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**LONG TERM SOURCES OF FUND AND PROJECT
FINANCING: OPTIONS FOR FINANCIAL MANAGERS IN
NIGERIA**

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The capital structure of a firm is vital to its operations, growth, efficiency, maximization of shareholders' wealth and maintenance of their control or ownership. A financial manager, while deciding the long-term sources of fund and obtaining optimal mix of the funds, must know the peculiarities of each fund including the benefits, limitations and when to exercise his option.

INTRODUCTION:

The importance of long-term sources of fund to the financial managers is numerous not only to provide a strong capital base to remain in business but also to play significant role in ensuring the existence, continuance and sustainability of the business. Long-term funds are repayable to investors and lenders within the short period. Long-term funds like the ordinary share capital provide ownership rights. They are permanent in nature because they do not have maturity dates like the repayable debts capital.

The objective of this paper is to identify the rationale for long-term sources of funds available to the financial managers, the peculiar characteristics, benefits and the limitations in the use of each of these funds. Project financing which is one of the emerging asset-based financing options available to the private and public sectors in Nigeria is also considered.

THE RATIONALE FOR LONG-TERM FUNDS

Long-term funds are usually required when the business is first established to acquire the necessary fixed assets and provide for initial working capital. It is also required during the expansion of business and assets replacement. Presently in Nigeria, many banks have resorted to the long-term sources of funds through initial public offering in order to meet the N25 billion capital-base required by the Central Bank of Nigeria before the 31st, December, 2005.

Caprio and Demirgüç, - Kunt (1997) argued that long-term credit is scarce in developing countries because of the macro-economic, institutional and the characteristics of the firms or classes of firms' factors. In other words, firms have difficulty in gaining access to long-term funds. High inflation rate, unstable macro-economic policies, high real interest rate, restrictions to the financial and stock markets and firm's size are partly responsible for this scarcity.

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A financial manager's optimal mix of long and short term funds depends upon the firm's credit rating, its portfolio of growth opportunities, the profitability of the project, the ability to fund the project through the retained earnings, the liquidation value of the assets, the perceived accuracy of financial information, the firm's size and the age and level of banking competition. Myer (1977) remarked that the greater the firm's growth option, the greater the conflict between the use of stock and bond. Diamond (1991) says banks usually issue short-term credit as a way to control borrowers because it permits loans to be repriced to reflect new information. It increases efficiency by allowing uneconomic projects to be easily terminated and it is a more credible near-term threat than long-term credit. A major factor in firm's choice of capital structure is the reduction of contracting between firms as well as the institutional environment. For instance where the legal system is inefficient or costly to use, short-term debt is likely to be used than long-term debt.

In the literature, some of the models highlight the undesirable effects of relying on long-term debt. It is argued that firm's efficiency may be maximized by adapting a capital structure which excludes long-term debt because it leads to greater distortions in the owners and manager's risk preference and may result in a split of return between shareholders and bondholders. Short-term debt also serves a disciplinary role (Jensen, 1986) leads to a reduction in wasteful activities by managers and ensures greater level of efficiency in a firm's operations. A firm which relies on short-term funding (debts) is able to respond more quickly to adverse shocks and more likely to adjust or exit easily. (Ofek, 1993).

However, an active stock market and improved ability of creditors and debtors to enter into long-term contract are reflected in the ability of firms to grow at greater and faster rates than by relying on internal and short-term sources of funds (Demirgüç - Kant and Maksimoic, 1996). There is also a positive correlation between external financing and industrial growth (Rajan, and Zingales, 1996). Long-term financing protects the firm from liquidation by imperfectly informed creditors and prevents opportunistic creditors from using threat of liquidation to expropriate the profit of healthy firms. In manufacturing firms, there is clear evidence that more long-term finance tends to be associated with higher productivity. There have been productivity improvement, growth and efficiency in Ecuador, Italy and UK firms through the use of long-term debts. While development of the financial market and effective legal structure are important in meeting long-term external financing needs of firms and facilitating firm growth, Demirguc-Kunt and Maksimovic (1996) found no evidence for the thirty *firms* in developed and developing countries studied to the effect that subsidies granted to firms are associated with the ability of firms to grow faster.

SOURCES OF LONG-TERM FUNDS

The following funds have been found to be sources of long-term capital to companies.

1. ORDINARY SHARES

Ordinary shareholders are the legal owners of the company. Ordinary shares are permanent source of capital as they do not have maturity date. Ordinary shareholders have a residual ownership claim on the income after paying all the expenses, interest charge, taxes and preference dividend in the form of dividend and retained earnings. They also have the right of control or the legal power to appoint directors on the board, or replace those failing to protect their interests. Besides, they have residual claim on the assets during liquidation after satisfying the claims of debts holders and preference holders. Apart from the pre-emptive right which entitles each shareholder to maintain his proportionate share of ownership in the company, they have limited liability and the right to vote at annual general meeting on important issues such as election of directors.

