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## **PARTICULARITIES OF PROJECT FINANCE SECURITY (EXAMPLE OF AN INDUSTRIAL ENTERPRISE IN THE ODESSA REGION)**

Considered are the distinctive features of project financing security, presented is the structure of security and types of collateral relating to a factory building project implemented in the Odessa Region with the application of project financing. Given are the results of research recommended for investors and banks that finance projects in Ukraine.

**General definition of the problem.** The project financing, in its classical understanding, is the target crediting of the borrower for the purpose of the investment project implementation the payment obligations collateral being the funds flows generated by the said investment project. Thus, project financing is a form of investment project crediting when the project is the collateral for the credit. In Ukraine the project financing does not exist as such. That is why, under the conditions of the present Ukrainian economy, besides the project implemented as a result of its investing with all its assets and generated funds flows, additional types of security are applied as the credit collateral. Their application is caused by the requirement to decrease the project risks from the bank's point of view. Special features of the project financing security are considered in this work.

**Analysis of research and publications of recent years.** The project financing problematics are studied by both foreign and domestic scientists economists including: I. Blanc, Z. Bodi, Yu. Brikh, S. Briu, A. Gropelli, T. V. Maiorova, I. I.

Mazur, Ya. S. Melkumov, N. G. Olderogge, A. A. Peresada, V. P. Savchuk and V. D. Shapiro.

The project financing considerably differs from other types of financing. The main differentiating feature of project financing is the fact that the source of the credit repayment within the framework of its financing structure are exclusively the gains that are generated by the project itself, while the commercial credits repayment source is, as a rule, the common activity of the borrower.

Project financing substantially differs from crediting concerning the invested funds repayment as the main source of reliability of the credit return is the project itself, i.e. the quality of its preparation and implementation. In some cases there may be no "solid" security under the project financing at all. However that does not mean that in the project financing the possibility to have this or that credit security may be neglected.

The following provisions as regards security in the project financing are contained in the works of economic scientists:

According to I. I. Mazur [1, pp. 110-111], the project financing is mainly secured ... by the funds obtained from the investment activity object operation and, if required, the assets relating to the invested project. A. A. Suetin [2, pp. 1-5] affirms that in the project financing the funds repayment is, in the first place, based on the use by the project of the cash flows which are generated by the project itself, while all assets, rights and benefits are used as security. In D. V. Sadchikov's estimation [3, pp. 217] the instruments of security and guaranties typical for the banks are not necessarily used in the project financing, but they may be applied at various stages of the project.

T. P. Kurylenko notes that the project financing is characterised by special security whose basis is the confirmation of maintaining the planned cash flows by means of identifying the whole complex of risks connected with the project and dividing them between the parties that take part in the project implementation [4, p. 12].

**Separating the general problem parts unsettled earlier.** The issues of the project financing security are insufficiently illuminated in the modern theoretical developments and publications.

The main problem of finding security in the project financing is to find a certain balance between the parties' interests as the creditors seek the most significant

security, while the project organisers wish to divert as little property from the project as possible and also to prevent the creditors from taking recourse against the collateral before due date. Unlike ordinary credit when the borrower or organiser of the project takes all risks, in the project financing the risks are distributed among the borrower, creditor and, as a rule, third party. The guarantee of the credit is the economic effect from the project implementation (plus, in addition, the assets of the borrower and those of the relating companies comprised by the holding to which the borrower belongs)

**Task definition.** The task of this research is to determine the specific details of security in the project financing and its constituent parts. It is also necessary to define the peculiarities of the project financing security characteristic of the present stage of the Ukrainian economy development.

**Description of the research basic material.** The essential differentiating part of the project financing consists in the fact that the source of the credit repayment within its financing structure framework are exclusively the gains which are generated by the project itself, while in commercial and investment crediting the general activity of the borrower serves as the source of the credit return. The project financing substantially differs from crediting as regards security of the invested funds repayment because the project itself, i.e. the quality of its preparation and implementation, serves as the principal source of the credit disbursement.

