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SOME ASPECTS OF UNITED KINGDOM EXPERIENCE IN ARRANGING THE FINANCING OF INDUSTRIAL PROJECTS IN DEVELOPING COUNTRIES

Submitted by the Government of the United Kingdom 1/

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* A summary of this document appears in document ID/CONF.1/G.43 SUMMARY which has been distributed in English, French, Spanish and Russian.

1/ This paper has been prepared, at the request of the Government of the United Kingdom, by institutions having an extensive experience of the financing of industrial projects in developing countries.

United Nations Industrial Development Organization

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SUMMARY

Submitted by the Government of the United Kingdom

* This paper is a summary of the document issued under the same title as ID/CONF.1/G.43

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GENERAL

1. Finance for an industrial project usually takes the form of a combination of share and loan capital, the loan capital generally including long-term loans, short-term finance (mainly advances from local banks for working capital purposes) and perhaps some medium-term loans. The principal sources from which long-term loan finance is derived are the sponsors, the sources mentioned in paragraphs 4 and 5 below and retained profits of the enterprise. Medium-term loan finance usually consists of suppliers' credits or credits from suppliers' bankers.

2. The gearing of the finance calls for careful consideration. Sponsors often hope to minimise their own contribution and to finance the project mainly with loan capital, but this is generally not acceptable to lenders. The stability of the project and the security afforded to the lenders depend upon a sound relationship between the company's share capital and its loan and other fixed interest capital. Where the project is specially sound and stable, development finance institutions may agree to the total loans being equal to the share capital, but in many cases they will insist on a lower proportion of loan finance. The repayment terms of the loan capital need to be carefully co-ordinated in relation to the expected flow of cash from the project so as to avoid over-burdening the project. This danger is particularly applicable to suppliers' credits.

3. If the country has balance of payments problems, finance for imported machinery may have to be raised in the form of foreign currency loans; this may necessitate deferment of the financing plan until the sources of the machinery have been ascertained. Conversely, if only certain currencies can be secured, the countries from which the plant can be bought will be correspondingly limited.

4. Finance raised from local sources will usually come from local development institutions, banks, insurance companies, etc. In addition, local companies which are to be involved in the management or in the distribution of the product may also participate.

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Generally, the public is unlikely to subscribe finance for a development project unless the sponsors are well known for their business success; if capital is offered to the public, underwriting of the offer will usually be advisable.

5. External finance (generally in foreign currencies) is normally raised from international or national bodies specializing in development finance; from banking and similar organizations in developed countries - probably confined to those countries whose exports are being purchased for the project; and the institutions established in some developed countries to assist development in which a citizen of the same country has a trading interest. The number of private institutions specializing in helping development has shown some (slow) growth in recent years.

6. Raising finance is an operation of some complexity, particularly if several financiers are involved; and its successful negotiation requires skill, diplomacy, foresight and good organization. It is desirable to establish early contact with the potential sources of finance so as to ascertain which of them are most likely to agree to provide the finance on acceptable terms, and to associate them with the planning of the project from an early stage. In this context, it should be noted that development finance institutions are different to ordinary investors. They do not insist on the same degree of security as ordinary investors, because in furtherance of their objective of fostering good development they make an exceptionally thorough study of the project and may propose a number of improvements in it. However, they do stipulate for a certain degree of security and require to approve the terms granted to other lenders. While a great deal of the negotiation may be carried out by correspondence, some personal contact is desirable in order to reduce the danger of misunderstandings.

7. All institutional sources of finance will make a thorough appraisal of the soundness of all aspects of the project - the market, the marketing arrangements, the selected technology, the arrangements for management, the profitability forecasts, the financial structure and the cash availabilities. These independent

examinations are valuable, but may be time-consuming unless the sponsors have made a thorough, workmanlike job of preparing the project in the first place. Good statistical data is an important element and Governments would render a considerable help to development if they were to assemble reliable basic data under one roof.

SOME SUBJECTS OF SPECIAL CONCERN TO FINANCIAL SOURCES

8. The paper discusses in some detail some subjects which experience shows to be of importance:

The importance of competent management

9. Management is the key to success in any industrial enterprise and the lender of money to a project will usually attach more importance to management than to the security or any other aspect of the project. There are a number of ways of obtaining good management, but UK experience indicates that the most successful, and in the long run generally the cheapest, form of management is obtained by the involvement of an experienced organization from overseas, frequently in combination with a local concern with good knowledge of the country and its people. If such organizations can co-operate and commit both men and money (see paragraph 12 below) to the project, they have every incentive to secure first-class men to it and ensure that it is successful.

10. Management consists of the Board of Directors, the General Manager and the subordinate staff. The Board's fundamental task is to select the best management, ensure that it retains its efficiency at all times, lay down basic objectives and policies and leave the Manager to manage the project on that basis without interference. The General Manager should have a proven record of management experience, characteristics of leadership, broad technical experience and financial acumen and the personal qualities of tact and patience required for successful working in a country where conditions may be difficult and unfamiliar. The subordinate staff should be chosen for their technical capacity and ability to accommodate themselves to the traditions and way of life of the people amongst whom they will have to work.

Any expatriate staff employed will be expensive and difficult to recruit and retain, so that an efficient Board will always do all it can, by training schemes, etc., to reduce and eventually eliminate the expatriates from the enterprise as quickly as possible.

The importance of a financial contribution from the sponsors and those responsible for management

11. Sponsors wishing to sell machinery or know-how to a developing country without investing any significant sum of money themselves are unlikely to obtain financial support from experienced financing institutions. The latter will normally require the sponsors to invest a sufficient sum of money in the project to ensure their full involvement in its success. Such an investment will be viewed against the background of the relationship between the sponsor and the project to ensure that this involvement is real.

12. As regards management, while there have been a considerable number of examples of managing agents with no stake in the project proving effective and reliable, this has not always been the case. There is a greater guarantee of a first-class standard of service if the concern or concerns responsible for management themselves have made a significant investment in the project, and financing institutions will usually expect this.

13. One consequence of this is that Governments need to investigate the intentions and financial resources of companies to whom they grant industrial licences, pioneer certificates or other privileges which may give them a virtual monopoly over some aspect of development. If they themselves will not make an appreciable investment in the proposed development, they will probably be unable to raise capital from the normal sources of development finance. Thus, the project may never take place, and the only consequence of the Government granting the concession will be the loss of time in getting the development started.

Delays and overrun of cost

14. The capital estimates should contain contingency provisions for unforeseen but probable extra expenses. In addition, however, any project in a developing country is always liable to run into troubles which may necessitate funds greater than those provided, even including the contingency provisions. Financial institutions will usually insist on a standby arrangement whereby some persons or institutions connected with the project agree to provide additional funds if they are found to be necessary to enable the project to be completed. Possible causes of extra cost are numerous: they may result from inadequate preparation by the sponsors, difficulties in acquiring title to the site, changes of plan, bad estimating, delays in delivery of imported or local materials, transport difficulties, failure of the plant to measure up to the specified performance, delays through the necessity of obtaining various Government consents or changes forced upon the project by Government order. Some of these may result in extra cost directly, others through imposing delays in completion. Delays mean that the earning of revenue from commercial production is postponed, while overhead costs continue to be incurred in accordance with the original estimates.

Some obstacles to development

15. Two of the most important facets of the feasibility of an industrial project are an adequate and expanding market for the product and competent, expert management for the enterprise; but there have been movements adverse to both these requirements in recent years. There have been some trends towards the breakdown of regional country groupings, thus reducing the corresponding markets. And many Governments by their taxation policy are making the recruitment of expatriate staff very difficult, although capable expatriate management may well be essential in the early stages while local management candidates are being trained. Developing countries might well consider whether to accord special tax holidays for a limited period to expatriates engaged in the setting up of new industries.