Ordinary share as a source of long-term fund is used

1. When the leverage is too high or the cost of financing is high.
2. When the inflation is low.
3. Income and profits are unstable and
4. Control is not important (Osaze and Anao, 1999).

Equity capital is the most important long-term source of financing because of the following benefits.

1. Ordinary share are irredeemable
2. There is no liability of cashflow associated with its redemption.
3. It increases the companies' financial base and its borrowing limits.
4. By issuing ordinary shares, the company increases its financing capacity to acquire or borrow additional funds. A company can raise ordinary share capital by going public.

Osaze (2001) lists the benefits of going public to include:

1. The opportunity for the companies to use the proceeds of a security issue for their expansion and modernization;
2. Opportunity to share investment risks of shareholders while still retaining their voting right ;
3. Creation of public confidence in company from investors and financial institutions;
4. Guarantees investor's confidence in the stock and enhances a company's access to lines of credits; and
5. It enhances growth process through corporate acquisitions, prestige and obtaining of additional capital.

However, the use of ordinary shares is limited in that ordinary shares have a higher cost because its dividends are not tax deductible and it has a higher floatation cost than debt. It is also riskier to the investors because of the uncertainty regarding dividend and capital gain. Indiscriminate issues of ordinary shares can dilute earnings per shares if profits increase is stagnant, thereby affecting ownership and control of the existing shareholders.

2. PREFERENCE SHARES.

Preference share is a hybrid security because it has features of ordinary shares and debenture. As ordinary shares, its dividends are not tax deductible. Irredeemable preference shares have no maturity dates and the delay or the non-payment of preference dividend does not force the company to insolvency or liquidation. Preference share is a debenture because its dividend rate is fixed. Preference shareholders do not have voting rights nor claim in the residual earnings. They usually have claims on income and assets in the events of liquidation prior to ordinary shareholders.

Preference share is called fixed income security because it provides a constant income (owing to the fixed percentage dividend rate) to investors. It may be convertible or non-convertible. A convertible preference share allows preference shareholders to convert their preference share, fully or partly into ordinary shares at specified price during a given period of time. Preference shares could also have participation, call, redemption and cumulative dividend features. Section 158 (2) of CAMA (1990) states that the redeemable preference shares shall not be redeemed unless they are fully paid and redemption shall be made only out of (a) profit of the company which would otherwise be available for dividend or (b) the proceeds of a fresh issues of shares for the purpose of the redemption.

Preference shares are used for raising long term finance when (1) leverage is required but yet profits are not very high or fluctuating, (2) cost of preference share is low compared to ordinary shares (3) interest rates are low, (4) the use of debts will involve excess risk and (5) control is very important to existing shareholders.

Preference shares provide some financial leverage as well as financial flexibility to the company. The non-payment or postponement of the fixed preference dividend does not force the company into liquidation. However, preference dividend is not tax-deductible and continuous non-payment can adversely affect the image of a company through clientele effect.

3. DEBENTURE

Debentures are long-term promissory notes used by a borrowing company to the lender acknowledging debt on which interest is earned. No specific physical assets are pledged as collateral or security for the debentures. Statement to be included in debentures include: the principal amount borrowed, the rate, date and manner in which interest and principal will be repaid, date and terms of conversion into shares for convertible debenture and date of exercise of rights, charges and maximum discount allowed on issue or re-issue of the debenture.

Debentures are long-term fixed income financial security with known and fixed interest rate. They are maturity date in which the company redeems the par value to the debenture holders either through the use of sinking fund or buy-back (call provision). Debenture holders are creditors of the firm and they have claim on the company's assets during liquidation and income prior

to the shareholders. A company can be forced into liquidation if it fails to pay interest to debenture holders. A debenture trust deed or indenture is a legal agreement between the company issuing the debentures and the debenture trustee who represents the debenture holders. The indenture provides the specific terms of the agreement including a description of debenture rights of the debenture holders, issuing companies and responsibilities of the trustee.

A person is disqualified for appointment as trustee of a debenture if he is:

1. Less than 18 years of age
2. Of unsound mind
3. An officer or employee of the issuing company
4. An undischarged bankrupt
5. A substantial shareholder of the company or disqualified director of a company (CAMA 1990, section 187).

Bond and long-term debts are used when (1) sales and profits are relatively stable and rising (2) profit margins are adequate to make leverages advantageous (3) leverage is low (4) shareholders insist on maintaining existing control (5) increase in inflation would reduce effective cost of bond interest (6) restrictions of bond indenture are not onerous (7) the existing debts ratio is relatively low (8) cashflow requirements under the bond agreement are not burdensome and (9) common stock price earning (P/E) ratios are low in relation to the levels of interest rates.

