



DUE DILIGENCE

FPU Factsheet 6

Essentially Due Diligence is the activity of a bank making a thorough assessment of a transaction.

This assessment includes:

- ensuring that the project's banking base case is acceptable;
- technical details of the project are understood so any associated risk can be reflected in its final terms;
- insurance provisions of all project parties are acceptable and placed correctly;
- the many project contracts reflect properly the commercial agreement between parties and interface correctly.

Details:

Financial Due Diligence

A financial model will exist for a project and will be drawn up by the party wishing to raise bank funding. The model will show the financial and accounting assumptions used for the project including repayment schedules, cashflow, balance sheet and a profit and loss account. The model will be used as an on-going monitoring tool during the project.

The bank will place reliance on this model. They will have it audited to check that it is arithmetically correct, logically built, the inputs reflect the agreed terms and that the funding and accounting assumptions are correct or acceptable.

The bank will sensitise the model. They will want to see what effect changing the inputs/assumptions will have on the model. They will interpret these results and structure the terms of the funding and/or overall funding to reflect them.

The bank will also carry out an internal assessment of the financial strength of project parties including analysis of their annual accounts.

Technical Due Diligence

Specialists will be called in by the bank to advise on all the technical aspects of a project. The bank is seeking confirmation that:

- Any construction works can be built in the agreed timescale and for the agreed cost;
- The final building will meet the requirements of the user;
- Any assumptions for the regular and major maintenance are reasonable;
- The specification for any services to be provided are acceptable.

The bank will also want to know the level of risk associated with a project. For PFI projects they will review the payment mechanism (e.g. are there penalties for worst performance) and may also seek advice on specialist operating environments, for example healthcare advice for hospital projects.

Insurance Due Diligence

Insurance generally falls into 2 categories: statutory and other insurances common to all projects, and those to address project specific risks. The insurance proposed by all project parties must be acceptable to the bank. The level of insurance and any deductibles must also be appropriate for the project. For project specific insurance it is important that the risk is appropriately mitigated and that the cost gives an acceptable benefit.

The cost of insurance will be included in the financial model.



A specialist insurance company would be employed by the bank to work closely with the borrower's insurance broker and the bank's other advisers.

Legal Due Diligence

The bank will employ specialist legal advice for project finance transactions. Usually the bank's legal adviser is responsible for the drafting of all loan and security documentation and review of project agreement. The review will cover all the legal aspects of the transaction including protection for the bank in downside situations and their rights to security and title etc.

Co-ordination of Advisers

There is a continuous need to exchange information on the project proposals and agreements between parties so that the bank's advisers can analyse and assess the acceptability of them. All advisers, whether with the bank or the project, must work closely together. In some cases the bank's due diligence may raise risks which the bank is unable to accept in their present form. The overall structure may need to be adjusted to mitigate this risk or to place it with the party best able to control it.

Timescale

There is no generic timescale. The adviser's input will vary considerably with the complexity of a project and the state of the documents required to be reviewed. It will also depend on whether there are revisions after the process has started.

Traditionally the bank's detailed due diligence process was not started until the Preferred Bidder stage. This was for 2 reasons: the bank's due diligence costs are normally for the account of the Project Company who will not want to incur high costs without the high likelihood of the contract, and at the Preferred Bidder stage the Public Sector's requirements and Project

Company's proposals will be sufficiently well developed for all of a bank's advisers to start their reviews and for the bank to assess the project in the round. However increasingly detailed due diligence is starting in the earlier phases of the bidding process, particularly legal due diligence, as funders are being asked to confirm their acceptance of key project terms.

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