Case studies

16. The paper concludes with four cases drawn from the experience of British financial institutions, illustrating the effects on development projects of complicated Government licensing provisions, the effects on capital costs of serious delays, and the time that may be lost through the causes referred to in paragraph 13 above.

Contents

Annex

SOURCES AND FORMS OF FINANCE

General

1. The principal sources from which industrial projects in developing countries can normally derive their finance are :-

(a) Long-term or permanent finance

i. Capital provided by the sponsors themselves.

ii. Capital raised locally from :-

(a) financial institutions such as development banks, development finance corporations, development corporations, insurance companies, pension funds and those banks which are able to provide term loans or to subscribe for share capital;

(b) the investing public.

iii. International financing institutions such as the IFC, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, ADELA, CDC, CDFC, etc.

iv. Banking and similar organisations in developed countries whose business includes the making of international loans, generally to help finance their own country's exports, e.g. Exporters Refinance Corporation Ltd. of London.

v. Retained profits of the enterprise. Normally these are only significant in cases where the proposed development is an expansion of an already existing industry, i.e. one which is already generating, or about to generate, profits.

(b) Medium-term finance

vi. Suppliers' credits (probably insured by an export credit guarantee institution, such as the ECGD of Great Britain).

(c) Short-term finance

vii. Bank finance (overdrafts or similar facilities).

2. The finance derived from these sources will usually take the form of a combination of some or all of the following categories :-

(a) Ordinary share capital.

(b) Preference share capital.

(c) Loan capital, i.e. long-term loans, usually in the form of debentures, and either secured or unsecured.

(d) Medium-term loan finance, i.e. finance repayable within 2-7 years. Suppliers' credits will usually fall into this category.

(e) Short-term finance repayable in less than one year, such as bank overdrafts repayable on demand, 90-day bills, etc.

3. The respective proportions of these different categories ("the capital gearing") need careful consideration. It is a common experience that projects put forward by sponsors from developing countries tend to rely on raising loans or other fixed interest capital (e.g. preference shares) which are disproportionately large. The gearing which prudent investors will normally agree to will very rarely allow the total medium and long-term debt of the enterprise to exceed the total of its equity (ordinary and preference share capital); usually a lower proportion of debt is required. It is not difficult to see why this should be. The lenders normally have no share in the profitability of the enterprise; they receive a fixed rate of return and they have no prospect of either large revenue profits or a capital gain. Consequently, security for their investments and for the interest or other return payable on the debt is of great importance to them; they will wish to introduce safeguards against possible over-trading by the enterprise and against suffering a loss of their capital if the enterprise should be a failure. In the latter contingency, the project or its assets would have to be sold to pay off the loan finance and it would be most unlikely to realise even as much as half of its original cost, particularly if it is the only enterprise of its kind in a developing country, as the market for the machinery and the building (both of which may well be specialised) will be extremely limited. To guard against the possibility of over-trading, limitations on the project's total borrowing powers may also form part of a term-lender's conditions.

4. For stability it is desirable that the repayment terms of the loan finance should accord as far as possible with the expected generation of surplus profits

and the expected useful life of the plant. A repayment schedule requiring payments to go faster than the growth of the profits out of which they are to be paid can put an enterprise under very severe financial strain and may, in fact, so denude it of liquid resources as to bring it to a standstill. Suppliers' credits are frequently provided on terms which call for an early repayment. This may be unavoidable, because of the Berne Convention or similar regulations, and in that case the sponsors will find it necessary to reduce the amount financed by suppliers' credits to a low proportion of the total cost or to arrange for a standby source of additional finance out of which the earliest repayments to the plant suppliers may be made. It is important during the planning phase to make careful estimates of the cash-flow of the enterprise and examine this aspect of the financing. (See paragraph 21, e., f. and g.)

5. Bank finance is a valuable source of working capital. In very many industries the working capital requirement is a fluctuating one, especially in the case of seasonal industries such as fertiliser manufacture. Because bank finance can be easily and quickly increased and reduced in line with working capital requirements, its use can keep the interest burden to a minimum. However, some working capital will nearly always need to be raised on a permanent basis, preferably as share capital, both because there is an irreducible minimum of stocks which any business needs to maintain and finance and because banks will usually not allow the overdraft to exceed a certain percentage (say, 75%) of the total cost of the stocks and debtors thereby financed. This margin is needed to guard the bank against fluctuations in the market value of the stocks.

6. Thus, a typical capital cost and financing pattern for an industrial project might be as set out below :

<u>Capital cost</u>	
Cost of land, clearing site and installation of services	£ 40,000
Factory building	170,000
Plant, machinery, vehicles, etc. (c.i.f. factory site)	450,000
Engineering fees	40,000
Preliminary and pre-operative expenses	50,000
Contingencies 1/	50,000
	£800,000
Working capital	150,000
	£950,000

2/ See paragraph 44

Financed by

Share capital, Ordinary	£400,000	
Preference	100,000	£500,000
12-year loans (secured by debentures charged on the fixed assets)		200,000
Suppliers' credits (repayable in five years from shipment of plant)		150,000
Bank overdraft (secured by a charge on the stocks and debtors)		100,000
		£950,000

Foreign exchange

7. In countries which operate exchange controls, the form of currency needed to pay for purchase of plant and materials, fees to contractors, etc. is an important element in the financing plan. The Government may well require the purchases of plant in country X to be financed by money raised on a permanent or long-term basis in the currency of country X or in another, convertible, currency. In such a case some part of the share capital or loan capital will need to be obtained from either an international financing institution or a local development finance corporation which has that currency or a convertible currency at its disposal, or from investors in the country of origin of the plant; and the financing plan will have to take this into account. If the project is to be put out to international tender, this factor may make it impossible to organise the whole of the financial resources until the countries of the suppliers and the precise payment terms of the contracts are known, unless an institution holding convertible currency or a wide range of currencies will undertake to provide the necessary finance. This could cause problems in organising the project; these problems are by no means insuperable, but they are a complicating factor and probably are an important part of the reasons for the prevalence of calls for tenders which are to include not only the provision of the plant, but also the provision of the corresponding finance. In general, it has been found that this kind of tender is likely to be more costly to the borrower than cases in which the finance is obtained independently of the supplier or contractor.

Raising share or loan capital from local sources

8. The raising of share capital or loan capital from local sources may be effected either by a private placing or by an invitation issued to the general public. In most developing countries the general public is little acquainted

with industrial investment and private placings are more common. When the product is intended to replace goods which were previously imported, it is quite usual for a part of the share capital of the project to find a ready market amongst firms who were previously engaged in the importation and distribution of the product, and some of whom may have agreed to continue to provide similar services to the local factory when it goes into production. The local Government or one of its development agencies may also wish to have a share in the equity or loan capital of the project, so as to participate in its profitability, and have some industrial securities which can be sold to the general public as they become interested in such investment. Where the conditions in the local capital market are favourable for a public issue, the sponsors will have to decide whether to make the issue immediately (this may be quite possible where the sponsors' names are well known, particularly if they are already associated with successful local industry), or to seek some institution which will take up the securities in the first place on terms that they will later be offered to the public at a suitable time. The sponsors may alternatively take up securities themselves with the same outcome in mind.

