ARTICLE ON PROJECT FINANCING

1. INTRODUCTION

Project financing means arranging funds for implementing a new project or undertaking expansion, diversification, modernization or rehabilitation of existing projects. In project finance the project is appraised by some competent agency while taking into consideration the technical feasibility, managerial competency, financial and commercial viability and environmental, economic and political viability.

In today business scenario where the world is facing the liquidity crunch and capital is scarce, optimum utilization of the funds is essential. There should be optimized capital structure so that internal rate of return (IRR) to be maximized with minimum cost of capital. Hence an appropriate mix of debt and equity should be decided while applying the proposal for project funding to the banks/ financials institutions.

Before implementing a new project or undertaking expansion, diversification, modernization or rehabilitation scheme ascertain the cost of the project and the means of finance is one of the most important consideration. For this purpose the company has to prepare a feasibility study covering various aspects of the projects including its costs and means of finance. It enables the company to anticipate the problem likely to encounter in the execution of the project and places it in a better position to respond to all the queries that may be raised by the financial institutions and others concerned with the projects.

2. PREPARATION OF PROJECT REPORT

A project report is essential before a decision for setting-up of any project is taken. Project Report must include the followings:

A. Technical Feasibility

All the factors relating to infrastructure needs, technology, availability of machine, material etc. are required to be scrutinized under this head. Broadly speaking the factors that are covered under this aspect include:

- Availability of basic infrastructure- It includes the land and its location as per present and future needs, lay out and building plan including finalization of structure, availability of water and power, availability of cheap labour in abundant supply.

- Licensing/ registration requirements

- Selection of technology/ technical process- The technical process/technology selected for the project must be readily available either indigenously or necessary arrangements for foreign collaboration must be finalized. Further the selected technology must find a successful application in Indian environment and the management shall be capable of fully absorbing the technology.

- Availability of suitable machinery/raw material/ skilled labour etc- After selection of technical process, the availability of suitable kind of machinery is most important factor which needs to be considered. It should be ensured that the suppliers are capable to supply the plant and machinery timely along with all spare parts

B. Managerial Competence

The ultimate success of even well conceived and viable project may depend on how competently it is managed. The promoters of the project have to provide necessary leadership and their qualification, experience and track record will be closely examined by lending institution. The detail of other projects successfully implemented by the same promoters may provide the necessary confidence of these institutions and help final approval of the project.

The reputation of the promoters group in the market is also very important factor which the banks/ financial institutions consider while lending to the companies. Also the bank/ financial institutions check the payment history of past loan raised by the companies in which the promoters are directors which shows their willingness of repayment of the loans. CIBIL is a very strong tool in the hand of banks/ financial institutions to verify the payment history and the number of loans raised by the companies from the date of existence.

C. Commercial Viability

Any project can be commercially viable only if it is able to sell its product at profit. For this purpose it would be necessary to study demand and supply pattern of that particular product to determine its marketability. Various methods such as trend method, regression method for estimation of demand are employed which is than to be matched with the available supply of a particular product.

D. Financial Viability

Factors need to consider for financial viability:

1. Cost of project:

   A realistic assessment of cost of project is necessary to determine the source for its availability and to properly evaluate the financial viability of the projects. For this purpose, the various items of cost may be sub-divided as many sub-heads as possible so that all factor are taken into consideration for arriving at the total cost.

   Cost includes the following:

   a. Land Cost- Acquisition of project land, registry charges, and charges for other clearance.

   b. Site Development Cost- to make the project easily accessible it is necessary to build roads, water tank, boundary walls, arranging electricity, leveling the site, demarcation of site, making available the basic amenities etc.

   c. Buildings Cost- it includes lay out and building plan along with the structure cost, building the site office, factory sheds, godowns, residential flats for staff etc.

   d. Plant and Machinery- cost of plant and machinery, any foreign assistance for installation, salary of technical staff, transportation cost, foreign currency fluctuations (if any), bank commissions, L/C Charges etc.

   e. Miscellaneous Fixed Assets

   f. Preliminary Expenses- licence required to start commercial production from the local authorities along with other clearances etc.

   g. Contingencies- normally 5% extra cost is taken as contingency to avoid any kind of cost over-run at the end of implementation of project.

   h. Margin for Working Capital- for running a project it is necessary to fuel it with the working capital. It works like a lubricant for any kind of business. It is financed against receivables and stock. A proper assessment of the same should be done. Banks now generally require that 25% of the total current assets (working capital) shall be the margin to be provided from the long term resources and 75% shall be financed by them.

