Unit V - Financing of Projects

Project Financing is a long term, limited resources financing solution that is available to a borrower against ~~these~~ the rights, assets and interests related to concerned project

Sources of Finance
- Capital structure
- Menu of Financing
- Equity capital
- Preference capital
- Internal Accruals
- Term Loans
- Debentures
- working capital advance
- Miscellaneous sources
- Raising venture capital
- Raising venture capital in International market.

Capital Structure.

Two broad sources of finances available to a firm are

Share Holders Funds

1 Equity capital & Retained Earnings
2 Preference capital

Loan Funds

1. Debenture capital
2. Term Loan
3. Deferred credit
4. Fixed deposits
5. The Working Capital Advance.

Difference between share holder's funds (equity) and loan funds (debt)

Equity Holder	Debt Holder
Share Holders have a residual claim on the income & wealth of the given firm	Have a fixed claim in the form of the interest and the principal payment
Not tax deductable payment	Interest paid to creditors is tax deductable payment
Has an indefinite life	Has a fixed maturity
Controls the affairs of the firm	Plays a passive role

Important considerations in planning the Capital Structure are

1 Earning per Share [EPS]
Earning per share which is simply equity earnings divided ~~by~~ by the number of outstanding equity shares

$$\boxed{EPS = \frac{(\text{Profit before interest and taxes} - \text{interest})(1 - \text{tax rate}) - \text{preference dividends}}{\text{No of equity shares}}}$$

To expand firm, the management has to rise additional capital either by issuing equity shares or through debentures with some percent interest.
Break-even analysis is also carried out for the financing plans.

2 Risk
The two principal sources of risk in a firm are
Business Risk
Financial Risk.

Business Risk
This refers to the variability of profit before interest and the taxes.
It is influenced by following factors
1 Demand variability
2 Price variability
3 Variability in input prices
4 Proportion of fixed costs

Financial Risk
This represents the risk emanting from financial average.
If debt is in high proportion, it increases the fixed financial commitments.
Equity shareholders face the risk in additional to business risk

3 Control
To enhance the additional capital for a firm; it may go for debt finance or rights issue of equity capital or combination of these.
The control on firm depends on the type of capital.

4 Flexibility
It refers to the ability of a firm to raise capital from any source.
It may be equity or the debt capital.
However debt equity ratio is normally not permitted to exceed a certain level.
A firm does not fully exhaust it's debt capacity.
It implies that the firm maintains reserve borrowing power to enable it to raise debt capital to fund unforeseen fund.

5 Nature of Assets
If the assets of a firm it's tangible their assets are debt.
If the assets are primarily intangible (brands and technical how); debt finance being used is less

Menu of Financing

- Source of Capital
  - Equity
    - Equity Capital
    - Preference Capital
    - Internal Accruals
  - Debt
    - Term Loans
    - Debentures
    - Working Capital Advances
    - Miscellaneous Resources

debenture - a long term security yielding a fixed rate of interest, issued by a company and secured against assets.

Different ways of Raising Equity and Debt

- Public and Private source of Capital: Public and private sources of capital is available to a firm to raise equity and debt.

- Public source is in the form of securities offered to the public through an offer document filed with with the Securities Exchange Board of India.

- Private capital is ~~the~~ in the form of loans given by banks and financial institutions or in the form of securities like equity shares, preference shares and debentures from investors like financial institutions, insurance companies, mutual funds and wealthy induviduals.

- Typical Pattern of Financing: When a company's formed; it first issues equity shares to the promoters (Founders) and also raises loans from banks, financial institutions and other sources.

- As the need for financing increases, the company may issue shares and debenteres privately to promoter's relatives, friends, business partners, employees, banks, mutual funds, venture and capital funds.

- As the company grows further; it may have to rise capital from the public.

- Apart from the equity shares; ~~a firm~~ a firm may issue preference shares and debenteres to the general investment ~~to~~ through public issues.