9. In relation to public issues, a brief reference may be made here to the subject of underwriting. It will generally be appropriate to make a public issue only after the plans for the project have become well advanced, and at that stage the sponsors may have committed themselves to the purchase of the factory and its contents. It will thus be of great importance to them that the public issue should not be a failure. The normal way to ensure this is to enter into an underwriting agreement whereby certain persons, firms or institutions with available funds undertake, in return for a small commission, that they will purchase all the securities which the public fails to subscribe for. If the issue is not a complete success and some of the securities are consequently taken by the underwriters, their usual practice is not to hold them any longer than they must, but to sell them to the investing public as and when opportunity offers. Thus, the developers get the funds immediately, but the securities will be fed into the market over a period in step with the market's ability to absorb them, and sudden large inroads into the total amount of locally available investible funds are avoided. The function of responsible underwriting is a useful and important one

in the development of a capital market. It gives confidence to proposed developers and helps to even out the flow of industrial securities into the hands of the investing public. In developing countries underwriters are most likely to be found amongst development finance corporations, insurance companies, pension funds and other big investors, although the insurance companies and pension funds will probably be somewhat selective in the securities they underwrite.

10. Most developing countries now have development finance organisations which can constitute one source of finance for industry, and many UK-sponsored industries favour including such institutions amongst their sources of industrial capital because they consider it both right and advantageous to introduce a local element into the project. The project derives a number of advantages from the presence on the Board of a representative of such a local institution. If the institution is a Government agency it also creates a valuable link between the project and the Government and helps to keep the Board of the project advised of Government policy and its possible implications for that industry; but without involving the Government (and thus perhaps bringing political considerations) directly in the policy-making counsels of the project.

Raising share or loan capital from external sources

11. Occasionally it has been possible for a project in a developing country to issue debentures to the investing public in a developed country, but this only happens infrequently and it is not a source that can generally be relied on. On the other hand, there are a number of international and public national institutions, and a gradually increasing number of private institutions, which specialise in providing finance for developments in the less-developed countries; some of them are named in paragraphs 1 a.,iii and iv above. Most of these institutions are primarily concerned with helping development; others are more concerned with financing exports from the country in which they are established, and their services may be utilised either to take the place of suppliers' credits or to supplement them. For instance, suppliers' credits for machinery will frequently be available only on condition of full repayment within five years, which may be too short for the finances of the project. This can be cured by reducing the amount represented by suppliers' credits and raising the balance as a seven-year (or longer) loan from a banking institution like the Exporters Refinance

Corporation Ltd.; alternatively, by eliminating the suppliers' credit altogether and raising the whole cost from such an institution on a more favourable repayment schedule.

12. The institutions mentioned in paragraph 1 a.iii. are development finance institutions with few limitations (other than geographical) on their sphere of activity. In addition, there are institutions in a number of industrialised countries which make industrial capital available, but only if commercial interests of their own countries are also associated with the project (for instance, the Deutsche Gesellschaft für Wirtschaftliche Zusammenarbeit (D.E.G.)). If a technical collaborator or one of the sponsors is a resident of such a country, part of the finance could be raised from the corresponding development finance institution. This is sometimes the means resorted to to complete the financing where a project in a country which suffers from a shortage of foreign exchange needs to buy substantial amounts of machinery from suppliers in different countries. In recent years, balance of payments difficulties have led to an increase in the tying of capital exports to physical exports from the same country, and where the machinery comes from more than one country sponsors have at times found it desirable to seek capital finance from all the countries from which the plant is to be obtained.

Negotiation procedure

13. The raising of finance is frequently an operation of some complexity. A study of the project's profit and cash-flow forecasts will indicate a desirable capital financing pattern, but this may, of course, have to undergo significant modification so as to fit in with the policies and needs of the sources from which the capital is raised. As the capital may come from a number of different sources each of which has its own policy and terms of participation, negotiation of the whole capital supply will require skill, diplomacy, foresight and good organisation. All the more so, when the finance comes from different countries. Even if there is only one financial source besides the sponsors, it can be readily seen that great advantage will follow from conducting a considerable part of the discussions and negotiations by personal contact. Otherwise, there is a danger of misunderstandings and loss of momentum. This does not seem to be always appreciated, and many examples exist of sponsors who have tried to raise large sums of capital

entirely by correspondence. This has often resulted in failure of mutual understanding and delays, the solution usually only being found after fully-authorised representatives of the parties have got round the same table with each other. Most of the successful development institutions make it an almost invariable practice to ensure that an important part of the negotiations takes place by personal discussion; in a big project direct contacts of this kind may take place several times before matters are complete.

14. Another error which is sometimes made by sponsors is to carry the plans for the project a long way towards completion, perhaps committing themselves to a certain form of project, to a certain technology, schedule of machinery, etc., before establishing the first contact with their likely sources of finance. While this is a not uncommon method for established companies in a country where there is an effective stock exchange, it is not a satisfactory way to deal with the development finance institutions and others who are the likely sources of finance for projects in developing countries. These institutions have an attitude which differs materially from that of the investing public and investment trusts. They look primarily for ways of giving their support to good development coupled, naturally, with security for their investment. This approach to industrial financing means that their study is much more that of the entrepreneur than of a simple investor. Where the latter would concentrate his scrutiny on ensuring that his investment has high security (perhaps four or five times capital cover and ten/twenty times income cover, combined with a long established profit record), the development finance institutions are usually prepared to give their support to new enterprises or enterprises with a very short profit record and to accept a comparatively low cover both for capital and income. This practice is based on a most careful appraisal of the project, its environment and prospects, above all of its management; but also on the finance institutions having real opportunities to propose improvements in the project plan. While they will not seek to usurp the sponsors' responsibilities as entrepreneurs, they do submit all aspects of the project to careful, specialist examination by their engineers, accountants, economists and loan officers; and it is not uncommon for their examination to reveal possibilities of improvement. Early contact with the institutions also enables the sponsors to take account of their financing policies and methods in preparing the financial plan and to narrow

down the choice of institutions at an early stage to those who offer the best prospect of agreeing to provide the finance on a basis appropriate to the sponsors' intentions.

15. In the course of a negotiation there usually comes at least one point - perhaps more than one - which contains the seeds of an impasse. This is where two or more essential steps need to be taken and there is difficulty in taking any of them until the others have been completed. One example is given in Case 'A' below; at the point described in paragraph 7g. a Central Bank permission was dependent on the grant of an import licence, and the grant of the import licence was dependent on the Central Bank permission. Another example, which is perhaps more frequent, is this: On the one hand, sponsors of a project will take a great risk if they call for tenders and place orders with civil contractors and machinery suppliers before they are certain that all the finance required will be forthcoming; on the other hand, each financier will be reluctant to enter into a firm commitment until he knows the precise total capital cost and is certain that, with the inclusion of his contribution, finance amounting to at least that total will have been firmly promised. A usual way to resolve this dilemma is to obtain reliable, professional estimates of the total capital cost (including a contingency allowance), and for the financiers to enter into conditional agreements in which they each undertake to provide a stated sum, subject to the fulfilment of a number of conditions. Those conditions will include the placing of contracts for the factory and its contents at prices which correspond with those already approved by the financial institutions, and the conclusion of firm contracts with all the other financiers in contemplation. Thus, a number of financial sources all become committed subject only to conditions which are outside their own control; when all these conditions are fulfilled before the terminal date stated in the conditional agreements, they all become formally committed automatically and simultaneously. If the conditions are not fulfilled by the terminal date all the financiers are released.

