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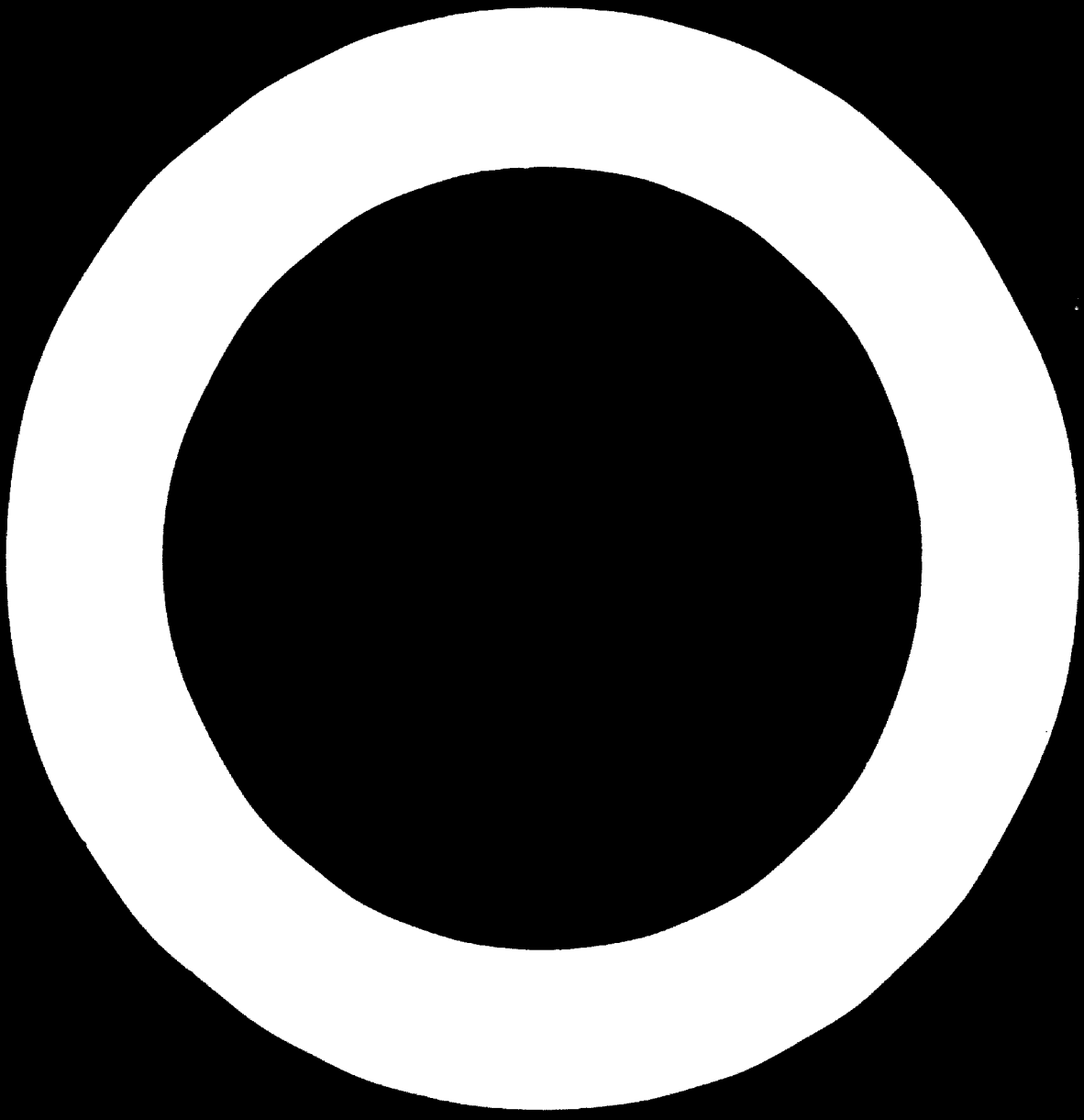

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CHAPTER I.

INTRODUCTION

1. A thorough, un-biased and complete project appraisal report is one of the most essential documents of any industrial development bank, as it details the criteria and facts, on which an investment decision is made. The report, to be complete, must be able to provide an answer to all questions, which could arise in connection with the viability and profitability of the project under consideration.

2. Logical presentation is largely a matter of organisation of the text and the tables of the annex. Basically, the project appraisal report will cover two principal aspects, i.e. the creditworthiness of the borrower and the feasibility of the project.

3. The scope of the investigation to be conducted before writing the report, will vary with the moral and financial standing of the sponsors, the type and size of the project, and the amount of the proposed financing. A multitude of basic information is usually available from the sponsors' initial presentation (loan application), submitted in response to the questionnaire of the finance institution.

4. The contents and types of questionnaires, the most suitable methods to handle these during the preliminary scrutiny stage and the required verification of information, supplied by the sponsors, will be dealt with in a separate paper on "Banking Techniques".

5. However, considerably more informative material and statistical data will be needed to complete the appraisal. Personal contacts with the sponsors, with representatives of the trade, equipment suppliers and Government will help to clarify important issues and questions arising from further study of individual problems.

FRAMEWORK OF THE UNIDO EXPERTS

6. The training course will be conducted by building up, gradually, a typical project appraisal report, emphasising at each step the ways and

means to ascertain as correctly as possible the facts and figures required for an objective appraisal and to explore eventual alternatives of methods.

7. To assist the UNIDO experts in their task, the present guide-lines and a sample report have been prepared. However, the way and means by which they should be used during the training course is left to the skill and experience of the UNIDO expert, to achieve the maximum impact on the participants.

8. The accompanying project appraisal report serves as a sample only; as it will be used by several UNIDO teams in many developing countries, where conditions will vary considerably, certain subject matter or even whole sections will have to be deleted and new ones added in others. Such changes in the report and the curriculum will have to be prepared on the spot after the teams' arrival in the country and after a comprehensive and thorough discussion with the head of loan operations has taken place.

9. To make an effective appraisal of a project a combination of engineering-, economics- and financial analysis-skills is required. Over the years two basic methods are used by finance institutions. By the first, three independent sections prepare three separate reports on the same project, which are then combined in a final report by the loan officer. By the second method, a team of the three specialists is formed within the loan department, who will work together on the final report until completed. This second method, owing to its many advantages, has proved to be considerably more effective and is basically best suited for finance institutions in developing countries.

10. The team of UNIDO experts consists however of an Economist and a Financial Adviser only, leaving the question of training the participants in engineering practices open. This omission must be explained by the fact that in a short, six-weeks' course it is not possible to aquaint the

participants with the many complexities of a large number of product processes, selection of adequate machinery and their out-put balancing, construction of suitable buildings and a multitude of other topical subjects, all of which are part and parcel of "engineering".

11. Regarding the lectures to be given by the UNIDO experts for two hours daily, (preferably during the first two working hours), a modus operandi will have to be established between themselves, how to distribute the work to the best advantage of all concerned.

12. For most countries it will be necessary to re-work the accounting tables (Annexes) in accordance with the economic, fiscal and other conditions prevailing in the country, to give the participants valid prototypes for their work. The re-working of the tables by the financial analyst is best carried out during the first few days of the training course, when the economist is lecturing 2 hours daily on general and economic subjects, relating to the opening sections of the report.

13. The sample appraisal report has been typed and mimeographed for each section separately. By this a section or a table not applicable to the prevailing conditions, can be exchanged by a substitute sheet, drafted on the spot.

14. The extensive use of a large blackboard is essential to achieve an audio-visual effect on the participants. Copying from the blackboard should be encouraged for better memory retention. Before the winding up - every participant shall receive a mimeographed copy of the sample appraisal report, as successively developed during the six-weekly course, to serve as a basic guide for his appraisal work.

15. To test the attention and retentiveness of the participants it is suggested to arrange before the close of the training course a written "test of comprehension", relating to a few basic subjects of the lectures. The marking of the papers could be done by the team-members or by an official of the finance institution.

16. It must again be emphasized that the connotations and observations on the individual sections of the project appraisal report, as shown on the following pages, represent only such guide lines for the lectures to be held, more of an aide-mémoire than a predetermined text to be followed. The UNIDO expert, based on his experience in industrial development banking, will want to impart his specific knowledge on a particular subject or a new method to the participants and he will go to some length to explain all possible alternatives, not mentioned here.