Bradley, Jarrell and Kim (1984) showed that the characteristics of an industry's optimal asset mix, plus the variability of its operating environment significantly influence the actual capital structure chosen by firm. In developed countries, industries like service firms, mining companies and most rapidly growing or technology- based manufacturing companies employ little or no long-term debt financing, whereas utilities, transportation companies and matured capital intensive manufacturing firms have high debt to equity ratios (Meggison, 1995). Myers (1993) shows that there is an inverse relationship between leverage and profitability. Also, the larger the perceived costs of bankruptcy and financial distress, the less debt will be used. The more concentrated a firm's ownership structure (the higher the pattern of share ownership) ,the more debt it seems to desire and to be able to tolerate. Hence, family controlled firms tend to be more levered than similar publicly-traded firms with more atomized share ownership (Meggison, 1995).

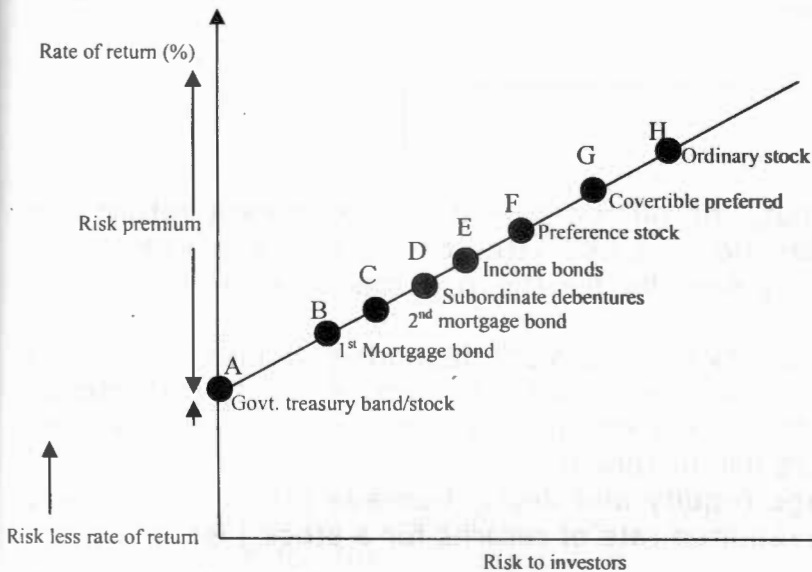
Debenture does not dilute ownership control since it does not carry voting right. It is also less costly than equity financing because interest payments are tax deductible. Its holders do not participate in extra-ordinary earnings of the company. However, debenture indentures contain restrictive covenants which might limit a company's flexible operations and while repayment of debentures on maturity involves large cashflows, non-payment can force the company into liquidation.

Rationale for Different Classes of Securities

Because different investors have different risk-return trade off preference, it is important if the company's securities are to appeal to the broadest possible market, for the company to a wide basket of securities. In fact most investors want a situation where they can choose from a varied range of securities from government stocks and treasury bonds to the ordinary stocks.

When implemented, a policy of selling differentiated securities can lower a firm's overall cost of capital below what it would have been if it used only as one class of debts and ordinary stock. This can be depicted in a diagram below:

Diag. 1: Risk and Expected Returns of Different Securities



Source: (Adapted from Managerial Finance by Weston J.F and Brigham E.F (1981), "On Risk and Expected Returns of Different Securities.

Most investors are concerned with unavoidable risk (systematic risk) that cannot be avoided by diversification of the stocks, bonds and other financial assets they hold. The required rate of return on investment is the return on a risk-free asset plus the market price of risks to the investors due to one or more factors. The greater the systematic or unavoidable risk, the greater the return expected of an investment opportunity. From CAPM, the expected rate of return for stock is:

$$R_j = R_f + (R_m - R_f) B_j$$

Where, R_f = risk free rate, R_m = expected overall return for the market portfolio, B_j = beta coefficient for security j. The greater the beta of a security, the greater the risk and the expected return required and vice versa.

$$B_j = \frac{(r_{jm} \delta_j \delta_m)}{\delta_m^2}$$

Where, $(r_{jm} \delta_j \delta_m)$, is the covariance of return of security j. It embodies r_{jm} (expected correlation between possible returns for security j and the market portfolio, δ_j the standard deviations of the profitability distribution of possible returns for security j, and δ_m , standard deviation of the probability distribution of possible returns for the market portfolio).

$$\text{Therefore, } R_j = \frac{(r_{jm} \delta_j \delta_m)}{\delta_m^2} B_j ((r_{jm} \delta_j \delta_m))$$

Or canceling δ_m

$$\bar{R}_j = R_f + \frac{(\bar{R}_m - R_f)}{\delta_m} B_j (r_{jm} \delta_j)$$

Van Home (2002) argued that "the numbers used for the market return and the risk-free rate should be the best estimates of the future possible". He advocated the use of treasury security for the risk free rate because of its controversiality.

