KING & SPALDING

CRISIS PRACTICE

Coronavirus

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The Impact of COVID-19 on Project Financing

On 11 March 2020, the World Health Organisation ("**WHO**") declared COVID-19 to be a pandemic, with the WHO "deeply concerned by the alarming levels of spread and severity" of the outbreak.[1] In response, the financial markets have plummeted to levels not seen since the 1987 stock market crash. Central banks in the UK and US announced interest rate cuts, along with a string of other support measures to stabilise economies. On 14 March 2020, the United States banned travel from 26 European countries, later extending this to the United Kingdom and Ireland and countries around the world are imposing lockdowns of varying severity.

The impact on global economies is only beginning to unfold and we are entering a period of prolonged economic uncertainty. The project development and finance sector is already feeling the effects. Below are some of the issues that we expect to see over the coming weeks and months, on a macro level and with respect to documentation.

LIQUIDITY CONSTRAINTS

One clear risk for the procurement and financing of greenfield projects is the impact on liquidity (and its knock-on effect on pricing) in the debt markets. The 2008 financial crisis saw a dramatic fall in bank liquidity for project development, with certain banks effectively retreating from the market. With regulatory reform in the intervening years, banks should now be better able to withstand turbulence in the financial markets and governments have been swift to announce stimulus packages with the aim of averting a crisis.

The United Kingdom has announced a £30 billion emergency package and the Trump administration has also unveiled a major economic stimulus plan in the United States. In the Middle East, the governments of the UAE and Saudi Arabia have unveiled measures amounting to $40 billion to fight the pandemic-induced crisis. However, the effectiveness of these measures will largely depend on the duration of the crisis and the extent to which it can be contained within manageable proportions. One possible side-effect of this large-scale diversion of government spending is on the funding made available to export credit agencies, multilaterals and development financing institutions for projects which may, in the current climate, be seen as non-essential. At the same time, should commercial banks scale back their funding for project development, the role of these institutions in supporting the industry will be critical. During the 2008 financial crisis, the World Bank was swift to announce measures to support development in emerging markets and it has already launched a $12 billion initiative to assist developing countries in dealing with COVID-19. Clearly, the immediate priority will be supporting health and financial systems but, as the longer-term economic picture emerges, additional measures to assist project development may be needed.

EMERGING ECONOMIES

Particular attention needs to be given to the effect of the crisis on emerging economies. Interruptions to supply chains, fluctuations in exchange rates (including the impact on indexation provisions to the USD in project documentation), limited finances of governments to honour support commitments for projects impacted by the spread of COVID-19, suspension of manufacturing/worksites, travel restrictions and less welfare support availability to workers that are unable to work can have a significant effect on the progress of projects, including impacts such as costs overruns and delays. Whilst the spread of COVID-19 is well understood and reported on by health organisations, the day-to-day effect on projects may be less clear, owing to lack of information and reporting. The availability of insurance to cover “pandemics” in the case of delay in start-up insurance should be checked.

All of these issues need to be considered by lenders and sponsors alike, as well as their counterparties, including EPC contractors, who may be coming under pressure from exposure to multiple projects impacted by the COVID-19.

VOLATILITY IN COMMODITY MARKETS

Even before the onset of COVID-19, there was significant uncertainty in the oil markets, due to the shifting balance of supply and demand, as well as regional instability in the Middle East. Added to that now is a rapid slowdown in the global aviation industry, historically one of the largest consumers of oil. In the years since the oil price fell in 2014, oil producing nations in the Gulf, for example, have increasingly focused on the development of a higher margin, downstream petrochemical industry, both at home and abroad. Yet these petrochemical developments are extremely capital intensive and necessitate a large degree of upfront cash. In a climate of prolonged economic uncertainty, investment decisions on large-scale projects of this kind may be deferred in the interests of consolidating the balance sheet. Even for projects already at the stage of negotiating their financing arrangements, the impact of COVID-19 may shift the economic frame of reference. The price of petrochemical products is linked to the price of oil and the financial models used for the sizing of debt financing on these projects are underpinned by oil price projections and the potential influence of various downside scenarios. As well as potential manufacturing and supply chain issues (see further below), the onset of COVID-19 could result in the price of debt increasing and a reduction in debt to equity ratios. Lenders may require that project sponsors insulate projects from variability in the commodity demand and pricing environment.

PROJECTS UNDER CONSTRUCTION

As one would expect, COVID-19 has already put pressure on supply chains and the availability of labour worldwide. In China, a major source of supply for projects, the Lunar Year holiday was substantially extended, and some factories shut down at the direction of government. While Chinese businesses are beginning to show signs of “waking up” post the spike in COVID-19 cases throughout China, many plants appear to have been operating at far below their capacity due to shortages in labour force.

