



PROJECT FINANCING – STEPPING STONE

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INTRODUCTION

Project Finance is one of the key stages in project management and it is the concept applied to a variety of financing structures that have features in common. In project finance, loans for the project are made on a non-recourse or limited basis. Whereas Lenders, who finance a project, normally assesses a loan proposition based on the credit worthiness of the borrower reflected by their asset portfolio and aggregate earning capacity, the lender in project finance is willing to look primarily to the expected income stream of the project for his repayment, since this is a key factor for his returns. If the project fails or the expected income stream fails to reach its goal, the liability for repayment of the loan does not pass the project sponsors and operators-except to the extent, which was assumed by them depend substantially on the performance of the project. Their accounts for another factor of project finance-project lenders scrutinize closely the feasibility studies prepared for the project, as it involves their monies. This typically involves assessing the technical aspects of the project as well as its economic projections. Project financing assumes increasing importance today as developing economies seek to develop their infrastructure. Infrastructures projects, such as Metro Rail Project, are invariably capital intensive ventures. Financial constraints may hamper countries, such as India ability to commit its financial resources for the development of its infrastructures. Permitting the project to be run by commercial enterprises allows certain insulation from the political factors that inhibits the efficacy of public sector projects, like Metro Rail Project. The government continues to play a vital role as the custodian of public interest by setting the terms of the concession and giving the appropriate regulatory responses, Acts, to unanticipated and deleterious effects of a project.

Financing a Project basically involves the following Risk Factors: Identification and Management

1. Feasibility Study

Primarily to assessing the bank ability of a project is the feasibility study. The non-resource basis of loans in project finance as well as the limited recovery that can be expected from the liquidation of project assets puts high premium on the reliability of the feasibility study.

(a) **Technical Feasibility** : Every Project requiring large capital commitment must involve careful and feasibility studies by reputable experts. Every aspect of the project which impacts on its feasibility has to be carefully studied. A project intended, must be capable of producing what it is intended to produce in the quality and quantities expected the market studies which form the basis of cost estimates and revenue projections must be realistic. Careful study by its lenders and its agents would conduct a careful study on the project design, the construction schedule, the startup performance standards to be satisfied prior to handing over of a turn-key project and of course, an appraisal of the output projections. A promoter who hopes to secure the commitment of lenders must prepare rigorous confidence in the promoter's ability to produce the results promised lenders generally prefer projects involving tried and tested technology. These are the projects which will produce the steady cash flow so essential to servicing the debt obligations. Projects which involve new technology, especially now-a-days and untested innovations are more properly reserved for ventures capitals after all venture capitals have the mandate to participate in risky projects which may produce much fruits for its investors.

(b) **Economic Viability**: Very next is the tried in with the technical feasibility of the project is its economic viability. The amount of contingencies of cost overruns, currency fluctuations and possible interest rate changes Lenders must be satisfied that revenues generated by the project are capable of covering operating expenses, debt service obligations, Tax liabilities, royalties and other financial obligations. Project finance thus involves a degree of sophisticated on credit analysis that extends beyond normal loans. While lenders would engage their own experts to see the feasibility study submitted by the promoter, lenders must be capable of evaluating the technical and financial projections as well as the assumptions used in the studies. Banks regularly participating in project fiancé will have their in- house technical experts who are invariably engineers with a career background in the industry capable of providing their independent evaluation of the feasibility studies.

2. The construction and Development Tools phase

The typical profile of an infrastructural project involves a high cost/high risk construction and development period followed by a relatively long low revenue-low risk cost recovery period. The construction and development phase constitutes the long gestation period before the project sees any significant revenue stream. Much of the capital required



for the project is ploughed in during this period. There are a multitude of causes for cost overruns a devaluation, due to various reason, in the currency to be converted resulting in increased cost of imported building material , an legal hurdle against the host country resulting in increased fund, energy and transportation costs, unexpected legal problems in certain measure of control can be taken into consideration over some of these risks. Delay in the completion of the construction, especially software project, will delay the commencement of revenue-generating operations. The consequences of delay should ideally be borne by the responsibility party or alternatively by some other resource.

3. On the track/Startup Phase

The on the track phase commences with the first operations of the project plant of facility. For the construction of a plant to be considered successfully, the plant must function at the projected cost and according to the specifications found in the feasibility study. These form the basis for the cost and revenue projections. Difference between the actual cost and the projected cost upsets the cast flow.

4. Management of Operational Risks and Risks common to all project phases.

If a risk profile is drawn over the life of a typical project, the period following start up the operational phase will show a steep decline in the risks associated with the project. The project is in the earlier stages of the project life, currency risks, fluctuations in product and commodity prices, natural disasters, civil disorders and political populism. Many of the risk management techniques that are discussed in this section are therefore applicable also to the previous sections.

- i) **Changes/Fluctuations in the price of raw materials, fuel and transportation:** A steep rise in the price of raw materials, fuel or transportation increases the cost and affects the net earnings of the project. Long term supply of contracts may be considered for fixing the price of items like the raw materials and transportation. Suppliers to the enterprise may held a monopoly over the supplies in that locality. The transportation company holding a monopoly in the area may extort exorbitant rates which seriously shave the margins of the project. Long term supply contracts give a certain assurance that the cost estimates will be kept within predicable bounds. Futures contracts available on the commodities market may also be adopted to hedge against the price fluctuation in certain raw materials, like Cement Prices.
- ii) **Financial Risk :** Currency and interest rate fluctuations : Currency and interest rate risk are not unique to the operational phase. They affect the cost items in the construction and development phase as they do the cost items in the operational contracts enable the entity at risk to fix in advance the conversion rate between currencies for a stipulated date.
- iii) **Changes in market demand and market price:** Financial projections used in the feasibility studies may go seriously off mark when the market price of the project product or service is vulnerable to fluctuation. Competition from manufactures of project product. In the worst case scenario, a collapse in the market for the product or service offered by the project will also mean the drying up of revenue and hence the case flows to the product.
- iv) **Disruption of Operations:** A variety of unwelcome events can potentially disrupt the operations of a project. Fires, civil disorders, natural disasters are but a few examples, such as people's revolt in various states etc. When insurance is obtainable, lenders will normally insist that adequate insurance be obtained. Otherwise the project may find itself short of funds to repair the damage. Lenders may then be compelled to advance future sums in order to have the chance of obtaining the further return/advances.

Credit Support and Enhancement

One of the key stage for project finance is typically highly leveraged without credit support and credit enhancement devices , the consequences of project failure would fall heavily on the lenders. The concentrations of risks upon the lenders often makes financing on a totally non-recourse basis.

Some of the risk spreading techniques

1. **Guarantees:** Guarantees are binding commitments on the part of the guarantor to answer for default in the performance of specified obligations. Guarantees can take up on the indebt ness of the promoter.
2. **Insurance:** Insurance as credit support is rather self-evident. If the plant is destroyed by an un insured event, the insurance proceeds provide the means for reconstruction of the plant- in part if not in whole.



Conclusions

Hence, project finance is best conceptualized as a kind of limited recourse financing. The project sponsor is able to insulate himself from the risk of project failure but lenders would invariably requires guarantees and other credit support from the project sponsor in order to be confident about the project sponsor's commitment to the project. The equity risk must in the end analysis rest with the project sponsor. A careful study of a project will definitely give fruits not only for current generations but also for the generations to come, especially project like Metro Rail Project.

Reference

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