

# Project Finance Instruments in PPP

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Project financing mechanisms for PPP projects in Kazakhstan are still not fully used. Project finance instruments can serve as an alternative form of financing PPP projects in the coming years. Currently, the bias towards traditional lending remains, bank loan is still the most popular form of raising funds in infrastructure transactions, but investors are gradually becoming interested in more complex structures.

Project financing is a method of attracting long-term debt financing for large projects on the condition of securing debt obligations with future assets and cash flows generated by the project. The successful implementation of project finance depends on **a detailed assessment of the risks associated with construction, operation, income generation and their distribution among investors, creditors** and other participants in contractual and other relationships. But first of all, it depends on the legal and commercial aspects of the contracts, which will ensure the income of the project and their sufficiency for the return of borrowed funds and profit for shareholders. One of the main constraints on the widespread use of the project financing mechanism in PPP projects is **the prudential restrictions** introduced by the National Bank of the Republic of Kazakhstan, according to which, the bank shall create provisions in **the amount of 50% against loans** secured by the future income under the contracts, which makes them too expensive.

In accordance with Article 9 of the Law "On Public-Private Partnership" (hereinafter - "PPP Law"), financing of public-private partnership projects using project finance **shall be carried out in accordance** with the Law on Project Financing and Securitization and the provisions of the PPP Law. The project finance transaction is implemented based on a basic agreement with the contractor, according to which the contractor acquires the right to systematic cash incomes on a long-term basis. The contractor based on the basic agreement concludes loan agreements with creditors and (or) issues bonds or receives financing from a special financial company.

At the same time, if one of the parties to a project finance transaction is the state, project finance shall be implemented with the participation of a **special financial company (SPV)**, which is established by the contractor solely to implement the project financing transaction. The state participates in the project finance as a customer in the manner and under the conditions prescribed by the laws of the Republic of Kazakhstan on PPP and on concessions. The contractor under the basic contract is selected on a competitive basis in accordance with the legislation in the field of PPP and concessions.

**In this review, we analysed the most interesting project financing instruments from a legal point of view and their applicability in practice. We also explored not typical financing instruments such as green bonds and Islamic finance that can be applied to PPP projects.**

| Type | Instrument                  | Legislation  | Advantages and disadvantages  | Practice   |
|------|-----------------------------|--|---|--|
| Debt | <b>Loan</b>                 | Civil Code of RoK, Special Part, Chapter 36 Loan.  | <ul style="list-style-type: none"> <li>• The most common and regulated mechanism;</li> <li>• The presence of a portfolio of problem loans in commercial banks indicates a lack of funds for lending to infrastructure projects;</li> <li>• There may be difficulties in attracting a loan for project finance purpose. Banks are forced to create reserves of up to 100% for lending a special project company;</li> <li>• The risk limit per borrower may be “exceeded”. That is, the bank may refuse to finance (mostly applies to private banks).</li> </ul>   | <p>Commercial banks of the Republic of Kazakhstan are reluctant to provide loans for large long-term PPP projects.</p> <p>An exception may be the provision of loans for small PPP projects, for example, the provision of a loan to SB Sberbank JSC for the construction of new innovative BINOM schools using the PPP mechanism in Nur-Sultan.</p> |
|      | <b>Syndicated lending</b>   | <p>Law on Project Financing and Securitization.</p> <p>In 2021, the concepts of “syndicated financing”, “members of a syndicate of lenders”, “agent”, “security agent” were introduced. Thus, now there is a legal certainty regarding the correct qualification of these concepts.</p> <p>Syndicated financing - a method of financing a borrower by several lenders on the basis of one syndicated loan agreement.</p> | <ul style="list-style-type: none"> <li>• Provides opportunity to finance large PPP projects due to the impossibility of financing the project by one bank on its own due to high risks or prudential standards;</li> <li>• The cost of financing for the borrower is lower than if several loans are attracted from different banks. There are no extra commissions / indirect payments, plus the rate is slightly lower than for a bilateral loan for the same period, since the risk per borrower for banks is reduced.</li> <li>• Provided in tranches, phased funding and flexible disbursement schedules;</li> <li>• The implementation of financial covenants for the project is well monitored.</li> </ul> | <p>A syndicated loan for the implementation of the BAKAD project was provided by the EBRD, the EDB, and the Islamic Development Bank.</p>  |
|      | <b>Infrastructure bonds</b> | Law on the Securities Market, Article 18-1.  | <ul style="list-style-type: none"> <li>• Due to insufficient institutional demand and relatively high costs of registration, accounting and settlement of securities, these mechanisms</li> </ul>   | <p>Negative experience in connection with the default of infrastructure bonds placed by Doszhan Temir</p>  |

