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ABM MODULE – C

Chapter 20: TERM LOAN

What we will study?

***What is TERM LOAN?**

***What is Deferred Payments Guarantee?**

***How Project Appraisal is done?**

IMPORTANT POINTS ABOUT TERM LOANS:

1. Banks provide term loans normally for acquiring the fixed assets like land, building, plant and machinery, infrastructure etc.,

(Personal loans, consumption loans, educational loans, etc., being exceptions)

While the working capital loans are provided for sustaining the working capital, i.e., current assets level.

2. In exceptional cases, banks provide term loans for current assets also. This is called Working Capital Term Loan (WCTL).

As we are aware, the business enterprise is supposed to bring a part of its funds required to maintain the desired level of current assets from its long term sources (capital or term liabilities), called NWC(net working capital=CA-CL) , so that the stipulated current ratio(CA/CL) can be maintained.

If the enterprise is not able to bring in the required amount of NWC, it will feel liquidity crunch and business operations will be affected . In such cases, banks may provide WCTL.

3. Working capital loans are normally sanctioned for one year but are payable on demand.

Term loans are payable as per the agreed repayment schedule, which is stipulated in the terms of the sanction.

Therefore, for the purpose of matching assets and liabilities of the bank, term loans are considered long term assets while working capital loans are considered as short term assets.

Practically, however, an enterprise continues to enjoy the working capital loan till its working is satisfactory, while the term loan gets repaid over a period of time.

4. As a term loan is expected to be repaid out of the future cash flows of the borrower, the DSCR (Debt Service Coverage Ratio) assumes great importance while considering term loans, while for working capital loans, the liquidity ratios(quick ratio, current ratio) assume greater importance.

5. There is no uniform repayment schedule for all term loans. Each term loan has its own peculiar repayment schedule depending upon the cash surplus of the borrower.

Thus, in case of a salaried person, where income level is constant, the repayment can be through EMI system and in case of a farmer, the repayment of principal and interest may coincide with the cropping pattern.

In case of industrial enterprises, normally, banks stipulate monthly/quarterly repayment of principal along with all the accumulated interest.

In some cases, the entire repayment may be stipulated in one instalment only, called the bullet repayment.

DEFERRED PAYMENT GUARANTEES (DPGs):

When the purchaser of a fixed assets does not pay to the supplier immediately, but pays according to an agreed repayment schedule, and the bank guarantees this repayment, the guarantee is called DPG.

This is a Non-fund based method for financing purchase of fixed assets.

However, if the purchaser defaults in payment of any amount, the bank has to pay the same to the supplier and the exposure becomes fund based till the amount is recovered from the client.

The risks involved in a DPG are same as those in a term loan and therefore, the appraisal for a DPG is same as that for a term loan.

DIFFERENCE BETWEEN TERM LOAN APPRAISAL AND PROJECT APPRAISAL:

The differences can be summarized as under:

(a) In project finance all the financial needs of the enterprise, including working capital requirements, are appraised.

This is because the total requirement of long term funds includes margin money for working capital.

After assessing the total requirement of long term funds, the banks decide upon the amount of term loan to be sanctioned and the contribution of the promoters.

(b) If an existing enterprise wants to purchase a few machineries, which are not going to have a major impact on the volume or composition of the business, it will serve little purpose to have a detailed examination of techno-economic feasibility, managerial competence, IRR, etc.

It may be enough for the bank to examine the projections for next 2-3 years to find out that DSCR is at satisfactory level.

In case of loans to individuals also, like housing loans, educational loans, etc., it may be enough to examine the projected DSCR to judge the viability.

However, the basic principles of appraisal of a project or a standalone term loan are not different and if one is clear about project appraisal, the appraisal of a standalone term loan proposal is even simpler.

PROJECT APPRAISAL: Project appraisal can be broadly taken in the following steps:

(a) Appraisal of Managerial Aspects

(b) Technical Appraisal

(c) Economic Appraisal

(a) Appraisal of Managerial Aspects:

The appraisal of managerial aspects involves seeking the answer to the following questions:

(i) What are the credentials of the promoters?

(ii) What is the financial stake of promoters in the project? Can they bring additional funds in case of contingencies arising out of delay in project implementation and changes in market conditions?

(iii) What is the form of business organisations? Who are the key persons to be appointed to run the business?

(b) Technical Appraisal:

The technical feasibility of a project involves the following aspects:

(i) location

(ii) products to be manufactured, production process

(iii) availability of infrastructure

(iv) provider of technology details of proposed construction

(vi) contractor for project execution

(vii) waste disposal and pollution control

(viii) availability of raw materials

(ix) marketing arrangements

(c) Economic Appraisal: The economic/financial feasibility of a project involves the following aspects.

(i) Return on Investment: The usual methods used are the NPV(net present value) , IRR(internal rate of return) , payback period, cost benefit ratio, accounting rate of return, etc.

(ii) Break-even Analysis: A project with a high break-even point is considered more risky compared to the one with lower break-even point.

(iii) Sensitivity Analysis: As market conditions are uncertain, a small change in the prices of raw materials or finished goods may have a drastic impact on the viability of a project. Sensitivity analysis examines such impact.

ABM MODULE – C

Chapter 20: TERM LOAN (PART-II)

What we will study?

***What is Appraisal and financing of Infrastructure Project?**

APPRAISAL AND FINANCING OF INFRASTRUCTURE PROJECTS

The sectors included in the definition of "Infrastructure" are as per the Gazette Notifications issued by the Ministry of Finance, Government of India, from time to time.

