**Chapter Seven- Sources of project financing**

**INTRODUCTION**

It is rightly said that finance is the life-blood of business. No Business can be carried on without source of finance . The financial manager is mainly responsible for raising the required finance for the business.

Firm need fund mainly for two purposes

1.To fund long term decisions(including expansion, diversification, modernization and other similar capital expenditures)‏

2. To meet working capital requirements.(day to day operations)‏

There are several sources of Finance and as such the finance has to be raised from the right kind of source.

Project Financing

Project financing is an innovative and timely financing technique that has been used on many high profile corporate projects. Project Financing discipline includes understanding the rationale for project financing, how to prepare the financial plan, assess the risks, design the financing mix, and raise the funds . Project finance is finance for a particular project, such as a mine, railway, pipeline, power station, ship, hospital etc.

Sources of project financing are :

**A. External:** External sources are those funding that do not originate from the organisation that owns the project. Examples of such include funding from banks, and international agencies. Local or Foreign.

**B. Internal** **:** Those that are generated from within the organisation.

Examples are: retained earnings, and rights issue from shareholders.

### 1. Equity/ownership financing:

Equity financing does not require collateral and offers the investor some form of ownership position in the venture. The investor shares in the profits of the venture, as well as any disposition of assets.

The acquisition of funds by issuing shares of common or preferred stock. Firms usually use equity financing when they are unable to raise sufficient funds through retained earnings or when they have to raise additional equity capital to offset debt.

**Sources of equity financing**

**Advantages ;**

* Does not cause economic burden to the company
* Permanent source of capital
* No charge on assets
* Equity shareholders get voting rights
* It enhances credit worthiness of the company.
* Sources of long-term finance

**Disadvantages**

* Highly expensive
* Shareholders have residual claim on earnings and assets.
* Volatile return
* Trading on equity not possible
* Higher dividend on equity leads to speculation

**2.Multilateral and Bilateral Lending Institutions**

The well known of these are the World Bank Group, International Monetary Fund (IMF) and African Development Bank.

Multilateral/Bilateral Agency Credit Facility

Loan, guarantee, or insurance (political or commercial) facility provided through a multilateral development bank (MDB) or bilateral agency. The tenure of this facility is usually long term. Loans may include a syndicated loan facility from other institutions, paralleling the MDB's own direct lending.

Spontaneous finance: Finance which naturally arises in the course of business is called as “spontaneous financing.” Trade creditors, credit from employees, credit from suppliers of services etc are the examples of spontaneous financing.

Negotiated financing: Financing which has to be negotiated with lenders, say commercial banks, financial institutions, general public are called as “negotiated financing.” A Business enterprise requires short-term and long-term finance.

It may raise financial resources by raising short-term loans and long-term loans.

**1. Short-term external sources**

Short term financing is essential to provide capital deficit businesses funds for short term period of a year or less. These funds are usually for businesses to run their day-to –day operations including payment of wages to employees, inventory ordering and supplies .

* Bank over-draft: If the borrower requires temporary finance , the banker may allow him to overdraw on his account with or without security
* Cash credit: Cash credit is a financial arrangement through which the commercial banks allow the borrower to the borrow money up to a certain limit.
* Public deposit: Business firm are raising short-term finance from their member , directors and the general public.
* Bills discounting: The commercial banks advance to the borrower by discounting his bill.
* Short-term loans: The bankers makes a lump-sum payment to the borrower or credit his deposit account with the money advanced.

**2.Long-Term internal Sources**

The internal accruals of a firm consist of depreciation charges and retained earnings.

**Retained Earnings :** Retained earnings is refers to accumulation of profits by a company to finance its developmental activities or repay loans.

**Depreciation fund :** Depreciation means decrease in value of asset.

It results into reduction of taxable income and hence income tax liability for the period is reduced.

**venture capital**

Venture capitalists are groups of (generally very wealthy) individuals or companies specifically set up to invest in developing companies. Venture capitalists are on the look out for companies with potential. They are prepared to offer capital (money) to help the business grow. In return the venture capitalist gets some stakes in the running of the company as well as a share in the profits made.

**Government grant**

These grants are often linked to incentives to firms to set up in areas that are in need of economic development. One of the disadvantages of this type of funding is that it involves large amounts of paperwork and administration. This can add to costs and in some cases might not make the project worthwhile.

**Mortgage**

A mortgage is a loan specially for the purchase of property. Mortgages are used as a security for a loan . It is often called taking out a second mortgage.

* If the business does not work out and the borrower could not pay the bank loan then the bank has the right to take the home of the borrower and sell it to recover their money.

