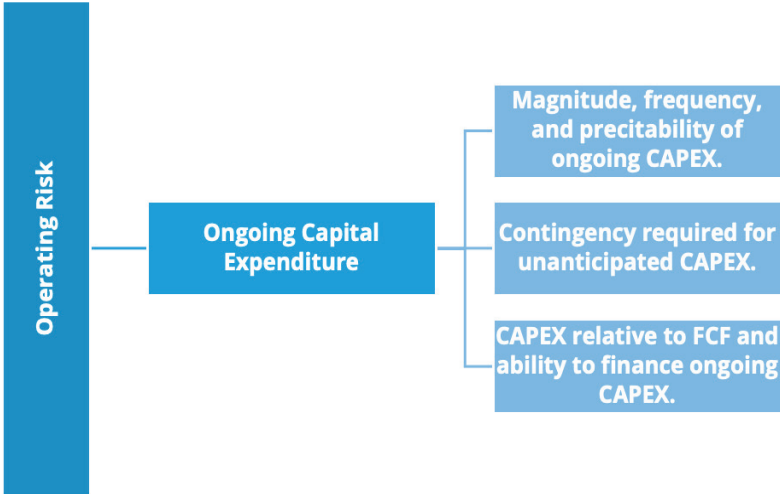
Figure 22: Technical Complexity Drivers



Ongoing Capital Expenditure

Assessment of the project’s required re-investment work required to maintain normal operations over the debt term and the forecast of capital expenditure (CAPEX). Emphasis is on CAPEX reinvestment that may impact the revenue generating capacity and the ability to service debt. Factors that drive ongoing CAPEX include:

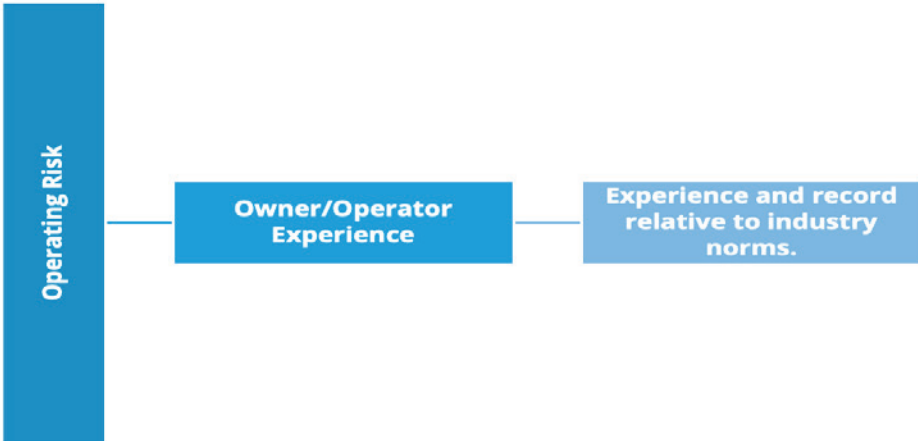
Figure 23: Ongoing Capital Expenditure Drivers



Owner / Operator Experience

Assessment of how the project’s operations or operating team have performed compared to industry norms for that particular asset type. If no historical performance, compared to similar projects with comparable technology. Factors that drive owner/operating experience include:

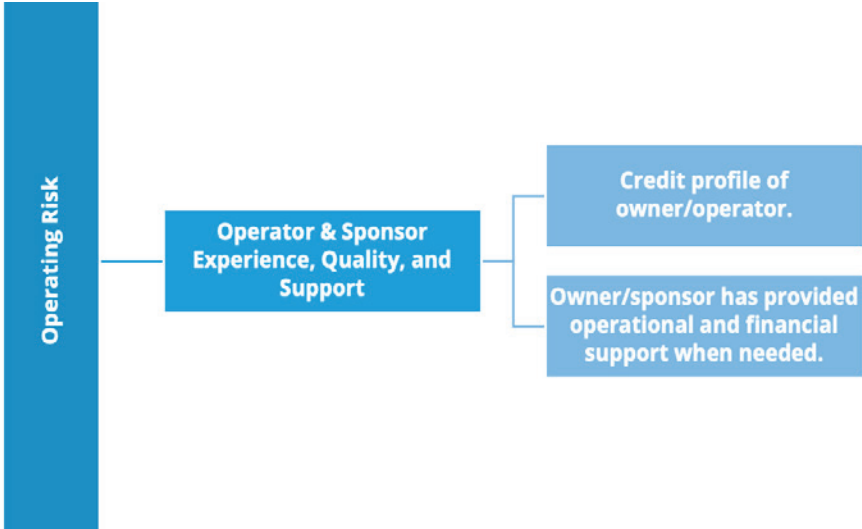
Figure 24: Owner/Operator Experience Drivers