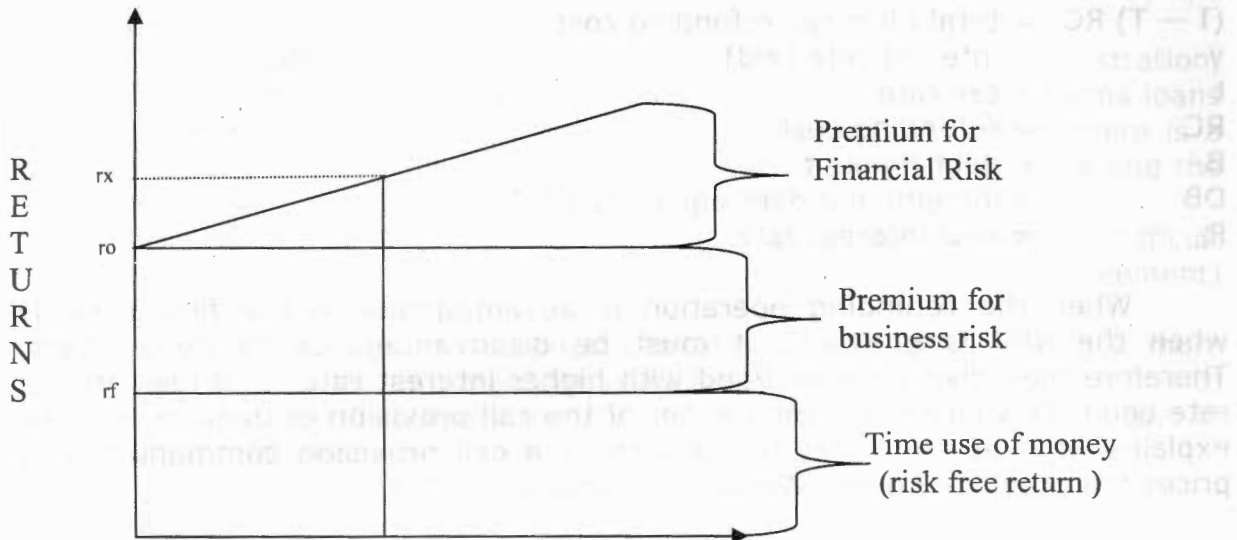
The magnitude of the equity risk premium depends on which maturity is used for the risk free security (whether short, medium or long term) and on risk aversion by investors. The equity risk premium measure used is ex-ante as opposed to ex-post. Others use historical risk premium.

Where there is leverage (equity and debt), Hamada (1969) and others have demonstrated that the required rate of returns for a stock j is:

$$\bar{R}_j = \bar{R}_f + \frac{\bar{R}_m - \bar{R}_f}{\delta_m^2} ((r_{jum} \delta_j \delta_m)) [(1 - D)(1 - T_c)]$$

Where, R_f = risk-free rate, R_m = expected overall return for the market portfolio, δ_m = standard deviation of the probability distribution of possible market returns. r_{jum} = correlation coefficient between returns for security j in the absence of leverage and the market portfolio. δ_{ju} = standard deviations of the probability distribution of possible returns for security j in the absence of leverage.

Diag. 2: Leverage (Equity and Debt)



Source: Hamada, R.S. (1969) "Portfolio Analysis, Market Equilibrium and Corporate Finance" *Journal of Finance*, 24, p.23.

Refunding a Bond or Preferred Stock Issue

If a bond preferred stock issue was sold when interest rates were higher than they are at present, and if the issue is callable, it may be profitable to call the old issue and refund it with a new lower cost issue. This is called refunding operations. The cost of refunding includes (1) the call premium paid for the privileges of calling (2) the flotation costs incurred in selling the new issue.

The Net Present Value (NPV) method is used to analyze the advantages of refunding. This is by discounting the future interest savings back to the present and comparing the discounted value with the cash outlays associated with the refunding. The after-tax cost of the new debt, and not the average cost of capital, is used as discount factor because of the relative certainty and relatively little risk to the savings.

