RESTRUCTURING THE FINANCIAL CHARACTERISTICS OF PROJECTS IN FINANCIAL DISTRESS

Igor Pustylnick, SMC University, Zug, Switzerland

ABSTRACT

This paper deals with project finance restructuring in the view of future or present financial distress. We treat the occurrences of negative cash flow and negative NPV as signs of potential project distress. The solutions offered for negative cash flow are (1) restructuring debt thereby making it payable earlier when the project has sufficient cash influx or (2) change of the project management and contractors. The paper explains advantages of the first technique over the second. We explain that legal costs in the latter can exceed perceived benefits. The paper argues the best solutions for negative NPV problems are deferring of payments and restructuring of cash disbursements as a part of the project financial agreement.

JEL: G31, G32

KEYWORDS: Project Finance, Financial Distress, Positive Cash Flow, Positive NPV, Finance Restructuring

INTRODUCTION

Despite "the fact that more than \$200 billion of capital investment was financed through project companies in 2001, an amount that grew at a compound annual rate of almost 20% during the 1990s, there has been very little academic research on project finance." (Esty, 2004) According to (Hainz & Kleimeier, 2004) the value of deals closed in the January 1980–March 2003 period was about 960 USD billion. This amount equals 5% of the total syndicated loans allowed worldwide in the same period (Gatti, Rigamonti, Saita, & Senati, 2007).

The topic of project finance has been a source of a large number of journal articles. The discussion generally is at the descriptive level. The comprehensive financial analysis of the Eurotunnel failure, presented in (Vilanova, 2005), is one of the few studies performing financial analysis of the phenomenon. The authors of this paper argue that financial tools described in financial textbooks can resolve complex and non-trivial problems causing the failing financial conditions of a project. However, application of these tools requires knowledge of the specifics of project finance especially its contractual side.

There are several unrelated reasons for a project to be in distress, namely managerial, organizational or financial. Projects can suffer from poor performance due to objective conditions such as supply delivery faults, fluctuations in quality and labor force availability. The majority of these reasons have nothing to do with financial elements of the project. They can influence the financial outlook of the project but rarely cause a big financial concern. Well-structured project financing has a sufficient number of securities, bonds and covenants, which are required or set in place to compensate for poor performance.

Invoking covenants or withdrawing conditions cannot prevent financial distress by itself. The causes of distress are usually set in place by the provisions of the original contract. Unless there is a looming bankruptcy threat, the project company may not be aware of the distress problem. Moreover, the project company will often not admit to its existence even if they detect the distress condition. Project lenders

are the only party interested in maintaining the projects financial health and the conditions of its debt. They often initiate the procedure to eliminate distress conditions.

This paper merges the general concepts of finance with the specific terms and techniques existing in the project finance field. It takes the financial terms, such as NPV and Cash Flow and shows how to improve a project financial standing by achieving positive NPV and Cash Flow. The research discusses the methods of reaching the desired financial conditions based on project finance features. The paper presents the literature review followed by the discussion of several methods of improvement of NPV and Cash Flows. The last part of the paper offers conclusions based on the presented methodology and suggests directions for further research.

LITERATURE REVIEW

According to (Marx, 1998), venture financing is commonly based on swapping equity for debt. In the case of a small project or a start-up venture, the scheme of financing is very simple. One company usually applies for financing with one or several financial institutions. The venture financing uses a principle of swapping debt for equity. However, there are a few significant differences between conventional financing and project financing. In conventional financing, the following is usually true: (1) the ratio of equity to debt is often in the 30-40% range with 49% of sold equity being a commonly set limit. This limit is set because the borrower wants to retain control over the policies and activities of the company. (2) Small borrowers are required to have a significant amount of recourse in a case of financial failure. The lenders want to be sure that they would be able to mitigate the risks of failure connected with financing (Berger & Udell, 1995).