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|  |                               | <p>Infrastructure bonds - A bond where the fulfilment of the issuer's obligations is secured by a guarantee of the state under a public-private partnership agreement, including a concession agreement, for the implementation of an infrastructure project concluded between the state and the issuer, in an amount corresponding to the value of the object transferred to the state.</p>  | <p>are not in demand in terms of financing PPP projects;</p> <ul style="list-style-type: none"> <li>• Low liquidity in the securities market;</li> <li>• Low demand from institutional investors.</li> </ul>   | <p>Zholy during the construction of a section of the Ust-Kamenogorsk - Shar railway.</p>   |
|  | <p><b>Islamic finance</b></p> | <p>Law "On the Securities Market" Chapter 5-1. Specifics of Issue and Circulation of Islamic Securities.</p> <p>Islamic securities - equity securities, the terms of issue of which comply with the principles of Islamic finance, certifying the right to own an indivisible share in tangible assets and (or) the right to dispose of assets and (or) income from their use, services or assets of specific projects for financing of which the securities were issued.</p> <p>The so-called Islamic Sukuk bond is essentially an investment certificate confirming the right to a share in a pool of assets, that is, some kind of property.</p> | <ul style="list-style-type: none"> <li>• The principles of Islamic finance are consistent with the principles of long-term project finance in infrastructure;</li> <li>• Highly reliable securities, as they meet the strict requirements of Sharia;</li> <li>• Islamic investors will be able to enter the market more actively;</li> <li>• Insufficient practice in Kazakhstan;</li> <li>• A Hub of Islamic Finance has been established at the AIFC.</li> </ul> | <p>In 2020, Islamic bonds of the Sukuk Qatar International Islamic Bank (International Islamic Bank of Qatar) were issued on the AIX AIFC exchange.</p> <p>Cross-listing of three Sukuk by the Islamic Development Bank on the AIFC stock exchange AIX within the framework of the program of issuing medium-term notes.</p> <p>The Development Bank of Kazakhstan placed Sukuk Islamic bonds in 2012 in Malaysia.</p> |

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|  |                           | <p>The most acceptable type of this instrument for project finance is Sukuk-al-istisna.</p>  |   |   |
|  | <p><b>Green bonds</b></p> | <p>Environmental Code, Part 3 of Art. 130.</p> <p>Green financing refers to investments aimed at the implementation of green projects and attracted with the help of such instruments as green bonds, green loans and other financial instruments determined by the authorized body for regulation, control and supervision of the financial market and financial organizations.</p> <p>The Agency for Regulation and Development of the Financial Market is preparing amendments to the legislation stipulating procedure for state registration, issuing, circulation and redemption of investment "green" bonds.</p> <p>The AIFC has developed a concept paper on the implementation and development of instruments and principles of green finance.</p> <p>The strategy for ensuring regional leadership of the AIFC in the field of</p> | <ul style="list-style-type: none"> <li>• Green bonds are attractive financing instrument for PPPs, since some PPP projects are implemented in the energy sector, housing and communal services, healthcare, etc.;</li> <li>• Green finance is in line with the UN Sustainable Development Goals;</li> <li>• In international practice, such bonds are in demand among institutional and global investors;</li> <li>• Require additional costs for the organization and external evaluation of the issue of bonds (audit by organizations that have qualifications specifically in the field of green finance);</li> <li>• The world market is relatively young and still underdeveloped. The secondary market for these bonds is even narrower;</li> <li>• There is little information on projects in which the tool was used (most of them have not yet entered the operational stage);</li> <li>• The demand for green bonds in the world exceeds the supply;</li> <li>• The issuer receives additional reputational benefits (including among lenders for further loans).</li> </ul> | <p>At the moment, JSC FRP "Damu" has placed "green" bonds on the AIFC stock exchange (AIX). The proceeds from the placement were used to finance SMEs implementing green projects.</p> <p>Moreover, the EDB has placed three-year green bonds in tenge at KASE in the amount of 20 billion at a coupon rate of 10.5% per annum.</p> |