The NPV of refunding can be expressed in two alternatives:

1. $NPV = [\text{present value of interest savings}] - [\text{present value of after tax refunding cost}]$

$$= \sum_{t=1}^N \frac{(1-T)(r-r_1)B}{[1+(1-T)r_1]^t} = (1-T)RC$$
2. $NPV = [\text{PV of interest savings}] - [\text{PV of interest on incremental debt}] - [\text{PV of repayment of incremental debt}] - [\text{Equity financing employed}]$

$$NPV = \sum_{t=1}^N \frac{(1-T)(r-r_1)B}{[1+(1-T)r_1]^t} - \sum_{t=1}^N \frac{(1-T)R_t \Delta B}{[1+(1-T)r_1]^t} - \frac{\Delta B}{[1+(1-T)r_1]^n - [(1-T)RC - \Delta B]}$$

Where,

NPV	= net present value
(I - T) RC	= total after tax refunding cost
v	= interest rate (old)
t	= tax rate
RC	= refunding cost
B	= debt amount
DB	= incremental debt equals (I-t)RC
R _i	= new interest rate.

When the refunding operation is advantageous to the firm (usually when the NPV is positive), it must be disadvantageous to bondholders. Therefore they give up their bond with higher interest rate for a low interest rate bond. This points out the danger of the call provision to bondholders and explains why, at any time, bonds without a call provision command higher prices than callable bonds (Weston and Brigham, 1981).

4. TERM LOANS AND DIRECT FINANCING

These are long sources of long-term debts and are obtained directly from the banks or financial institutions. Generally, they are obtained for financing large expansion, modernization or diversification projects. The purpose of term loan is mostly to finance the company's capital expenditures. They are usually loans with more than one year maturity. In India, these loans are obtained by private placement rather than public subscription as is the case with most debenture issues. According to Weston and Brigham (1981):

"Term loans are direct business loans having a maturity of more than one year but less than fifteen years and with provisions for systematic repayment (amortization during the life of the loan)".

Private placements are direct business loans with a maturity of more than fifteen years (Cohan, 1961). Corey (1961) remarked that half of such placements have been in the form of long-term promissory notes "The distinction between terms loans and private placement is arbitrary. In fact private placement differs from the term loans only in its arbitrary maturity length. The distinction becomes insignificant when talking about loan repayment, which represent the same kind of financing arrangement (Weston and Brigham, 1981).

Shapiro and Wolf (1972) said that "the most important characteristics of private placement market is that it serves as the major source of long term debt financing for smaller and less financially secure companies".

Considerations that make Direct Financing of interest to borrowers.

1. Terms loans and private placements represent in part a shift by business firms from dependence on short-term bank borrowing to a

greater utilization of longer term financing. This shift helps businesses avoid the problem of unavailability of short term loans during tight money periods.

2. Term loans and private placements were stimulated after 1934 by the increased cost and time involved in public offerings.
3. A public offering takes time to prepare in terms of registration, underwriting and offering. Whereas a private placement or terms loans can be taken care of in a matter of hours especially where there is a continuity relationship between the insurance company or bank and the borrower.
4. If the securities of a public offering are widely held, it is more difficult to negotiate a modification in the indenture (loan agreement) provisions than a term loan.
5. The increased rates of corporate taxation in the 1930s made it more difficult for small and medium sized firms to finance their growth with internal funds. The firms resorted to external sources of funds and in fact, direct longer-term fund.

FEATURES OF TERM LOANS

1. **Maturity:** Normally, term loans have a maturity of over one year. Banks and financial institutions are the main sources of these loans and they could have up to 6 to 10 years for repayment. Similarly, a moratorium of 1 to 2 years could also be given to a company that is not able to pay back the loans.
2. **Security:** Terms are specifically secured by the assets acquired using the term loans fund. A lender can take a fixed or floating charge against the company's asset. While fixed charge means a legal mortgage of specific assets, floating charge is a general mortgage (equitable mortgage) covering all assets. This provides the company with relative flexibility as it can deal with its assets in the normal course of business without obtaining lenders' approval.
3. **Direct negotiations:** Here, a firm negotiates term loans financing directly with the bank or financial institutions. Hence, it is a private placement and there is therefore the ease of negotiation and low cost of raising loan. Firm also avoids underwriting commission and other floatation costs since it does not underwrite term loans.
4. **Repayment schedule:** Or loan amortization states the time schedule for paying the principal and interest. The principal is repaid in equal installment and interest paid on the unpaid (outstanding) loan. Hence, interest payment declines over the years. Subsequently, the total loan payment decreases over time too. These payments are called *Balloon payments*. It saves the company of repaying huge amount at the end of the loan maturity. (Van Home, 2002).
5. **Convertibility:** This is the opportunity to convert a part or all of the term loans into equity because of the large amount or financial stake of

these banks and financial institutions. The terms and conditions of conversion are generally spelt out to facilitate such process.