Terms of loan capital

16. A point that might be mentioned here is that most financial institutions (whether local or external) attach great importance to security for any loan funds they provide. This finds expression not merely in the requirement of some form

of security [illegible] a mortgage or charge over the assets of the project, a bank guarantee, etc., but also an insistence that no one provider of capital should gain a privileged position vis-a-vis the others. This creates a general trend whereby the terms of the different elements of the outside finance are assimilated to each other, which means, in practice, that the financier who drives the hardest bargain generally fixes the terms for the whole of the outside finance. This seems to be an unavoidable feature of joint financing; it affords another argument in favour of the sponsors making preliminary soundings with the possible sources of finance before deciding to whom they will make the formal approaches.

APPRAISAL

General

17. The sources of finance may be expected to make a thorough appraisal to establish whether the project is sound in all aspects - technical, economical and financial; and to judge whether management arrangements are, or will be, satisfactory. As indicated above, a number of institutions are likely to be involved in the appraisal, and each of them will generally wish to make its own appraisal before reaching a decision whether or not to invest. International agencies, such as the World Bank and IFC and private foreign financing institutions, will wish not only to satisfy themselves that the project has a reasonable chance of success, but to make their evaluation of it in the context of the national economy. The Government of the country may also conduct an appraisal to decide whether the project should be given incentives such as tax exemptions and relief from duty on imported capital goods or raw materials and also to determine whether or not it should invest directly in the project or through one of its development agencies.

18. Experience has shown that such independent appraisals by a number of institutions and experts, interested in the soundness and success of the project, are most valuable and should be welcomed. The more thorough the investigation, preparation and presentation of the initial appraisal carried out by the sponsors, the more likely are they to obtain a quick decision from the investor. No corners should be cut in the process of carrying out the appraisal and presenting the outcome to investors; time spent at this stage will almost certainly save a much greater loss of time later when a number of investors consider what further

investigations they will require to be undertaken. It is rare to find a sponsor who produces an initial feasibility study which is complete in all aspects and who is able to demonstrate step by step that all the necessary appraisal processes have been thoroughly and competently carried out; but when this is done the overall saving in time is impressive.

The importance of reliable statistical data

19. An industrial project does not stand alone; it is part of a larger industrial development programme which in turn is, or should be, part of an overall economic development programme. Before any single project within this overall programme can be planned, its setting in the overall programme needs to be foreseen. A wise investor will look to the country's general economic activity and its long-range development programme and will study such basic information as population trends, gross national product, marketing and distribution facilities price levels and wage levels and will assess projected activities several years hence. It is therefore essential that adequate and reliable data are readily available upon which the investor may base his judgments. It has not always been the experience that the Government departments charged with economic planning have been able to produce reliable basic information.

20. The difficulty in obtaining reliable basic data in some developing countries may account for the fact that some sponsors of industrial projects in the developing countries produce inadequate feasibility studies when approaching financial institutions for assistance. Often, the study is confined to the narrow technical and financial appraisal of the project instead of ranging over that wider economic feasibility which the financial institutions will invariably wish to see. For example, often an insufficient analysis has been made of the market for the product at the price necessary for profitable operation. If the usual starting point - import statistics for the product to be made - is lacking, or if the statistical category is too broad, as is sometimes the case, then a comprehensive market survey will need to be made, including an appraisal of the present and prospective size of the total domestic market, based on some other reliable and related basic data, e.g. growth of population or per capita income. It would be helpful if the appropriate Government department would assemble such

data under one roof, where this is not being done, as this would save much time-consuming effort on the part of the potential industrialist and investor.

Investment Criteria

21. The financial institutions' appraisal will cover all aspects of the project, but major emphasis is likely to be directed to ascertaining :

(a) that a reliable market survey has been carried out which shows that the expected size, price level and development of the market for the product will be adequate in relation to the capacity of the project;

(b) that the sponsors' marketing plans inspire confidence;

(c) that the technology and design selected are appropriate to the market, the raw materials and the quality of available labour and management;

(d) that arrangements for an acceptable level of general and technical management have been made;

(e) that the operating expenses and revenue over a period of years have been estimated on a realistic basis and show satisfactory expectations of profit[3/] and an acceptable break-even point;

(f) that the proposed financial structure is sound; and

(g) that the cash flow forecasts over a period of years are in accordance with all estimates and indicate a sufficiency of liquid resources at all times.

22. Evidently the same careful examination cannot be made by members of the investing public and great responsibility devolves upon the sponsors and their professional advisers when offering shares for public subscription, to ensure that only sound projects are put forward for public subscription and that any special risks or uncertainties involved in them are indicated in the prospectus or other document making the offer.

3/ i.e. a rate of return on the capital employed which indicates that the project is an efficient way of using the capital to be invested in it; and sufficient profits year by year to provide the interest and dividends on all loan and preference capital, pay off loan capital at the due times and afford adequate dividends to ordinary shareholders within a reasonable time.

SOME SUBJECTS OF SPECIAL CONCERN TO FINANCIAL SOURCES

The importance of competent management

23. Financial institutions, when appraising industrial projects in developing countries, look particularly carefully into the arrangements proposed for management. From the point of view of the lender of money to a project, management is of more importance than the security offered; in fact, the quality of the management is his ultimate security rather than a charge over the assets. A factory full of machinery in a new industrialising corner of the world is almost valueless unless there are competent persons on the spot able to make it work and produce goods saleable at competitive prices.

24. Management is the key to success in any industrial enterprise. In developing countries it is an even more important factor of production than elsewhere, but it is unfortunately true that whenever and wherever the subject of industrial development in such countries is discussed there seems to be a lack of emphasis upon management and its problems. Industrial development is very much concerned with human beings as well as money, machinery and merchandise.

25. When trying to promote an industrial project, Governments in particular, and many other sponsors, tend to spend a great deal of time trying to tie up sources of finance and other basic requirements before settling the question of management. It cannot be too strongly emphasised that, provided an acceptable feasibility study shows that a project is likely to be commercially viable, it is relatively easy to find the finance for it if the proposed management is of the highest quality. Conversely, until good management is assured, wise finance will hold off. It does, however, appear to be extremely difficult to get these facts across to many sponsors and to the industrial promotion departments of some Governments.

26. It is dangerous to place expensive industrial enterprises under the control of civil servants who, however skilful at their own work, have not the experience, judgment or temperament for industrial management. Another fallacy, which arises from the common situation in which today's entrepreneurs and would-be industrialists in developing countries are the merchants and traders of yesterday, is that it is possible for them to run their industrial enterprises in the same manner as

they conduct their trading businesses. When management of either of these kinds is proposed, experienced financiers may be expected to refuse their help, however profitable the project may seem to be on paper.

Attracting good management

27. The basic requirement must always be the best possible management that is available. Second best is not good enough, since apart from the management ability needed for any project anywhere in the world, the management must also be able to adapt itself readily to new and sometimes difficult conditions, usually remote from servicing and other facilities, and to deal with the innumerable local problems that arise with sympathy and tact. The best solution in developing countries is to find a working arrangement which will marry technical experience of the industry concerned (usually brought in from overseas) with local experience of the country and its peoples. This generally suggests a management team, since it is unusual to find a person with both the technical and local experience required to manage the project.

28. UK experience indicates that the most successful (and, in the long run, generally the cheapest) form of management is obtained by the involvement of a large and experienced organisation from overseas prepared to commit both men and money to the success of the project, together with a local concern with adequate knowledge of the country and its people prepared to do likewise. In such partnerships, where both sides are heavily committed financially (particularly with risk capital) there is every incentive for them to second their best men to the project. In some countries such projects tend to run into political problems over the question of control. In a number of countries it is politically impracticable for an overseas organisation to hold a majority of the voting equity shares in the project. This does not usually present difficulties over management provided the overseas and local partners together are able to control the project, particularly if the balance of voting shares is held by a local development bank.

