How Interest Rate Miscalculations Can Derail Project Finance

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Interest rates are like the weather. We can prepare for typical fluctuations, but sudden changes can still catch us out. After the 2008 Global Financial Crisis (GFC), we enjoyed a decade of clear skies and low rates. Even as the winds rose in 2019 and the economy struggled with a higher Fed Funds Rate, rate reductions eventually followed, and we ultimately returned to zero interest rates after the pandemic.

Recently, however, a violent storm has descended. Desperate to battle inflation, the Federal Reserve hiked at an unprecedented pace recently, hitting its highest point in over 22 years with a target range of 5.25% to 5.50%. And the moves have caught many by surprise.

Consider Saudi Arabia. Its private sector has experienced remarkable credit expansion in the last few years. The July 2023 Monthly Statistical Bulletin from the Saudi Central Bank (SAMA) indicates that banks' credit exposure to the private sector grew at a compounded annual rate of 10% from 2018 to 2022. This growth culminated in a record outstanding credit of SAR 2.4 trillion (equivalent to US$ 0.64 trillion). Notably, nearly half of this exposure has a maturity period exceeding three years.

Meanwhile, since the launch of the 2030 Vision, Saudi Arabia has announced around US$ 1 trillion worth of real estate and infrastructure projects. Last June, the National Privatization Center & PPP (NPC) declared a pipeline of 200 projects across 17 sectors, reinforcing the commitment to Public-Private Partnership initiatives.

These initiatives, combined with the massive credit expansion in the private sector, mean there are many projects with long-dated floating borrowing exposure. And the interest-rate volatility has put them under more pressure than ever before. The risk? Failing to accurately plan for rate changes. The consequences? Spiraling costs, blown budgets, and an uncertain future. The question is, how do you navigate the storm?

The Financial Model and Interest Rate Assumptions

The assumption of interest rates is a cornerstone of leveraged transactions with extended exposure. For long-term projects under SAR borrowing, liquidity typically permits hedging for 5-7 years. Consequently, lender covenants bind many projects to hedge a substantial portion of this borrowing.

But how do we address the exposure's remaining lifespan? I have observed numerous projects applying static, unsubstantiated interest rate assumptions, particularly for periods beyond 7-10 years. These are clearly unsuitable for today's evolving rates landscape. Therefore, it is imperative to recalibrate models to reflect elevated rates, using robust practices to extrapolate a reasonable interest rate curve.

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Addressing the Present Dilemma

Adjusting models to the current interest rate environment – after the fact – will undoubtedly affect core profitability metrics. It may compromise a project's financial viability. And the ramifications become even more pronounced with increased leverage. Yet failing to address the problem will only compound the negative consequences.

For projects facing higher interest rates, updating models to account for the current environment is painful if the floating debt portion is material. This challenge remains even when the debt is partially hedged. Therefore, examining long-term borrowing implications is as essential as assessing immediate exposures. So, how should companies navigate this environment? And is derivative hedging the only answer? No.

The On-Balance Sheet Approach

A primary approach should be looking at the balance sheet. Financially evaluate the project given the prevailing interest rate conditions. Should it show enhanced performance in its current phase—whether construction or operation—consider debt refinancing for more favorable terms. Alongside this review, carefully monitor the project's covenants in line with both commercial and accounting objectives.

Any refinancing proposition, however, exclusively remains a function of agreed terms and conditions governing the underlying financing documents. Project Finance lenders typically agree to soft mini perm financing structure (mini perm is a type of loan that has a short- to medium-term initial period during which the borrower pays only interest or a combination of interest and a small amount of principal) that incentivizes the project to refinance at initial maturity (medium term; 5-7 years post drawdown). For new projects, such key terms including the cash sweep and pricing mechanism need to be carefully recalibrated to manifest the best effect on underlying project economics for the sponsors.

Increased financial performance and creditworthiness could enable a diminished credit spread upon refinancing. This reduction can curtail interest expenses, bolstering cash flow and lessening the blow of a heightened interest rate environment.

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A vital component of this on-balance sheet strategy is the potential to release equity value by refinancing on more flexible terms. Replacing a segment of debt with equity financing can sustain the project company's balance sheet and amplify its financial resiliency. Proper refinancing can recalibrate the capital structure, ensuring debt maturity and costs resonate with the project's cash flow capabilities—culminating in a more robust financial standing.

Ultimately, these benefits can bolster investor trust, particularly for publicly traded entities. Enhanced confidence can widen the investor pool and augment the liquidity of debt securities in secondary markets, especially in instances of public Bond/Sukuk issuance.

The Off-Balance Sheet Approach

The pandemic saw the "Blend and Extend Strategy" become prevalent. With interest rates presenting an opportunity, many sought to prolong their higher fixed Interest Rate Swaps (IRS) hedging. This extended high-rate hedges beyond their maturity to capitalize on reduced swap rates, thereby achieving a blended, diminished rate. By merging an existing swap and a new one into an extended term swap, entities could immediately lessen cash flow burdens and spread the swap's adverse liability over a prolonged period.

The current scenario presents the reverse opportunity. A project company with an extended IRS but only partial hedging against debt exposure can alleviate liquidity risk and looming covenant breaches. The project company might reduce the duration, channeling the favorable Mark-to-Market (MtM) to broaden short-term hedge coverage.

Yet what of the stretched hedge duration now even more vulnerable to subsequent rate variations? Verging on financial distress, companies may take drastic measures to uphold financial stability and remain solvent.

If the project's future performance seems promising, such steps provide short-term benefits and a reprieve as the company navigates the complexities ahead. But does this entail the preservation of long-term exposure as is? Not necessarily. Several hedging strategies, particularly those addressing tail risk, can provide substantial coverage.

Importantly, off-balance and on-balance sheet methods are not mutually exclusive. Implementing them sequentially or in tandem can optimize the advantages of each.

Concluding Insights

To navigate the storms of interest rate variability, we would prioritize two things: foresight and flexibility. Addressing rate fluctuations requires foresight, even before a project begins. Financing documentation, coupled with pertinent hedge covenants, should proactively anticipate shifts. For instance, lenders should avoid imposing rigid "systematic hedge windows" for floating debt exposure, enabling the project company to strategize flexibly for future rate variability.

Diligence here is key. Regardless of projections within the financial model, the project company must monitor evolving rate dynamics and reflect the implications of any existing hedge, encompassing exposures still unhedged.

It is also critical to capitalize on opportunities. Enhanced project performance, viewed from a balance sheet angle, affords the chance to refinance under more favorable conditions. But you must establish this adaptability upfront before achieving Financial Close (FC).

Eventually, a company's ideal trajectory aligns with its predefined risk management goals and KPIs, underpinning both on- and off-balance sheet determinations. We must acknowledge the uniqueness of each project and the fact that a universal, one-size-fits-all strategy does not exist.

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