Financing

How lenders size debt on a project

Cover ratios, sculpting and the cash flow lenders actually use, explained with a worked example.

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Project lenders do not lend against the value of a project. They lend against its ability to repay. That distinction shapes how much debt a project can raise, and it is why two projects with the same cost and the same equity return can support very different amounts of debt.

The cash flow lenders use

Lenders size debt on cash flow available for debt service (CFADS): revenue less operating costs, taxes, maintenance capital spending and changes in working capital. It is the cash left over each period to pay interest and principal. The exact definition is set in the loan agreement, and the model should follow it line by line.

Two tests, and the lower one wins

Debt is usually sized as the lower of two amounts. The first is a gearing cap: debt may not exceed a set share of project cost, for example 70%. The second is a cover ratio test: in every period, CFADS must exceed debt service by a minimum margin. That margin is the debt service cover ratio (DSCR), CFADS divided by interest plus principal for the period. A minimum DSCR of 1.30x means the project must generate 30% more cash than it needs to service its debt.

A related measure, the loan life cover ratio (LLCR), compares the present value of CFADS over the remaining loan life with the debt outstanding. It shows how much cushion the lender has across the whole loan, not just in a single year.

Sculpting versus level repayments

With level (annuity) repayments, debt service is the same each year, so the minimum DSCR is set by the weakest year. Sculpting instead sets each year's debt service so that the DSCR is the same in every year: debt service equals CFADS divided by the target ratio. Because repayments follow the cash flow, sculpting usually allows more debt for the same minimum cover.

The example below uses a ten-year loan at 6% and a target DSCR of 1.30x, for a project with CFADS that ramps up, plateaus and then declines.

Year	CFADS	Debt service	Interest	Principal	Closing debt
1	14.0	10.8	6.1	4.6	97.6
2	17.0	13.1	5.9	7.2	90.4
3	20.0	15.4	5.4	10.0	80.4
4	20.0	15.4	4.8	10.6	69.9
5	20.0	15.4	4.2	11.2	58.7
6	20.0	15.4	3.5	11.9	46.8
7	19.0	14.6	2.8	11.8	35.0
8	18.0	13.8	2.1	11.7	23.3
9	17.0	13.1	1.4	11.7	11.6
10	16.0	12.3	0.7	11.6	0.0

Sculpted repayment profile. USD millions. Opening debt USD 102.3m. Figures may not sum due to rounding.

Sculpting supports USD 102.3m of debt with a DSCR of 1.30x in every year. A level repayment profile that keeps the minimum DSCR at 1.30x would support only USD 79.3m, because the first year's CFADS of USD 14m sets the limit. If the same USD 102.3m were repaid in level instalments, the DSCR would fall to 1.01x in year one, below any lender's threshold.

Now apply the gearing cap. If the project costs USD 160m and gearing is capped at 70%, the cap allows USD 112m. The cover ratio test allows USD 102.3m, so the cover ratio test binds and gearing ends up at about 64%. Equity must fund the rest.

The banking case

Lenders size debt on their own banking case, not the sponsor's base case. The banking case typically uses more conservative assumptions: lower prices, a P90 production or generation forecast rather than P50, and higher costs. A project that shows a comfortable DSCR in the sponsor's case may show a much thinner one in the banking case, and it is the banking case that sets the debt.

Other features that affect debt capacity

- Tenor and tail: lenders want the loan repaid well before the end of the asset's life, leaving a tail of cash flows as a cushion.
- Reserve accounts: a debt service reserve account, often sized at six months of debt service, ties up cash that would otherwise go to equity.
- Lock-up and default ratios: distributions to equity are typically blocked if the DSCR falls below a lock-up level set below the sizing ratio, and a lower ratio again may trigger a default.

Reserve-based lending

Oil and gas lenders often use reserve-based lending (RBL) instead. The borrowing base is the net present value of CFADS from the borrowing base assets, using the banks' price deck and production case, divided by cover ratios such as the loan life and field life cover ratios. Lenders also apply a reserve tail test, requiring the loan to be repaid while a set share of reserves remains. The borrowing base is redetermined periodically, so debt capacity moves with prices and reserves.

What this means for sponsors

Debt capacity is set by the shape and reliability of the cash flow, not just its size. Contracted revenue, a smooth production profile and conservative assumptions all support more debt. A model that follows the lenders' definitions and tests from the start avoids surprises in credit review, and shows sponsors early how much equity they will really need.

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