29. However, where for political reasons a local development agency or the Government itself is to hold a majority of the voting shares in a project and thus have control, it is frequently found that the best and most able technical

partners from overseas are not particularly interested in participating. This is due, of course, to a reluctance to assume management responsibilities without the corresponding control being in the hands of the parties responsible for management. A compromise solution is sometimes reached by offering such firms attractive terms to run the project on a managing agency basis, but a good deal of the incentive to make a complete success of the venture is thereby lost (see paragraph 41), and the value of a partnership with a local company having a knowledge of the country and its peoples is lost. The tendency in such cases is for only the more second-rate overseas firms to be interested in participation on the terms offered, which again does not make for the most efficient running of new industries.

30. Countries which insist upon the majority of voting shares in a company, and thus its control, being held by persons and institutions within the country frequently justify such requirements by stating that if the overseas company has control it might exploit the country concerned, particularly the workers in the factory. It is difficult to justify this point of view; the country concerned, through its Government, has the means, the power and the authority to prevent any exploitation.

31. Management on a managing agency basis by an overseas concern experienced in the particular industry is a very commonplace method of obtaining the required expertise for local industries. Frequently the fee includes an incentive in the form of a share in the profits; this method is often adopted where the investment required from the overseas firm is relatively small or non-existent. It is difficult to generalise on the success or failure of this method of obtaining management, since the result in different industries and in different parts of the world tend to be very variable. The managing agency system has been most successful in India where for very many decades there has been an established tradition of providing modern management through such agencies. It was particularly valuable in the earlier days as a means whereby a relatively limited supply of overseas managers could be utilised to run a large number of comparatively small enterprises, but later managing agents were also used to provide the management expertise for some of the larger industries. Elsewhere in the developing countries the results have been very variable and not always successful.

The most successful agents appear to be those who have moved across from India and elsewhere where the tradition is already established, and who are thus able to combine technical expertise with at least some knowledge of some conditions elsewhere in the developing world. The least successful have been those who have come straight from Europe or North America with little idea of the conditions they could expect to meet in the project country. UK experience indicates that in developing countries with market economies the managing agency system has, in general, a less successful record than direct management through a partnership between overseas technical expertise and local knowledge, particularly when both the partners are heavily committed financially.

Basic requirements for good management

32. Good management begins at Board level. It is essential for the shareholders to appoint capable directors to the Board of the project. The Board must draw up and establish the objectives and policies of the project, and lay down the general principles for it to follow. The Board's fundamental task is to select the best management and to ensure that it retains its efficiency at all times. It must, however, leave the manager to manage the project and should not interfere with his functions or intervene in purely management matters. It is not always easy in developing countries to dissuade some directors, particularly those nominated by the Government or its agencies, from interfering with the management. Difficulties are sometimes encountered in finding suitable persons to serve on a project Board. It is desirable that some members should have a good knowledge of the country and local business methods, whilst others should have sufficient industrial knowledge to make a useful contribution to Board proceedings.

33. If good management begins at Board level, its focus is the chief executive, the general manager of the project. Whether the general manager is obtained through the sponsors, through managing agents or by any other means, he must be the best possible person available for the job. In addition to the usual qualities required from managers anywhere in the world - a proven record of management experience, the characteristics of leadership, broad technical experience and financial acumen - he will need additional qualities if he is to be successful in a developing country. Probably the most important are patience

and tact. Working conditions will invariably be found to be more difficult, the customs and ways of the people are likely to be completely new, and in many cases the climate and environment will be found difficult. A project can never be successful unless the manager enjoys the full confidence of his Board. He should receive their full support, together with their full authority to run the project on the lines laid down by them, and must be responsible to them for all his actions. If he is not given full authority to manage he cannot be held responsible if things go wrong. He must attend all Board meetings, both to maintain familiarity with Board policies and to keep the directors fully informed of the progress of the project.

34. The manager must be supported by adequate experienced subordinate staff, and should be capable of delegating work to them whilst retaining overall control of the project. The qualities required from subordinate staff are similar to those required from the manager himself, and patience and tact are of considerable importance. In particular, adequate staff must be available to produce promptly the accurate accounting and production data required to retain purposeful control of production and to enable the Board to fulfil their functions. In developing countries personnel relations are also of particular importance, more especially since the labour employed, its traditions and way of life are likely to be entirely foreign and strange to most staff coming in from overseas. The personnel officer must accordingly be chosen with particular care.

Training for management

35. Because of the high cost of expatriate staff every progressive and cost-conscious Board will give the highest priority to training local persons for management posts at all levels. Some Governments and many politicians are quick to criticise a project which by its nature has to employ a relatively large number of expatriates in the first instance, on the grounds that the project has in the main been set up to give employment to expatriates. Few of such critics seem to appreciate the high cost of employing expatriates or the difficulties in recruiting and retaining them, and the consequent fact that every efficient Board of projects employing them will be doing all it can by training schemes to reduce and finally eliminate the expatriates as quickly as possible.

36. It would be out of place in this paper to go into details as to methods of training for management, except to mention that in a number of countries the method giving the most consistent results appears to be to select promising management trainees as they leave the universities and colleges and give them training, sometimes partly overseas but for the most part on the job within the project.

THE IMPORTANCE OF A CONTRIBUTION FROM THE SPONSORS AND THOSE RESPONSIBLE FOR MANAGEMENT

37. In developing countries during the last decade many ventures have been sponsored by companies or individuals who have wished to exploit a commercial situation or to sell machinery, know-how or goodwill without investing any significant sum of money themselves. If the company in question is of high repute this kind of transaction has sometimes been successful, but there is unfortunately an impressive record of cases which demonstrate the reverse. Reference to one type of transaction of this nature is made on pages 20-21 of "National Development Plan - Progress Report 1964", published by the Nigerian Federal Ministry of Economic Development; and United Kingdom industrialists and financiers have seen many other examples.

38. It is a normal working rule of most international and national development financing institutions that the sponsors of a project should make a significant contribution to its finances. No formula can be laid down for the size of the contribution, but the general principle is that it should be sufficiently large to ensure that the sponsors' interests are closely involved in the project, that they will suffer if the project is a failure and that they will be able to see a clear benefit to themselves if it is a success. This generally means that they should make a contribution to the equity capital which is substantial in relation to their own resources.

39. By insisting on this, the financing institutions preserve what the Nigerian publication mentioned above calls "the fundamental canon of sound private investment that the investor should bear the full risks and consequences of his judgment or miscalculation and entrepreneurship". One could go a little further than this: if the project encounters unforeseen difficulties and is still making losses at a time when profits were anticipated, a sponsor with a substantial sum of capital at stake is more likely to remain concerned and to work to save the project and less likely quickly to cut his losses.

40. However. it is not enough merely to require the sponsor in question to take up some shares; his entire relationship with the project needs to be considered, as some sponsors have found methods of appearing to comply with this requirement while in fact not doing so. For instance, a sponsoring

company setting up a project on the footing that it receives a contract to supply the plant or buildings may agree that some part of the price it is to receive will take the form of, or be returned to the project in the form of, an investment in shares in the project company. This is acceptable provided that the nominal cost of the shares is more than the profit element in the price of the plant or building. Sometimes it is less than that profit; there have even been cases where the engineers employed by financial institutions have formed the firm opinion that the contractor has raised the price so that, in addition to a normal rate of profit, the price includes an extra profit approximately equivalent to the cost of the promised equity investment. In either of these cases, if the project is unsuccessful the sponsoring contractor stands to lose no out-of-pocket payments at all; and if the profit has in fact been inflated, it may stand to lose nothing whatever, not even the reasonable profit on the contract. When such a transaction is proposed, a prudent financial institution will be very particular in its examination of the project and the contracts proposed. If not satisfied on this score, it may refuse to go ahead.

