Sources of Project Finance

Project finance may come from a variety of sources. The main sources include equity, debt and government grants. Financing from these alternative sources have important implications on project's overall cost, cash flow, ultimate liability and claims to project incomes and assets.

What are equity and debt?

Equity refers to capital invested by sponsor(s) of the PPP project and others.

Debt refers to borrowed capital from banks and other financial institutions. It has fixed maturity and a fixed rate of interest is paid on the principal.

Equity is provided by project sponsors, government, third party private investors, and internally generated cash. Equity providers require a rate of return target, which is higher than the interest rate of debt financing. This is to compensate the higher risks taken by equity investors as they have junior claim to income and assets of the project.

Lenders of debt capital have senior claim on income and assets of the project. Generally, debt finance makes up the major share of investment needs (usually about 70 to 90 per cent) in PPP projects. The **common forms of debt** are:

- Commercial loan
- Bridge finance
- Bonds and other debt instruments (for borrowing from the capital market)
- Subordinate loans

Commercial loans are funds lent by commercial banks and other financial institutions and are usually the main source of debt financing. Bridge financing is a short-term financing arrangement (e.g., for the construction period or for an initial period) which is generally used until a long-term financing arrangement can be implemented. Bonds are long-term interest-bearing debt instruments purchased either through the capital markets or through private placement (which means direct sale to the purchaser, generally an institutional investor - see below). **Subordinate loans** are similar to commercial loans but they are secondary or subordinate to commercial loans in their claim on income and assets of the project.