The main distinctive features of the project financing are the following points:

- the project is financed by a bank, if the founders of the project (natural or legal persons) make their own, at least 30-per cent contribution to the project and agree to provide guarantee of the leading companies of the holding to which the borrower belongs and/or personal guarantee of principal business proprietors that initiate the project;
- as a rule, for the project implementation a special new company (SPV) acting as the borrower is organised.
- the project designed in the course of financing is taken by the bank as a pledge;
- the project includes a great many of enterprises involved at various stages of its preparation and implementation which belong to the project-initiating

holding and outside companies and organisations; and

- given the fact of security limitation at the initial stage of the project financing, there arises such essential peculiarity as the principle of allocating risks among the great number of the project participants affiliated to the project-initiating holding and outside companies and organisations connected with the project implementation.

When taking a decision on the concrete project funding possibility the bank appraises not only the existing assets of the project, but also the assets created in the course of the project implementation. Besides, the bank picks out and determines the project subjects possessing the assets acceptable for collateral formation and the relationships between the project subjects which may be formalised into the project collateral.

The collaterals most often singled out by the banks in the project finance in Ukraine are presented in Fig.1.

All the shown types of collaterals, or a part of them, may be used under the conditions of real projects. Besides, other types of collateral may be added. In each separate case the list of collaterals and concrete conditions may vary depending on the specific character of the financed project.

Let us consider the actual structure of a group of borrowers which has initiated and implemented the building of a factory in the Odessa Region with the use of the project financing by the bank with foreign capital (Fig.2).

The members of the invested holding:

1. The enterprise X (the entity related to the borrower, the constitutor of the Borrower, the Guarantor 1) and the Enterprise Z (the entity connected with the Enterprise X, the Guarantor 2) that control the Borrower's business, their own business is not connected with the principal activity of the Borrower, the Limited Liability Company N.
2. The Borrower, the LLC N, the company, which is a building products manufacturer, provides specialised equipment supply services, acts as the general contractor of building projects and performs the main stages of the building cycle.

