Christian Ostendorf

Disruption strategy in international **project finance**

Dr. Christian Ostendorf, Essen

The fact that Fintechs are threatening the payment transactions and investment business of many banks or at least strongly accelerating market developments in these segments is illustrated almost daily by new examples or studies. From the perspective of the author, "high-end areas" of the banking business are by no means safe from destructive attacks by newcomers. In this context, he describes his considerations in the business unit of project finance. In times of increasing regulation by Basel III and Solvency II he sees the traditionally strong market position of banks and insurers in this field of business threatened by the lack of profitability of long-term financing. The author thinks that new providers and, above all, platforms that are subject to less stringent regulatory requirements and are able to offer debt capital without the minimum requirements, stand a realistic chance of ultimately dominating this business if they cooperate with specialized service providers. (ed.)

Is the combination of disruption and international project finance an absurdity? – The technical term used in this article is to be understood as follows: The central feature of digitization is the focus on automation with a large part of the work previously performed by humans being replaced by systems, robots or artificial intelligence. In the era of digitization, many start-up companies are established mainly in Silicon Valley with the aim of destroying industries. They even attack industry giants with the aim of destroying them and thus improving the world.[1]

Schumpeter compared this process which is inherent to the system of market economy to a genetic code to creative destruction. Why should one question one's own business model if it has obviously been successful all over the world?[2] In this article, disruption strategy refers to the targeted development and marketing of a disruptive innovation in order to force existing market participants out of the market.

Lack of flexibility of many established companies

Clayton M. Christensen has coined the term "disruption". Established companies are focusing on the existing market and on existing customer relationships. Due to the rigid market and customer structures they often do not have the flexibility to open up to disruptive technologies. At the beginning, the performance of the disruptive technologies is often poor, since they are only active in niche markets but not in the mass market. Established companies classify disruptive technologies as uninteresting and hesitate until the technology improves and eventually becomes marketable. Digital transformation affects the following three business areas of a company:

1. Digitization of products and services,

2. Digitization of processes and decisions,

3. Digitization of entire business models.

In addition, the velocity, which develops exponentially, is often underestimated.[3] According to Christensen, there are two types of disruptions: Either a qualitatively inferior technology at the lower end of the market causes a disruption in a niche, or a new market is created with a disruptive technology. Matzler expands on this definition by saying that it is also possible for a new technology to enter a high-end market segment and then penetrate the entire market from top to bottom. He mentions Tesla as an example, which started in the premium segment and worked its way through the market from top to bottom.[4]

Disruption also in the high-end segment?

Over the last 20 years, disruption has been most noticeable in the commerce, travel and publishing industries by innovative companies such as Google and Amazon. The second wave of digital disruption is now focusing on the financial industry.[5] Bill Gates already said in 1994: "Banking is necessary, banks are not". Still today, the crowdfunding revolution, which developed during the financial crisis, generates explosive growth and reaches mass market suitability with further developed crowdfunding technologies. Since then, the digital revolution in finance has been called "FinTech" with London continuing to be the center of developments. Here, both the authorities and the financial industry have recognized the opportunities for a rejuvenation of the financial center and a sustainably increased international competitiveness.[6]

Especially the banking and insurance markets are undergoing major changes and will have to be restructured almost entirely in the coming years. Goldman Sachs, for example, has been positioning itself as a Tech Company and today more than 30% of its employees are engineers and programmers.[7] Gunter Dueck warns of mass unemployment and directly addresses the majority of the private customer service in the banking and insurance market when using expressions like "flat screen backside consulting".[8] If today Auxmoney, Seedmatch and other providers at the lower end of the markets are successfully placing credits in a niche of C2C or C2B in the

form of direct lending; the disruption-process after Clayton is already in progress. This raises the question whether disruption according to Matzler can also take place in the high-end segment of the banking and insurance market? International project finance would be such a high-end market.

Market for project finance also a target

In the following, the international project finance market will critically be analyzed to answer this question. In this article international project financing is defined as follows: Project financing is an integral part of Structured Finance and enables the long-term financing of large-scale infrastructure projects. Infrastructure is often divided into: Power, Oil & Gas, Transportation, Mining, Industry and Telecommunication.

The participants in the project act together in a structured framework and with a structured approach, and in doing so deploy their individual economic and technical skills. Banks provide long-term debt exclusively for self-supporting non-recourse projects in a separate project company "SPV", since the sponsors do not provide a full guarantee. The basic conditions for an investment in project finance are:

– Independent project company

– Project cash flows as a focal point

– Risk management and risk sharing

– Non- or limited recourse.[9]

Why, in particular, is project finance susceptible to a disruption strategy? On the one hand, disruption is characterized by systematization, standardization and digitization, and, on the other hand, project finance is characterized by the high complexity and the individuality of each unique project. At the same time, project finance is currently experiencing a period of transition and, as a consequence, may be a greater target and offer better opportunities for a successful disruption. In general, the project finance market is a very attractive business model for potential disruptors.