Equity Capital

→ Equity capital represents ownership as equity share holders

→ The equity share holders are the owners of the company who have significant control over it's management.

→ They enjoy the rewards and bear the risk of ownership.

→ The equity capital is also called as the share capital / equity financing.

Authorized Capital : It is the maximum amount of capital that a company can raise through the issue of shares to share holder.

Issued Capital : The issued capital refers to the number of shares issued by the company to the stakeholders

Subscribed Capital : The part of issued capital ~~which~~ which has been subscribed to by the investors represents the subscribed capital.

Paid-Up Capital : The actual amount paid by the investor.

Par Value : Of an equity share is the value stated in the memorandum and written on the share scrap, it is generally ₹10.

Issue Price : It is the price at which the equity share is issued, an existing company may sometimes set it's issue price higher than the par value.

Book value : $\frac{\text{Paid-up equity capital + Reserves and surplus - intangibles}}{\text{No of outstanding equity shares.}}$

Market value : Of an equity share is the price at which it is traded in market.

Rights of Equity share holders

Rights to income : The equity investors have a residual claim to the income of the firm.
The equity share-holders are entitled to dividend that is declared by the Board of Directors.

Right to control : Equity share holders as owners of the firm elect the Board of Directors and have the right to vote on every resolution placed before company.
Board of directors select the management which controls the operations on firm

Pre-Emptive Right : The pre-emptive right enables existing equity share holders to maintain their proportion ownership by purchasing additional equity shares issued by firm
Equity share holder has the right to purchase additional share with the first preference.

Right in Liquidation:

As in the case of income, equity shareholders have a residual claim over the assets of the event of liquidation.

The claims of all other debentures holder and preferred share holders are settled prior to the firm of the equity share holders.

methods of Raising Equity Capital

When a company is formed, it first issues equity shares to promoters(Founders) and to the selected group of investors.

As the company grows; following are methods of raising the equity shares.

1 Initial Public Offering
2 Seasoned Offering
3 Rights issues
4 Private placement
5 Preferential placement

Initial Public Offering

The first public offering of the equity shares of a company which is followed by a listing of it's shares in the stock market; is called as Initial Public Offering.

Benefits of IPO

1. Access larger pool of capital
2. Respectability
3. Lower cost of capital compared to private placement
4. Liquidity.

Seasoned Offering

- As company grows they are likely to make further trips to the capital market with issues of debt and equity.
- The procedure for a public issue of seasoned offering is similar to that of an initial public offering

Rights Issues

→ When a company issues additional equity capital; it has to be offered in the first ~~instantance~~ instance to the existing share holders ~~to ratio~~ on a pro rata basis

Private Placement

* It refers to sale of equity of an unlisted company or sale of debentures of a listed or listed company to sophisticated investors such as finicial institutions, mutual funds banks etc.

Preferential Allotment

\# An issue of equity by a listed company to selected investors at a price which may or may not be related to the prevailing market price is referred as preferential allotment in the Indian Capital market

Advantages of Equity Capital

- There is no compulsion to pay the dividends
- Equity capital has no maturity date
- Larger the equity base ; the greater ability of the firm to raise debt finance on the favourable terms
- Equity dividends are tax exempt up to a certain extent

Disadvantages of Equity Capital

- Sale of equity shares to outsiders dilute the control of existing owner
- Cost of equity capital is high
- Equity dividends are paid out of the profit after tax.
- Cost of issuing shares is generally higher than the cost of ~~issuing~~ issuing other types of securities

Preference Capital.

This is a hybrid form of financing; it ~~has characteristics~~ has characteristics of equity and debentures.

Characteristics of Equity Shares

1. Profit is distributed.
2. Not an obligatory payment
3. Not a tax deductable payment

Characteristics of Debentures

1. Divided rate is fixed
2. Claims prior to ~~the~~ equity share holder
3. Do not enjoy the right of vote

Advantages of Preference Capital

⇒ No Legal obligation to pay the preference dividend.
⇒ There is no liability in the case of perpetual preference shares
⇒ Part of net worth
⇒ No voting rights, so no dilution of power
⇒ No collatheal is pledged for the preference share.