CO-ORDINATION OF TRAINING

17. The present training course is devised for all officers of the operations (loan) department, to acquaint them with the latest methods of project appraisal, the assembly of the most important data, their analysis and utilization and the final preparation of a thorough and un-biased appraisal report.

18. This in-bank training course is mainly directed to the middle class cadre of specialists (economists, accountants, financial analysts and partly also to engineers) and to all other officers of the operations department, including new employees and less experienced staff.

19. Although a specialist is generally concerned with his own sphere of work duties, for a smooth co-operation within the appraisal team it will be of advantage for him to know the methods employed by the other specialists, as well as how an integrated appraisal report is prepared and thus to be able to substitute for others in case of need.

20. Management should therefore insist that the whole staff of the operations department attends the six-weekly course, necessitating only two hours each day, thus hardly interfering with the normal work of the finance institution.

21. Management will probably not object if officers from other departments volunteer to participate in the course, as it would give them a useful understanding of the working of the credit department, which performs in practice the most meaningful function within the organization.

22. Whenever needed, typing and mimeographing services should be arranged by Management, as well as an office put at the disposal of the UNIDO experts.

THE PROJECT APPRAISAL

23. The functions of an industrial development finance institution are manifold, they extend from

a) promotional activities
b) project investigation
c) loan negotiation
d) project appraisal
e) credit investigation
f) loan sanction
g) loan agreement
h) foreign exchange dealings
i) accounts
j) audit
k) loan-follow-up and inspections
l) statistics

to m) administration/secretariat

and in larger institutions:

n) public relations
o) organization and methods
p) training and others.

24. Proper communication within the organization is essential. As departmentalisation, or at least the distribution of functions to individual officers takes place in every institution, it would, for several reasons, be ill-advised to distribute freely the final project appraisal report to all; it should be given only to departments or officers, requiring it for their further work, as for instance to f), g), and k).

25. The project abstract sheet, compiled after loan sanction, will give sufficient information of the concluded transaction to all other officers of the institution.

ASSUMPTIONS AND LIMITATIONS

26. The selection of one prototype appraisal report, to serve as a teaching sample to the staff of many finance institutions in developing countries can only be tentative. In the present case a sample has been chosen, relating to "difficult" conditions of many appraisal aspects, so that a larger than usual number of subjects and economic and fiscal factors is being dealt with.

a) The project selected represent for all purposes a "medium size" project and that in connection with the formation of a private limited company.

"Large size" projects (multi-million Dollar projects) require a much more thorough study, including socio-economic aspects, benefit-cost analysis, etc., which could not be undertaken during a short instruction course.

"Small-scale industry" loans require investigations on a minor scale and a slightly different type of appraisal report, for which a questionnaire is given in the annexes.

b) To obviate quoting any particular currency unit of a developing country, the symbol "C.U." = "Currency Unit" has been used throughout the appraisal report.

c) The selected country is pre-dominantly agricultural, with industries being successively built up, producing import substituting goods, but trying also to export manufactured merchandise from indigenous raw materials. For the present exercise the production of an agro-based commodity has been choosen.

d) The development finance institution obtained several lines of credit from foreign governments and international agencies, some "tied",

others "not tied", but all for a repayment period of 10 years, without grace period. To avoid exchange risks, the institution grants all loans to industry for the same 10 year period, with half yearly repayments. The foreign credit agreements do not foresee a "pre-payment" clause, which is not included in the loan agreement of the industrialist, to avoid possible exchange risks.

e) The sponsors (in this case) dispose of sufficient funds in domestic currency to invest over 60 % in the project; they however seek from the bank a loan in foreign currency for the import of machinery, as the premium for buying foreign currency on the open market is excessive.

27. Government assistance:

(i) Government grants to the company a 3-year tax holiday, commencing from start of operation.

(ii) Government agrees to accept deferred custom duty debentures for 50 % of the duty, payable in 3 equal instalments commencing from the second year of operation.

(iii) Government issues bonus vouchers for 30 % of the export value. These vouchers can be sold to importers with a premium.

(iv) Government allows a continuously reducing depreciation allowance of 10 % on machinery and 5 % on buildings per year; machinery can be depreciated at 15 % on double shift and 20 % on triple shift worked.

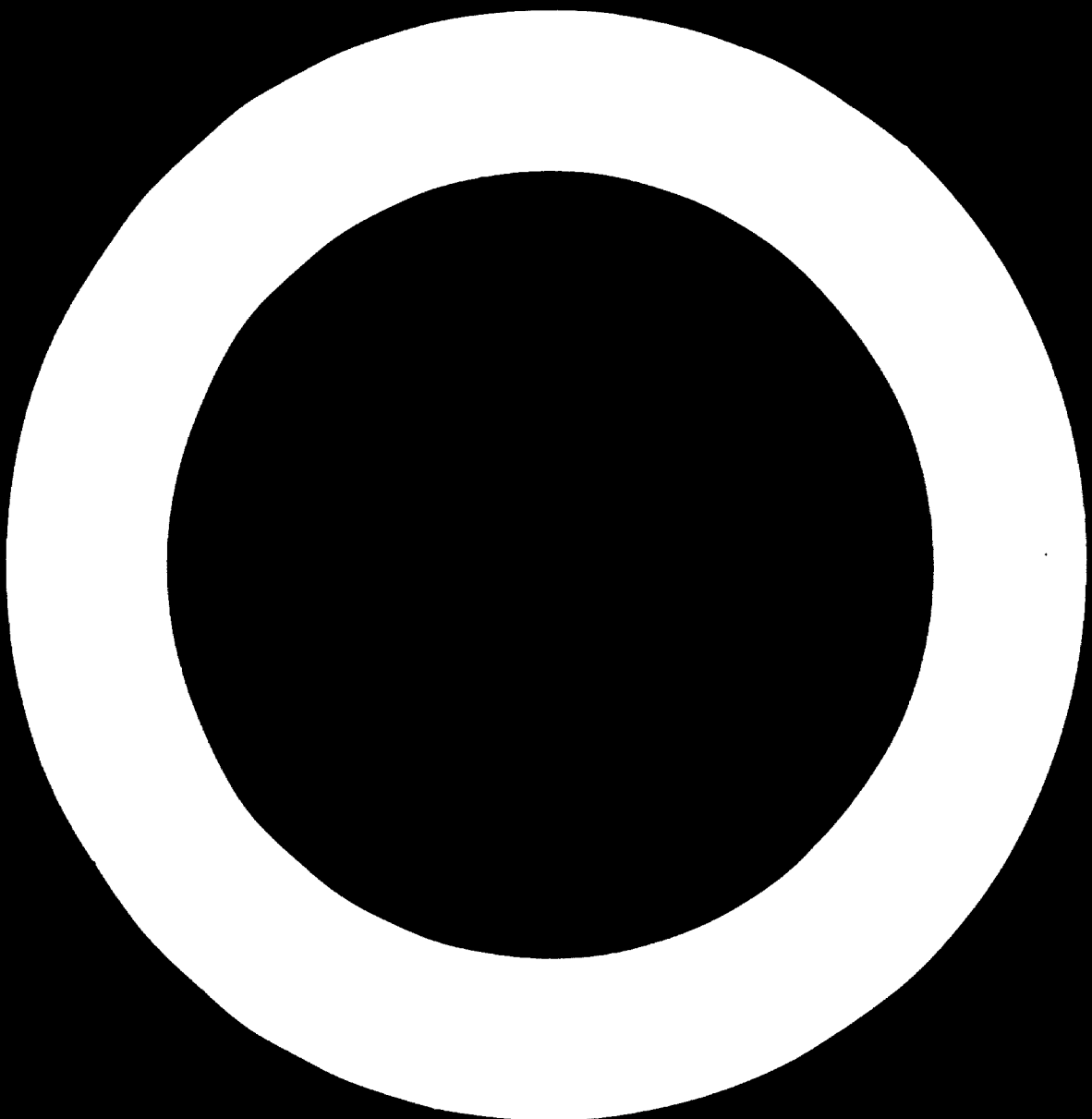
28. Government impositions:

(i) Government imposes an income tax of 55 % on net earnings.

(ii) Government imposes a 20 % tax on the par value on the issue of bonus shares.