**OWNER'S CAPITAL**

Some people are in a fortunate position of having some money which they can use to help set up their business. The money may be the result of savings, money left to them by a relative in a will or money received as the result of a redundancy payment.This has the advantage that it does not carry with it any interest. It might not, however, be a large enough sum to finance the business need but will be one of the contributions to the overall finance of the business.

**Internal accruals :** This is a source of finance that would only be available to a business that was already in existence. Profits from a business can be used by the owners for their own personal use or can be used to put back into the business. This is often called laughing back the profits'. This finance can be used to buy new equipment and machinery as well as more stock or raw materials and hopefully make the business more efficient and profitable in the future.

**ADVANTAGES :-**

* 1. They are readily available. Management does not have to talk outsiders.
  2. Use of Internal Accruals eliminates issue cost and losses on account of under pricing.
  3. There is no dilution of control when firm relies on these sources.

**DISADVANTGES :-**

* 1. The amount through this source is limited
  2. Higher the Retain earning lead to higher dissatisfaction among the shareholders because it is the cost forgone by the shareholders.

1. **LEASE FINANCING**

**What is LEASE?**

A lease is a contract whereby the owner of an asset grant to another party the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.” A lease is an agreement allowing one party to use another’s property, plant, or equipment for a stated period of time in exchange for consideration.

A lease agreement involves at least two parties ) a lesser (such as a bank), who owns the property, and a lessee, who uses the property. The lesser, essentially a creditor in the transaction, is repaid from a combination of lease or rental payments, tax benefits, and proceeds from the sale or re-lease of the property at the end of the lease term.

**Advantage**

**Provides full finance :** provision of 100% finance is main benefit of leasing . If the lessee borrows money from banks to purchase the asset he gets 70 to 80% finance only. While in case of lease he does not have to make any provision for finance. He gets 100% finance. He will be required to pay rent only.

**Flexible :** it is flexible in the sense that risk of obsolescence can be avoided, because he can return the asset to the lesser if the asset become obsolete.

**Save from recurring cost of finance :** In case asset are taken on lease, the firm will not have to incur the cost of raising finance frequently whenever it wants to purchase any asset.

**Tax benefit : -** both the parties get certain deduction. The lessee gets full rent as deduction.

**Absence of restriction : -** it is main advantage of leasing. If money is borrowed from banks or other financial institution , they would put restriction on borrower as regard further amt. to be borrowed dividend etc.. but in case of lease it is absolutely free from all such restriction.

**Increase the capacity to borrows : -** the lesser does not show the asset in his balance sheet nor the future liability for payment of rentals. Hence less debts equity ratio remains law and he will be able to borrow more funds in future.

**Useful in case if fast changing technology : -** it is particularly useful to the lessee in case were fast technology change are taking i.e reason why more and more business resort to leasing in case of very costly and expensive machines.

**Faster and cheaper credit : -** its is faster than if money is to be borrowed from banks or other financial institution. Leasing company promptly sanction the request and it is more accommodative in respect of terms of financing.

**Disadvantages**

**No benefit of residential value :-** whena firm purchase an asset, it is has full right to value of asset at the end of its useful life.

**No benefit of ownership : -** the lessee does not get any benefit, which would be available if he were the owner of asset e.g price of an asset has increased considerably, the lessee can’t sell it.

**High cost of leasing : -** It is experienced that leasing is more costly than borrowing. The rate of interest charged very much higher than that on borrowing. if the lesser is making purchase of asset in large scale he gets the benefit of the lower cost and this can be form of lower rent.

* **Not flexible : -** In case the lessee is not able to arrange for finance for buying an asset he will have to lease the asset. In that case, the amount of lease rent is fixed in advance for the whole period. If the rate of interest declines in market the borrowing can be returned and interest can be saving. But that is not possible in a change, because rent amount is not changed.

## 7.2. Cost of Capital

The cost of capital is the rate of return that could be earned on an investment with similar risk. It can be defined from two points of view, that of a company and that of an [investor](https://www.boundless.com/finance/definition/investor/). From an investor's point of view, the cost of capital is the [required return](https://www.boundless.com/finance/definition/required-return/) an investment must provide in order to be worth undertaking. From a company's point of view, the cost of capital refers to the cost of obtaining funds debt or equity to [finance](https://www.boundless.com/finance/definition/finance/) an investment. The cost of capital is used to evaluate new projects of a company, as it is the minimum return that investors expect for providing capital to the company. Thus, the cost of capital is a [benchmark](https://www.boundless.com/finance/definition/benchmark/) that a new project has to meet.