Disadvantages

Δ More expensive than the debt capital
Δ Skipping dividends can adversely affect the image of the firm in the capital market.
Δ Prior claim than the equity share holders
Δ If a firm skips preference dividends for three years, it has to grant voting rights to the preference share holders.

Internal Accurals

- Internal Accurals of a firm consists of depreciation charges and retained earnings.
- Depreciation earnings represents the allocations of capital expenditure is expected to benefit the firm.
- Depreciation is a non cash charge.
- Hence it is considered as an internal source of Finance.
- Retained Earnings are that portion of equity ~~earnings~~ earnings [dividends] which are ploughed back in the firm.

- Retained earnings are the sacrifices made by the equity stakeholders, they are referred as internal equity.

- Retained earnings are an important source of the long term financing.

Advantages of ~~Long Term F.~~ Inaccurate Accurals

- They are readily avaliable
- Use of internal accurals eliminates issue cost and losses on account of under picking
- There is dilution of the control.
- NO any negative connotation

Disadvantages of Inaccurate Accurals

* Amount may be limited
* It is dividends foregone by equity share holders.
* Many firms do not fully appreciate the opportunity costs of retained earnings and the depreciation generated funds.

Term Loan

The firms obtain long term debt mainly by raising term ~~loans~~ loans and foreign currency term loan.

Currency
The rupee term loans are given directly for the buildings, preliminary expenses, working capital.

Financial institutions provide foreign currency term loan for meeting the foreign currency expenditure towards import of plant, machinery.

Security: Usually assets, which are ~~formed~~ financed with the term loans, providing the prime security. Other assets of the firm may serve as collateral security.

All loans provided by financial institution with interest, liquified damages, commitment charges, expenses are secured by way of

1. Equitable mortgage for immovable properties of the burrower
2. Hypothecation of all movable properties of the burrower

The firms obtain long term debt mainly by raising the term loans or issuing debentures for private firms & public firms

Term. Loan is referred as term finance, loan is generally repayable is less than 10 years with equal installments.

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Intrest Payment & Principal ~~R Payment~~ Re-Payment

* Typically the term loans provided by financial institutions are repayable in the equal installments

* These installments include intrest and part of the principal

* Intrests burdens declines over the time

* The burrower has to pay principal with intrest irrespective of the financial situation of the firm.

* Financial insitutions impose a penalty for defaults and in this case burrower is liable to pay compound intrest and other additional charges.

Features of Term Loans

- Currency
- Security
- Intrest payment & principal repayment
- Restrictive covenants

Restrictive covenants

- Financial institutions impose restrictive conditions on the burrowers.

- This conditions depends on nature of project and financial situation of burrower.

7 Obtain clearances and licenses from different government agencies

2 Repay existing loans with the concurrence of the financial institutions.

3 Refrain from undertaking any new project or expansion without a prior approval.

4 Refrain from additional borrowing

Term Loan Procedure

1 Submission of Application :
The applicalication submitted for the term loan covers the following
- Promoter background
- Particular industrial concern
- Particulars of the project
- Cost of the project
- The means of financing
- market and selling Arrangements
- Profitability and cash Flow
- Economic Considerations
- Government Consent

2 Initial Processing of the Loan Applications :
→ Officers of the financial institution reviews to ascertain whether it is complete for processing.
→ If it is incomplete asked to give the required information
→ Then they prepare a "Flash Report".
→ Flash Report is summarization of the Loan Application

3. Approval of Proposed Project :

* Approval covers the ~~marketing~~ marking, technical, financial managerial and economic aspects.

* Based on this decision is taken to accept or reject the project

4 Issue of the letter to sanction :

If the project is accepted, a financial letter of sanction is issued to burrower.