(iii) Government reserves itself the right to approve or reject any new industrial project. In view of badly required foreign exchange earnings Government encourages the establishment of those enterprises which could earn the maximum of foreign exchange with the

minimum of productive costs, according to the formula "Investment Criteria", included in the appraisal report. Ordinarily, a limit is prescribed for the resulting coefficient. Alternatively, when comparisons of a larger number of proposed projects are made, but only a few can be approved, those with the lowest coefficient would have priority.



[illegible]

[illegible]

'A' - [illegible]

29. The 7 indications quoted summarize the essentials of the project, submitted for financing.

'B' - INTRODUCTION

30. In a few sentences the preliminaries outline the intentions of the sponsors of setting up a limited company, the purpose of the foreign exchange loan and the future activities of the enterprise.

'C' - HISTORY OF PAST OPERATIONS

31. From the various categories of individuals or groups of sponsors, the majority of loan requests originate with businessmen, who own already a business, a company or a productive enterprise. It is understandable that the finance institution would like to know full details of present and past performance. Broadly, the following headings indicate the extent of inquiry:

a) Ownership and control of the enterprise and its capital structure

b) Quality of the management and efficiency of organisation

c) present manufacturing facilities

d) past and present operational performance, earnings record and financial position of the applicants.

32. The present appraisal report reproduces the summarized 'Trading Profit and Loss Account" and a summarized "Balance Sheet" for the preceding three years. It would be advisable for the UNIDO expert to explain briefly, expecially for those participants who have little or no knowledge of accounting, how to extract the relevant figures from financial reports, however to postpone interpretation of the ratios, until at a later stage when the actual tables of the report will be dealt with.

33. Besides the financial results and the financial position, the bank is also interested in the 'reputation' of the sponsor/s and confidential inquiries are made with his/their bankers, major creditors, competitors and customers. The information gathered from these sources are of a confidential nature and should, for obvious reasons, not appear in the project appraisal report.

34. The officer in charge of these investigations shall prepare a confidential report for the board of directors only to be annexed as part II to the appraisal report, being the proposal for the conditions and covenants of the loan agreement.

'D' - DESCRIPTION OF THE PROJECT

35. A general description of the project could be considered as a preliminary of the following section, "Facilities for the implementation of the project". The type and classification of finished goods is specified and their final utilization stated. Furthermore, the number of shifs worked each day is given, as well as the assumed basis of yearly capacities, on which the appraisal results are calculated.

'E' - FACILITIES FOR THE IMPLEMENTATION OF THE PROJECT

(i) MANUFACTURING PROCESS

36. The manufacturing process is described in detail. To produce semi-worsted woollen yarn from greasy sheeps' wool is a comparatively simple process. A more involved manufacturing process would require a step-by-step description during the production stages, including flow of materials, inspection procedures and whether special techniques are employed under a licence agreement.

37. Eventual by-products should be specified, their quantity, their value and their disposition (sale, self-use).

38. Spoilage and waste assume an important role in the cost calculation and should therefore be thoroughly investigated.

(ii) LAND

39. In the present case the sponsors have arranged to aquire a free-hold property of 60.000 square feet of 'developed' land from the industrial estate administration for C.U. 55.000.-. To this the cost of installing on the property sewers, drainage and water mains of C.U. 3000 and of an internal road at C.U. 2000 has to be added.

40. As the site of the industrial estate has already been selected by the Government planners for its all-round suitability, the report does not give further information on important points, which will have to be dealt with a project in a different location, namely:

nearness to labour quarters
distance from next larger town
nearness to raw material markets
transportation facilities (road, rail, harbour)
nearest connection point to required utilities
(water, power, sewer, etc.)

41. The term 'developed' land in the usual sense includes the parceling and grading, as well as sewage, drainage, water, power and suitable roads brought up to the bordors of the property. However, often for lack of drainage and sewer mains substitute arrangements have to be made on the property itself. Also water has to be drawn from tubewells where no central supply system exists.

42. A map of the area, showing the location of the factory and other buildings should be annexed to the report.

(iii) BUILDING

43. A scrutiny of the drawings and description of the building/s by the bank's engineer will, amongst other queries, include an examination of the following:

a) The size and shape of the factory will primarily depend on the prepared layout of the machinery; the flow of materials must conform to the requirements of the manufacturing process. Material handling and the correct placing of access and main aisles is a prerequisite of good planning.

b) major process equipment should be located that no re-location will be required during the useful life of the factory

c) adequate work space must be provided for each employee and his safety and comfort considered

d) light and ventilation is a very important factor for the efficiency of operations

e) wash-rooms and cloth storage for the employees must be provided

f) the type of construction and the materials used will to a certain extent depend on the anticipated useful life of the factory, the availability of building components and on the construction budget. Flood and earthquake hazards are also to be considered

g) adequate storage space for raw-materials, intermediate and final products and spares must be planned, either within the factory or in an adjacent building

h) the production flow chart should show whether in- and out-doors or loading docks could improve the movement of materials and products, to avoid counter-flow and bottlenecks

i) not always is sufficient thought given to future expansion of the enterprise. Unless other reasons prevail, a tentative assumption of a 10% expansion of productive and storage space within a given number of years ought to be considered. This will reflect on the planning of the ground space as well as the actual design of the factory. Amongst the possibilities is the positioning of the extension side by side of the original building or in linear continuation of its main axis.

j) offices can be planned in front or above the factory or as a separate building. In each case the advantages and disadvantages have to be weighed.

k) occasionally, with a small-scale industrial project, owned and operated by the proprietor himself, accommodation for the family is built above the factory, if permitted by local building regulations.

44. The project appraisal report states full particulars of the buildings, their size, the type of construction and the material specification of the main building components, as well as rate of cost per unit and total costs. Architects' drawings are an integral part of the report.

45. Detailed description and specifications are an essential requirement for the inspections by the bank's engineer during the loan follow-up stage.

(iv) MACHINERY AND EQUIPMENT

46. As a rule the sponsors of the project submit with their loan application to the bank three detailed and firm quotations from machinery suppliers, not necessarily from three different countries.

47. The quotations describe the technological production process, the machinery and equipment, the hourly or daily capacity of each item and state their individual prices. Prices again have to be specified, whether they are for machinery uncrated ex factory warehouse, or crated F.O.R. (free of charges loaded on railway waggon), F.O.B. (free of charges loaded aboard ship), C.+ F. (cost of crated machinery and all freight to customers' harbour) or C.I.F. (cost of crated machinery, full insurance and all freight to customers' harbour). C + F and C.I.F. does not include unloading, nor clearance of goods.

48. The currency of the quotation, eventual exchange rates, payment conditions and the time limit for acceptance of the offer are clearly stated.

49. Many suppliers, assisting their prospective clients, enclose drawings of machinery lay-outs, flow sheets and even architectural drawings of a suggested factory design.

50. Other items of the quotation refer to charges of personnel for the creation of machinery or for starting up production and training of local employees.

51. The duty of the engineering department towards a project submitted to the bank for financing is the checking of all aspects of plant design, selection of machinery and suitability of the production process under the given conditions, but never to accept the responsibility of undertaking the overall design and selecting machinery or process.

52. But the checking of technological features alone is not enough.

53. One of the important criteria for plant design and production process:

Is the minimum level of output reached for economical production? Or in other words, can at the stated capacity the factory produce goods at really competitive prices plus a reasonable profit? Should the capacity be altered or the production process be changed to reach the goal? Alternative solutions should be taken into consideration and compared, to find the optimum results within the financial means available.

54. As already stated, the machinery supplier must state in his offer the hourly or daily (8 hour shift) rated capacity of each machine. During the scrutiny the engineer will make sure that the output of the individual units will be "balanced", thus preventing bottlenecks during production.

55. With the increasing production in developing countries of engineering components and universal type of machinery, it is feasible that certain items of the plant equipment could be purchased from local manufacturers. Lack of foreign exchange, common to nearly all developing countries, makes it mandatory to substitute foreign by locally produced equipment of a similar quality and size.

56. Of importance to the sponsors of the project, and incidentally also to the bank, is a positive equipment guarantee from the suppliers, as well as the performance of tests (specified in detail), once the plant has been completed. These provisions of the quotation and the machinery order should be carefully checked by the bank's engineer.

ANNEXES (Tables) I, II-A, II-B and III

57. The Tables I, II-A, II-B and III of the Annexes are directly related to the observations of paragraph (ii) Land, (iii) Building and (iv) Machinery and Equipment, dealt with in the appraisal report and in the present guidelines.