41. Where the whole or part of the management of the project is to be provided by a company, the considerations mentioned in paragraphs 38 and 39 generally apply, although not always with quite the same force. As indicated in paragraphs 29 and 31, a simple managing agency can be satisfactory, but it is not generally so acceptable to financial institutions. It is evident that such a management firm is under a smaller inducement to send men of the highest class to the managed project than if its own money were at stake there. Faced with the necessity of allocating its management staff between various ventures, it is more likely to send its best men to enterprises where its own capital is invested. However, this doctrine should not be pressed too far; in particular, if the general management is forthcoming under acceptable arrangements on the lines indicated, agreements with reputable suppliers of technical know-how who themselves make no investment may well be accepted. Here again, the terms of the management contract will be studied as part of the overall relationship between the management firm and the project.

42. One consequence of the foregoing considerations is the necessity for Governments to bear them in mind when granting licences, pioneer certificates, etc., or entering into other arrangements with sponsors which give them a virtual

monopoly of a possible development. In a small country the fact that a particular firm holds a pioneer certificate or a licence for a particular type of manufacture may well make it economically impossible for anybody else to consider starting the same manufacture. If the intention of the grantee of the certificate is, in fact, to establish an enterprise on lines (e.g. as regards the grantee's own investment stake) which are unlikely to commend themselves to the financial institutions whose assistance will be necessary, that project will be most unlikely ever to go forward; but so long as the grantee's certificate remains in effect, nobody else will be willing to venture into the same field and the country's development will accordingly be held up. The same results may follow from the grant of industrial licences, options over specially suitable factory sites, etc. Cases 'C' and 'D' below contain two illustrations of the way time can be lost through Governments putting proposed developers into such a position when preliminary study should have indicated serious doubts about their ability to raise the necessary finance for their project.

Delays in construction and overrun of costs

43. The feasibility study will usually include approximate estimates of the total capital costs, and these will be given more precision when contracts for the purchase of the site, its preparation, the construction of the factory, the manufacture of the plant, etc., have all been placed. Financiers will usually defer the date when their undertakings to provide capital finance for a development project become binding until all these contracts have been placed, or at least firm prices have been quoted, and the total contractual cost is known. Even then, however, it is common experience that the expected capital cost is in fact exceeded. One of the most frequent causes of increased cost is delay in completion of the project. As soon as the time is exceeded costs will almost invariably start rising (see paragraphs 51 and 52). In the succeeding paragraphs, therefore, delays and cost increases will be considered together.

44. Some causes of increased cost are unavoidable and beyond the control of either the sponsors or the contractors, but many stem from errors of appreciation, lack of experience or even misguided optimism. Virtually all financial

institutions insist that all capital estimates should contain contingency allowances making reasonable provision for such occurrences as unforeseen difficulties in civil engineering construction, increases in statutory labour rates, rises in material costs beyond the normal trend pattern, and commissioning costs (such as teething troubles and minor modifications which have to be made to plant and machinery during the testing stages). These are the eventualities which experience shows are frequently encountered in the course of construction of the factory; but, in addition, there are many possibilities of increased cost and delays ~~which~~ any one or more of which may affect a project in an unforeseeable manner. The most common are briefly summarised below and, for convenience, are listed under the name of the person or institution which is likely to bear the main responsibility.

Delays for which the sponsor may be responsible

45. The financial and administrative arrangements for the project require very careful planning and interlocking in order to avoid bottlenecks and delays. This calls for the exercise of great foresight. For example, the raising of a number of different forms of finance, the fulfilment of the conditions of the loan agreements, the administrative arrangements for bringing expatriates to the site, the recruitment of the professional and administrative staff needed for the smooth and efficient supervision of construction, the preparations for the training of labour, all have to be included in the plan, properly prepared and effectively timed. Failure to put any one of these elements in its right place may cause a hold-up and result in expensive staff and equipment being rendered idle.

46. A frequent cause of serious delay is difficulty in acquiring an acceptable title to the site. The land laws of many countries are still in a form appropriate to pre-industrial economic and social conditions, and acquisition of the best site may be difficult or even impossible. In extreme cases difficulties over title have resulted in an original site having to be abandoned and another substituted, with consequent need to re-plan various aspects of the project.

47. Sponsors sometimes run into delays and excess cost through insufficient attention to specifications and design at the outset. Thus they may fail to appreciate the additional items or services which they must themselves obtain,

particularly at the "mating points" between separate contracts. This omission may result in hurried orders for additional items of equipment having to be sent out during the construction, resulting in severe delays which may on occasion be avoidable but only on payment of a specially high price for quick delivery. Other possible outcomes of insufficient hard thinking at the outset are second thoughts about plant specifications and design, interference in the contractors' design and lay-out work, delays over approving lay-outs, etc.

48. Finally, over-optimism is a common pitfall in project planning. Optimistic estimates about the completion date or how soon the plant can be brought up to its planned out-put are always welcome, and are not always scrutinised as sceptically as is desirable. The acceptance of cost estimates as if they were final prices instead of treating them as tentative until firm quotations have been obtained may be a cause of unexpected increases in cost (see Case 'A' below). It might also be mentioned that the cost of arguing with contractors over claims for extras which are a normal accompaniment of a construction contract may sometimes reach a substantial sum and provision for this ought normally to be made.

Delays for which the contractor may be responsible

49. In addition to unforeseeable delays such as striking bad ground, underground streams, hidden rocks, etc., which are beyond the control of the contractor, he may be responsible for delays and/or extra cost through bad estimating. If he has under-priced the work, the contractor may be tempted to try to make good his losses by any means at his disposal, principally by inflating those claims which he is able to make under the terms of the contract. He may also be held up by delays in delivery of imported raw materials; by bottlenecks in local raw materials due to too many competing demands upon the local producers; or by transport difficulties due to inferior roads or lack of heavy transport equipment. When the plant has been erected, some items may fail to meet the specified performance and this may delay the commencement of commercial production while modifications and re-testing take place.

Delays due to government and official bodies

50. In countries where the Government has an extensive system for controlling industrial activity and financial transactions with foreigners, the possibilities of delay through the need to obtain Government approvals are considerable. Import permits, tax relief approvals, industrial licences, approved status

documents, entry permits for expatriate workers, permits for nationals to be trained overseas, approval of foreign loan agreements, all offer possibilities of delay on their own account and for impeding each other unless there is some effective co-ordinating procedure (see, for instance, Case 'A' below). Cases sometimes occur where, after permission for the import of certain equipment has been given, Government has found that similar equipment is available from indigenous sources and has thereupon forbidden the import. This generally results in extended delivery times, modifications to the plant layout to accept a different type of machinery and, frequently, more costly machinery. Similarly, insistence on the use of national shipping lines may cause delays because these lines have fewer available vessels. Finally, it is not uncommon for the utilities needed for the construction work to be provided too late because of failure to foresee the necessity for installing feeder lines before the construction begins.

51. Delays, whether caused by some of the above, or by other eventualities, are the rule rather than the exception in development projects and it is almost universal experience that as soon as the expected time is exceeded costs start to rise. In addition to the possibility of inflation of cost of supplies and labour which are always present, delays in starting up production will mean that the salaries and wages of employees engaged in anticipation of the original starting date will have to be paid at a time when the corresponding sales revenue is not being earned; and interest on borrowed money will, of course, be payable whether the factory has started production or not.