This communicates to the borrower in terms & conditions

5 Acceptance of the term & conditions by borrowing unit:

⇝ The acceptance of terms and conditions has to be conveyed to the financial institution within a stipulated period.

6 Execution of loan arrangement :

* After the acceptance from the terms and conditions by the borrower the agreement is executed as per the Indian stamp Act 1889, along with the other ~~documents~~ documents.

* Once the financial institutions sign agreements it becomes effective

7 ~~One~~ Creation of the securities:

- Term Loan and the deferred payment provided by the financial institutions are secured through mortage of immovable properties and hypothecation of the movable properties.

8 Disbursement of the Loan:

→ Periodically the borrower is required to submit the information on physical progress of projects.

→ Based on the information provided by the borrower the financial institution will determine the amount of term loan to be disbursed from time to time.

9 Monitoring :

Δ Monitoring of the project is done ~~during~~ at the implementation phase / stage as well as at operation stage through

- Regular Reports - which provide information about placement order
- Perodic visits
- Discussions with promoters, bankers
- Progress Reports
- Audited accounts of company

Project Appraisal

Financial institutions appraise a project from the marketing, technical, financial, economic and managerial angles.

Market Appraisal : Examine the reasonable demand projections by utilizing the demand findings of the available surveys, industry association projections, planning commission projections and independent market surveys.

Technical Appraisal: This focuses on product mix, the capacity, process of manufacture, raw materials, location, site, building etc.

Financial Appraisal: Reasonableness of the estimate of the capital cost, reasonableness of the estimate of working costs results, adequacy of rate of returns, appropriateness of financing pattern.

Economic Appraisal: The economic appraisal look at the project from the larger social point of view, it is referred as social cost ~~benefit~~ benefit analysis

Managerial Appraisal: In order to judge the managerial capabilities of the promoters, following questions are raised.

1 How resources are used as promoters?
2 How sound is the promoter's understanding of the required project.?
3 How committed are the promoters?

Debentures

- Debentures are the instruments for raising debt finance from public.

- Debenture holders are the creditors of a company.

- For ~~largely~~ large public trade firms, debentures are a viable alternative to the term loans

Features of Debentures

→ When a ~~debenture~~ debenture is issued and is sold to the investigating public, a trustee is appointed through a trustee deed.

→ Debentures issued in India are typically secured by mortgages / charges on the immovable properties of companies.

→ Debentures are typically redeemable in nature

→ Debenture maturity period of less than one year (short term debenture)
1 year - 5 year (medium term)
5 year - 12 year (long term)

→ Publicly issued debentures have a maturity period of 18 months / more.

→ Debentures may carry a fixed rate of interest or floating rate of interest or zero rate of interest.

Innovations in Debentures

Deep Discount Bond

- It is a form of bond which is issued at significant discount to it's face value
- It records a promise by the issuer of the bond to pay bond holder, on the stated maturity date, an amount which is greater than the amount originally recieved.

Convertible Debentures

- It is a debenture that is convertible, partially or wholly into the equity shares.
- Securities and ~~Exhange~~ Exchange Board of India (SEBI) guide lines are followed during ~~the~~ the conversion.
- Convertible Debentures are commonly used all over the world.

~~Fixed~~ Floating Rate Bonds

- Convertible bonds carry a fixed rate of intrest.
- Floating Rate bonds earn an intrest rate that is linked to a benchmark rate such as ~~the~~ Treasure Bill Intrest Rate.

Secured Premium Notes (SPN)

- After getting approval from the Central Government, SPN's are issued by the listing company.
- These are non-convertible debentures issued by the companies with a lock-in period.
- The SPN holder will get principal amount with the intrest on installment basis after the lock-in period.

Indexed Bond

The payoff of a typical indexed bond consists of 2 ~~part~~ parts
The 1st part represents fixed amount and ~~sed~~ second

part represents a variability component whose value is linked to some index.