According to (Kleimeier & Megginson, 2000) project financing uses limited or no-recourse approach. The project company formed to take over the financial part of the project has very limited assets besides the assets of the project itself (Nevitt & Fabozzi, 2000). Therefore, the lenders must rely on the success of the project as a mean to the recovery of the debt. Projects, seeking project finance, are usually very large in scope and long in duration. No single financial institution can afford to carry the debt for the full term of the project. According to (Esty, 2001) this means that syndicated financing is the only type of financing the project can obtain. The large projects, such as Eurotunnel, typically have over a hundred lenders at any time during their existence (Stonham, 1995; Vilanova, 2005).

A venture typically seeks financing to create or acquire assets with the intent to sell them later to recover the borrowed funds (Gompers, 1995). Project, on the contrary, may not create any sellable assets. It tends to create assets, which will generate the cash flow by means of their exploitation (Esty, 2002). Toll highways, apartment building complexes, public buildings, such as hospitals and schools, are examples of these assets. For venture, financing the average repayment period is 3-5 years. According to (Esty, 2002a), it can take as much time for the large project, just to start generating the cash flow, by moving into the post-construction stage.

When the project company seeks financing, it prepares the offering, in the form of an information memorandum. In it, the company describes the project in enough detail. This gives the lender sufficient information for making an informative decision on the project worthiness of money lending (Fight, 2006). The information memorandum is very similar to the conventional marketing plan. It outlines the production process, the business strategies and the means of generating cash flow. The non-recourse nature of the project financing usually warrants larger expert based due diligence, than a venture financing (Amalric, 2005). The best interests of the project compel it to disclose as much information as possible about the nature and the process of the project (Ueda, 2004). In the project financing both a lender and a borrower employ the services of the independent engineers to sign off the technical plans.

The presence of the independent experts make the finance seeking party providing honest and comprehensive information, compiled to the best of their abilities (Dell, et al., 2004).

Due to the prolonged nature of the project, the project financing must take into consideration much larger number of risks than any venture financing (Rode, Lewis, & Dean, 2003). The projects, which have to operate over the longer period, are more susceptible to environmental, economic and financial conditions (Grimsey & Lewis, 2002). The lenders must take into account all risks, associated with the project operation and the surrounding environment. The project company is often required to take additional securities and insurances, associated with these risks. This in turn makes a project more costly (Stulz, 1999). The project company can identify some of the risks upfront by using the expert analysis. However, it cannot foresee some of the risks at the time when it seeks financing. The unidentified risks can contribute to the financial distress of the project if they require additional funds to mitigate them. One of the most typical examples of distress compounding factor is raising cost of fuel and supplies. It alone can skew the financial planning of the project (Ruster, 1996).

The term Net Present Value or NPV lies in the base of a very common distress condition (Esty, 2004). NPV represents the present value of the future net cash (Gitman & Hennessey, 2005). The NPV calculations use the estimated inflation value. We consider the projects with the negative NPV as failures, because they actually lost money at the end of their cycle. The NPV calculations cannot give a complete objective picture of the success or the failure of the project. The person calculating NPV estimates the rate of inflation at the time of the calculations. This future rate of inflation can fluctuate based on the expert perception and economic outlook. However, recalculating NPV on the regular basis can give a lender a good idea of whether the project is on track to generating the positive cash flow or slides closer to a financial distress.

Some lenders use the internal rate of return (IRR) of the project as a measure of the project health. IRR represents the discount rate under which NPV is zero. It is the rate of bringing the project even. Banks usually have preset conditions for IRR/NPV for the venture type investments (Chen, Weston, & Altman, 1994). According to (Yescombe, 2002), the project can negotiate the IRR/NPV of its financing because of the advantage established by a mere size of the project.

