equaliFi ACADEMY

CPF

CERTIFICATE IN PROJECT FINANCE

Session 4-Assessing Risk and Risk Mitigation

Contents

Construction & Completion Risk

- **Delay:**
  Completion represents the end of the construction phase of the project. The construction contractor will be liable for liquidated damages for late completion, therefore the definition of "completion" will have a large impact on the construction contractor's risk.

- **Performance:**
  The works will be subject to certain technical tests and demonstration of performance capacity before completion is achieved.

*** Performance Guarantee Amount**

Operating Risk

- Following are the operational risks:
- Increase in cost of Raw Materials like Fuel & Wage
- Technical Performance

- Increase in cost risk can be mitigated by hedging and future contract.

- To get an idea of incremental wages, Retail Price Index can be referred

Demand Risk

- Demand risk is the potential for a loss due to a gap between forecast and actual demand. It is common for capital investments, marketing, sales and supply chain decisions to be based on demand forecasts. When these forecasts are inaccurate it can result in losses or suboptimal performance

Types of Demand Risks:

- Demand Shortfall
- Latent Demand
- Seasonal Demand
- Excess Demand
- Demand that rises fast and suddenly collapses

Force Majeure & change in law

- Certain events, beyond the control of the parties, may inhibit the parties from fulfilling their duties and obligations under the project agreements. To avoid the resultant breach of contract, parties may prefer to excuse contractual obligations to the extent that they have been so inhibited.

- In order to avoid the uncertainties and delays involved in relying on the applicable law, parties to contracts often prefer to provide for a specific regime for force majeure, along with a definition of which events shall qualify for special treatment.

Political & Regulatory Risks

- Government's decision to cancel a project
- Government to change terms of contract
- Government's decision to increase tariff of an input item like power
- Political intervention
- Decline to give clearance

Environmental Risks

- Change in environmental laws- e.g. plastic ban, law related to brickfield

Social Risks

- Project impact of society, consumers and civil society generally, can result in resistance from local interest groups that can delay project implementation, increase the cost of implementation and undermine project viability.

- Eg. of Social Risk- Tata Nano Factory project in West Bengal

- Also there are few factors:

- Change in taste
- Availability of substitute
- Change in Income level

Currency Risks

- Project finance debt is often sourced from foreign lenders, in foreign currencies, yet project revenues are generally denominated in local currency. Where the exchange rate between the currency of revenue and the currency of debt diverge, the cost of debt can increase, often dramatically.

- Mitigation technique- Hedging & Forward Contracts

Interest Rate Risks

- Increase in Interest Rate by RBI
- Change in LIBOR or any other inter banking rate
- Increase in finance expense because of disparity between local and foreign currency

LIBOR- London Inter-Bank Offered Rate

Tenor & Refinancing Risks

- Enhanced Tenor- Long Tenor is risky
- Restructuring sometimes leads to long tenor
- In case the loans are not refinanced, if hampers the cash flow of the lender

Hedging

- Hedging in finance refers to protecting investments. A hedge is an investment status, which aims at decreasing the possible losses suffered by an investment. Hedging is used by those investors investing in market-linked instruments.

- The best example of hedging is availing car insurance to safeguard your car against damages arising due to an accident.

- For Project Finance the Crude Oil import/other input item price can be hedged

Types of Hedging Strategies

- **Forward Contract:**
  It is a contract between two parties for buying or selling assets on a specified date, at a particular price.

- **This is not recognized by exchange**

- **Future Contract:**
  This is a standard contract between two parties for buying or selling assets at an agreed price and quantity on a specified date. This covers various contracts such as a currency futures contract. This kind of contract is recognized by exchange.

Methods of Hedging

- **Asset Allocation:**

  This is done by diversifying an investor's portfolio with various classes of assets. For instance, you can invest 40% in the equities market and the rest in stable asset classes. This balances your investments. For Project, you can spread your corpus in different project and in different sectors.

- **Structure:**

  This is done by investing a certain portion of the portfolio in debt instruments and the rest in derivatives. Investing in debt provides stability to the portfolio while investing in derivatives protects you from various risks.

- **Through Options:**

  This strategy includes options of call (right to buy) and put (right to sell) of assets. This facilitates you to secure your portfolio directly.

Mitigation Strategies

Risks	Mitigation Strategies
Construction & Completion Risk	Close Monitoring, hiring technical expert service
Operating Risk	Monitor day to day productivity
Demand Risk	Frequent market research, customer feedback
Force Majeure Risk	Keep provision
Political & Regulatory Risks	Good connection, create a fund
Environment Risk	Hire environmental consultant
Social Risk	Keep an Open Eye
Tenor & Refinancing Risk	Monitor the portfolio
Currency Exchange Risk	Monitor the market
Interest Rate Risk	Negotiate the interest expense

Thank You