6. **Restrictive covenant:** Besides the primary and secondary security, the lender wants further protection of his money. It may specify stringent conditions to be complied with by the firm. For instance, that the firm keeps the lender informed of its financial statement and all necessary information such as:
 - i. Maintaining of a minimum asset base, i.e. a minimum working capital in terms of a minimum current ratio and not to dispose any of the fixed assets without the lender's approval.
 - ii. Putting restriction on incurring further debts or repayment of existing loans, or the firm made to reduce its debts equity ratio by issuing additional equity and preference capital.
 - iii. It may also restrain the firm cash outflow by restricting cash dividends, capital expenditures, salaries and perks of managerial staff.
 - iv. The lender may interfere with the firm's management by ensuring that competent and skilled personnel manage its operations. It can therefore provide for the opportunity of suitable staff and shake up of the boards of directors. This could be achieved by the appointment of nominee directors whose role is to safeguard the interest of the financial institutions.

In Nigeria, the concept of term loan is not yet visibly practised. Something near, project financing which is gradually being embraced by private and public institutions.

Terms loans have the advantage of no underwriting or floatation cost since they are done through private placements and negotiations with the interests paid following a reducing balance. Also interest is tax deductible in the hands of the borrowing firms. With favourable terms and conditions, the terms loans can be converted to equity thereby reducing or eliminating the loan payment. The firm could also have a grace period to enable it repay the loan instead of forced liquidation of its assets.

The interest rate on a term loan may be a fixed rate over the life of the loan or a floating rate, to be adjusted in keeping with changes with the prime rate, or in some cost of funds index.

In 1972, Hay, Joelink and Melicher conducted a study to analyze risk premiums when corporate debt was issued in public offering versus private placements during the period 1970-1975 period. Among others they found that on private placements, the interest rate generally ran from about ten to fifty basis points higher than that on comparable public issues. The yield to maturity on the private placements was forty-six basis points higher than on the public offerings. According to them, the economies of using private placements were offset by their somewhat higher interest rates.

However, the terms and conditions (restrictive covenants) may be too stringent that these could displace ownership and control of the firm and

cause delay in negotiation for term loans with the banks or financial institutions. Also there is a higher interest cost than could be obtained with a public issue.

The advantage of a term loan is flexibility. The borrower deals directly with the bank or insurance company and the loan can be tailored to the borrowers' needs through direct negotiation. Should the firm's requirement change, the terms and conditions of the loans may be renegotiated. (Van Home, 2002). Another advantage of a term loan is that it assures the borrowers of the use of the funds for an extended period. The bank or financial institution commits itself for a period of years because of the long term commitment. Restrictive provisions are incorporated into the loan agreement to protect the lender for the duration of the loan.

ADVANTAGES OF DIRECT FINANCING

1. Much seasonal short- term borrowing can be dispensed with, thereby reducing the danger of non-renewal of loans.
2. The borrower avoids the expenses of registration and investment banker's distribution.
3. Less time is required to complete arrangement for obtaining a loan than is involved in a bond issue.
4. Since only one lender is involved rather than many bond holders it is possible to modify the loan indenture.

DISADVANTAGES OF DIRECT FINANCING

1. The interest may be higher on a term loan than on a short-term loan because the lender is tying up money for a longer period and therefore does not have the opportunity to review the borrower's status periodically (as with short term loans).
2. The cash drain is large. Since the loans provide for regular amortization or sinking fund payments, the company experiences a continuous cash drain. From this standpoint, direct loans are less advantageous than equity money (which never has to be repaid), a preferred stock without maturity, or even a bond issue without a sinking fund requirements.
3. Since the loan is a long-term commitment, the lender employs high cost credit standards, insisting that borrowers be in a strong financial position and have a good current ratio and profitability ratio.
4. The loan agreement has restrictions that are not found in a ninety-day note.
5. Investigation cost may be high. The lender stays with the company for a long period.

ASSETS BASED FINANCING

Firms have always embarked on traditional financing, that is, issues of debt or equity to expand its capitalization. However, equity becomes expensive as source of financing when company's earnings decline or there is low price-earning (PIE) ratio. Similarly, long-term debts become very

expensive during inflation because interest rate also rises. Therefore, corporate finance managers develop asset-based financing to lower the cost and redistribute the risk and also use such assets as direct security. These asset-based financing include: (1) Lease financing, (2) Hire purchase (3) Project financing.

We shall dwell on only project financing because of its evolving and relatives importance to the Nigerian economic growth and development.

PROJECT FINANCING

According to Nevitt (1983), Project Financing may be defined as that scheme of "financing of a particular economic unit in which a lender is satisfied in looking at the cash flows and the earnings of that economic unit as a collateral for the loan". This method of financing has been embraced by government in developing countries and companies in the private and public sectors, in oil, gas, coal exploration and mineral extractions, port construction, infrastructure projects, refineries, telecommunications, pipelines (Van Horne, 2002).