When a lender or a group of lenders perceive a project is edging closer to financial distress, they take action. In a large project, the number of lenders is very high. It is common to have 150-200 lenders with a stake in the project at the same time (Sufi, 2004). The project has the large number of vendors because its debt is a publicly traded financial instrument. At the same time, a large number of stakeholders makes it hard to achieve consensus on the state of the project finance and to come to a solution, which will satisfy all parties. The lenders are equity participants (shareholders) of the project. The only method of communicating the project financial state to them is through the annual shareholder statements and the annual shareholder meetings. In distress times, the large number of shareholders can become a detriment to project finance if the solution to financial problems requires quick and determinate action. One mechanism, proposed in the literature is the immediate buyout and the concentration of shareholder debt in the hands of a few key lenders (Vinter & Price, 2006). In the case of buyout success, the concentrated group of lenders is able to make swift and direct decisions over the project future. If the buyout does not happen within a short timeframe, attempts of restructuring of the project can appear futile.

The buyout of minority equity holders can also drive the debt of the project higher especially if the project is uncertain by nature. An example of such project is oil exploration in non-drilling areas. The minority holders can perceive the attempt to buy them out as an effort to consolidate profits in a view of future discoveries. In this case, they can hike the price of their equity share (Vilanova, 2004).

METHOD

This paper discusses two different types of distress, namely negative NPV and negative cash flow. Negative cash flows or a cash deficit can happen in the project at any time. Raising operating costs are a common explanation for this phenomenon. There are many reasons for cost overruns. However, we can classify them into the following types: (1) Raising costs of materials, machinery, labour and other current expenses. This problem commonly occurs in the long-term ventures or projects. The current costs tend to rise due to the current demand, state of economy and inflation. (2) Labour or safety legislations with immediate effective date cause increase in maintenance and labour costs. (3) Scheduling problems can contribute to the negative cash flows of the project. During the construction stage of the project, the discrepancy in the availability of the personnel and machinery can cause the additional lease payments on the unused equipment.

The influx of additional cash can rectify the negative cash flow problem. While it sounds like a very simple solution, it has many serious complications. The additional project cash can come as a loan or as a savings measure. Since all equity holders in the project are lenders to the project, the additional loan can come in the form of a cash draw similar to a partnership cash draw. There are several negative consequences of this procedure. Every equity holder must agree for the cash draw to happen. The additional loan usually decreases equity value (similar to the share split). If investors perceive the project as having troubles, selling the additional debt is not easy.

The second approach to solving the cash flow problem is finding additional cash resources within the project itself. Usually projects of large size employ a variety of law and consulting firms each specializing on one or very few tasks. If the lender does not prescribe the engagement of these firms in the financing covenants, the project can revise, monitor, consolidate (into one or fewer sources) or eliminate the use of these consultants. The increase in project management efficiency is another source of savings. The "waste" of cash by management can appear in the form of mistiming of leasing of key equipment, poor scheduling of the labour force, inability to secure the vacancy of the project real estate lots, etc. These scheduling mistakes carry consequences of tighter control of, or outright replacement of the management body. Performing this procedure in publicly traded companies is easy. These organizations can assemble a meeting of shareholders faster than the project company could. On the other hand, the project company is not a contractor itself. It relies on the contractors to lend expertise and perform work. Cost overruns and cash waste can occur deep down in the contracting hierarchy. The project company may not have knowledge about cash problems unless they surface in the form of nonpayments. Sometimes it is not easy to replace a contractor in the middle of a project due to loan covenants, which specify this contractor for a particular work. Sometimes, changing this contractor because of the financial issues can be more costly than investing more into continuing working with them.

Table 1 represents the initial state of the project as envisioned during its inception. The project company estimated the project cash flows as positive and commenced the project. Now, suppose that during the course of the project a contractor incurred additional costs due to mismanagement, lease conflicts and other issues. Change in the project cash flow must occur. Assuming that there are no additional internal sources of cash, such as reserve working capital, the new project outlook will look as depicted in Table 2.

Table 2 shows the project does not meet its cash obligations in the years 2012-2015, which puts it into a distress condition. There are several ways to rectify this distress condition. Table 2 shows project interest payments form a straight line. The renegotiated payments, presented in Table 3 bring positive project cash flow to the sponsor. Knowing that the lender would rather renegotiate loan payments than call off the full loan, this restructuring can prove itself feasible if the rest of the numbers stay in place.