Operator & Sponsor Experience, Quality, and Support

Assessment of the operator and sponsor’s experience with comparable projects. Operators are evaluated in terms of their credit quality, experience with similar assets, experience with projects in the specific region, and how replaceable the operator is. Sponsors are evaluated in terms of the likelihood to provide future financing or operating support. Critical to delineate financial and strategic project sponsors as their investment term differs. Strategic sponsors are more likely to protect the investment, inject equity, if the need were to arise. Factors that drive operator and sponsor experience, quality, and support include:

Figure 25: Operator & Sponsor Experience, Quality, and Support Drivers



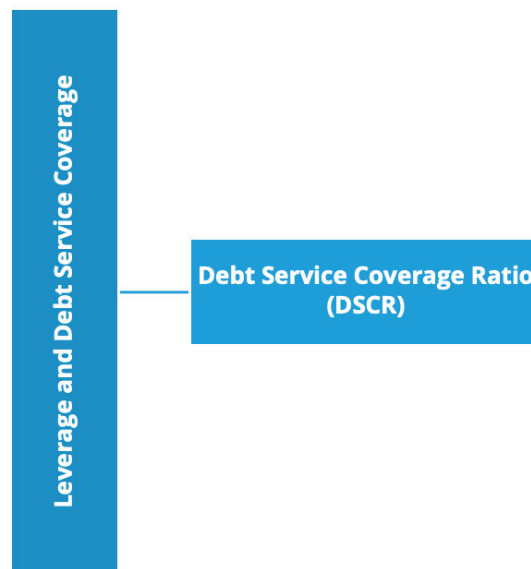
Leverage and Debt Coverage

Assessment of the leverage and debt coverage of a project pertain to evaluating the degree of debt financing used relative to the cash generating capacity of the project. Leverage and debt coverage are critical indicators of a project's financial flexibility and long-term viability; these measure the ability to adapt to changes in the economic and business environment. These metrics are critical to measure simultaneously with business profile and other factors.

Debt Service Coverage Ratio (DSCR)

Calculated on a forward-looking assessment, DSCR is a metric that reveals the project's available cash flow to satisfy the debt obligations. It is expressed as a multiple of how much higher the net operating income of a project is, relative to the debt obligations. Higher DSCR metrics mean that interest on loans can be covered many times over with available cash flows; higher risk projects tend to require higher DSCR forecasts to be considered higher quality. Thresholds for DSCR vary by project but typically lenders prefer a DSCR (section 1.2).

Figure 26: Leverage and Debt Service



4. Financial Structuring

Capital Structure and Due Diligence

Decisions surrounding capital structure are strategic that require due diligence related to the project's industry, growth prospects, risk, tolerance, and market conditions; due diligence adheres to the key components introduced in section "3. Creditworthiness".

Capital structure is the composition of debt and equity and the terms of the respective financing sources, which offer insight on the market's perception of the SPV and project.

The capital structure of project that rely on project finance and involve First Nations vary widely depending on the specific project characteristics. Use of SPVs, government funding support, and credible operating revenues will often increase availability of debt at cheaper interest rates earlier in the project's lifecycle.

Gearing ratios provide valuable insights into the extent to which a project relies on debt financing compared to equity. Understanding these ratios is essential for assessing the financial leverage and its ability to meet debt obligations. In the context of projects involving First Nations, gearing ratios can be particularly informative, as they help gauge the balance between external financing and First Nations ownership in these unique endeavors.