In Nigeria, some banks are presently involved in project financing by helping to finance students' hostels in higher institutions and other developmental projects. Project financing is made possible by combining undertakings and various kinds of guarantees by parties who are interested in a project. No one party bears the full responsibility of the party project. When all the undertakings are combined and reviewed together, it results in an equivalent of the satisfactory credit risk for the lender. The parent company is affected by the actual plight of the project and the interest on the project loan depends on the parent's stake in the project (Pandey, 1999; Brealey and Myers, 1991).

CHARACTERISTICS OF PROJECT FINANCING

According to Pandey (1999), the characteristics include:

1. A separate project entity is created that receives loans from lenders and equity from sponsors.
2. The component of debt is very high in project financing. Thus, project financing is a highly leveraged financing.
3. The project funding and all its other cash flows are separated from the parent's company's balance sheet.
4. Debt services and repayments entirely depend on the project's cash flows. Project assets are used as collateral for loan repayments.
5. Project financiers' risks are not entirely covered by the sponsor's guarantees.
6. Third parties like suppliers, customers, government and sponsors commit to share the risk of the project.

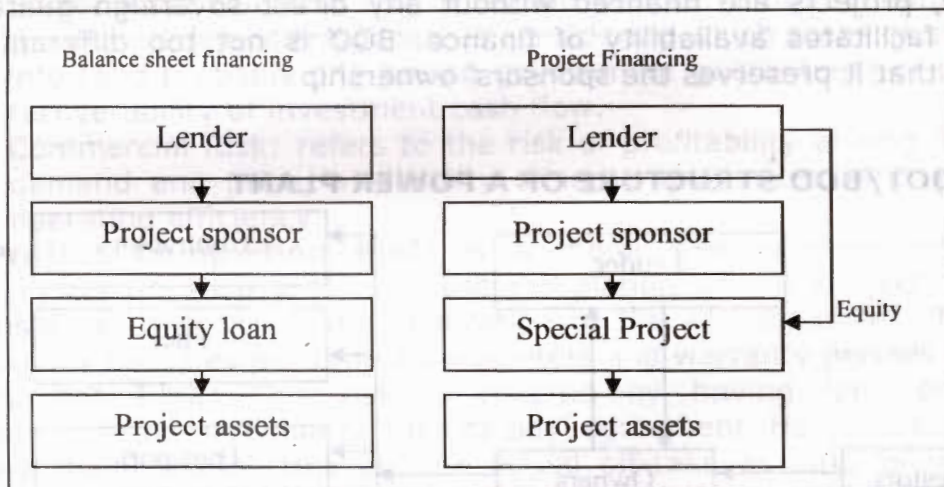
Project financing is most appropriate for those projects which require large amount of capital expenditure and involve high risk. It is used by companies

to reduce their own risk by allocating the risk to a number of parties. It allows sponsors to:

1. Finance large projects than the company's credit and financial capability would permit,
2. Insulate the company's balance sheet from the impact of the project;
3. Use high degree of leverage to benefit the equity owners.

A distinction between corporate, traditional financing or the balance sheet financing and the project financing can be illustrated in the following diagram below:

Diag 3. Distinction between Balance Sheet financing and project financing



Source: Adapted Pandey, M.I. *Financial Management*, New Delhi, Vikas Publishing House, PVT Limited, pp. 997-1072.

Unlike the traditional financing where the lender advances loan to the project sponsor and in which he also expects repayment at the maturity of the loan, the lender in project financing looks at the cash flows and assets of the whole company in order to service the debt and provide securities. Project financing is the most common method of financing large infrastructured projects by governments and the private sector.

PROJECT FINANCING ARRANGEMENTS

Project financing arrangement could take the following forms:

1. The build-own-operate-transfer (BOOT) structure.
2. The build-own-operate (BOD) structure
3. The build-lease transfer (BLT) structure.