Years	2008	2009	2010	2011	2012	2013	2014	2015
Gross Revenues	0	0	360	1124	1304	1236	1150	712
Capital Expense	540	780	80	0	0	0	0	0
Operating Costs	0	0	124	132	148	164	180	196
Taxes	0	0	0	0	376	564	528	432
Cash flow before debt	540	790	156	992	780	508	442	84
Drawdowns	460	664	0	0	0	0	0	0
Debt Repayments	0	0	0	308	310	308	308	0
Interest payments	0	0	124	124	92	62	30	0
Cash Flow to Sponsor	80	116	32	560	378	138	104	84

Table 1: Initial Financial Indicators (in \$1000)

The table is adapted from (Fight, 2006). It shows the main financial indicators for the project in relatively good standing indicated by a positive cash flow in all years of project existence.

10002. Influence of $1000000000000000000000000000000000000$	Table 2:	Influence of Additional Cash Draw	(in \$1000))
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Years	2008	2009	2010	2011	2012	2013	2014	2015
Gross Revenues	0	0	360	1124	1304	1236	1150	712
Capital Expense	540	780	80	0	0	0	0	0
Operating Costs	0	0	124	132	548	364	330	300
Taxes	0	0	0	0	376	564	528	432
Cash flow before debt	540	790	156	992	780	508	442	84
Drawdowns	460	664	0	0	0	0	0	0
Debt Repayments	0	0	0	308	310	308	308	0
Interest payments	0	0	124	124	92	62	30	0
Cash Flow to Sponsor	80	116	32	560	-122	-62	-46	-20

The table shows changes in project financial structure incurred by drawing additional cash towards the operating costs later in the project lifecycle. The changes to the project finance numbers are shown in bold

It is not possible to alter the project financial infrastructure post-factum. However, based on the calculations presented in the Table 3 it is possible to suggest that deferring some of the cash payments to the sponsor and directing the freed funds towards the debt/interest repayment reserve must help the project company to keep overall cash flows positive despite the potential extra cash withdrawals.

The syndicated lenders can also suspect that the position of the project showed in Table 2 occurred due to the poor management and not due to the objective circumstances. In this case, the lenders can consider the action of replacing the management rather than renegotiating the loan term. It can happen if the lenders do not believe that the present management can keep the financial situation of the project under control and that the projections of current costs do not represent reality. We assume that the financing agreement has a number of covenants, including the contractor covenant, which allows the replacement of the original contractor. Let us also assume that the replacement of the contractor brings the costs of the project lower, thus altering cash flow depicted in table 2 in the following manner.

Years	2008	2009	2010	2011	2012	2013	2014	2015
Gross Revenues	0	0	360	1124	1304	1236	1150	712
Capital Expense	540	780	80	0	0	0	0	0
Operating Costs	0	0	124	132	548	364	330	300
Taxes	0	0	0	0	376	564	528	432
Cash flow before debt	540	780	156	992	780	508	442	84
Drawdowns	460	664	0	0	0	0	0	0
Debt Repayments	0	0	0	616	310	308	0	0
Interest payments	80	104	124	124	0	0	0	0
Cash Flow to Sponsor	0	12	32	252	-30	0	292	-20

Table 3: Restructure Interest and Debt Payments (in \$1000)

Table shows restructured numbers for interest and debt payments. The numbers in bold indicate the changes which can be applied to the project to keep it out of the distress position

This cash flow situation looks more promising to both the lender, who will rely on the same payment schedule, and to the sponsor, who will be drawing positive cash from the project. Although the situation seems very bright from the cash flow perspective, the sponsor and lenders should incur additional legal and administrative fees. The firing of the old contractor and process of selecting a new one are the source of the additional expense. These expenses in the form of legal fees should not exceed the gains from the restructuring in any given year. The initiators of the restructuring must keep this in mind and factor contractor replacement into the cash outlook of the project.

