Project finance will survive a prolonged Covid-19 crisis beyond 2022

Investors benefit from solid asset resilience

The significant drop in energy prices and passenger traffic on transportation networks caused by restrictions to contain the pandemic led to an economic contraction of a magnitude not seen since World War II. Even so, most project finance assets have held up well, thanks to political support for mission-critical products and services, and other risk-mitigating factors.

Regardless of the timing of any recovery, project finance has proven to be a stable asset class. The negative impact on some project sub-sectors is not fundamental in nature so will not have long-term effects. We expect that the recovery will be quick and solid once restrictions are lifted.

Resilience of PF asset class

Project finance assets have tended to be highly resilient to the Covid-19 Black Swan event, depending on the type of revenue, nature of service, financial structure, and phase of the project. Projects in operation with no fixed tariffs or volume conditions have suffered from reduced revenues due to lockdown policies, forced service suspension and disruption to the logistics chain.

Projects under construction have suffered from slower progress due to operational restrictions imposed on construction contractors and logistics providers. Some project finance assets with limited merchant risk and countercyclical assets, especially renewables and digital infrastructure, have demonstrated the strongest resilience (see 2021 Project Finance Outlook by Scope). Key project counterparties, including lenders, sponsors and public contractors, have strongly supported strategic infrastructure projects to keep them afloat and prevent strong value impairment.

Around half the renewable energy projects out of roughly 50 projects analysed by Scope are either fully contracted or price-regulated and thus have no merchant risk. The other half have partially contracted revenues, with less than 50% merchant risk exposure. The renewable energy projects are mostly solar and wind around the world. Covid-19 has had little or no impact on such assets, since temporary market price reductions do not harm their fundamental economic value. Depending on the structure of power purchase agreements and the duration of subsidy regimes, only long-term and deep market price reductions will damage the fundamental economic value of such projects.

Many private-public partnerships and critical infrastructure projects such as highways, roads, bridges, public transport, schools, hospitals, and utilities have availability-based revenue streams paid by local governments so depend on the latter's political and financial stability. Such projects have demonstrated strong resilience as they are usually of a high priority for government support.

Some purely commercial projects have also proven to be very resilient, as they have either availability-based revenues or a long-term contracted revenue structure. Examples include conventional power, oil and gas pipelines, processing facilities, and offshore wind farm servicers.

Digital infrastructure projects have benefited from the economic and social disruption as the pandemic has caused cascading spikes in internet traffic around the word, requiring significant capacity additions across the digital infra spectrum including fibre networks, wireless access points, and data centres. Airports and pure commercial transport services have suffered the most. Airport revenues fell by more than 50% worldwide but some European countries have lost up to 90% passenger traffic.

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Stable outlook for project finance albeit with divergent underlying trends
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Other important factors leading to the strong resilience of project finance include structural and contractual benefits.

PF benefits from strong structural contract provisions

Structural benefits of PF

Project finance transactions typically benefit from strong structural contract provisions that help withstand downturns:

1 Project finance assets are normally ring-fenced in bankruptcy-remote special purpose vehicles, which protect collateral values from third-party claims and help maximise recovery rates for creditors in an event of default.

2 Project finance benefits from structural features designed to mitigate liquidity risks and make credit impairment events less likely. These structural features include various reserve accounts, distribution restrictions and cash sweep triggers.

3 Project finance has other structural features that protect creditors, such as financial covenants based on historical and projected coverage ratios, key project milestones, strict waterfall provisions and security packages.

4 Project finance transactions have structural features that protect the fundamental economic value of a project in case of a Black Swan event, including force majeure provisions, robust insurance packages, back-to-back liquidated damages, and liquidity related features. These structural features helped most projects to continue operations and service debt during the Covid-19 pandemic.

Strong support by key counterparties

Key project counterparties lend unprecedented support

Scope assumes that if the value of a project is impaired, lenders and sponsors can restructure it in two ways:

1 A going-concern scenario, in which senior creditors take control of the project and stay invested, either retaining or replacing the initial sponsor;

2 A project sale scenario, in which the project is sold to new debt and equity investors.

In the going-concern scenario, stakeholders may accept different haircuts. In most cases, an impaired project would follow the first route under Covid-19 circumstances. Senior creditors may agree to a deferral of debt service in the hope of a full repayment once the project is running successfully again. For further details, please refer to Scope's General Project Finance Rating Methodology.