The [cost of funds](http://www.investopedia.com/terms/c/costoffunds.asp) used for [financing](http://www.investopedia.com/terms/f/financing.asp) a business. Cost of capital depends on the mode of financing used – it refers to the [cost of equity](http://www.investopedia.com/terms/c/costofequity.asp) if the business is financed solely through equity, or to the [cost of debt](http://www.investopedia.com/terms/c/costofdebt.asp) if it is financed solely through debt. Many companies use a combination of debt and equity to finance their businesses, and for such companies, their overall cost of capital is derived from a [weighted average](http://www.investopedia.com/terms/w/weightedaverage.asp) of all capital sources, widely known as the [weighted average cost of capital (WACC).](http://www.investopedia.com/terms/w/wacc.asp) Since the cost of capital represents a [hurdle rate](http://www.investopedia.com/terms/h/hurdlerate.asp) that a company must overcome before it can generate value, it is extensively used in the [capital budgeting](http://www.investopedia.com/terms/c/capitalbudgeting.asp) process to determine whether the company should proceed with a project.

If a project is of similar risk to a company's average business activities, it is reasonable to use the company's average cost of capital as a basis for project evaluation. For an investment to be worthwhile, the [expected return](https://www.boundless.com/finance/definition/expected-return/) on capital must be greater than the cost of capital. A company's securities typically include both debt and equity; therefore, one must calculate both the cost of debt and the cost of equity to determine a company's cost of capital. A more specific calculation of cost of capital is the weighted average cost of capital. This [metric](https://www.boundless.com/finance/definition/metric/) takes into account the amount of financing that comes through the use of debt and the use of equity. Thus, the costs of debt and equity are weighted to reflect the extent of their use.

**7.3. 'Financial Institution - FI'**

A financial institution (FI) is an establishment that focuses on dealing with financial transactions, such as investments, loans and [deposits](http://www.investopedia.com/terms/d/deposit.asp). Conventionally, financial institutions are composed of organizations such as banks, [trust companies](http://www.investopedia.com/terms/t/trustcompany.asp), [insurance companies](http://www.investopedia.com/video/play/life-insurance/) and investment [dealers](http://www.investopedia.com/terms/d/dealer.asp). Everything from depositing money to taking out loans and exchange currencies must be done through financial institutions.

A financial institution is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions. Here is an overview of some of the major categories of financial institutions and their roles in the financial system.

**Commercial Banks**

Commercial banks accept deposits and provide security and convenience to their customers. Part of the original purpose of banks was to offer customers safe keeping for their money. By keeping physical cash at home or in a wallet, there are risks of loss due to theft and accidents, not to mention the loss of possible income from interest. With banks, consumers no longer need to keep large amounts of currency on hand; transactions can be handled with checks, debit cards or credit cards, instead.

Commercial banks also make loans that individuals and businesses use to buy goods or expand business operations, which in turn leads to more deposited funds that make their way to banks. If banks can lend money at a higher interest rate than they have to pay for funds and operating costs, they make money.

**Investment Banks**

An investment bank is a financial intermediary that performs a variety of services for businesses and some governments. These services include [underwriting](http://www.investopedia.com/terms/u/underwriting.asp) debt and equity offerings, acting as an intermediary between an issuer of securities and the investing public, making markets, facilitating mergers and other corporate reorganizations, and acting as a broker for institutional clients. They may also provide research and financial advisory services to companies. As a general rule, investment banks focus on [initial public offerings](http://www.investopedia.com/terms/i/ipo.asp) (IPOs) and large public and [private share offerings](http://www.investopedia.com/terms/p/privateplacement.asp).

**Insurance Companies**

Insurance companies pool risk by collecting premiums from a large group of people who want to protect themselves and/or their loved ones against a particular loss, such as a fire, car accident, illness, lawsuit, disability or death. Insurance helps individuals and companies manage risk and preserve wealth. By insuring a large number of people, insurance companies can operate profitably and at the same time pay for claims that may arise. Insurance companies use statistical analysis to project what their actual losses will be within a given class. They know that not all insured individuals will suffer losses at the same time or at all.

**Brokerages**A brokerage acts as an intermediary between buyers and sellers to facilitate securities transactions. Brokerage companies are compensated via [commission](http://www.investopedia.com/terms/c/commission.asp) after the transaction has been successfully completed. For example, when a trade order for a stock is carried out, an individual often pays a transaction fee for the brokerage company's efforts to execute the trade.  
  
A brokerage can be either full service or discount. A full service brokerage provides investment advice, portfolio management and trade execution. In exchange for this high level of service, customers pay significant commissions on each trade. Discount brokers allow investors to perform their own investment research and make their own decisions. The brokerage still executes the investor's trades, but since it doesn't provide the other services of a full-service brokerage, its trade commissions are much smaller.

**Investment Companies**

An investment company is a corporation or a trust through which individuals invest in diversified, professionally managed portfolios of securities by pooling their funds with those of other investors. Rather than purchasing combinations of individual stocks and bonds for a portfolio, an investor can purchase securities indirectly through a package product like a mutual fund.