Frequently Asked Questions Series

Introduction to Financial Guarantees for project funding through In3

Here are some frequently asked questions to help demystify In3's *Completion Assurance Program™* (CAP funding), to clarify industry jargon, build certainty and accelerate closings. Introduction or request our media.

What is a project finance Loan/Capital Guarantee?

A **capital guarantee** or **financial guarantee** is a letter of commitment (when sent by a bank, a bank instrument) from a party or institution that serves as **credit enhancement** for the borrower. "Credit enhancement" is a method whereby a company attempts to improve its credit worthiness for one or more specific transactions.

- ***Bank Guarantee* (BG) or *Standby Letter of Credit* (SbLC)**, issued by a bank, using a "blocked" asset (per MT760, see below) for the specific period to increase borrowing power and (for CAP funding) to ensure project completion. SbLCs are by far the most widely used but also *the most widely misunderstood*.
- ***Bank-Endorsed* or *Avalized Promissory Note* (PN or AvPN)**, issued by a company, alternative to SbLC for creditworthy companies that are in good standing with a bank to request an Aval or stamp. More
- ***Sovereign Guarantees*** are issued for public/private cooperation, and are usually the least expensive method of qualifying for project capital. They do require access to the right government officials (the country's Minister of Finance), and are thus subject to the quirks and sometimes politics of national governments.

Why is a guarantee needed at all?

Typically, new project companies (also called "greenfield" projects because nothing is yet built on the project site) do not have three years of audited financial statements, thus borrowing capacity is limited. Although many projects can be financed without such guarantees, SbLCs, AvPNs and SGs do help developers qualify for **better terms** (lower interest rates), **faster closings** with **greater certainty and leverage** (less decreasing the amount of cash the developer must co-invest, preserving owner's rights to the project's cashflows/profits).

Such guarantees, whether from sovereign governments, companies or banks, are instruments traditionally used to overcome the lack of lending in a country or sector. Guarantee instruments first emerged in Europe centuries ago, but today they are widely used in both the developed and developing worlds to improve infrastructure, the regional economy, create jobs, etc.

Another attractive feature of In3's guaranteed project financing: instead of directly investing one's own cash capital in the special purpose vehicle (with limited or no recourse to the project company owners), the guarantor frees up long-term capital, placed in operating assets, without encumbering those assets with a lien. Technically such guarantees are "contingent obligations", not shown as debt on the guarantor's balance sheet[1].

What is a project sponsor and why might you need one?

If an SG is unavailable, another method widely used by project developers, with little or no cost to them, is to involve a private sponsor as the guarantor. Sponsors can be stakeholders (with an equity interest), contractors (such as a well-established Engineering, Procurement & Construction firm), equipment providers, or other mission-aligned parties. Sponsors use their existing resources (cash on deposit, a corporate balance sheet, public equities, precious metals or other "fair market value" assets) to deliver a BG/SbLC or AvPN.

What is a SWIFT Code? SWIFT = *Society for Worldwide Interbank Financial Telecommunications*. Banks regularly use SWIFT codes and specialized equipment to transact with one another (send or receive messages). Message Types (MT) are 3-digit numbers; here are the main SWIFT codes used for CAP funding:

1. **Swift MT760 Guarantee – either Sovereign** or **Bank Guarantee / SbLC** – issued by the sender bank, upon instructions of its account holder, in favor of a particular party or counterparty ("beneficiary").

   Since banks do not generally put their own money on the line, the client's asset is "blocked" by the bank, held as security (collateral) for the issuance of the guarantee. The type of asset is between the bank and

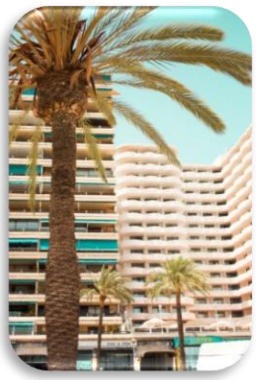
[1] The IMF uses footnotes in financial statements; corporate.findlaw.com/business-operations/sovereign-guarantees-in-project-finance.html

their client. MT760, therefore, is more than just an inter-bank message: with the original hardcopy sent via courier, it becomes a full-blown, cash-backed, callable, operative instrument, similar to a bearer bond.

2. **SWIFT MT799 or 199** are purely advisory messages, specifically "pre-advise" messages, used to signal intended transactions and (for CAP funding) confirm the funding bank's capacity and commitment to fund the project. This type of message, by itself, does not constitute a demand guarantee; DGs require MT760 and delivery of the instrument hardcopy.

   It is important to avoid getting lost in a sea of jargon … **Swift MT799 is purely inter-bank communication**. A lot of fraudulent actors would have you believe MT799 delivers the value of a DG, but by itself, it does not constitute the "operative" (active) instrument; only MT760 does.