58. Table I and the machinery and equipment Tables II-A and II-B need hardly any further explanation.

Column 6 of Table I "Basis for Estimate" should be read in conjunction with the explanation given at the end of the table. The status for ordering, whether a pro-forma quotation or only an estimated price for an item has been given, is closely related to the percentage of 'contingencies' to be added, which question is being discussed below.

59. Sometimes a project is submitted to the bank, where the sponsors have already bought items enumerated in Table I. In such case the bank's engineer will have to summarize the bought items in an addendum to Table I, as these purchases could alter the financial plan of the project.

60. Interest during construction: There is no hard and fast rule relating to the apportioning of interests during the construction period. However, taking the case that the construction costs of the plant are paid from equity capital, interest during construction are not to be charged to the construction budget, because it will in fact not be paid to an outside lender. On the other hand such interest would have to be included in the profitability calculation.

61. Interests during construction must be included in the cost of project forecast whenever a loan for this purpose has been asked.

62. In the present project appraisal interests for the machinery are included, but not for the building, which is financed from equity.

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63. Contingencies: It is reasonable and prudent to include in the fixed costs of the project an amount or a percentage for unforeseen expenditure. However precise an estimate is attempted, more as a rule than an exception, costs of the project have a tendency to increase.

64. Experience in developing countries have shown, that an appreciable number of projects show an 'over-run' of the budgeted 'cost of project". Development banks consider that it is the responsibility of the sponsors to provide the funds for "over-runs' and this is incorporated in the text of the loan agreement. In some extreme cases, the sponsors were unable to meet the requirements from personal or institutional resources and the bank had to provide part of the funds to complete the project.

65. Only by checking and re-checking of all expenditures can the bank's engineering department reduce the number and the size of "over-runs".

The most common causes of "over-runs" would be:

- price escalation in building construction or equipment
- incomplete equipment selection
- changes in the original project through introduction of refinements or automation
- increased cost of site-levelling
- increased cost of foundations
- underestimation of transport charges
- 'force majeur' (accidents, floods, earthquakes)
- underestimation of erection - and starting-up expenses
- lag in providing required utilities (power, water, railway-sidings etc.)
- fiscal changes (import duty, surcharges, etc)
- foreign exchange fluctuations

66. To minimize some of the "over-run" factors, which are foreseeable, the following steps can be taken:

- to have the costs of project re-checked by independent experts or consultants
- to obtain full and unequivocable guarantees from the suppliers for completeness and performance of machinery
- to open the letter of credit within the validity of the quotation
- to obtain written confirmation from public-sector authorities on timely availibility of utilities.

67. Considering the size of the present project under discussion, the possible causes for eventual up-sets and the general stability of machinery and civil engineering prices, the contingency of 5 % in the appraisal report under scrutiny is rather on the low side. It is suggested that a 10 % contingency for a fairly accurately prepared construction budget is not an exaggerated percentage to be used for projects in developing countries.

Table III - Construction Time Table

68. From the various time limits, given by the machinery suppliers for delivery and erection and the construction company for completion of buildings a time table is established, including one month for unforeseen delays, which shows for the present project that normal production is anticipated to start 18 months after establishing the letter of credit for the machinery.

'F' - MARKET AND ECONOMIC JUSTIFICATION

69. In analysing the future scope of an industrial project, the first line of investigation will be directed towards the present and future markets and prices of the product/s to be manufactured; the second into the technical feasibility and the third into the financial feasibility.

I. [illegible]

70. (i) The process of project formulation starts with the selection of the product/s to be manufactured. To this end a few considerations are essential:

a) examination of import statistics and the identification of those goods which could be produced locally to substitute imports

b) study of the natural resources of the country to ascertain suitable raw-materials, which are either rare or low-priced (forestry, minerals, [illegible]-based, or others)

c) examination of export statistics and the export trade, to ascertain whether raw materials or semi-finished goods exported could be further processed into finished goods

d) forecasting the increase of future local consumption and exports

e) investigation into production figures, domestic consumption and exports of certain products of other countries with a more developed economy to ascertain consumer acceptance and growth of production.

71. Under the assumption that the product has been identified, the above list touches already on some of the criteria for market research. To be able to investigate further, an attempt should be made to ascertain the important facts and figures on a time-length basis, best over a period of 10 years in the following form:

Quantitites / Years	19..	19..	19..	19..	19..	19..	19..	19..	19..	19..
Installed local capacities										
Local production										
Imports										
Exports										
Local consumption:										
- Total										
- per capita										
National income:										
- per capita										
Population growth (%)										

72. If near enough figures can be ascertained, the trend becomes clear, however, only in the case of goods which are already manufactured locally or imported. For new kind of goods to be introduced on the market or to be newly manufactured for export, a market analysis will be required, normally carried out by an economic research institute or a market research organization. (Comments of the UNIDO expert will be appropriate)

73. Assuming that the above table for a locally manufactured or imported product can be satisfactorily completed, the trend will of course become clear, but a linear continuation of the up- or down-swing will not necessarily result in a satisfactory forecast for future years. Economists have developed various concepts of forecasting market movements on a scientific basis, taking the increase of the per-capita income, population growth, the price fluctuation and other factors into consideration.

(Lecture of the UNIDO expert)

74. The majority of industrial projects in developing countries are geared to import substitution, namely to the production of goods, for which the market is well known. Normally it is the importer of the commodity who becomes the sponsor of a new production unit and being well acquainted with the market, its size and prices, with his co-operation the trend figures are easily established. Considering in addition the population growth, the increase in per-capita income, a cautious consumption forecast for a small- or medium-sized project can be prepared.

75. The figures of the market analysis and the production capacity of the planned project must be considered jointly. Here, extreme caution must be exercised and over-optimism avoided. It is inconceivable that a new manufacturing company will capture the whole of an existing market (even a monopoly position lasts only a certain time). Firstly, sales are building up slowly over the years, secondly, not every potential consumer can be reached, thirdly, competition is not remaining static, neither with regard to production output, product quality nor price, and lastly the appearance on the market of a substitute or fashion-influenced changed product has to be taken into account.

76. Only caution, logic and experience can determine the slice of the present and future market to be captured and thus draw conclusions for the planned production capacity.

77. Unfortunately, far too many plants in developing countries work at greatly reduced capacity or have been closed down, due to incompetent or over-optimistic planning.

(ii) PRICES

78. To recognize the trend of prices of a product, again a 10 year table is recommended, similar to the one shown above:

Prices (of competition)	Years	19..	19..	19..	19..	19..	19..	19..	19..	19..	19..
Domestic product:											
- wholesale											
- retail											
- for export											
Imported product:											
- wholesale											
- retail											
- cost C.I.F.											
- cost customs cleared											
Main raw materials (delievered to plant)											
- raw material A											
- raw material B											
- raw material C											
- which raw material is being exported and at what F.O.B. price?											

Suggested selling prices

(for the next 5 years, own production) 19.. 19.. 19.. 19.. 19..

- wholesale
- retail
- for export

79. The calculation, or estimation, at which the goods produced have to be sold is the most difficult, but also one of the most important questions of project appraisal, as the profitability of the enterprise depends primarily on the aggregate sales value received.

80. The price system in developing countries is, as a rule, very distorted. Price fluctuations are much more pronounced than in industrialized countries, and it is not an easy task to ascertain a reasonably valid and average price for a product over a certain time period.

81. For imported goods the price fluctuations are probably greater than for locally produced commodities. This is due to fluctuating foreign exchange rates, import controls and import relaxation, change in custom duties or other fiscal measures, and often due to an importer occupying a monopoly position.

82. For goods to be exported the world market prices should be applied, taking under certain conditions the freight charges into consideration. World market prices are also subject to fluctuations, due to scarcity or abundance, or due to political or military events.

83. These are some of the difficulties in pricing forecasts the sponsor of the project and the bank's officials are confronted with. There are no hard and fast rules for correct pricing, only extreme caution and knowledge of past and indication of future market trends will prevent an over-optimistic approach to pricing estimates.

Inflationary pressures:

84. So far in dealing with prices, only the "real" price of a product has been considered, omitting any reference to inflationary pressures on the domestic economy.

85. "Inflation is usually defined as a condition in which the financial resources of a country are greater than the current value of its real resources."

86. If government measures are taken to protect shrinking foreign currency (and they tend to be necessary in such a situation) the pressure is diverted inward, and the result is likely to be increased prices.

