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Abstract

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The Benefits of Leverage on an Investor's Return by Maximizing the Capital Structure of Energy Projects in Indonesia

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Abstract

A project may be financed by a company as an addition to its existing business rather than on a stand-alone project finance basis. In this case, the company uses its available cash and credit lines to pay for the project, and if necessary, raise new credit lines and new equity capital to do so.

A project company, unlike a corporate borrower has no business record to serve as the basis for a lending decision. Nonetheless, lenders must be confident that they will be repaid, especially taking account of the additional risk from the high level of debt inherent in project-finance transactions. The lenders therefore need to evaluate the terms of the project's contracts insofar as these provide a basis for its construction cost, operating cash flow and quantify the risk inherent in the project with particular care.

State-owned companies in Indonesia's energy sector often face restrictions due to covenants set by lenders and creditors. At the same time, lenders need to keep a close eye on the project company's activities to ensure these agreements aren't violated. Loan agreements usually include provisions that could trigger a technical default, so the project company, as the borrower, must follow all the terms laid out in the loan throughout its duration.

This creates restrictions for the project company, making it difficult for them to pledge their shares as collateral for the loan agreement. As a result, there are limits on how much a project can borrow. One big reason for using project finance is that investments in areas like power generation or natural resource projects tend to be long-term but don't usually provide high returns. Because of this, investors need to find the right capital structure to boost their returns.

High ratio of debt is the essence of project finance. Within prudent limits, therefore, sponsors wish to limit the amount of equity the invest in a project, and thus to raise the maximum level of debt. There are some of the popular financing structures these days, for instance, 90:10 for an accommodation-based contract, 70:30 for a power plant project, and 50:50 for a natural resource.

This study aims how to develop the financing models to maximize returns by using indicators such as ROIC and ROE while uncover how lenders can take security over project company's shares to present a win-win solution for both sides either the lenders or the borrowers.