3. **Ready, Willing and Able** (RWA) **Letters** are issued by banks to explain their intent to proceed on behalf of a client for a specified future transaction (such as BG/SbLC via MT760) if/when the time comes. The verbiage we prefer is available as a template. Note that it is not a form of payment or commitment to block funds. More at in3capital.net/what-is-an-RWA-letter



Of particular interest for In3 CAP funding is SWIFT MT760, which is what banks can use for both Sovereign Guarantees (SGs) and direct Bank Guarantees (BGs)/SbLCs. Sovereign Guarantees within the PPP structure, or a bank-endorsed (with an Aval) Promissory Note (AvPN) may be preferable because they're usually less "expensive" (or free) for developers, but for those developers or sponsors that have some liquid assets, funds can be used to directly purchase a BG or SbLC[2], which works just as effectively, and is faster and easier to enhance the credit of the borrower, assure completion and leverage advantageous project financing.

<u>Bank Guarantee Example</u>

A hotel developer working in Southeast Asia selects a well-established EPC firm to build the project, and asks this firm's senior management if they might be willing to offer a Bank Guarantee (Standby LC) to accelerate the project. Upon accepting this proposal, which included a completion bonus to the EPC for on-time completion, the developer contacted In3 to ensure the bank was large and itself creditworthy, and that the SbLC itself would be workable.

Following a site visit by the underwriters, the EPC's bank used their customer's long-term asset account to block and send, via SWIFT MT-760, a SbLC equivalent to the amount of the project's financing to our underwriter's bank in the US.

This arrangement expedited the hotel construction project's funding, delivered reliably, and at favorable terms.

What banks can be used for a Bank Guarantee/SbLC or Sovereign Guarantee verification?

A very long list. Guarantee of commercial value must be issued from, be endorsed or verified by a **<u>Rated</u> Commercial Bank** and for SGs and BG/SbLCs, initially delivered via SWIFT. Not every guarantee that comes to us is necessarily valid and usable, which is why we recommend sending the proposed verbiage to us before going to the trouble of obtaining the instrument. AvPNs are sent via hardcopy only, as the company issues them and a top global bank offers its endorsement via an Aval. Smaller banks can be used for AvPNs when there is an additional, larger confirming bank involved, per the RWA letter.

In3 works with our partners to ensure that each guarantee provided is legitimate, and we follow our lender's underwriting process and protocol. Full "inception to completion" procedure shown here.

All SGs are discounted, but developers with SGs from countries with low credit-ratings or even unrated countries can still use an SG, once confirmed as legitimate by a commercial bank. Our investment partners will make up the difference. Note that we cannot work in countries with sanctions against them – currently Russia, N. Korea and Venezuela – nor accept guarantees from banks in those countries.

What is the difference between a *Documentary* Letter of Credit and *Standby* Letter of Credit?

A Standby Letter of Credit (SbLC) is a type of financial instrument that can be used to secure the bank's backing for a commercial transaction. BGs are typically based on the bank's own funds, while an SbLC can be backed by assets or cash from the bank's customer. Either of these are also known as a "demand guarantee"

[2] Note that top banks tend to charge much more than if an SBLC asset were held as collateral.

(more on DGs). By contrast, a "Documentary" LC (DLC) is used mostly for commodity trade transactions, namely international import/export of goods, with rather different rules. Technically, a **DLC** is a credit document that is used to make payment to the beneficiary (the seller in the case of a DLC) on the fulfillment of the trade transaction, while a Demand Guarantee structured as a ***Standby*** LC (SbLC) is a *contingent* payment used by the beneficiary only if the borrower fails to fulfill contractual terms prior to expiration, following a "cure" period to fix any breach; it does *not* ensure the loan repayment because it expires upon maturity.

SbLCs and AvPNs are contingent – a "standby" or "demand guarantee" – generally issued by a bank on behalf of a client, securing payment to a third party ("Beneficiary") in the event of default. In3's partner would be the Beneficiary when funds are loaned and invested from their account(s) to the client via the owner's legal entity, a Special Purpose Vehicle (SPV). The guarantee typically expires once the project is built (is allowed to expire upon maturity), and in that way is dissimilar to a *loan guarantee*, which is entirely for credit enhancement.

Thus, this is how a Completion Assurance Guarantee filters out fraud. The capital partners can accept risks that others would not, but simply *will not accept the majority of risk of non-completion* (due to fraud). In the event the client willfully fails to fulfill a contractual commitment prior to Commercial Operation Date (constituting fraud or other malfeasance by the client), the issuing bank would be obligated to release payment to the lender. That's the guarantee part. This has never happened in our history, and will be avoided at all costs. There is a "cure period" written into the financing agreements, and the parties would come together to address whatever caused the non-performance, to get the project development or construction back on track.

Although entitled to, the capital partners will not call the guarantee as it would a strong negative reflection on all parties involved. In practice, no matter what happens (short of running away with money instead of using it as proscribed), the parties will work together to complete the project. If the project at hand cannot be completed, the last ditch solution would be to complete a different project. The guarantee will not and must not be called.

The obligation to the issuer serves as a form of accountability, so in the event of a problem there is impetus to resolve the situation in an amicable manner. The real purpose is balancing the legitimate interests of the parties.

How do Sovereign and Bank Guarantees differ in practice?