(Lecture of the UNIDO expert on inflation in general and its implications)

87. Inflation, existing or anticipated, requires added care in project appraisal by the bank's officials. Here are some possible questions to be asked:

- Have price and cost forecasts presumed any changes in cost and prices, due to the consequences of inflation? If yes, are they reasonable?
- Would it be feasible to separate price increases into "real" cost and price increases (higher world market prices for imported raw material, increased machinery and spares prices, higher local purchase prices due to scarcity, and many others) and into a percentage factor for inflation? This would be worksaving in an accelerating inflation.
- Would price increases hold the level of the rate of inflation, be lower or higher? It has been universally observed that with a low rate of inflation, price increases are at or below, with a severe and accelerating inflation far above the level.
- Is management of the project competent to adapt themselves quickly to changing conditions, caused by inflationary pressures? A few direct questions would reveal the abilities of management to take advantage of rising prices and to act promptly and effectively in the face of impending economic changes, or even devaluation of the currency.

Table IV - Sales Estimates (ex Factory)

88. Table IV shows quantities of finished goods, produced over a 4 year period, based on a capacity utilization of 65 % for the first, 75 % for the second and 85 % for the third and fourth year of operation. Due to the great demand for woollen yarn of 7's count, no difficulties are anticipated of selling the total quantity. The sales prices are calculated on the assumption of an increase of 2.5 % per year.

II. ECONOMIC JUSTIFICATION

89. The statements of "Net foreign exchange earnings" and "Value added" seem to be self explanatory, as well as the observations on "Employment opportunities".

90. Three of the most frequently cited objectives of a country's development policy are:

- improvement of the balance of payments
- reduction of unemployment
- increase of national income

91. The three statements of the present appraisal report are closely related to the first and second development objective above. Regarding the third objective, the increase of national income results from productive investments, which in turn increase future consumption by expanding the employment base.

'G' - COST OF PROJECT, MEANS OF FINANCE + DEBT - EQUITY RATIO

1. Cost of Project

92. The fixed cost of the project has been summarized from table I.

93. To this, the working capital requirement of C.U. 560.000 has been added, representing an approximate figure for cash to be provided at the end of the construction year.

94. Probably the most often encountered mistakes in financial planning refer to working capital requirements. To arrive at the minimum figure for the cash required, Table VIII shows one of the ways to calculate the working capital.

95. Industrial development banks do not, as a rule, provide loans for working capital and in nearly all cases short term loans are secured from commercial banks and from the owners. Development banks do not like to compete with commercial banks in the short-term loan field, especially if there is already a well established commercial banking system in the country.

96. The commercial bank accepts as security for the loan the hypothecation of the revolving stocks of raw-materials and finished goods. The size of the loan is normally limited to 75 % of the average value of stocks.

97. Since it appears that the consequences of underestimating requirements for working capital are much more likely to have serious consequences for a new industrial project than overestimates, it is recommended in case of doubt, to allow for substantial reserves in cash or in unused short-term credit, as it is only seldom that a business can operate exactly to a pre-arranged financial plan.

2. Means of finance

98. After ascertaining the amount of investments (fixed cost plus working capital) the sources of funds have to be assured, out of which the investments are to be financed.

Three different sources can be singled out:

- short-term borrowings
- long-term debt
- equity investment.

Short-term borrowings for the present project refer only to the financing of part of the working capital requirements, the balance to be provided from the equity contribution of the sponsors.

99. Long-term debt includes the development bank's loan for the import of machinery, the deferred part of customs duty (the last instalment is due after 5 years from import - this debt would better be classified as medium-term debt) and the loan from directors. According to the loan agreement, the loan from the directors can only be repaid after full settlement of the bank's loan, which means after 10 years. The paid-in capital (equity) will cover partly the fixed costs, partly the working capital requirements.

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100. With an already established industrial enterprise, operating successfully for some time, "internal financing" could be (contrary to the above case of "external financing") a different source for investments, serving for expansion of production starting a subsidiary or even participation in another enterprise.

101. "Internal financing" generatesfunds for investments from

- retained profit
- reserves (reserve accounts for various purposes, not needed now)
- depreciation (but only the surplus, not needed for renewal of fixed assets).

3. Debt-Equity Ratio

102. The debt-equity ratio is a measure of financial prudence that bears a relationship to the risk that a company is undergoing in the normal course of its operation. It sets forth a certain relationship between owned and borrowed funds and is a measure, not only of the financial risk, but also of investor leverage.

103. Equity owners like to see a high debt-equity ratio, because it gives leverage to equity capital. That is, with a high debt-equity ratio there is less risk for investors and the same investors stand to make greater profits per unit of capital invested. Additionally, with a small amount of equity, a small group can more easily acquire and maintain control.

The development bank however is looking for the security of its investment. Comparing the debt-equity ratio of a development bank (a bank also borrows funds from the Government, from the public and from international agencies) with that of a productive enterprise, it must be remembered the risks of a bank is distributed throughout its portfolio, whereas the future of an industrial enterprise may depend on the sales of a single product.

104. Taking further into consideration that the larger part, or the whole of the equity of an enterprise is invested in land, buildings and machinery, which in case of failure may be unsaleable or only at a great loss, the insistence of the bank for a reasonable sound debt-equity relation is prudent and business-like.

105. Generally, industrial development banks do not grant loans for a project in excess of the amounts, the sponsors are themselves willing to put up. Thus the size of the loan will be limited to 50 % of the capital requirements of the new enterprise. Exceptions are occasionally made mainly by public (state-owned) development banks for economically important and infra-structural projects.

106. Therefore, considering the project under discussion, an overall debt-equity ratio of 32:68 is very satisfactory.

'H' - PROFITABILITY

107. Whatever the economic, social, technical or other merits of a project may be, unless a reasonably satisfactory profitability can be shown, its financing will not be attractive to an industrial development institution. As far as the sponsors of a project are concerned, they will be primarily interested in the profitability in relation to the equity they have put up and tend to minimise the impact of borrowed funds on the profit setup.

(The question of leverage has been referred to in the preceding paragraph on "Debt-Equity" ratio).

108. Besides the profitability measurement "return on equity" and further variants ('return on investment' and 'return on sales') development bankers and government planners, especially for large projects, apply frequently in addition yard-sticks by the "pay-back or recoupment" and the a more sophisticated method of "discounted cash flow".

(If appropriate and seemingly useful the UNIDO expert may enlarge on these methods)

109. However, for the purpose of preparing an appraisal report on a medium-size project, the various "returns on ..... " ratios seem to be quite informative and allow a comparatively sound judgement on profitability.

110. It has been stated previously, that profitability of a project should not be taken as the only yardstick whether a project should be financed or rejected. Often some other factors may outweigh a less favourable profitability calculation, as for instance the promise of a potential government incentive, a very capable management, a product of elementary importance to the economy and many others.

111. Table IX shows in summarized form a forecast of earnings for four years of operations and in conjunctions with the ratios given under chapter [illegible] - Profitability, all relevant possibilities of "returns on ...." have been given.

112. Now to the calculation of some ratios:

(i) <u>Debt-Equity Ratio:</u> This is a ratio between all long term loans and the owners' equity at any given date. This ratio provides some insight into the relative size of the "cushion" of ownership funds, which the bank can rely on to absorb possible losses from operations, decrease in asset values and poor estimates of future fund flows. Loans from directors are essentially long term loans. But as long as loans from directors are not to be repaid during the continuance of the bank loan without prior approval of the bank, these are to be treated as part of owners' equity <u>for the purpose of computing this ratio only</u>.

(ii) Return on Owner's Equity: While calculating this ratio, owner's equity should be treated to include share capital paid-in, equity reserves and the unappropriate profits. Loans from directors are not to be treated as part of owner's equity for this purpose. Return on equity is calculated by dividing the amount of profit before or after tax (as the case may be) by the average amount of the owner's equity (i.e. equity at the beginning of the year plus that at the end of the year, divided by two).

(iii) Return on Capitalization: Capitalization represents funds made available from all long term sources and is obtained by adding the owner's equity and all long term loans, including loans from directors. Return on capitalization is calculated by dividing the profit (before or after tax, as the case may be) plus the interests on long term loans, by the average amount of capitalisation (i.e. capitalisation at the beginning of the year plus that at the end of the year, divided by two).