The Covid-19 crisis has shown that most project lenders, sponsors and grantors can assume that the underlying economic value of their projects is sustainable and stress-resilient. During this crisis, we have seen strong project support from all stakeholders. Lenders have agreed to postpone debt repayments and key long-stop dates, and/or provide additional liquidity; sponsors have provided equity injections and shareholder loans; grantors have covered revenue shortfalls, increased their investments, provided new public grants, or postponed key project milestone requirements.

Quick recovery conditional on measures taken

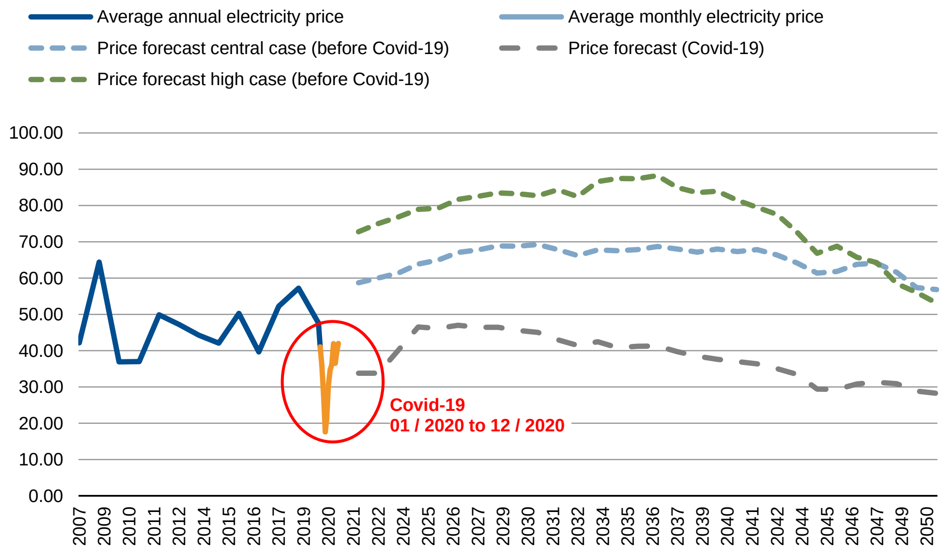
Many PF assets will be able to recover quickly and fully

Project finance transactions with low exposure to merchant risk, critical infrastructure supported by governments and counter-cyclical projects will most likely not show signs of financial distress during the period of constraints triggered by Covid-19. But how would a project with merchant risk exposure behave?

We calculated the recovery rates of a Spanish photovoltaic project partially exposed to merchant risk, assuming that the project would be sold (the second project sales scenario above) to new debt and equity investors after an impairment event. We also assumed that electricity prices could be depressed for one, two or three years due to Covid-19 impacts.

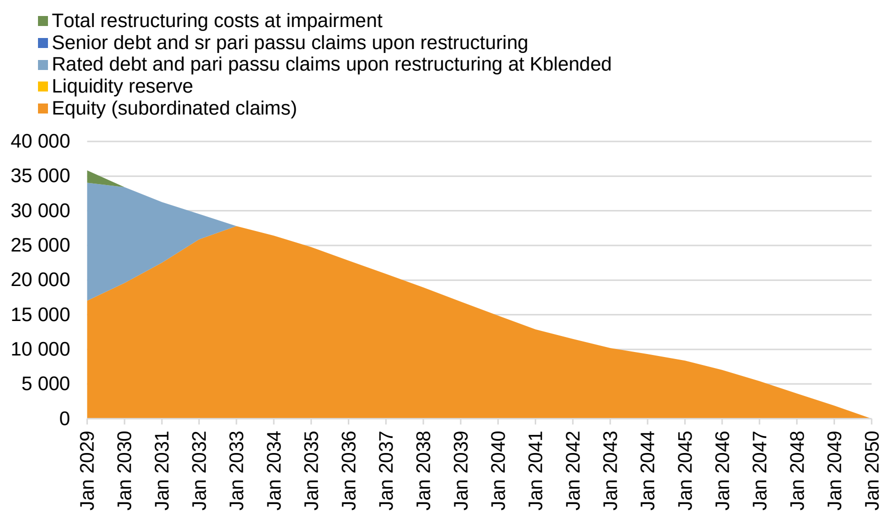
In the worst-case scenario, we assumed that depressed prices in 2021 and 2022 would be equal to the average price in 2020, with a gradual recovery in 2023 (see Figure 1). The recovery rate was above 93% even in the worst-case scenario. See the development of the project value in Figure 2), as the depressed price is very close to the break-even price of the project.

Figure 1: Historical and forecast annual average day-ahead prices in Spain (EUR/MWh)



Source: OMIE, Scope

Figure 2: Post default claims for the 'three years' Covid-19 scenario impairment event



Source: Scope

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