Sovereign Guarantee	Bank Guarantee / SbLC
SGs are effectively free to developers, with rare exception. Governments sometimes own equity.	Costs vary depending the bank used and the asset used as collateral; fees usually range from 0.5-15%.
Issued (signed) by the country's Ministry of Finance, authenticity verified by a rated bank using RWA letter	Issued by a rated bank, preceded by RWA letter. Low-rated banks are asked to use a Confirming bank.
Issued for 100% of the project's budget (typically discounted in terms of effective value as credit enhancement)	100% loan-to-value (LTV) is preferred, but can be leveraged 1.2-2x… recommend at least 50% LTV coverage for the best terms. 75%+ is even better.
Stays in effect for the life of the project or at least the life of the loan, typically ~10-20 years	Stays live as an "operative instrument" only during construction, until commercial operation date (COD)
Offer of equity % in SPV based on country's credit rating and verifying bank's rating and capacity. Both SGs and BG/SbLCs are ultimately sent via SWIFT MT760, with verbiage to comply with international rules (URDG 758 from ICC), not politics or the IMF.	BG coverage (LTV) is one of the main factors in determining the equity kicker. Both SG & BG use an RWA letter to initiate due diligence, the results of which will put an offer for % of equity carried interest (AKA rights to profits or cashflows) on the table.
Requires a letter from the developer acknowledging the type of public-private cooperation (e.g., PPP).	No PPP/letter required. When using leverage, initial Monthly Draw Schedule become sensitive.

Is a Guarantee needed if there's a Completion Bond or Insurance Wrap?

Similar to insurance, guarantees are indeed used to allocate risk, including commercial, credit, political, or in the case of In3's CAP funding, the risk of failure (default) during construction, or non-completion of the project asset due to developer or contractor non-performance. **No insurance product constitutes a financial (demand) guarantee**. Developers might still want to obtain completion or performance bonds from hired contractors (EPC or GC firms), just as they would want to use vendors that warranty their work or products.

Why is a Financial or Demand Guarantee needed if there is a Bank Confirmation Letter (BCL)?

Bank Confirmation Letters (BCL) simply do not qualify. BCLs contrast with what is acceptable for project financing under a financial/demand guarantee because they are used only if

1. You want to confirm account numbers and balances of accounts with a financial institution.
2. You want to determine if the party actually owns any accounts with the financial institution.
3. You want to ensure all of the party's accounts are included in an estate settlement, etc.

It is a verification of assets and nothing more.

What other products or instruments do not qualify? As stated above, *Documentary* LCs use for trade finance, nor insurance products, even if government-issued, or performance, payment or completion bonds.

CONCLUSIONS: Why is all this necessary? What's the bottom line? Why bother?

The main advantage of a securing a demand guarantee is that is **speeds up the financing process, and greatly reduces costs, while increasing the odds delivering capital** to develop, build and operate projects.

The best options are either

A. If working in a country that can offer a **Sovereign Guarantee** (SG) from the Ministry of Finance, confirmed by a bank. Public-Private Partnerships (PPPs) are helpful in gaining the full cooperation of the public-sector sponsor, but it is the qualifying guarantee that secures CAP funding. There is no cost to the developer, but most countries cannot provide a qualifying SG due to IMF restrictions. If so, Plans B or C:

B. Obtain a qualifying **Demand Guarantee** (Standby LC, or SbLC) from backers involved with the project, or that can be introduced to your project with confidence in the qualifications of the developer, project proposal, risk transparency, equitable compensation and commitment/certainty of completion and commissioning no matter what circumstances crop up.

   Keep in mind that there are usually bank fees for issuance of SWIFT MT760 that are not insubstantial for larger projects, ranging from 0.5% up to 2% of the investment/loan amount, depending on the bank used. The instrument stays in place until reaching Commercial Operation Date (COD), so typically 1-3 years (subsequent years can be paid from invested proceeds, if necessary). It *can* be left in place longer, depending on the desired effect, such as with more leverage, to lengthen interest-only deferral, etc.

   If some cash is available, or can be borrowed on a short-term (bridge bridge) basis, it can be leveraged, and in some cases used to directly procuring a usable Standby Letter of Credit. Bank fees range from 4% up to 15% or more, depending on the bank's rating. ~12% is typical for top-tier banks like Barclays or Lloyds. **But with 20% available, other options open up (explore at In3).**

C. If the issuer is quite creditworthy and in good standing with the bank, avoid these fees with an AvPN.

These arrangements can be either facilitated by the developer, or in cooperation with an In3 Affiliate office (developers are nonetheless responsible to attract their own guarantor). Or consider hiring In3 to obtain a guarantor for select projects under a Management Services Agreement. The guarantor would occupy a securitized position, enabling them to step in (replace the developer) in the unlikely event of developer default.

Next steps: visit In3's knowledgebase for …

- ❖ Complete stepwise approach **here**
- ❖ Templates for DGs and RWA letter
- ❖ Indicative Terms for CAP loan/investment

Visit In3finance.com for …

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- ❖ Alternative funding options **here**
- ❖ New Client Onboarding: **In3finance.com/apply**

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