Any project distress caused by negative cash flows is certainly fixable. The project companies and lenders are inclined to negotiate the restructuring of debt rather than to change the project structure. With all things being equal, the restructuring of debt lowers risk and decreases uncertainty better than the change of management. If all parties are honest with each other and attempt to perform to the best of their abilities, the restructuring of debt would be much less taxing on the project company and the lenders, than changing the project management and the contractors. It is not a given, that the new management would be able to achieve the reduction in costs and the positive cash flows, shown in Table 4.

Years	2008	2009	2010	2011	2012	2013	2014	2015
Gross Revenues	0	0	360	1124	1304	1236	1150	712
Capital Expense	540	780	80	0	0	0	0	0
Operating Costs	0	0	124	132	348	264	230	250
Taxes	0	0	0	0	376	564	528	432
Cash flow before debt	540	780	156	992	780	508	442	84
Drawdowns	460	664	0	0	0	0	0	0
Debt Repayments	0	0	0	308	310	308	308	0
Interest payments	0	0	124	124	92	62	30	0
Cash Flow to Sponsor	80	116	32	560	78	38	54	30

Table 4: Cash flow after Contractor Replacement (in \$1000)

The table shows changes in the cash flow which resulted in bringing the new project management team which reduced the cost projections in the later stages of the project. Numbers appearing in bold figures constitute the difference as compared with the ones in Table 2.

Any financial institution, which acts as a lender to a project of any size will seek positive NPV as an assurance that the project work reflects both good performance and good faith on the part of the project company. The NPV calculations commonly rely on two major components, namely an initial investment

and the cash returns from the construction and maintenance work. The NPV calculations use a discount rate to bring the future values to their present equivalents. This rate represents the best possible estimation effort based on the knowledge and the experience of those, calculating NPV. Since large projects have a large number of lenders in syndication, these lenders must agree on the common discount rate for the calculations of the financial outcome for this particular project.

Unlike the cash flows, which have an immediate effect on the operation of the project, NPV has no real bearing on whether the project will or will not be completed. On the contrary, the project can have negative NPV and enough cash to accomplish all project plans. Even considering this, NPV is still a very valid factor of estimating a relative financial position of the project at any time during its lifecycle. The financial and economic conditions in the country where the project takes place and in the financial world change on the regular basis. Therefore, the NPV calculations are due for every report period to reflect changing rates of inflation (discount rates).

Let us assume that a project obtained 1,000,000 USD in lent finances in order to complete the work. If we look at the numbers in Table 1, we will see the value of total drawn cash is 1,492,000 USD. It seems to be enough to cover the operations of the project and yield profit to a sponsor. Let us assume that the cost of borrowing or discount rate is 10%, which is a very favorable rate in North America. At this rate, the project NPV is -17,920 USD. It means that the project would be "no go" had it just started under the described conditions. Let us now assume that this is a tail end of the project, which incurred additional costs and has to continue in order to generate revenue. In this situation, we are dealing with the project in distress, which needs restructuring in order to meet the lender's NPV conditions. In this paper, we discuss two ways restructuring the finances of the failing project, namely generating more cash up front and drawing the cash at the future dates.

It is not likely that the project generates more revenue than originally projected. In order to generate more cash, the project would have to defer expenses. Table 5 shows cash flows of the project with the deferred operating expenses. The figures in bold show changes to project cash flows. The project's NPV changes to 62,930USD making it a profitable. Although this technique is very tempting for the project companies and the lenders, it is not acceptable for the recipients of the cash, such as lease companies, contractors and suppliers of the raw materials. It might take a negotiating power of the lender to make the cash recipients accepting changed conditions.

This technique can only be considered if leasing vendors of the equipment have surplus of the inventory or the contractors seek to participate in the project for the reasons other than monetary (ex. upstart company with no record of accomplishment, which desperately requires good references). Unlike the project companies, the lenders to the project are usually mature financial institutions. They can offer the project a schedule of cash disbursements instead of a lump sum, provided at the beginning. In order to illustrate this technique, we use data from Table 1 and assume that lenders and borrowers agreed that project would receive 500,000 at the beginning and 500,000 at the end of year 2011. In this case, NPV of the project will be 175,970USD and the project will retain the positive NPV. This technique is much more preferable for the project, than the one, requiring the deferred payments. It does not require any third party concessions. On the other hand, structuring of the cash disbursements will require additional legal work. The financing contract should have extra covenants, ensuring that lenders keep their commitment. A cash only transaction in excess of existing cash can be pending almost indefinitely if third party does not accept the structured payments or the lender guarantees.