(iv) Earnings per Share: Earnings per share are calculated by dividing the earnings before tax and earnings after tax (as the case may be) by the number of ordinary shares outstanding at the end of the year. (Only ordinary shares have been issued).

(v) Break-up Value of Share: If the share capital consists of ordinary shares only, the break-up value is obtained by dividing the owner's equity, including reserves and unappropriated profits, by the number of shares outstanding. Intangible and fictitious assets, if any, are to be deducted from owner's equity. In case the share capital consists of ordinary as well as preference shares, the break-up value of the ordinary shares is obtained by first deducting from the owner's total capital, the preference share capital and any unpaid dividends on preference shares and then dividing the balance by the number of ordinary shares outstanding.

113. As already stated, ratios allow a comparatively sound judgement of the profitability of operations. But to test the applicability of ratios in actual appraisals, a leading industrial development finance institution was asked for more precise figures and expressed its views in these terms. "In general, a project is considered viable and fit for financing, if it meets roughly the following norms:

Gross profit to sales	20 - 25 per cent
Operating profit to sales	15 - 20 per cent
Net income (after tax) to sales	5 - 7.5 per cent
Net income (after tax and interests) to equity	10 per cent
Debt service coverage	2 - 2.5 times

114. As an afterthought those words were added:

"Like other aspects of project appraisal, the emphasis here is on realism, moderation and caution."

'I' - DEBT - SERVICE COVERAGE

115. Once the earnings of the enterprise have been forecast for several years, the next step consist in re-checking the financial plan to make sure that all long-term loans and the related financial expenses can be repaid in the agreed yearly instalments, without depriving the enterprise of needed funds.

116. A debt-service calculation is being prepared, as shown in chapter "I - Debt-Service Coverage", which indicates the "cushion" of funds available for redemption of long-term loans and payment of interests. As obviously the non-payment (default) of firm and legally defined instalments could have severe repercussions to the enterprise, the coverage ratio for debt service must prove that the leverage is at least twice, or better three-times of the actual requirement.

117. Although the project of the present appraisal report enjoys a 3-year holiday, the calculations were extended for a tax-paying unit, showing that even then the debt-service coverage can be considered as satisfactory.

118. It will be noticed that the yearly interests relating to the loan of the directors to the enterprise have not been included in the tabulation. It is a matter of opinion, whether the directors in case of a fund shortage would insist on payment of interests, as seemingly their claim would have a low priority.

[illegible]

119. The project appraisal report endeavors to give a realistic calculation of sales revenue and cost of production at a given capacity utilization. The development banker would also like to know what the financial position will be, if the assumption of the appraisal can not be realized.

120. As has been stated previously, the market possibilities, or in other words, the sales revenue is the 'number one' fact to estimate correctly. On the other hand, it is easier to estimate the cost of production, as nearly all components of the calculation are known within narrow limits.

121. Should the sales revenue decrease, production will have to be reduced (to avoid over-large stocks of finished goods, resulting in tied-up funds), the question arises how far can production be throttled down until sales revenue will equal production costs, that is to a stage when no profits will be generated, or when the break-even point will be reached.

122. Equally important is the break-even point to the owner/s of the enterprise. To ascertain profits or losses, balance sheets and profit and loss accounts will provide the required information, but they are prepared only once, sometimes twice a year. With a diminishing sales revenue, the break-even point (actually a danger signal) can be ascertained fairly quickly and at any time during the year.

123. The amount of sales revenue does not depend only on the quantity of units sold, but also on the sales price per unit. Due to market conditions or other circumstances prices may have to be marked down. In this case, before a price reduction the break-even point can be calculated at various price levels and thus it will become clear at what different capacity utilisation a break-even point will be reached.

124. The break-even point can be drawn graphically or calculated with the help of the formula, explained in Table XIII.

(The UNIDO expert may demonstrate on the blackboard both methods, using various examples).

125. When working out examples with various assumptions, one conclusion stands out, namely: an increase in fixed costs results in an increase of the break-even point by the same percentage and an increase in variable costs does not cause an equivalent percentage change of the break-even point. In the case of decreases the same observation remains valid, only with inverse results.

'H' - CASH FLOW AND PROJECTED BALANCE SHEET (TABLE X and XI)

126. To estimate the financial requirements of a new (or expanding) enterprise a "projected balance sheet" and/or a "cash-flow forecast" is used. Under certain circumstances either method can be useful, each representing a distinctive approach to achieve the same purpose. Industrial development bankers employ both types of forecasting, as one supplements the other and read together facilitate the marshaling of projected funds to be employed.

127. The "balance-sheet" method of determining future needs for funds is built around a forecast of key balance sheet items as of a selected future date. The investment required in all key items, as fixed assets, accounts receivables, operating cash and all other assets and liabilities for smooth performance of the enterprise are determined and tabulated. The projected

balance sheet forecast is in fact a complete financial picture, as will appear on a certain date. The date is an important factor, as it should be at a time of normal operation. Cautious forecasters would prepare a second balance sheet of a future date, when for one or the other reason (diminishing sales, delayed accounts receivables, increased costs of production, and others) the enterprise might be in financial difficulties. A comparison of the two balance sheets should indicate where to allow for "cushions" of funds.

128. The more comprehensive method of forecasting the amount of needed funds and the time at which they have to be provided is by the "cash-flow" method, which in many ways is comparable to a "budgeting" method. The theory of the "cash-flow" forecast is based on the anticipated receipt of cash at a certain time and the predicted outflow of cash at other times. As the cash-flow statement deals only with cash-transactions, non-cash items will not appear thereon, as depreciation, bad debts write-offs, intangibles and others.

(Lecture of the UNIDO expert on preparing balance sheets and cash-flow statements).

Some observations:

129. - Entrepreneurs can normally finance a substantial portion of the needed working capital through commercial bank borrowings against hypothecation of the revolving stock of raw materials and finished goods. If at any time the cash flow statement suggests availability of sufficient liquid funds, such commercial bank borrowings should be substantially reduced or entirely liquidated, without jeopardizing the overall liquidity of the enterprise.

The management of the present project, "XYZ Woollen Mills Ltd." would repay the loan in full in the second year of operation, being well aware that the interest to be paid on the loans is the highest of all debt-position

130. - Whenever in any year the equity reserves (representing profits retained for specific purposes) and other unappropriated profits are likely to exceed the paid-in share capital, a portion of such retained profits should be capitalized through issuance of bonus shares, to make the paid-up capital larger than the balance of all equity reserves and unappropriated profits. Otherwise the tax laws in many countries foresee a high rate of tax each year for such reserves.

131. - Development bankers differ in their opinion, whether a copy of the bank's projected balance sheet and cash flow statement should be made available to the entrepreneur/s. Generally, there should be no valid objections for not letting the management of an enterprise make use of the forecasts as a standard, against which performance can be measured and evaluated. Timely recognition of deviating results in performance will be of value to management of the enterprise, as well as to the development bank.

TABLE XIV - INVESTMENT CRITERIA

132. Industrial development bankers, determining the viability of a project, put commercial profitability in the first line of considerations. Government economists, planning the industrial development of the country, view any new project from the perspective of national economic profitability, which inter alia includes socio-economic aspects, increase in national income, higher foreign exchange earnings, better employment opportunities and others. But both find common ground in the aim to export locally produced goods and earn foreign currency.

133. In every developing country the government places the greatest emphasis on the need for increase of foreign exchange earnings, to improve the balance of payments. It encourages exports in many ways, in particular for manufactured goods, and preferably those using mainly indigenous raw materials.

134. After having reached a satisfactory level of import substitution for essential goods, the government planning authority, in formulating its export oriented industrial development, will give preference to those projects which for the input of the smallest amount of local currency earn the highest amount of foreign currency. Should there be a number of projects to choose from, by applying the formula detailed in Table XIV - "Investment Criteria", the project with the lowest ratio can be selected for implementation. Conversely, Government could also fix an upper ratio limit beyond which approval for a new project may be given only in exceptional circumstances.

GENERAL COMMENTS

ON THE

PREPARATION OF PROJECT APPRAISAL REPORTS

AND ON

VARIOUS OTHER FUNCTIONS

OF THE

LOAN DEPARTMENT

CHAPTER III.

CRITICISM OF THE SAMPLE APPRAISAL REPORT

135. The sample appraisal report of 'XYZ Woollen Mills Ltd' has been prepared by the loan operations department of a medium sized industrial development bank and is used for the present training programme as the basic document for the instruction of the participants of the course. It must be pointed out that the report, as presented, is not a 'perfect' appraisal report; it has its weak but also its strong sides.