1. The Build-Own-Operate-Transfer (BOOT) Structure.

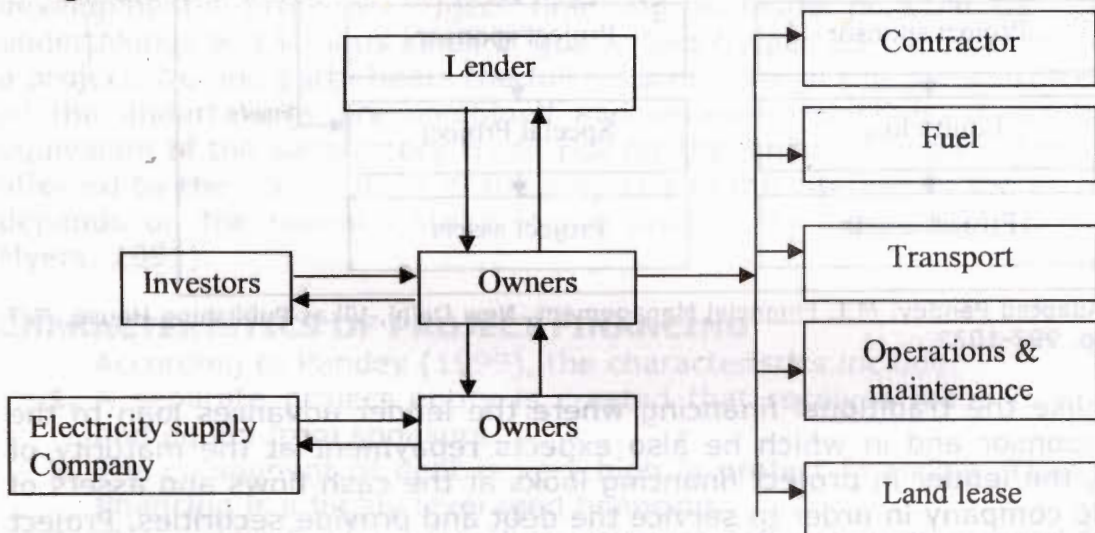
In a **BOOT** arrangement, the project sponsor builds a project, operates it for a long period of time to earn a reasonable return, and then transfer it to the host government or its agency. It is a scheme that is meant to draw private participations in financing, constructing and operating infrastructure

projects. The value of efficiency gain from their involvement far outweighs the cost of borrowing through BOOT project, relative to government borrowing (World Bank, 1994). Power, roads, student's hostels and other projects like ports, mass transits, rail etc have been implemented using the BOOT structure. These projects are either solicited or unsolicited.

2. The Build-Own-Operate (BOO) Structure

In the BOO arrangement, the project is not transferred to the host government or agency, rather the owner divest its stake in the capital markets. This arrangement is arrived at as a result of the problem with the transfer provisions in BOOT and thereby gives the opportunity for divestiture of entire equity or due to some negotiated percentage at the end of the stipulated time period. Under BOO, projects are financed without any direct sovereign guarantee. Divestiture facilitates availability of finance. BOO is not too different from BOOT, only that it preserves the sponsors' ownership

Diag. 4: BOOT/BOO STRUCTURE OF A POWER PLANT



Source: Adapted from the World Bank, Industry and Energy Department Occasional Paper, 1994.

3. The Build-Lease Transfer (BLT) structure.

In a build, lease and transfer arrangement, the owners transfer the project to a lease for operational purpose but still keeps the ownership intact. The owner (lessor) receives a lease rental from the leasee.

SOME RISKS IN PROJECT FINANCING

- 1. Foreign Exchange Risk:** This risk entails whether the project will have access to foreign exchange to cover debt services and equity payment (macro-economic convertibility) and whether the foreign exchange

equivalent of the project's local revenues will be adequate to service foreign debts and equity.

Government guarantee is required most times because of risks which relates to

- (a) Country risk
- (b) Sector risk
- (c) Commercial risk

- i. **Country Risk:** Includes the risks of currency transfer, expropriation, war, civil disturbances and breach of contract by the host government. For instance, a project financing which is being implemented in a country like Iraq following US Army invasion or in Indonesia due to the tsunamis will be greatly exposed to country risk.
- ii. **Sector Risk:** refers to risk in certain sectors of the economy such that the project financier/sponsor is considering which areas or sectors to go into (and probably one having government guarantees) or prospects of recoverability of investment cash flow.
- iii. **Commercial Risk:** refers to the risk of profitability arising from market demand and price, availability of input and prices, and variations in operating efficiency.
2. **Project Completion Risk:** is a major risk in most infrastructural projects because it is only the completion of the project, in the first instance, that will foster realization of the set objectives. The contract usually specifies performed parameters and warranty periods for defects.
3. **Market Risk:** This risk is covered by having long-term quantity agreements, particularly 'take or pay' agreement. Here, certain payments are made irrespective of the actual off-take as long as the company makes available the necessary capacity. This facility helps in the recovery of the fixed costs and the variable costs associated with the projects and effectively transfer the market risk to the purchaser.
4. **Supply of Input Risk:** is evident where a project requires a reliable supply of inputs. An arrangement is put in place to transfer increase in prices from the project to the purchasers. This may have an adverse impact on the incentives of the project sponsor to control price increases. This scheme increases the purchaser's power and responsibility to monitor increase in input prices.

CONCLUSION

In this paper the major sources of long term funds have been considered in terms of their features, when to use them and the benefits and limitations when used by the finance manager. We also found that because of the different risk-return trade off preference of investors, the company offers a wide range of securities to appeal to them and that the required (expected) rate of return is the return on risk-free asset plus the market (risk) premium. This increases with increase in the systematic or unavoidable risk. A bond or preferred stock can be refunded if there is a callable provision, where the

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