52. An extreme example of the unfortunate effects that delays may have on a project is afforded by the enterprise briefly described in Case 'B' below. It suffered delays of 19 months before the plant was ready for production, and the capital cost increased by 26 per cent.

53. Consequently, prudent financiers will always envisage the possibility that the capital cost will be considerably more than the estimates, even when the estimates include apparently reasonable contingency provisions, and will usually insist on a fall-back arrangement for dealing with a shortfall in finance. In other words, they will require to have an understanding with one or more persons connected with the project on lines similar to the following:

(a) That they will provide any funds needed to complete the project in excess of the estimates. The form in which the funds will be provided (share capital, unsecured loan, etc.) may also be prescribed.

(b) That this undertaking to cover the shortfall should remain in force up to a stated time, e.g. the commencement of commercial production.

(c) The amount of the shortfall covered by the undertaking may be unlimited, or if the parties concerned are not prepared to agree to an unlimited liability, the limit should be a generous one which will cover any likely eventualities.

54. The sponsors of the project should be prepared for a requirement of this kind to be put to them by the financiers to whom they apply for participation. They should also bear in mind that if Exchange Control law necessitates it, some part of the standby may need to be in a stated foreign currency.

OBSTACLES TO DEVELOPMENT

55. Finally, attention may be drawn to two developments of recent years which are contributing to a contraction in the number of feasible projects capable of attracting development finance. Two of the most important facets of the feasibility of an industrial project are marketing and management. Unless there is likely to be an adequate and expanding market for the product to be manufactured and competent expert management for the enterprise, the project is doomed to failure from the start and, of course, is unlikely to attract support from the financial institutions.

56. Often a worthwhile industrial project will depend upon a market wider than the country in which the project is located. In other words, the project may require unimpeded access to a regional market. While some international efforts are now being made to encourage regional country groupings, there have been a number of recent examples of the tearing apart of economic units earlier pieced together; for example common market areas both in West and East Africa are being weakened: Singapore has become separated from Malaysia. One result is the contraction of the market for industries located in the smaller economic unit, and the chances of the smaller unit attracting large scale industry are thereby lessened. As to management, as indicated in paragraph 35, it will frequently be essential to rely on a certain number of expatriates in the early stages of the

project whilst it is being established and a local management team is being trained to take their places. The disincentives for expatriate staff who may be contemplating short-term work in developing countries are increasing almost everywhere. Effective rates of income tax are tending to increase and developing countries are turning to the taxation of fringe benefits, including overseas inducement allowances, special educational and leave passage allowances which loom particularly large in the expatriates calculations. If, as a consequence, expatriates refuse to accept employment in these countries, it may prove impossible to initiate the developments. It is for consideration whether developing countries wishing to attract industry should (as India does) offer relief from tax for those expatriates engaged in the setting up of new industries, rather in the same way as the industry itself may be given relief in its early years.

Annex

SOME CASES DRAWN FROM THE EXPERIENCE OF BRITISH FINANCIAL INSTITUTIONS

1. The cases summarized below are drawn from actual experience and are based to a large extent on confidential information. In order to prevent recognition of the parties, no names are mentioned, dates are referred to simply by stating the number of months that have elapsed from the time that the experiences described first began, and the parties involved are referred to only by the following initials :-

B = the borrowing company;

S = the sponsor or sponsors of the project.

Case 'A'

2. In this case the project needed to obtain a considerable number of Government consents, namely :-

an industrial licence;

Capital Issues consent;

Central Bank approval;

approval of the Ministry of Mines;

import licences for machinery.

3. As will be seen below, the requirements of the different authorities responsible for the issue of some of these led at one point to an embarrassing situation. Moreover, the time which elapsed while the many applications were dealt with was such that in the meantime there had been a very significant change in machinery prices and virtually all the applications had to be represented with new figures. Eventually, after 39 months the terminal date contained in one of the financial loan agreements expired and the financier in question withdrew, leaving the project in a state of uncertainty. The relevant facts are as follows :

a. Month 1: B, a company engaged in a smelting and metal refining business, applied to the Ministry of Industry for a licence (a) to expand its productive capacity, and (b) to increase its range of production by making, as a by-product, a commodity never before

produced from indigenous sources. Both (a) and (b) when implemented would represent a substantial saving in foreign exchange.

b. The licence, for a two-year period, was granted in Month 11. B thereupon entered into collaboration agreements with foreign technological expertise and set about raising the necessary finance. At this stage capital and other financial estimates were prepared.

c. In Month 17, B applied for Capital Issues consent in outline. The application stated the source of the local finance and the amount, but no source of foreign exchange. Consent was given in Month 20.

d. B then entered into negotiations with prospective lenders of the necessary foreign exchange finance and by Month 22 had received conditional offers of the total required. Capital Issues consent for the proposed loan terms was thereupon requested. At the same time, application for approval was made to the Ministry of Mines.

e. In Month 22, B approached the Central Bank for approval of the technical collaboration agreements and of the raising of foreign exchange. In Month 23 the Central Bank stipulated that formal application for approval of any foreign exchange loans must be accompanied by draft loan agreements and a copy of the import licence granted to B for the goods being purchased with the foreign exchange loans in question.

f. In Month 25 the Ministry of Mines gave its approval in principle (re d. above), followed in Month 27 by Capital Issues consent.

g. Thus, at this point B had tentatively arranged foreign exchange loans (but the lenders would not enter into firm commitments until all consents, including that of the Central Bank, had been obtained) and obtained all consents except that of the Central Bank, which was dependent upon the granting of an import licence by the appropriate Government department. However the latter would not give its consent until the lenders were fully committed to make their loans. Thus there was a deadlock. This was eventually resolved in Month 29 by the lenders formally signing the final loan agreement, but including in it a condition that it was only to become effective upon B obtaining all the necessary consents (i.e. including both the import licence and Central Bank approval).

h. In Month 29 the import licence was granted, but because of changes in the trading and price position which had occurred during the long period of delay since the original estimates were prepared the sum covered by the licence was now less than was needed. Consequently the import licence had to be revised. This revision was not effected until Month 34, by which time the original industrial licence (b. above) had expired and had to be renewed. It was not until all these matters had been disposed of that B could make formal application, complete with copy licences, to the Central Bank for permission to draw the foreign exchange funds to be provided by the loans. This consent came almost by return of post and the loan agreements thereupon became binding.

j. B was now in a position to proceed with the placing of orders for machinery, etc. Unfortunately, by now two years had elapsed since the date of the original capital cost estimates; it was found that these were very much out of date and the prices tendered by plant manufacturers in Months 34/35 were considerably in excess of the original estimates. Some months then elapsed while negotiations with plant manufacturers took place, but the eventual price was still higher than estimated and the loans, licences and consents already secured were all inadequate for the project. A fresh start had to be made in filling the foreign exchange gap and obtaining Government consent.

k. In the meantime in Month 39 the deadline for implementing one of the foreign exchange loan agreements, signed a year earlier, was reached and the lending institution concerned withdrew from the project. This made such a large gap in the finance that it brought the whole project to a standstill until the gap could be filled.

Case 'B'

4. This was an expansion project requiring considerable erection expertise (obtainable only from abroad), which was expected to be completed over a two-year period. It was eventually completed 19 months behind schedule, the delays having been caused by events outside the control of S. The following table compares the original estimates of capital costs with actual costs :-

£'000

	Original Estimated Cost	Actual Cost	Causes of Increase: Directly due to delay	Causes of Increase: Price revisions during Construction	Causes of Increase: Extraneous
Fixed Plant	1,257	1,411	-	155	-
Electrical Plant	116	195	-	-	79
Duty, freight and insurance	200	254	-	51	-
Erection costs	75	225	75	75	-
Building and civil works	.375	450	-	75	-
Interest and other financial charges during construction	225	345	120	-	-
	2,248	2,880	195	356	79

5. The capital cost showed a startling increase of 28%, of which 8.7% was directly caused by the delay and 15.7% was caused by price rises during the $3\frac{1}{2}$ years of construction. Some part of the latter would probably have occurred even if construction had been completed within the estimated period of two years, but the record indicates that a significant part of the inflation occurred during the 19 months of delay. The increase in the cost of the electrical plant was not due to lapse of time but to a failure on the part of the local electricity undertaking to make electric power available when promised.