Presently, the following infrastructure sectors qualify under 'infrastructure lending':

(a) Transport: This includes Roads and bridges, Ports, Inland Waterways, Airport, Railway Track

(b) Energy: This includes Electricity Generation, Electricity Transmission, Electricity Distribution, Oil pipelines,Liquefied Natural Gas (LNG).

(c) Water & Sanitation: This includes Solid Waste Management, Water supply pipelines, Water treatment plants, Sewage collection.

(d)Communication;This includes Telecommunication, Telecommunication towers,Telecom Services.

(e) Social and Commercial Infrastructure; This includes Education Institutions (capital stock), Hospitals (capital stock), , SEZ, tourism facilities and agriculture markets, Fertilizer (Capital investment).

RBI guidelines to the banks for financing infrastructure projects, are as follows:

(a) Types of Financing by Banks:

In order to meet financial requirements of infrastructure projects, banks may extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/preference shares/equity shares.

(i) Take-out Financing: Banks may enter into take-out financing arrangement with IDFC/other financial institutions or avail of liquidity support from IDFC/other FIs.

(ii) Inter-institutional Guarantees: Banks are permitted to issue guarantees favouring other lending institutions in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project.

(iii) Financing Promoter's Equity:

banks were advised that the promoter's contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies.

In view of the importance attached to the infrastructure sector, RBI has permitted that, under certain circumstances, an exception may be made to this policy for financing the acquisition of the promoter's shares in an existing company, which is engaged in implementing or operating an infrastructure project in India.

(b) Appraisal:

(i) In respect of financing of infrastructure projects undertaken by Government owned entities, banks/ Financial Institutions should undertake due diligence on the viability of the projects.

Banks should ensure that the individual components of financing and returns on the project are well defined and assessed.

(ii) Infrastructure projects are often financed through Special Purpose Vehicles.

Financing of these projects would, therefore, call for special appraisal skills on the part of lending agencies.

(c) Prudential Requirements:

(i) Prudential Credit Exposure Limits:

Credit exposure to borrowers belonging to a group may exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent (i.e., up to 50 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects.

Credit exposure to single borrower may exceed the exposure norm of 15 per cent of the bank's capital funds by an additional 5 per cent (i.e., up to 20 per cent) provided the additional credit exposure is on account of infrastructure.

(ii) Assignment of Risk Weight for Capital Adequacy Purposes:

Banks are required to be guided by the Prudential Guidelines on Capital Adequacy and Market Discipline-Implementation of the New Capital Adequacy Framework.

(iii) Asset-Liability Management:

The long-term financing of infrastructure projects may lead to asset – liability mismatches, particularly when such financing is not in conformity with the maturity profile of a bank's liabilities.

Banks would, therefore, need to exercise due vigil on their asset-liability position to ensure that they do not run into liquidity mismatches on account of lending to such projects.

(iv) Administrative arrangements:

Timely and adequate availability of credit is the pre-requisite for successful implementation of infrastructure projects.

Banks/FIs should, therefore, clearly delineate the procedure for approval of loan proposals and institute a suitable monitoring mechanism for reviewing applications pending beyond the specified period.

(d) Take-out Financing/Liquidity Support:

(i) Take-out Financing Arrangement:

Take-out financing structure is essentially a mechanism designed to enable banks to avoid asset-liability maturity mismatches that may arise out of extending long tenor loans to infrastructure projects.

Under the arrangements, banks financing the infrastructure projects will have an arrangement with IDFC or any other financial institution for transferring to the latter the outstanding in their books on a pre-determined basis. IDFC and SBI have devised different take-out financing structures to suit the requirements of various banks, addressing issues such as liquidity, asset-liability mismatches, limited availability of project appraisal skills, etc.

(ii) Liquidity Support from IDFC: As an alternative to take-out financing structure, IDFC and SBI have devised a product, providing liquidity support to banks. Under the scheme, IDFC would commit, at the point of sanction, to refinance the entire outstanding loan (principal + un recovered interest) or part of the loan, to the bank after an agreed period, say, five years.

(e) Partial Credit Enhancement (PCE) to Corporate Bonds:

The credit needs of the infrastructure sector in India are huge. As the Indian corporate bond market is at a nascent stage of development, there is excessive pressure on the banking system to fund the credit needs for project development, including the infrastructure sector.

Due to greater asset-liability mismatch in infrastructure and project financing, banks are exposed to liquidity risk.

The insurance and provident/ pension funds, whose liabilities are long term, may be better suited to finance such projects. With a view to encouraging corporates to avail of bond financing, RBI has decided to allow banks to provide PCE to bonds issued by corporates/special purpose vehicles (SPVs) for funding all types of projects , subject to certain guidelines.

To begin with, banks are allowed to offer PCE only in the form of a non-funded irrevocable contingent line of credit. The objective behind allowing banks to extend PCE is to enhance the credit rating of the bonds issued so as to enable corporates to access the funds from the bond market on better terms.

(f) Financing of Cost Overruns for Projects under Implementation

1. Internationally, project finance lenders sanction a 'standby credit facility' to fund cost overruns if needed.

Such 'standby credit facilities' are sanctioned at the time of initial financial closure; but disbursed only when there is a cost overrun.

At the time of credit assessment of borrowers/project, such cost overruns are also taken into account while determining the project Debt Equity Ratio, Debt Service Coverage Ratio, Fixed Asset Coverage Ratio etc.