2. Means of Finance:

After estimation of the cost of the project, the next step will be to find out the source of funds by means of which the project will be financed. The project will be financed by contribution of funds by the promoter himself and also by raising loans from others including term loans from banks and financial institutions. The means of financing will include:

- Issue of share capital including ordinary/preference shares.
- Issue of secured debentures.
- Secured long-term and medium-term loans (including the loans for which the application is being put up to term lending institutions).
- Unsecured loans and deposits from promoters, directors etc.
- Deferred payments.
- Capital subsidy from Central/State Government.

3. Security Coverage and Promoters Contribution

In today scenario and being to play safe, the bankers wants that at least the promoters should contribute 40% of the total project cost. The long term sources of funds are utilized for acquisition of land, procuring the fixed assets and construction of building etc. But for day to day expenses, payment of staff salary, purchasing the stocks etc. the project require short term loan or working capital loans. Hence the financing for a project is the mix of both long term and short term loans.

In project funding the bank has charge on the land, building, any super structure thereof and hypothecation of stocks & receivables and all the current assets relating to project. It is considered as primary security but the bankers may ask for collaterals also in addition to the primary security.

4. Profitability Analysis

After determine the cost of the project and means of financing, the viability of the project will depend on its capacity to earn profits to service the debts and capital. To undertake the profitability analysis, it will be necessary to draw estimates of the cost of production and working results. These estimates are made for a period which should at least cover the moratorium and repayment periods.

Generally in case of project loans repayment begins after 2-3 years, the time gap between the disbursement of loan and repayment of first installment is called moratorium period.

Further repayment should start in that quarter or month when it is assured that the project will have sufficient cash profit to service the same in that particular quarter or month. Also, the moratorium and repayment period is decided while submitting the

proposal to the banks hence while selecting these periods' accurate calculations should be done.

5. Projected Balance Sheet, Profit and Loss Account and Projected Cash Flow:

The projected financials of the project is prepared for the entire tenure as estimated above.

6. Break-Even Point:

Estimations of working results pre-suppose a definite level of production and sales and all calculations are based on that level. The minimum level of production and sales at which the unit will run on "no profit no loss" is know as break-even point and the first goal of any project would be to reach that level. The break-even point can be expressed in terms of volume of production or as a percentage of plant capacity utilization.

Break-even in terms of volume of production = Total Fixed Cost/ Contribution per unit

7. Debt Service Coverage Ratio (DSCR):

Debt Service Coverage Ratio is calculated to find out the capacity of the project servicing its debt i.e. in repayment of the term loan borrowings and interest. The DSCR is worked out in the following manner:

$$\text{D.S.C.R} = \frac{\text{PAT + Depreciation + Interest on Long Term Borrowings}}{\text{Repayments of Term Borrowings during the year + Interest on long-term borrowings}}$$

The higher D.S.C.R. would impart intrinsic strength to the project to repay its term borrowings and interest as per the schedule even if some of the projections are not fully realized. Normally a minimum D.S.C.R. of 2:1 is insisted upon by the term lending institutions and repayment is fixed on that basis.

8. Sensitivity Analysis:

While evaluating profitability projections, the sensitivity analysis may be carried in relation to changes in the sale price and raw material costs, i.e. sale price may reduce by 5% to 10% and raw material costs may be increased by 5% to 10% and the impact of these changes on DSCR shall be analyzed. If the new DSCR, so calculated after changes, still proves that the project is viable, the financial institution may go ahead in funding the project.

9. Internal Rate of Return:

This is an indicator of earning capacity of the project and a higher IRR indicates better prospects for the project. The present investment in the cash flow which is assumed to be negative cash flow and the return (cash inflow) are assumed to be positive cash flows. Normally bankers want that internal rate of return should be at least 18% because it depicts the strength of the project and its earning and repayment capacity at the same time. Better the IRR better rating to the project.

E. Environmental, Political and Economic Viability

The performance of the project is also influenced by the external factors also such as existing government policies regarding particular sector, easiness in getting the licence to operate in a particular region or state, effects of the project on the environment, tax exemptions for particular region etc. Hence while compiling the project report it is important to study the industry scenario, government policies etc and these should be covered in the project report.

3. CONCLUSION

The most important thing in any project financing is preparation of Detailed Project Report (DPR) which should be made beautifully for getting the project approved from banks/financial institutions. After preparation of DPR the proposal is moved to the banks/financial institutions for processing of the file.

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