Firstly, project finance is a highly profitable business model for all participants and offers strong growth on a global level and will continue to do so for many years to come. Secondly, the volume of default recorded in the portfolios was low and the number of incidents rather limited. However, if there was a default in the past, only a comparatively low loss ratio was recorded. Thirdly, the project finance market is currently in a period of change, which can be described as follows: Due to the implementation of Basel III by 2020, the profitability of the banks with regard to the long-term provision of debt will be coming increasingly under pressure in the years to come and the business model will lose its attractiveness.

Pension funds as natural partners

This is primarily due to the classification of project finance as Specialized Lending and the minimum ratios for risk weighted portfolios.[10] Zenke stressed the need for strong banks and the commitment of insurance companies and pension funds.[11] But the banks have been weakened by Basel III. A transfer of know-how in the project finance market can already be seen at this time. On the one hand, the large WP companies are already hogging the lucrative advisory mandates; on the other hand, the insurance sector is also upgrading its know-how in the project finance business.

According to Brodehser, insurances and pension funds with their long-term deposits have an adverse term transformation risk and therefore stand out as natural partners in project finance.[12] While the capital requirements according to Solvency II have been loosened for insurers in the infrastructure sector, insurers, similar to banks, are subject to the strict guidelines of the insurance supervisory authority EIOPA, which restricts their involvement in project finance.[13]

Provision of debt without minimum requirements

When two parties quarrel, the disruptor rejoices. In general, the advisor has a greater chance of winning a mandate if he can also offer debt financing. This creates trust among other debt providers and thus a better placement of the total debt capital tranche on the market. If the advisory quality is the same, WP companies, in conclusio, have a general disadvantage compared to the banks and insurance companies. A disruptor would therefore have the best chances on the market if he offered an advisory performance of equivalent quality while at the same time providing debt without minimum requirements according to Basel III or EIOPA.

As with all FinTechs, there could be a platform-based solution where, similar to crowdfunding, structured project finance is made available to private investors. In this case, the quality of the structured products would have top priority. In order to establish a long-term trust base, the quality of the product would have to be presented to private investors in a clearly comprehensible, credible and convincing manner. A newly established, transparent and freely accessible rating structure would support the quality and comparability of the individual products. It is also possible to bundle several project financings as a fund, which, like a bank credit portfolio, factors in the default probability of individual projects and in doing so completely eliminates the fund's loss risk. Purchasing the structuring know-how as a platform operator is very capital-intensive and could, as before, be well covered by the relevant WP companies.

Size and scale effects on platforms have shown that a maximum of two competing platforms in the market can be established in the long-term (Google and Bing or Amazon). With a variety of platforms to choose from, the private investor's motivation to register with each platform is very low. Thus the private investor will register on the platform with the largest project selection. Consequently, this platform will have the largest financial capacity, which in turn leads to more projects and more private investors. Accordingly, there may only be one or two platforms in the long-term, since smaller platforms will be automatically forced out of the market.

Tesla has impressively shown how capital-intensive a market penetration with a disruptive top-down approach is. If a disruptor in the project finance market also purchased his own know-how with great capital expenditure and if he were one of the first to establish his own brand as a platform, the opportunity would be great to dominate the project financing market in the long-term and destroy banks and insurance companies in their project fi-

nance business area. The number of capital-intensive projects, on the one hand, and private investors with a long-term investment horizon, dividend focus and great security focus (retirement provision),on the other, have the potential for a successful platform solution, and may even evolve into a global company. There is a lot of cake to be distributed once the product "project finance" has been ruined for the banks and insurance companies and taken over by disruptors.

Bibliography:

Bozicevic, Falko, Liebig, Svenja: Phase I – Die digitale Disruption erreicht Finanzindustrie; 2017
Böttcher, Jörg; Blattner, Peter: Projektfinanzierung; 2013
Dueck, Gunter: Schwarmdumm: So blöd sind wir nur gemeinsam; 2015
Fabozzi, Frank J; de Nahlik, Carmel: Project financing; 2012
Kleiner, Marcus, Brodehser, Peter: Infrastrukturfinanzierungen – ein Markt mit Zukunft für Banken und institutionelle Investoren 2013
Matzler, Kurt im Interview mit Winfried Kretschmer: Verlauf exponentiell, Wirkung disruptiv; 2017
Nevitt, Peter K: Project financing; 1980
Pitzer, Jürgen: Glaubwürdige Kommunikation im Zeitalter der Disruption; 2016
Richter, Thomas: Erleichterte Finanzierung von Infrastruktur durch Spezialfonds; 2016
Tytko, Dagmar: Grundlagen der Projektfinanzierung; 1999
Watzek, Harald: Einfluss interner Modelle auf die Infrastruktur- und Projektfinanzierung; 2017
Yescombe, Edward R: Principles of project finance; 2013
Zenke, Harald D.: Export- und Projektfinanzierung: Gesellschaftliche Trends aufspüren und begleiten; 2012

Footnotes:

1) cf. Matzler.
2) cf. Pitzer.
3) cf. Matzler.
4) cf. Matzler.
5) cf. Bozicevic, Liebig.
6) cf. Bozicevic, Liebig.
7) cf. Bozicevic, Liebig.
8) cf. Dueck.
9) cf. Nevitt; Fabozzi; Böttcher, Blattner; Yescombe; Tytko.
10) cf. Watzek.
11) cf. Zenke.
12) cf. Kleiner, Brodehser.
13) cf. Richter.