PROJECT FINANCE RATING METHODOLOGY

Project finance can be defined as the financing of long-term projects (generally infrastructure-related) based on a non-recourse or limited recourse financial structure, where the debt and equity of the project are paid back from the cash flows generated by the project. In other words, project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets and ownership being held as collateral.

To rate a project finance debt, PEFINDO follows these steps:
1. Determine the eligibility of the transaction to be considered as a project finance. If it does not meet the minimum requirements, PEFINDO will not use the project finance methodology to rate the debt instrument.
2. Assess the construction risks to determine the construction phase stand-alone credit rating (SACR) for greenfield projects.
3. Assess the operation risks to determine the operation phase SACR for greenfield and brownfield projects.
4. Determine the SACR of the project(s), which usually reflects the SACR of the construction or operations phase, whichever is lower or riskier.
5. Assess the transaction structure, which includes analysis of parent linkage and structural protection.
6. Assess extraordinary government support for the project if there is such.
7. Assess any guarantees, if there is a full or partial guarantee to the project.
8. Determine the final rating of the project finance debt.

[I] Minimum requirements for a transaction to be rated using the project finance methodology
PEFINDO will use the project finance methodology to rate the project and transaction structure if they have all of the following:

① A project finance transaction structure:
A project must have a transaction structure that meets the following **minimum requirements**:
a. The project is structured as a limited-purpose company (LPC).
b. The project provides senior lenders a senior secured ranking through a security package to the main assets of the project.
c. There are covenants that clearly provide a clear limitation of the project’s permitted and non-permitted actions.
d. There are cash management covenants, creating a cash management system that prioritizes debt service payments to senior debts over other financial obligations.

② Limited or non-recourse to the sponsors or shareholders of a project, but full recourse to the project's cash flows and assets:
In a project finance transaction, the lenders only have recourse to the project's assets, cash flows, and contractual agreements as they rely on the project's cash flow available for debt service and collateral for the servicing, repayment, refinancing, and security of the project debt. There are key structural elements to ensure that this will happen, which include the security structure, legal framework, payment structure, cash flow mechanics, reserve accounts, and credit enhancements.

③ Risks related to the cash flows generated by the assets: A project's ability to fulfill its financial obligations for both the principal and interests comes from the future cash flows generated by the asset once it is fully operational.

④ **A limited asset life with restricted activities:** A project finance transaction's economic life is limited by its concession period, and the project's activities are also limited by covenants.

⑤ **Covenants and controls for senior secured debt in the structure:** Project finance transactions are usually structured for senior secured debt, representing the majority of the project's capital structure. For credit protection, the senior secured debt is backed by covenants and other forms of security.

⑥ **Established and specified responsibilities:** Project finance transactions have established and specified responsibilities. It is a mixture of integrated contracts that exist throughout the life of a project.

II. Assessment of a Stand-Alone Credit Rating (SACR) of the project

a. We usually define a project under one of these two stages – construction or operational stage.
b. We assess both the business and financial risks to determine the SACR of each stage.
c. To determine the construction stage SACR, we assess the business risks and financial risks during the construction phase. For the business risks assessment, we look at factors such as construction technology and design, difficulty of construction, degree of risk transfer during construction, experience of main contractor(s) and the quality and experience of project management. For the financial risks assessment, we look at the adequacy of funding and the certainty that all sources of funding will be available when the project starts. We also assess the credit profile of the several counterparties a project has during this stage. The final construction stage SACR is determined as the lower of the counterparties' credit profile or the SACR before the counterparties are assessed.
d. To determine the operation stage SACR, we assess the business risks and financial risks during the operational phase. For the business risks assessment, we look at the operational performance of the project and, if relevant and significant, the impact of market price volatility on the project. Performance is assessed by analyzing operational stability due to the difference in the types of assets in the project. Adjustments are made to the initial operating performance stability by looking at several aspects, such as contractual terms and risk attributes embedded in the project, minimum performance standards, and risks related to the availability of resources and supply of raw materials. For the financial risks assessment, we first determine the minimum debt service coverage ratio (DSCR) based on the preliminary operation stage business risks assessment.
   We will make several adjustments, based on the sensitivity analysis, debt structure, liquidity assessment, and refinancing risks to determine the initial operation stage SACR. The final operation phase SACR is determined after comparison with projects of similar nature and operation stage counterparty weak-link assessment.
e. A project SACR is the lower of the construction stage SACR or the operation stage SACR.
f. PEFINDO ratings reflect the credit quality of a project during its weakest period over the remaining term of the debt and until the debt is paid off using cash flow from the project's asset.

III. Assessment of a project finance transaction structure

We could lower the project SACR if there are weaknesses in the project finance transaction structure. Specifically, under the project finance transaction structure methodology, we look at:

a. The parent linkage analysis, whether it is de-linked from, linked to, or capped by the credit rating of its parent(s).
   Depending on the degree of parent linkage, the SACR can be totally unaffected by the creditworthiness of the parent(s), up to the SACR being capped by it.
b. The strength of the project's structural protection, by looking at its LPC and cash management covenants.
c. The existence of cross-default provisions to a third party (such as the parent) that can result in debt acceleration, which may cap the project SACR at the creditworthiness of that party.
d. Whether a project's transaction structure has any other significant deficiencies, not covered in points 1 to 3 above.

IV.Assessment of a project's final credit rating

We determine the final project finance credit rating and any subordinated project finance credit rating after applying any full or partial credit guarantees. Please refer to PEFINDO's rating methodology for full and partial guarantees.