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|        |                            | <p>green finance until 2025 was approved.</p> <p>The rules for the placement of Green Bonds on the AIFC stock exchange AIX were approved.</p>  |  |  |
|        | <b>Securitization</b>      | <p>Law "On Project Financing and Securitization"</p> <p>Securitization - financing under the assignment of a monetary claim by issuing bonds secured by allocated assets.</p> <p>Securitization transaction is the acquisition by a special financial company of the rights of claim and the issue of bonds secured by the allocated assets.</p> | <ul style="list-style-type: none"> <li>• Ability to re-attract money to the project through the sale of previous loans and obligations;</li> <li>• Banks can reduce regulatory capital;</li> <li>• High risk compared to primary loans;</li> <li>• Requires structuring experience and qualified players;</li> <li>• Credit risk;</li> <li>• Failure to make payments by the borrower increases the risk of default on bonds by the issuer;</li> <li>• Tax risks.</li> </ul> | Kazakhstan plans to securitize mortgage loans.   |
| Mixed  | <b>Mezzanine financing</b> | <p>According to article 1-1 of the Law "On the Development Bank of Kazakhstan", mezzanine financing is the provision of a subordinated loan with the right to convert it into shares or equity participation in the borrower's capital.</p>  | <ul style="list-style-type: none"> <li>• Possibility to increase gross equity financing. A loan at the initial stage of implementation and an option to buy out a share in a company (conversion into shares);</li> <li>• Typically, such funding is no more than 10–20% of the project cost;</li> <li>• Considered as a low liquid instrument, it is difficult to transfer the rights of claim to another person.</li> </ul>  | Direct investment fund DBK, a subsidiary of the Development Bank of Kazakhstan and Kazyna Capital Management JSC provided mezzanine financing for the implementation of the Keruen-Saray tourist complex project in Turkestan. |
| Equity | <b>Institutional PPP</b>   | <p>According to paragraph 2 of Article 7 of the PPP Law, institutional PPP is implemented by a PPP company in accordance with a PPP agreement.</p>   | <ul style="list-style-type: none"> <li>• Not widely used by investors, loan is a more common instrument of financing;</li> <li>• With an increase in capitalization, the value of a share rises;</li> </ul>  | The implementation of a project under the institutional PPP scheme makes sense when the state partner plans to transfer  |

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|  |  | <p>The PPP company operates in the legal form of an LLP or JSC, where partners own 100% of voting shares (interest in the charter capital).</p> | <ul style="list-style-type: none"> <li>• Alternative capitalization of subjects of the quasi-public sector at the expense of the state budget;</li> <li>• Not all groups of shareholders get along with each other in one project;</li> <li>• Specialized construction companies, equipment suppliers and operators (including foreign companies) can participate in the share capital. Such players can bring expertise to the project;</li> <li>• Allows you to limit liability within the established company, i.e. institutional PPP partners bear the risk of losses within the limits of their contributions.</li> </ul> | <p>assets to the project and participates in the formation of the charter capital of the newly created PPP company.</p> <p>There is no information about completed projects in Kazakhstan.</p> |
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The use of the above project financing instruments in PPP projects will help diversify sources of financing and thus **increase** the number of high-quality long-term infrastructure projects required for further economic growth in Kazakhstan. However, the government needs to implement institutional reforms in **the capital and securities markets** in order to increase liquidity in the securities market and demand from institutional investors for Kazakhstani assets.

Unicase lawyers have extensive experience **in supporting infrastructure projects using project finance instruments**. In addition, Unicase is actively involved in the implementation and development of new sustainable finance instruments such as green finance. At the moment, Unicase has signed a Memorandum of Understanding with the AIFC Green Finance Centre, which will allow us to jointly resolve and consider issues in the field of green finance.