136. Weaknesses are visible in the presentation of individual chapters, in needless repetitions, in not tying up the text with the annexed tables, in not stating market prices for a longer period of years, and also in the omission of a chapter on 'Management'; management capabilities of production, sales and finance have to be identified and an opinion thereon should be included in the report.

137. It might be of advantage to use a not too perfect report for the training course, as the attentiveness, intelligence and knowledge of the participants can be gauged and they can be challenged to improve on details of the report.

138. The strong sides of the report, and especially suitable for the purpose of the present training programme, are a number of chapters, which, if not entirely new in their concept, do not appear in so-called 'standard' appraisal reports. These additional chapters and tables will give to the participants of the course an insight in methods of extended investigations and calculations, which under certain circumstances may prove very helpful.

139. It is not an easy matter to prepare a 'perfect' appraisal report. The executives or the board of directors, who decide on the merits of a loan for a project, put to the loan department two demands, namely: first, that the project appraisal report should be limited to a reasonable length and secondly, that all major points are covered and thus give readily an answer to any and all questions, which could arise out of the complexity of a project.

140. The purpose of a project appraisal report can be defined as follows:

"An appraisal report should have a well organized and logical presentation, ensuring that all major points have been covered. Brevity without omitting any essential fact is the characteristic of a good report. Logical presentation is largely a matter of organization of the written text and the tables or statements enclosed.

MANAGEMENT

141. Without an export management, an otherwise well planned and well equipped enterprise does not have sound chances for a lasting success. In fact, management is the key factor in all industrial operations. But how to evaluate its capability? Unless the individuals making up the executive team have managed successfully an enterprise (preferably in the same line of production) it is difficult to appraise the knowledge and ability of each member in planning, organizing, supervising and controlling, being the basic functions, common to all managers.

142. Basically a medium size industrial enterprise will divide the functional areas of management into: a) production, b) sales and c) finance and administration. Each area includes a number of sub-ordinated functions. Usually, three managers forming a team take care of all operations, but sometimes the control of activities and direction of affairs is entrusted to a higher ranking executive, the general manager.

143. As an industrial organisation grows, the functional break-down of managing activities grows in proportion, the number of executives increases, and the role of the managing director as co-ordinator increases in importance. When a project is to be implemented by an already existing management team, the capabilities of the team or of individual managers can be measured by the results achieved in the past, but it can also often be observed that the same quite successful team is not capable of handling a large expansion of an existing industrial enterprise, as new and bigger problems appear.

144. What is the usual procedure to evaluate a candidate for a managerial post? Executive employment agencies are using various tests, partly practical, partly psychological and prepare a report of their findings. However, industrial development banks do not hire managers, but often it is essential in the interest of the project to know more about the technical and commercial suitability of the team. To form an opinion of a manager's capabilities and character, first his previous performance in industry is analysed and evaluated. Following this, the opinion of former employers and colleagues is sought. Multiple interviews with the manager himself should reveal a picture as comprehensive as attainable; however, only the test of time can tell whether the formed opinion has proven correct.

(The accompanying report on "XYZ Woollen Mills Ltd." does not give any information on the capability of management, only the financial results of a long established trading company. The question arises whether the former merchants will be successful as manufacturers. Could there be production problems, supply difficulties, or others, with which management could not cope? Although, the report clearly indicates a "seller's market", could marketing problems arise? These and other questions may be discussed by the UNIDO expert with the participants.)

LOANS TO SMALL INDUSTRIES

145. The present appraisal report of "XYZ Woollen Mills Ltd." refers to a loan for a medium size industrial enterprise. The question arises, what is a small, a medium size or a large size industry. No clear or valid answer can be given; any interpretation of these terms depends on the industrial size and wealth of the economy of the country concerned. What bankers consider in the U.S.A., Japan or Europe a small industry, would be rated in a developing country as medium sized and similarly a recognised medium sized industry in an industrialised country would be categorised as large-size in a developing country. No internationally accepted classification exists on this subject matter.

146. Agreed upon, however, are the terms for the length (duration) of a loan, namely "short-term" for up to one year, "medium term" for one to five years and "long-term" for over five years.

147. For lack of a better guide-line, it is assumed that a small industry in a developing country employs not more than 25 workers and/or limits its power consumption to 30 HP.

148. Loans to small industries, being of smaller amount than for larger enterprises, are less remunerative for the development bank and have to be handled more economically. The project appraisal report can be less comprehensive and will be somewhat simplified, but nevertheless all the basic financial, technical and market information must be provided. Experienced loan officers will have the advantage in recognizing at an early stage the viability and profitability of the project and will be able to restrict their investigations to the most essential aspects, thus reducing the time of appraisal preparation.

149. Some time ago, the International Bank for Reconstruction and Development (IBRD) published a questionnaire for loans to light industrial projects as a guide for the applicant/s and for the staff of the loan department, conducting the relevant investigations.

"The following questions should be answered when they are pertinent:

1. Borrower:

   (a) Name and address.

   (b) Nature and location of enterprise.

   (c) Corporate organization - whether privately or publicly owned, by whom shares held, brief details of affiliation to any other company or group.

   (d) Quality of management, business and technical experience, knowledge of this industry.

   (e) Plant description, production capacity, condition of facilities, etc.

   (f) Operational and financial history:

      (i) Record of production and sales for past four years;

      (ii) Financial statements: balance sheets and profit and loss statements and distribution of earnings records for past four years.

(j) Financial position - analysis of most recent balance sheet, including comments on capital structure, nature of reserves, valuation of inventories and fixed assets, etc.

2. Project:

(a) Description of entire project, including that part, if any, financed from other than IDB funds, indicating expected results, increase in production capacity, increase in efficiency, reduction in production costs, etc.

(b) Are qualified personnel available for the engineering and installation, maintenance and operation of the equipment? Will technical service be required?

(c) Total cost of the project, showing cost of fixed assets (in suitable breakdown) separately from working capital requirements. Indicate foreign exchange requirements included in total cost.

(d) List of goods to be acquired. Will competitive bids be obtained for this equipment?

(e) Construction and installation schedule.

(f) Proposed sources of raw materials, labour, power, water, transportation, etc.

(g) Present status of the project:

(i) Expenditures to date;

(ii) Equipment on order;

(iii) Problems, if any.

(h) Market:

(i) Information on existing markets and plans for supplying and expanding them. Imports in past years.

(ii) Estimated itemized production costs as compared with selling prices of competition, indicating customs duty for raw materials and finished goods, transportation costs, etc.

(iii) Methods of marketing the product and adequacy of the present or planned distribution set-up. Export possibilities.

(iv) Information available on existing or expected competing plants, such as their capacities and locations, sales territories etc.

(i) Operating and financial projections (if applicable):

(i) Estimated unit production for each of the first three years of operation.

(ii) Estimated sales revenues, costs and expenses (showing interest, depreciation and taxes separately) and net profits for each of the first three years of operation. Profits should be related to all financial charges, including probable dividend payments.

(iii) Cash flow estimate for each construction year through the first year of normal operation.

(iv) Pro forma balance sheets as at the completion of the project and first year of normal operations.

(j) General economic justification of the project (if applicable):

(i) Over-all benefits to the country.

(ii) Utilization of unemployed natural resources.

(iii) Employment of labour.

(iv) Foreign exchange savings.

(v) Economic diversification.

(vi) Benefits to other industries.

(k) Any other relevant information, e.g. on necessary government licenses, consents, effect of tariffs, taxes, etc.

3. Proposed loan:

(a) Amount requested.

(b) Proposed term of loan. Repayment schedule, specifying proposed grace period.

(c) Security available for loan.

(d) Credit standing of proposed guarantors, if any.

(e) Any special legal, tax or corporate consideration.

EXPANSION OF A MEDIUM SIZE ENTERPRISE INTO A LARGE SIZE INDUSTRIAL PROJECT.

150. Although it has been previously stated that the present guidelines for project appraisal refer mainly to medium size projects, it is felt that more information should be made available to the participants of the training course for certain loan applications, where the owner/s of an existing medium-size enterprise submit to the industrial development bank

an expansion programme, by which the project rises in its classification as a large size manufacturing operation.