6. As the project was the expansion of an existing factory, the plans provided for only a small expansion of management. Consequently, the above items contain no item of salaries and wages paid out during the period of delay while no revenue was being earned. In the case of a new project, this item might have been an important addition to the actual capital cost.

Case 'C'

7. A small country had no metallurgical industry, but it imported and used a sufficient quantity of simple steel products (conorete reinforcing bars. ironmongery, manhole covers, etc.) to support a small scrap-melting and re-rolling works. The economy also utilised a substantial quantity of very high quality steel products made to very exacting specifications. The Government was approached by S, a group of promoters, with a proposed project for the melting, refining and processing of

imported scrap metal to produce the whole range of steel products required by the economy. If feasible, the project was evidently a very attractive one and the Government granted the sponsors a pioneer certificate. As the economy of the country clearly could not support more than one iron and steel project, the issue of this certificate was tantamount to granting S a monopoly - during the period of validity of the certificate it was most unlikely that any other entrepreneur would consider any form of activity in that field in that country.

8. The proposals put forward by S involved no equity subscription being provided by them; they were to receive a free issue of "founder's shares ", and they expected the rest of the capital to be provided by the Government and other sources. After receiving the pioneer certificate they endeavoured to stimulate interest amongst possible financiers, but examination by the latter revealed that S had no knowledge at all of the highly specialised processes required to produce the high-quality steel products mentioned above; that the turnover they forecast was unrealistic; that the project could not earn an acceptable rate of return on the capital cost envisaged by them. The fact that S were putting forward a project with an estimated capital cost of the order of US $ 15 mn., which they were to erect and manage for an extended period under a favourable contract, but without the intention of putting up any part of the capital cost themselves, was enough by itself to make any experienced financier very wary; all the more so when it appeared that the project was to buy all its scrap metal from S.

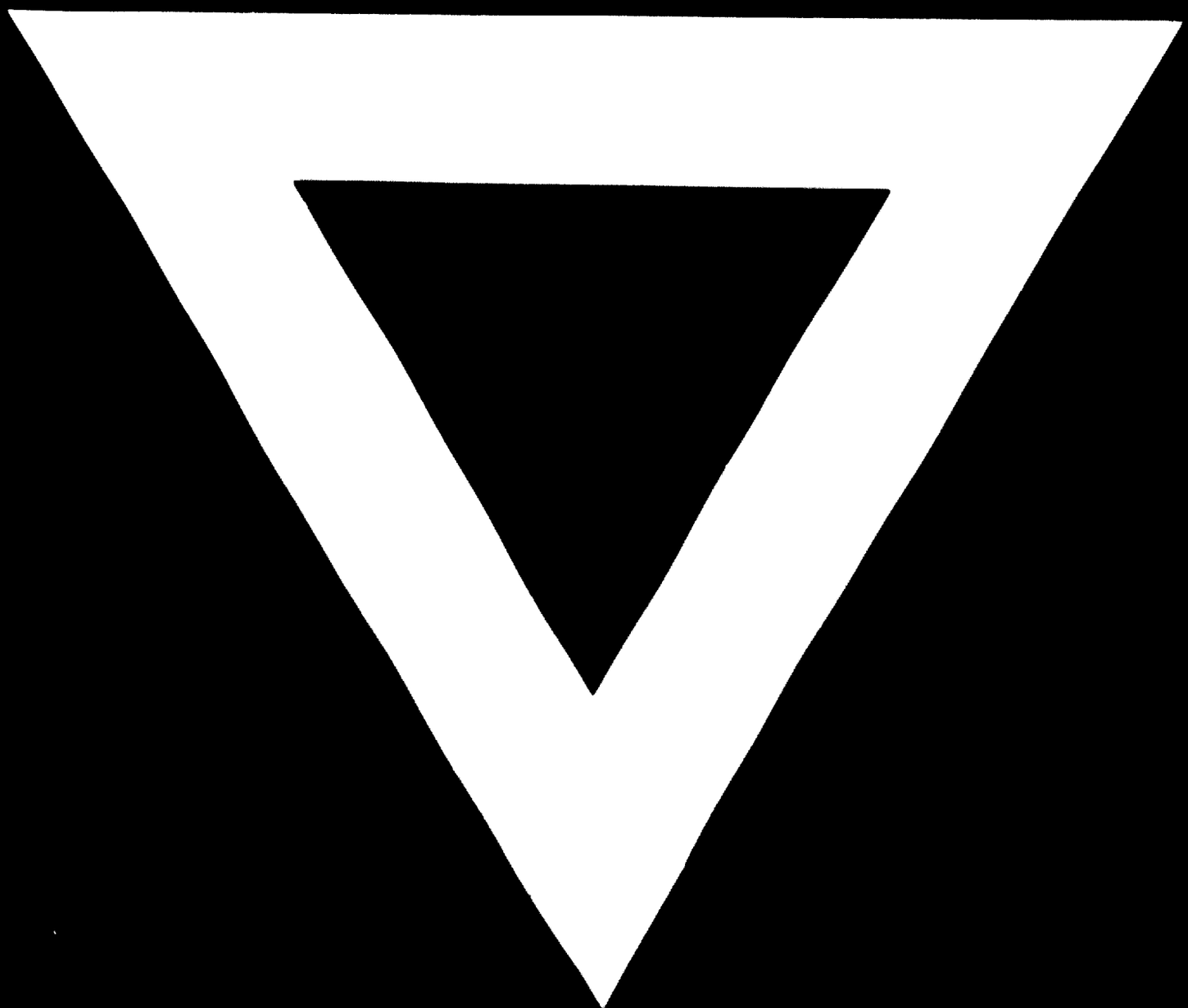
9. No finance at all could be raised and the project never got started. Eventually the pioneer certificate expired and the way was left clear for a more realistic proposal to be formulated by other interests; but in the meantime two years or more had been lost.

Case 'D'

10. The development of a small country was hampered by the absence of suitable hotel accommodation in the capital city, with the consequence that very few business visitors were prepared to spend more than the barest minimum time there. The Government was anxious to secure the construction of an international type hotel and granted to S, a firm of civil contractors, an option for this purpose over an appropriate site. The site was pre-eminently suitable for a hotel of international status; in fact, there was virtually no other available site of

the right size and with the right physical characteristics within a convenient distance of the business centre and Government offices.

11. One of the terms of the option was that S, who would build the hotel, would form a company to operate it. It was intended that the participants in the capital of the company should include a firm with experience of hotel operation and that S themselves should provide about 40% of the share capital. Negotiations were commenced, in the course of which it became apparent to the financial institutions that S lacked the financial resources to put up their share of the company's capital and, in fact, that the size of their resources raised doubts about whether they would be able to build the hotel to adequate standards and within a reasonable time. The result was that none of the financial institutions approached would agree to participate and the project had to be abandoned, but the Government had to wait until S's option had expired before it was possible to go ahead with other parties. This meant that the option period was entirely wasted, a result which could have been avoided if the Government had investigated S's financial background before granting them the option.



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