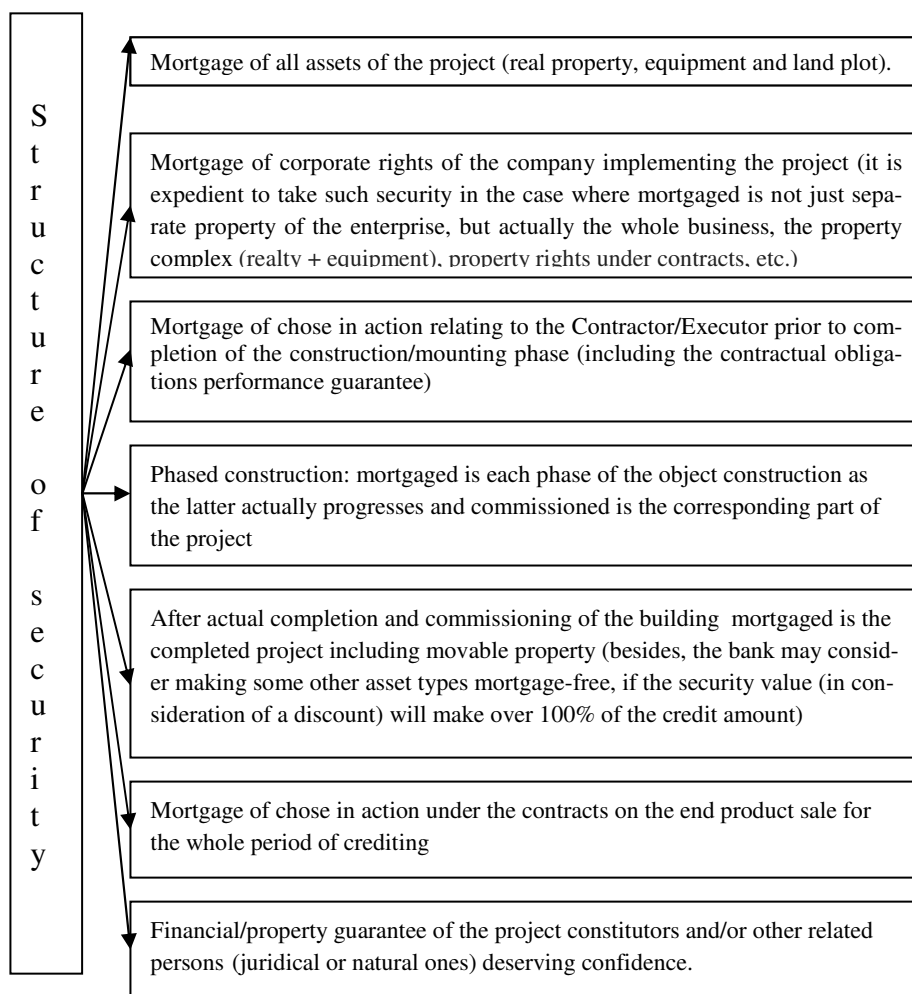


Fig.1. Structure and Types of Security Characteristic of Project Finance in Ukraine

3. The Firm 1 and Firm 2 are the companies-principals of the building and owners of

the land under the built objects.

4. The LLC W is a company of the group that performs designing and provides the project promotion services.

The scheme of interaction between the group members:

1. The company constitutors invest funds in the authorized capital of the following companies:

- the LLC N, the Borrower,
- the Firm 1 and
- the Firm 2, by financing their development at the initial stage and performing strategic and operating control over the companies activities;

2. The Borrower, LLC N, supplies finished products, the building materials, to both the companies of the group (the Firms 1 and 2) and external customers, and acts as the general contractor under the building projects;

3. The company of the LLC W group takes part in the project promotion.

4. The Borrower, LLC N, purchases the materials and component parts for building materials production, building machines, transport and equipment from the outside suppliers; the Firms 1 and 2 buy the building services that cannot be provided by the Borrower, LLC N, and all materials except for the building materials manufactured by the LLC N from the outside suppliers.

5. The finished products, the realty objects, are sold to outside purchasers (investors).

The project investing bank, on considering the structure of the Borrower's company holding and of outside companies and organisations taking part in the project implementation, forms a corresponding structure of the given project security being guided by the principle of risks allocation among the project participants. The actual structure and types of security acceptable for the bank in financing the project of construction of a factory in the Odessa Region are shown in Fig. 3.

Types of collateral on the project accepted by the bank:

1. Hypothecation:

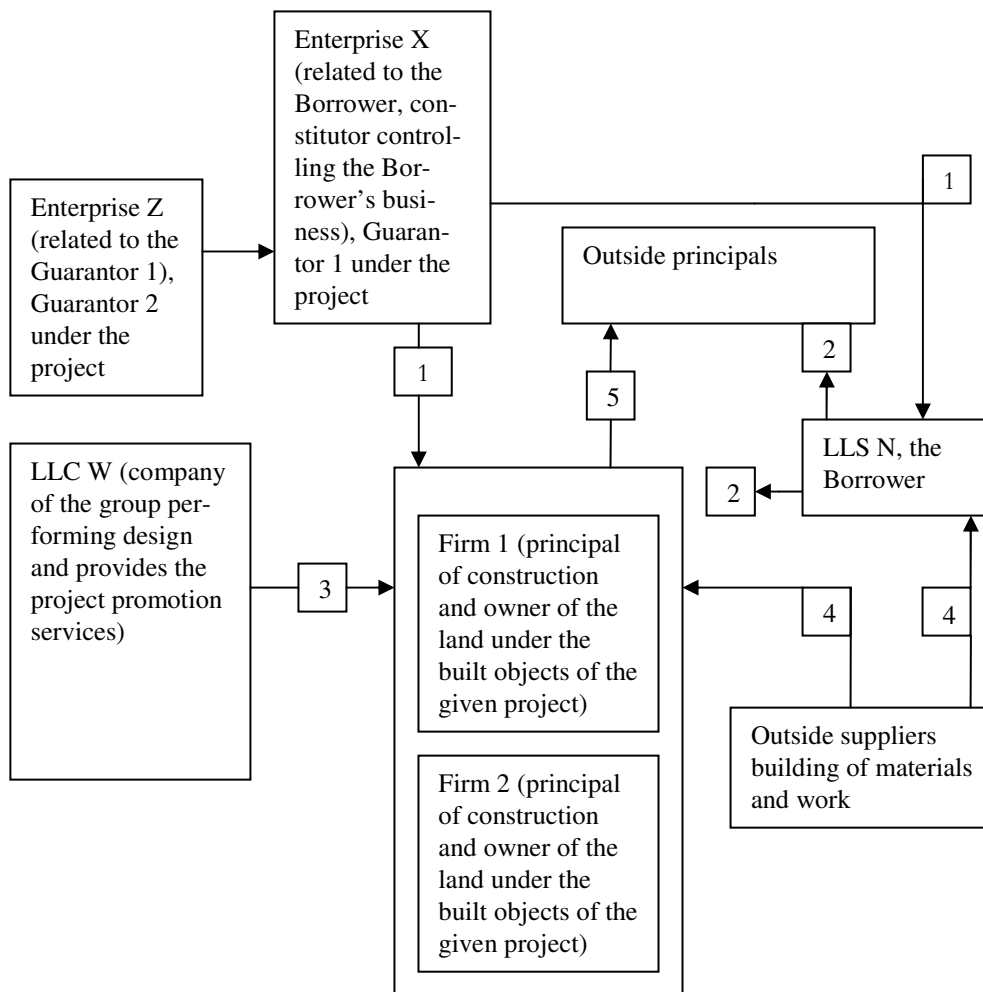


Fig. 2. Structure and Scheme of Interaction between the Borrower's Group Holding Members in Project Financing

the factory as an object of uncompleted construction is mortgaged in the form of mortgaged rights to the land plot on which such object is located. The Firm 1 acts as the mortgagee.

- Real property owned by the Borrower under a sale-and-purchase contract, which was used by the latter in the course of the project implementation and mortgaged;
- leasing agreement on the land plot 2 belonging to the Firm 2 on which the factory was built has not been concluded. The bank provided the time for making the agreement, 1-1.5 month after which mortgaged was the factory as an object of uncompleted construction by means of mortgaging the title for the land plot on which the given object is located. The mortgager was the Firm 2.

2. Pledge of transport facilities of the Borrower (20 units of cargo and specialised motor transport).

3. Pledge of contracts on supply of equipment and the factory building. Taken in pledge are the rights under all Borrower's contracts on the factory construction and purchase of equipment within 10 days after their entering in the Balance Sheet of the Borrower (before actual completion and commissioning of the factory). After actual completion of the factory building and commissioning the object of the factory first phase as a single property complex including movable property is given in pledge.

4. Pledge of corporate rights. Actually the whole business, the property complex (immovable property + equipment, property rights under contracts, etc.) was taken as a pledge, not some detached property of the borrowing enterprise.

In case of recovery against the pledged object the bank will sell the entire business. In such case corporate rights will be sold, while the whole property will remain on the Balance Sheet of the enterprise, a juridical entity. In order to pledge the corporate rights of the Borrower's LLC N members to a share in the LLC's Authorised Capital the Borrower have submitted the properly executed legal documents to the bank.