Lenders, such as banks, rarely have surplus of cash. They operate using proceeds of short-term investments and interbank operations in their cash flow. If present financial and economic conditions change significantly, the lender may not have enough cash to cover its financing commitments. If the lender has a temporary cash problem, the project company can seek a bridge financing loan, charging its

interest back to the original lender. The project can encounter another distress condition if the lender is not able to fulfill their obligations at all. During the financial crisis, it is entirely possible that the lender becomes permanently insolvent.

Under the regular financial conditions, a project, seeking to resolve the negative NPV problem, prefers separate cash disbursement to deferring cash payments. In the conditions of the financial force majeure, the cash can be unavailable. The guarantees of the availability of the deferred cash do not secure its actual availability. The project falls into the ultimate distress condition.

Years	2008	2009	2010	2011	2012	2013	2014	2015
Gross Revenues	0	0	360	1124	1304	1236	1150	712
Capital Expense	540	780	80	0	0	0	0	0
Operating Costs	0	0	0	0	272	296	180	196
Taxes	0	0	0	0	376	564	528	432
Cash flow before debt	540	790	156	992	780	508	442	84
Drawdowns	460	664	0	0	0	0	0	0
Debt Repayments	0	0	0	308	310	308	308	0
Interest payments	0	0	124	124	92	62	30	0
Cash Flow to Sponsor	80	116	156	692	254	6	104	84

 Table 5: Generating Cash Upfront (in \$1000)

The figures in this table show project position which is based on generating more cash at the beginning of the project by deferring the operating costs to the later stages of the project. Changes from Table 1 are shown in bold.

CONCLUSION AND FUTURE RESEARCH

Any project can fall into distress due to the mismanagement, problems with contractors and suppliers and so on. Covenants in financial agreement can resolve a number of mentioned problems. They anticipate many of such problems based on the experience of lenders and borrowers alike. Legal preparations and due diligence can rectify and mitigate the financial risks by using securities, bonds and insurance terms.

This paper deals with the elements of project financial distress. The models, provided in this paper are extremely simple. They show potential solutions to some financial problems a project can encounter, such as negative future cash flows and negative NPVs. While these problems constitute a good reason for concern for lenders and maybe a project company, they are hypothetical problems, dealing with future cash flows and future negative NPV calculated based on the future earnings. The paper shows that a remedy for the future problems exists at present time. Anticipating these problems, the financiers, such as lenders and borrowers, must have a clear understanding that the displayed solution is only good for future situations as they appear in the present.

In the case of economic Force Majeure such as recession and/or depression, any lenders and borrowers can face the fact that the debt and the cash flows of the project are out of their control. The lenders might not be able to fulfill their obligations towards the project. The borrowers can face limited or extinguished cash flows due to the overall economic situation. If the project does not have sufficient reserve funds to continue and there are no lenders willing to take over project debt, it might fail or concede part of its profits in exchange for a remedy.

When a project is in the inception stage and seeks financing, its managing body must be able to anticipate potential threats and put a sufficient number of legal covenants in the financial agreement to cover some of the anticipated outcomes. By acting in such manner, the projects can reduce the number of the

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potential distress conditions and enjoy the financial and operational success. The models presented in this paper are simple. Further research would result in analysis of a sufficient number of these projects with the purpose of analyzing their financial position. The author assumes that a number of such projects exist in countries with a large number of federal or local projects such as the countries of BRIC.

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BIOGRAPHY

Dr. Igor Pustylnick is a Professor of Finance and Management Information Systems in SMC University. He can be contacted at SMC University, Balz Zimmermannstrasse 7, 8302 Zurich-Kloten, Switzerland. Email: i.pustylnick@swissmc.ch