



SECTION - 6

SOURCE OF PROJECT FINANCE & FOREIGN COLLABORATION

This Section includes

- **Financing of Projects and Foreign Collaboration**

6.1 FINANCING OF PROJECTS AND FOREIGN COLLABORATION

- Financing of large projects comes under the purview of project finance which is defined as the financing of a project such that the lender is prepared to look only to the earnings of the project as the source of funds from which his loan will be repaid and to the assets of the project as collateral for the loan
- Construction of Suez Canal, expansion of North sea oilfields are earlier examples of project finance. International banks provide project financing for a vast range of projects, including mineral developments, toll roads, tunneling projects, theme parks, power stations and shipping and aircraft finance
- The uniqueness of project finance is that every financial facility is specifically tailored to suit the individual project and the needs of the parties sponsoring it.
- Project finance describes a large scale, highly leveraged financing facility established for a specific undertaking whose creditworthiness and economic justification is based on the project's expected cash flows. It is the project's own economics rather than its sponsor's financial strength that determines its viability. The sponsor isolates this activity, a method known as ring-fencing, from its other business.
- Through careful structuring, the sponsor may shift specific risk to project customers, developers and other participants, thus limiting its own financial risk
- The process of sharing risk is expensive. The increased cost is caused by the identification of a whole range of risks which must be incorporated in any contract documentation. Since, project finance is highly leveraged, its overall cost of finance may still be lower than a company's usual WACC.
- Non-recourse project financing happens when lenders do not at any stage during the loan period, have recourse for repayment from any cash flows other than project cash flows. These are very rare.
- Most projects are financed on a limited recourse basis



- The difference between without recourse and with limited recourse happens when the project is abandoned. On a non-recourse basis, the sponsors can walk away from the project without liability to repay the debt. Limited recourse financing is a more accurate description of most project financing involving bank lenders, where the ability of lenders to look to project sponsors for repayment of debt in the event of problems with the loans is restricted.
- Lenders are attracted to project finance because they receive processing and other fees compared with other business transactions they undertake. They can be protected from interest and capital repayment default by a range of covenants from the sponsor and other parties.
- Spreading specific project risk over several participating lenders lessens dependence on a single sponsor's own credit standing.

6.1.1 How project finance is different from conventional corporate borrowing?

- Project is established as a distinct, separate entity
- It primarily relies on debt financing, which form nearly 60 to 70 percent of project cost, the balance being equity contributions or subordinated loans from the sponsors.
- Project loans are directly linked to project assets and cash flows
- The sponsor's guarantees to lenders do not, cover all the risks.
- These projects are rated by credit rating agencies
- Firm commitments by various third parties, such as suppliers performance guarantees, purchasers of the project's output, government authorities providing planning permissions and the project sponsors themselves, are obtained and these create significant components to support the credit financing of the project
- The debt of the project entity is separate from the sponsor's companies direct obligations
- The finance is usually for a longer period of time

6.1.2 Risks in project finance

- Internal risks
 - Operating risk
 - Raw material handling risk
 - Completion
- External risks
 - Country or political risk
 - Off take risk

- Market risk
- Financial risks(foreign exchange)
- Documentary risk
- Force majeure risk

6.1.3 Private finance initiative

- Public services, often face service demands that they can not meet for want of infrastructure and facilities. This may be due to a shortage of finance in the sense that public borrowing is constrained by macro economic policies
- Many governments today, in order alleviate the above situation, are encouraging the use of private investments in services traditionally provided by the public sector. This is done through private finance initiative
- It has become the governments main instrument for delivering higher quality and more cost effective public services. Its aim is to bring the private sector more directly into the provision of public services, with the public sector as an enabler and guarding the interest of the users and customers of public services.
- PFI and PPP(Public private partnership) schemes allow public bodies to contract directly with the private sector organizations for the provision of capital finance.
- The private sector organizations accept some of the project's risk in return for an operator's licences to provide specified services with a view to making a profit and hence a return on equity
- The operator generates this return on equity through revenue stream arising from the services
- The operator will be part of a consortium
- PFI projects have the following characteristics
 - The contractor provides the capital investment
 - The investments is funded by banks and other members of the consortium, including the operators
 - The contractor assumes some of the venture's construction risks
 - The operator is awarded an operating licence for the capital facility to provide associated services, for example hospitals and assumes operating risks
 - The ownership of the facility is transferred to the private sector through the setting up of a separate company to build and run the project

Foreign Collaboration:

India is the second largest country in Asia and the seventh largest in the world. The opening up of the Indian Economy has thrown open investment opportunities in almost every field of business from the consumer sector to core infrastructure sectors. All these sectors are witnessing growing multinational interest.



Economic activity in India is carried out in two broad segments viz. the organized sector and unorganized sector.

The Organised sector is engaged in:

- Industry;
- Banking;
- Defence;
- Infrastructure such as Air, Road, Rail, Power, Communication, Ports, Shipping etc)

The Unorganized sector is engaged in:

- Agriculture;
- Retail and wholesale trade;
- Road transport;
- Miscellaneous service etc.

There used to be all pervasive regulatory framework controlling every aspect of corporate, industrial, trade, banking and other financial activities.

The Government has in recent times, moved ahead aggressively to reduce state control and ownership in the economy, remove protectional barriers, invite foreign direct and portfolio investment and initiate other reforms to make India a free market economy.

After India's economic reforms and globalization measures, it has become very common for foreign companies collaborating with Indian companies and vice-versa in several industrial sectors.

The Government has also relaxed many conditions for entering into collaboration agreements with foreign companies.

Foreign Investment Promotion Board (FIPB) under the Ministry of Commerce, is empowered to approve even 100% foreign equity, under certain categories. Foreign companies can open branch offices in India for specified activities and foreign institutions can operate in the Indian capital markets. Automatic approval for investment in Indian companies is permitted by Reserve Bank of India up to certain % of share capital depending on industry. RBI has prescribed sectoral caps for such investments in Indian companies.

Several Direct Tax reforms, trade policy measures, financial sector operational reforms have been initiated and continuous being relaxed more and more.

Industrial policy reforms have already started contributing for the growth of the economy of the country.

Students are advised to refer the websites of Reserve Bank of India, Government of India's websites of various ministries for more details.