**Conclusions and perspective of further developments.** In this Article we have considered the approaches to determining such aspects of the project financing as the requirements to the project financing security in Ukraine by a bank with foreign investments. The bank's main approaches and requirements to project security were



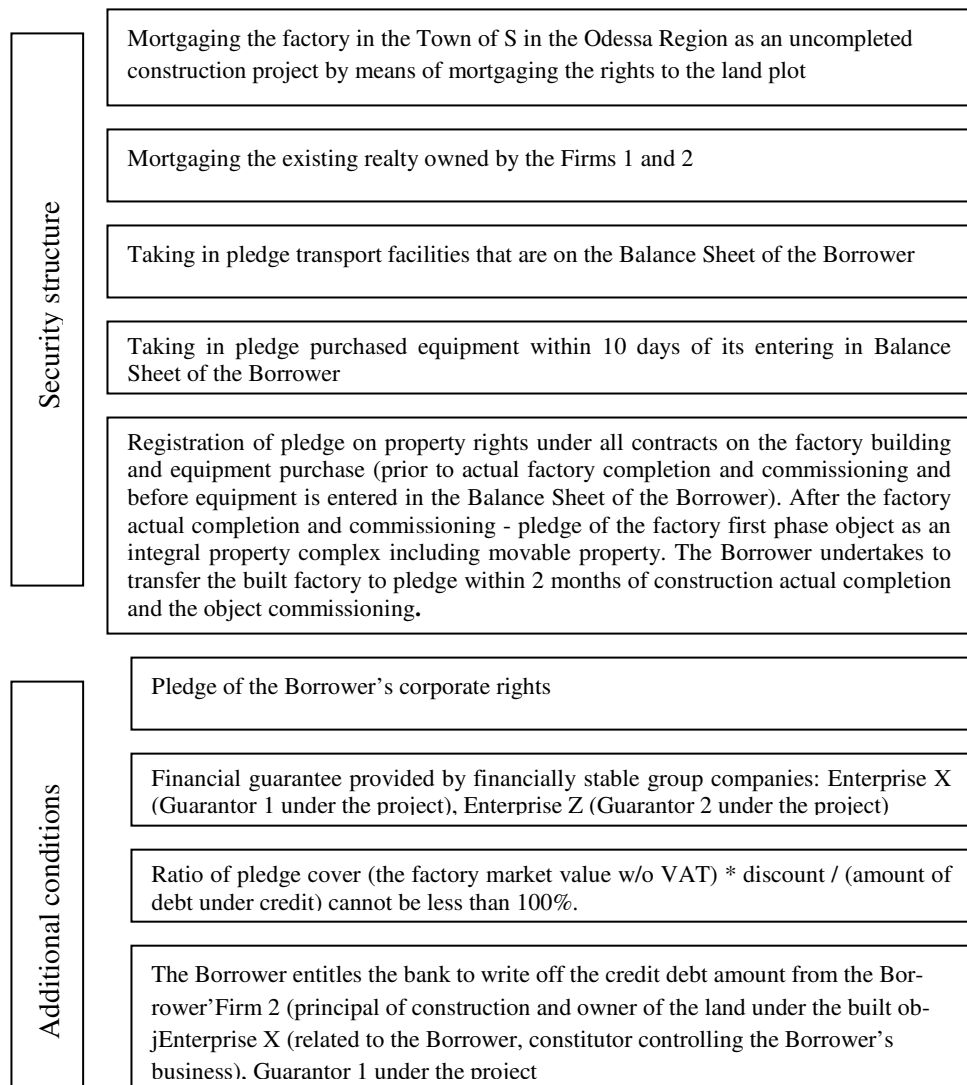


Fig. 3. Actual Structure and Types of Security under the Implemented Project

presented with the use of an example of a factory construction implemented in the Odessa Region.

Set forth were the principal types of security: mortgage, guarantee and additional conditions acceptable both for a bank with foreign investments that finances the project and for a domestic investor, the initiator of the project. This practical experience allows using it for both foreign banks which have come to the Ukrainian financial market and domestic and foreign investors.

Further research is planned to be directed to more thorough study of such parameters as conditions and structures of project financing.

### **Literature**

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