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Private Placement of Debentures

⇒ Private placement implies any offer or invitation to subscribe or issue debentures by a company to a certain category of listed financial institution through privately placement offer cum application letter.

⇒ The principal buyers of privately placed debentures, the insurance companies, army group ~~insurance~~ insurance, navy group insurance

Accesibility of private placement of Debenture

⇒ Almost every company can access the private placement market, the private placement market can accomodate issues of smaller sizes where as the public issues of markets don't permit an issue ~~below~~ below certain minimum size.

Flexability

⇒ In a private placements there are greater flexabilities in working out the terms of the issue.

⇒ For example, when a non conventional debenture issue is privately placed a discount may be given to institutional investors to make the issue more attractive.

Speed

⇒ A private placement issue of debenture requires lesser time than the public issue cycle.

⇒ An elaborate procedure followed in a public issue is largely bypassed in private placement.

Lower issue costs

⇒ Issue of debenture in private placement is substantially less compared to the public issues. because of the public issues entails the expenses like brokerage, printing, promotion.

Working Capital Advance

* Cash credit / overdraft :
- Under a cash credit or over draft arrangement a pre-determined limit of loan for borrowing is specified by bank
- Whenever required the borrower can draw cash within the limit.
- He / She can also repay the amount partially or fully as and when desires.
- Interest is only charged on the running ~~bal~~ balance not on limit sanctioned.
- A minimum charge may be payable irrespective of the level of borrowing for availing of ~~the~~ this facility.

* Loans :
- These are the advances of fixed amounts to the borrower.
- The borrower is charged with interest on the entire loan amount ; irrespective of how much he/she draws.

* Purchase / Discount bills :
- Bill arises of a trade transaction.
- The Bill maybe payable after a usance period
- The seller offers the bill to the bank for discount or feedback
- When the bank purchases the, it releases the funds to the seller
- The bank presents the bill to the purchaser on the ~~dat~~ due date and gets it's payment.

* Letter of Credit :
  - This document will be issued by the bank of the buyer to the bank of seller guranteeing to pay the agreed amount of money to the other as specified in the letter of credit.

~~Miscellaneous~~ Sources

Apart from regular sources of finance, there are several other ways in which finance may be obtained

1 Deferred credit
2 Lease & hire purchase finance
3 Unsecured loans and deposits
4 Special schmes of institution
5 Subsidies and sales tax deferments & exemptions
6 Short term loans from financial institutions
7 Commericial paper

→ Deferred Credit
- Many time the supplier of machinery provide credit facility under which payment for the purchase of machinery is made over a period of time.
- Normally the supplier of machinery when he offers deferred credit facility insists that a bank gurantee should be furnished by the buyer.

covenant - an agreement

Lease Finance & Hire Purchase:

- A Lease represents a contractual arrangement whereby the lessor (owner) grants the lessee the rights to use an asset in return for ~~perodic~~ periodic lease rental payments.
- Leasing of industrial ~~payments~~ equipments is a relatively recent phenomenon particularly on the Indian scene
- Hire purchase is an arrangement made while buying expensive goods
- The consumer makes a down payment during the purchase and outstanding balance will be paid in installments with intrest charge.

Unsecured Loan ~~s~~ and Deposits:

- Unsecured Loans are a type of funding which is offered without the applicant having to provide any collatreal to bank.
- These unsecured loans are offered on the basis of an applicant's financial documents, credit score, income.
- Deposits from the public represents unsecured borrowing of one to three years duration.
- Many existing companies prefer to raise public deposits instead of term loans from financial institutions because restrictive ~~covenants~~ covenants do not accompany the public deposits.

Special Schmes Schemes of Institutions:

a) Bill Rediscounting Scheme: Under this scheme, the seller realizes the sale proceeds by discounting the bills accepted by the buyer with a commercial bank which in turn ~~rediscounts~~ rediscounts them with financial institutions.

b) Supplier line of Credit: Under this agreement the bank directly pays for the machinery manufacturer against used bill which is duly accepted or guranteed by the bank or purchaser

Subsidies, Sales Tax Deferments and Exemptions:

- Government and development agencies may provide subsidies for certain kind of projects.
- The central government as well as the state government ~~provided~~ provides ~~subsidies~~ subsidies to industrial units located in the backward area.

