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FINANCING A PROJECT

As we have seen earlier, in any business, funds are required for financing fixed assets and/or current assets.

Where do these funds come from? The answer is obvious. They either come from the *Owners* (by way of Capital, Profits, Deposits, etc) or are *Borrowed* (from Institutions, Outside Depositors, Creditors, Banks, etc).

Has the company borrowed enough? Has the promoters participated adequately in financing the company? At what cost has it borrowed? Will the company have financing problems? These and such other questions do crop up.

There is always a temptation to borrow. Many entrepreneurs would like to set up bigger projects with the hope that future profits will enable them to service the borrowings and also to repay. But what if the profits go down? From where can they repay the loan?

At the same time, if too cautious approach is taken, the company will not borrow at all! Then it cannot grow because owners cannot have endless funds of their own.

A balance has to be struck. The capital structure therefore has to be properly finalized.

The following aspects need consideration while finalising the capital structure:

a. It is generally felt that Long Term Uses of funds (in fixed assets and in minimum level of current assets) should be financed by Long Term Sources of funds. In other words, these assets should be financed by Share Capital, Reserves, and Long Term Borrowings.

b. A further question arises and that is, what should be the 'Ratio' of long term Borrowings and Capital + Reserves? Here the answer is not clear. But generally it is stated that a company that enjoys a higher contribution percentage on its products and has a

lower breakeven point, can go in for more borrowings over its capital than other companies. The reason is simple. In such a business, the risk is low. So you can safely borrow!

But as a thumb-rule, the Debt:equity ratio should not, under normal conditions, exceed 2:1.

c. Similarly, Investments in Current Assets (Stock + Debtors etc.) also need to be financed.

Against these assets, normally entrepreneurs get credit from the market (current liabilities) and working capital loans from banks.

Sundry creditors and other current liabilities are of a purely temporary in nature. The company should have enough liquidity to repay them, whenever they fall due or whenever there is demand.

This would mean that total current assets should be sufficiently higher than current liabilities. Not only that, easily *Encashable Current Assets* (Cash, Bank Balance and Good Debtors) should also be more than the *'Immediately Due'* current liabilities (outstanding wages, overdue payments, etc).

It is generally felt that the current assets: current liabilities ratio should exceed 1.3:1 and the liquid asset: immediate current liabilities ratio should exceed 1:1.

The above naturally means that for financing current assets, sources other than current liabilities will have to be utilized. Bank borrowings are one of them. Normally bankers do not finance the entire gap between current assets and current liabilities. It is generally expected of the Owners to Contribute an amount equal to at least 25% of the gross current assets.

Thus, the owners funds should finance a part of

1. Fixed assets
2. Current assets.

This has major bearings on the capital structure.

d. The company or entrepreneur, thus also has to decide on quite a few issues:

1. What should be the amount contributed by way of capital? And how to raise it?

* In order to augment capital, a company can issue shares to the promoter group and also to public. The shares can also be issued to public at a price higher than its face value (at premium). Sometimes, Financial Institutions & Large Investors (private equity) also subscribe to shares instead of lending loans to the company. There can also be variations of share capital like preference shares, convertible debentures and the like. The company, in these cases, has to follow the guidelines issued by *Securities & Exchange Board of India (SEBI), Stock Exchanges, Foreign Exchange Management Act (FEMA)* if foreign equity funds are to be accepted and of course follow the Companies Act. The extent of funds that can be augmented through these routes depends upon the extent of dilution that the promoters want to accept in their holding, vis-a-vis the cost of borrowing that it can afford. The perceived profitability of the specific company and of course, the overall investment climate in the economy also have to be borne in mind, while deciding the financing & projects.

2 What should be long term borrowings, and at what terms and conditions?

* The management always strives for the minimum cost of borrowing.

Various financial institutions have a number of schemes and incentives for priority industry and locations. Many a time, investment decisions are affected by the terms and conditions of these loans.

3 Whether to borrow from public (either by way of deposits or by way of convertible/non-convertible debentures) and on what terms? How much deposits should the owner bring in to meet the gap?

In order to decide such issues, a very good idea of the expected funds requirement and expected capacity to meet the commitments is a must.

e. Last but not the least is the aspect of *'Timing'.* A clear plan about the time when the funds will be needed for the project and matching the same with the expected receipt of the funds, is a must. Mismatch of time would unnecessarily delay the project, would lead to an over-run and add to costs.

f. Financing a project and deciding the capital structure is not a one-time issue. For meeting the expansion plans & growth, a running company also needs funds and hence capital structuring needs to be looked at. It is a good practice to Review the Capital Structure Periodically to bring about changes that are possible and desirable in this fast changing financial market.

Points to Ponder

1. What is an 'ideal' capital structure?
2. Would it vary from industry to industry?
   * from unit to unit?
   * from time to time?
3. As loans have their 'cost' by way of 'interest' and 'repayments'... does equity have its cost? What bearing would that have on deciding capital structure?
4. What role does 'subsidy' play in financing a project?
5. What is the importance of working capital assessment in project financing?
6. Does a promoter need more funds than what is contemplated in the overall project financing shceme? If Yes, why?

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WORKING CAPITAL MANAGEMENT

INTRODUCTION

Efficiency in working capital management has acquired great significance in the Indian industry, particularly in view of dear money conditions prevailing in the country, and also due to the restrictive credit policy of the Reserve Bank of India.

'Working Capital' means the difference between total current assets and total current liabilities. As the definition itself suggests, to ascertain working capital requirements, one will have to estimate the amount that will have to be kept invested in stocks of raw material, stores, finished goods, work-in-progress, debtors, advances, etc. and one will also have to estimate the amount of credit that one can enjoy from suppliers of goods and services.

Coming to think of it, working capital would cover almost the entire operation of the company.

Best illustration to understand the working capital would be to draw parallel with a pipeline. The moment business starts, raw material will have to be fed continuously every day. It will take roughly 15 days to one month (depending upon the production process) to convert raw material into finished goods.

Even after producing these goods, it will take some time to sell these goods, and even after selling these goods, it will take some time to receive money from debtors. Continuously throughout this period, raw material will have to be pumped in, stores and spares will have to be used and various expenses will have to be incurred. Besides, adequate inventory of raw material, finished goods, stores and work-in-process will have to be maintained. Summation of all these, in other words, would be the gross working capital requirement.