The supply of certain equipment to projects under construction has already been disrupted and, as the impact of the virus accelerates across Europe (with France, Germany and Italy all playing a significant role in global project finance supply chains), it is possible that the effects will be amplified. EPC contractors are already seeking to test natural force majeure definitions in construction contracts. This in turn may require borrowers to make back-to-back force majeure claims under concession agreements to avoid breaching milestone completion dates and incurring liability for liquidated damages. Where force majeure is claimed and not contested, parties should document this to avoid potential disputes later on, when anticipated delays in completion (and the associated costs) materialise.

Delivery or receipt of force majeure claim notices may also trigger reporting obligations to lenders and, depending on the nature of the required remedial measures, may give rise to questions not only around compliance with completion longstop dates in the finance documents but also around forecast funding shortfalls.

OPERATIONAL PROJECTS

In existing projects, borrowers and sponsors should be cognisant of provisions in their financing documentation that might be triggered as the situation evolves. Wherever possible, these issues should be identified ahead of time, to allow an orderly discussion with lenders and waivers to be obtained in advance, so as to avoid default and cross-default issues before they arise. Various aspects of the documentation may be triggered by COVID-19 related circumstances:

a. ***Operational impairment***: shortages in labour or spare parts may lead to reduced operations or, in a worst-case scenario, outages. Force majeure relief may be available under supply/offtake arrangements but this will not translate into the finance documents, where debt repayment schedules will be fixed. Certain projects, typically those in the commodity-based sectors, may contain limited provision for deferral of debt repayments, which could facilitate relief for one or two repayment dates at most. Otherwise, debt service reserve accounts should provide relief for around six months. Borrowers will also need to think about the availability of insurance to mitigate the impact of operational issues.

b. ***Financial ratios***: projects which are exposed to demand or price risk (especially those with exposure to commodity markets or the transportation sector, which could be heavily affected by social lockdown) may suffer breaches of forward-looking financial ratios as economic projections deteriorate. Utility based projects, with long-term fixed price offtake arrangements should be relatively well insulated from these issues for now, provided their operations are unaffected. Financial ratios in such projects are often structured as historic only, based on actual data, so are not susceptible to negative forward looking projections.

c. ***Material adverse effect clauses***: for projects which contain stand-alone MAE/MAC clauses, it is possible that these could be triggered by circumstances relating to COVID-19. However, the circumstances in which this could occur should be limited, since these clauses are typically drafted in such a way that they are only triggered by events directly impacting the project, rather than the wider, macro-economic or social environment. To the extent that covenants or events of default are independently triggered, material adverse effect carve-outs and qualifications will need to be reviewed. Again, assuming such provisions are drafted in customary market terms, they should only be triggered to the extent of an identifiable impact on the project.

d. ***Information undertakings***: borrowers should be mindful of their obligations to notify lenders of material circumstances affecting the project, such as notices from commercial counterparties or any claim of force majeure. Such notification obligations often have very short timeframes and borrowers are at risk of being in breach of their finance documents before they are even aware that they have an obligation.

e. ***Rating downgrades***: project sponsors may be subject to downgrades in their credit ratings, which could render them ineligible to provide corporate guarantees to backstop obligations in the finance documents or, alternatively, require them to cash collateralise such obligations.

f. ***Insurance exclusions:*** project sponsors, contractors and lenders need to carefully check project insurance policies to assess the impact if any of the COVID-19 being declared a “pandemic”.

Whilst the majority of compliance issues will relate to the borrower, there will also be potential pitfalls for lenders, including:

a. ***Funding***: should the crisis impact on the ability of individual lenders to fund drawdowns, this could lead to defaulting lender provisions being triggered in loan documentation, unless the issue can be characterised as a disruption to the wider financial markets.

b. ***Voting***: skeleton staffing arrangements or absences due to sickness could lead to delays in response to voting requests, potentially causing banks to fall foul of snooze and lose provisions.

c. ***Agency functions***: banks which are engaged in agency roles may suffer impairment of their ability to perform administrative functions and to manage communications among the lender group.

d. ***Rating downgrades***: banks suffering rating downgrades may become ineligible to perform the functions of LC provider, account bank or hedge provider, or otherwise to be an "Approved Bank" for the purposes of the financing.

e. ***Due Diligence***: lenders will need to consider COVID-19 and its effects as part of their due diligence review, including its effect on host government's ability to honour support commitments across multiple projects, any currency indexation provisions in the project documentation, information covenants, insurance policy exclusions, ability of project counterparties to perform their obligations where multiple projects they may be exposed to are affected by COVID-19 and assessment of levels of sponsor support required to cover potential cost overruns and delays.

The circumstances arising from COVID-19 are unprecedented in modern times and it can be expected that the situation will evolve rapidly. King & Spalding continues to monitor developments and their potential impact on the project financing industry, so as to help our clients in navigating these difficult times.

[1] WHO Director-General's opening remarks at the media briefing on COVID-19 - 11 March 2020.