- To attract industries, the state provides incentives in the form of sales tax deferments and sales tax exceptions.

Short Term Loans from Financial Institutions:

- Financial institutions provides unsecured short-term loans for a period of one year (renewable) to companies with a good track record.
- To be eligible for such a loan, a company must satisfy certain conditions relating to dividend track record, debt equity ratio, current ratio and the interest coverage ratio.

Commericial Paper

- A commericial paper represents short term unsecured promisory notes is issued by the firm while enjoying a fairly high credit rating, maturity period of a commericial paper ranges from 90 to 180 days
- Commericial Paper is sold at a discount from it's face value and ~~redem~~ redeemable at face value.
- Commericial Paper is directly placed with investors who intend holding it till it's maturity

Venture Capital

- Start up companies with a potential to grow a need of certain amount of investments
- Such investments is provided by venture capital funds.
- venture capital represent financial investment in a risky proposition made in the hope of earning a high rate of ~~return~~ return.

Preparing a Business Plan

Some guidelines to approach venture capitalist to finance your project :

1 Use simple and clean language during the presentation and avoid technical terms

2 Focus on 4 basic elements i.e. People, Product, market and Competition

3 Give projections for about 2 to 5 years with emphasis on the cash flows

4 Identify the risks and development of strategies to cope up with the same

5 Convince them that the management team is talented, experienced, committed and determined.

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* Raising Capital in International Market

Indian Firm can raise capital from
- Euro-markets
- Domestic markets of the various countries
- Export credits

⇒ Euromarkets

- Euromarkets refers to a collection of international banks that helps firms in raising capital in global market which is beyond the purview of any national regulatory body

- An Indian Firm can access the Euromarkets to raise a
  1. Eurocurrency Loan
  2. Issue of the Eurobonds
  3. Issue of the global depository receipts

→ ~~Eurocurre~~ Eurocurrency Loan
- Eurocurrency Loans are often syndicate loans, where a group of lenders, particularly banks participate jointly in the process of lending under a single loan agreement.
- Syndicate leader of lender is represented by the lead bank.
- The rate of interest on Eurocurrency Loan is a floating rate and usually linked to the
  London Interbank Offer Rate
  Singapore Interbank Offer Rate

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* Eurobonds:
Firms using ~~Euromarkets~~ Euromarkets can sell bonds

1 eurobond is issued outside the country in which in whose currency is denominated.

2 managed by syndicate of investment bank.

3 It is bearer bonds; unregistered payable bonds to any person.

4 The interest on it is usually paid annually or half years.

* Global Depository Receipts

- Indian Companies have issued global depository reciepts (GDR), which indirectly equity placement, in Euromarkets.

- The underlying shares called depository shares.

- A company planned a GDR issue must obtain the approval from the ministry of finance and Foreign Investment ~~Promotion~~ Promotion Board.

△ Foreign Domestic market

→ It is a way to raise money internationally is to sell securities directly in the Domestic capital markets of the Foreign countries.

→ This is referred as Direct Issuance.

→ Indian Firms can issue bonds and equities in the domestic capital market of a foreign country.

□ Export Credit Schemes

⇝ Export credit agencies have been established by the government of major industrialized countries for financing exports of capital goods and the related technical services.

⇝ Two kinds of the export credit are provided
1. Buyer's credit
2. Supplier's credit

⇝ Under buyer's credit scheme, credit is provided directly to the Indian Buyer for purchase of the capital goods and technical services from overseas exporter.

⇝ Supplier's credit scheme in which credit is provided to the overseas exporters so that they can make ~~available~~ available medium term finance to Indian importers.