Gearing Ratio Determination

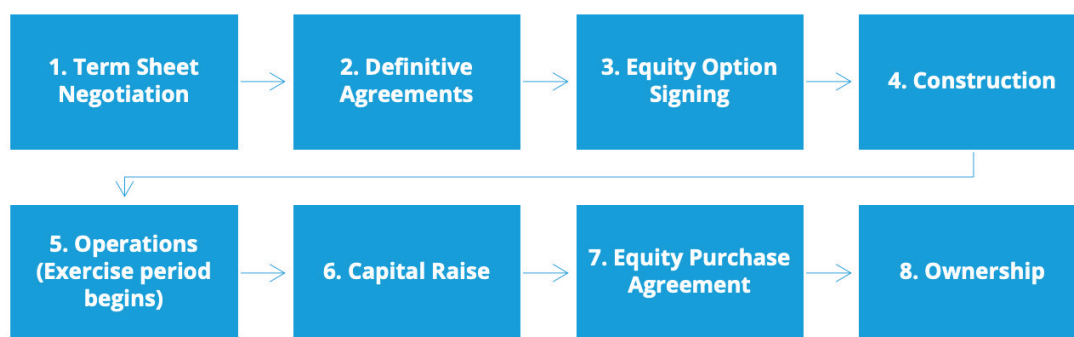
Gearing ratio determination, the process of calculating the debt-to-equity ratio for a company or project's capital structure, is valuable to interpret financial leverage and risk. At the outset of a project's evaluation, target capital structures based off industry standards or comparable infrastructure projects are used.

While guidance on gearing ratios begins with industry targets, it is finalized in the due diligence phase through discussions with debt lenders. They will undertake technical and financial analyses, to determine the percentage of overall project costs that they are willing to provide, the duration and the cost of that debt. Equity sizing is therefore in large part dictated by the debt lenders, who require a certain equity buffer to protect their investment.

Equity Option Agreements

Equity option agreements are contracts that convey to the holder the right, but not obligation, to purchase shares in the project at a given price on or before a given date. Equity option agreements are commonly used for First Nations to take a low-risk equity stake in infrastructure projects. Equity option agreements facilitate First Nation participation in infrastructure projects by offering protection from certain risks (e.g., financial, design, construction risks) since, equity option agreements can be structured whereby First Nations are not financially committed until the operations phase has begun, when there is greater confidence in project revenue generating capacity.

Figure 27: Equity Option Agreement



Minority or Majority Equity Positions

The differences between majority and minority ownership models go beyond the size of the ownership stake and include increasing responsibilities of the majority owner through design, development, and delivery.

Minority ownership contained in an option agreement is one approach that may be attractive to First Nations. In this scenario an option agreement can de-risk their investment by stipulating that they do not need to invest until the project becomes operational (i.e., at the commercial operations date) and revenue begins to accrue. Specifically, First Nations with this agreement do not bear any design or construction risk; if the project fails during construction, or if the cost overruns and delays are material enough to significantly diminish the financial outlook for the project, First Nations may decline to execute their equity option, but are no better or no worse off. Alternatively, if all goes well and projected returns on equity remain attractive as expected, then First Nations have the option to execute their equity option agreement and purchase their equity allocation.

Figure 28: Responsibilities of Majority versus Minority Equity Partners

Majority Equity Partner	Minority Equity Partner
<ul style="list-style-type: none">▪ Leads project development and delivery and arranges project debt.▪ Regular injections of capital leading up to financial investment decision.▪ Retains development, construction, and financing risks.	<ul style="list-style-type: none">▪ Silent partner.▪ Equity injected at commercial operation date.▪ No exposure to development and construction risks.

As majority or sole equity partner, a First Nation's involvement in the project usually begins much earlier and includes the sponsor role in the development and execution of the project. The early development phase requires often significant capital investment to fund feasibility and investment analysis leading to the financial investment decision. Depending on the nature of the project, development costs can be vary substantially and there may be a considerable time lag before the First Nation will begin to see a return on investment. This development capital is often a barrier for First Nations, and a common reason for dilution of First Nations interest in viable projects. Specifically, First Nations often offer partnerships (i.e., equity positions) with the private sector in exchange for development stage, at-risk capital. If the project does not go forward these investments are lost, if the project does go forward, the private partner has largely shaped the project. The majority owner is exposed to considerably more risk during the development and construction phases, but also gets to drive the deal and benefits the most from the project.

5. Conclusion

Project finance is a powerful tool that can unlock a range of benefits and opportunities for First Nations pursuing economic development and self-sufficiency through investment in major projects. By building expertise on the mechanics of project finance, First Nations can harness its potential to address critical infrastructure needs, create sustainable businesses, and build stronger, more resilient communities. In conclusion, project finance is not just a financial tool; it can be a tool for both self-determination and economic development. It is our hope that this report has enhanced First Nations' knowledge of project finance and key factors to consider and integrate when pursuing project finance.

6. For More Information

The First Nations Major Projects Coalition recognizes that we are stronger together. We continuously work to promote our First Nation members' interests and will continue to develop additional educational modules on financing participation in major natural resource and infrastructure projects. Meanwhile, please feel free to browse our existing resources at <https://fnmpc.ca/resources/>.



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