151. For large scale industrial plant expansion, extensive investments are needed and often a financing scheme foresees besides the loan of the industrial development bank or their equity participation, the public issue of shares or bonds, participation of other financing agencies and sometimes even government co-partnership. This means that the documentation, substantiating the loan requirements, will have to be prepared with special care and that investigations and appraisal by the loan department staff of the financial, technical and market aspects will be extensive and very thorough.

152. Generally, the prospects of a new expanded project are being judged by the performance and results of the existing enterprise and the information to be gathered will concentrate in the first line on the sponsors of the project, the ownership distribution, the control, the financial and the sales reports. A questionnaire is submitted by the bank to the sponsors, which is usually divided into two parts; the first deals with all aspects of the existing enterprise and the second with the new project of expanded operations.

153. A specimen of the first part of the questionnaire is given below. The second part is basically similar to that of any new project, as dealt with so far.

Specimen questionnaire, part one:

THE BORROWER

154. Part one of the questionnaire refers to questions in connection with the existing enterprise and serves primarily as a basis for the evaluation of the new project for expansion; it covers the type of information required from going concerns. The following questions should be answered when they are pertinent:

I. GENERAL

1.01 Name of Applicant (exact wording of firm) and address:

Location of a) Head office
b) plant.

1.02 Brief history of the enterprise since inception,(any changes in name or business, mergers, reorganisations etc.)

1.03 Reputation:
Reference to:
a) Bankers

(i) credit standing

(ii) balances carried, type and length of loans

(iii) guarantees (if any)

(iv) general performance

b) Major creditors

(i) buying policies, special terms

(ii) payment record

(iii) general performance

c) Competitors

(i) management (weak, strong, conservative, progressive)

(ii) plant and machinery)

1) suitable (new style, improved, expanded)

2) unsuitable (obsolete, run-down, poorly cared for, poorly located).

(iii) efficiency (high cost/low cost producer).

d) Customers

Standing of company and its products in the trade and its advantage or disadvantage over other companies in same industry.

II. OWNERSHIP AND CONTROL

2.01 Corporate Set Up (limited company-public or private partnership, sole proprietor)

a) Date of incorporation

b) Is the present set-up suitable to obtain new financing? (if not, what is required to make it suitable).

2.02 Control:

a) Sole owner (active/inactive what is his relation to the management)

b) Controlling owned by management

c) Widely scattered (obtain names of principal shareholders controlling 10 % or more of any class of voting shares.)

d) Affiliation to any other company, group or invidividual: list subsidiaries showing percentage of ownership in each - any substantial holdings by fiduciaries?

III. MANAGEMENT

3.01 Directors (Partners) their background, qualification, activity, their affiliation with other concerns.

3.02 Key man or men:

a) Knowledge and experience

b) Age and length of service

c) Outside interests and activities

d) Terms of contract

3.03 Internal organization:

a) Divisions of departments, their functions - suitable distribution of responsibilities.

b) Qualities of second line executives and their ability to fill vacancies in first line.

c) Technical consultants, their functions, terms of employment, relations to management.

IV. CAPITAL STRUCTURE

4.01 Capital Stock

a) Distribution to shares

	No. Issued	Total Nominal Amount	Total Paid-up Amount	No. of votes per share
Ordinary				
Preference				
Deferred				

Is any un-issued stock held for special purposes?

b) Details concerning:

(i) voting, pre-emptive rights

(ii) liability to further calls

(iii) any stock dividends or bonus issue in last years (basis of distribution, number of shares issued, amount capitalized).

(iv) any shares issued for properties in the last .. years and basis of valuation.

c) Are securities listed on stock exchanges?

(i) annual price range for each of the past .. years together with current market prices

(ii) ratio of current security prices to earnings

(iii) value of the company in terms of total market values of its securities.

4.02 **Bonds and/or Mortgages**

Review issues outstanding as of date of latest balance sheet (see para 8.03 g) in regard to:

a) Security provisions (secured/unsecured)

b) Type and priority of mortgages or other liens (identify properties subject to lien)

c) Redemption provisions

d) Convertibility

e) Any covenants requiring or limiting payment of dividends, maintenance of working capital, investment in subsidiaries, investment in fixed assets etc.

f) Trusteeship

g) Principal type of holders (banks, insurance companies, general public).

V. MANUFACTURING FACILITIES

5.01 **Factory and Buildings**

a) Location
(nearness to markets, raw materials, power transportation)

b) Are buildings and site owned or leased
(terms of lease)

c) Plant lay-out and condition:

(i) maps and drawings
(ii) type of construction (wood, brick, steel reinforced concrete)
(iii) for four (preferably more) years annual repairs and depreciation charges (conservative, adequate, insufficient)
(iv) estimated life and replacement cost.

d) Adequate storage space

e) Suitability and adequacy of space for expansion

f) Insurance (fire, flood, wind-storm, burglary, etc).

5.02 Machinery and Equipment

a) Major sections and date of installation and remodelling

b) Type (automatic/semi-automatic/hand operated)

c) Condition (up-to-date/obsolete/ in need of improvement)

d) Annual repairs and depreciation charges. (conservative/ adequate/insufficient)

e) Capacity:

(i) estimated capacity (values) of major sections in the past .. years, working in .. shift/s per day

(ii) production as % of capacity in the past .. years

f) Estimated life and replacement cost.

5.03 State of Integration of Company

(horisontal/vertical/combination of two)

VI. PRODUCTION

6.01 Product/Products

a) Specifications of major products or classes of products

b) Diversification

c) Licensed/own brand

6.02 Operating Methods

a) Operating practices and production techniques (material flow, material balances, fuel and energy balances, spare parts, consumption)

b) Inspection (where, tolerance)

c) Spoilage and waste (how much - increase/decrease)

d) By-products (how much - value - disposition)

6.03 Normal time of manufacturing process from raw material order to delivery of finished product.

6.04 Costs

a) Determine costs and operating profit for each major product or product line in following break-down:

Net Sales Revenue:

Cost of Goods Sold:
- Raw materials 1/
- Direct labor 2/
- Other direct production expenses 3/
- Indirect labor and manufacturing overheads 3/
- Depreciation

Total cost of goods sold

Gross profit

Selling and administrative expenses

Operating profit

b) Fixed and variable costs as % of operating costs.

c) Maintenance expenditures for each of the past .. years.

d) Is cost system in operation:

(i) is inventory control effective?
(ii) how is burden determined?
(iii) how is burden charged?
(iv) how are labour and material charged?
(v) is standard cost system used?: -
- how checked with operating figures?
- how frequently changed?

6.05 Raw Materials and Supplies

a) Volume, unit price and total cost of each major raw material used in production in each of the last .. years.

b) Sources of supply:

(i) domestic/foreign
(ii) sufficient and steady
(iii) procured from one or more suppliers
(iv) adequate supplies in future
(v) possible substitutes.

c) Own raw materials

(i) volume, unit price and total cost of raw material purchased or extracted from own properties in each of past .. years.
(ii) estimated reserves (supporting data)

1/ Show quantity and cost of each major item
2/ Show man hours and rates
3/ Itemize

d) Purchase of raw material and goods

(i) who is in charge of procurement
(ii) principal sources of supply
(iii) trend of prices over past for .. years
(iv) methods of purchasing. Any long term major purchase contracts? (duration, amount, price etc.)
(v) terms of payment for goods purchased
(vi) seasonal variations in company purchases
(vii) seasonal variations in raw material price
(viii) is raw material subject to rationing? (Specifications-quality control)
(ix) is trade in raw material controlled by Government action which affects or could affect raw material supplies)?

e) Inventory: (See also para .03 b)

(i) physical volume, book value and market value of inventory by major items as at date of latest balance sheet
(ii) where is seasonal peak in raw material inventory?
(iii) what portion of present inventories (if any) is not readily saleable because of lack of demand, obsolescence, deterioration etc.?

6.06 Labor

a) Male/Female

(i) Number:
skilled
semi-skilled
un-skilled
(ii) Working hours:
(iii) Number of shifts worked per day:

b) Compensation

(i) direct wages (salaries) and fringe benefits in comparison to other companies in industry:
(ii) method of payment (piece rates, day wages, hourly rates)
(iii) how frequently adjusted?
(iv) incentive scheme?

c) Conditions in plant

(i) labour turnover (rate)
(ii) accident and occupational disease record
(iii) strike record

d) Government regulations

6.07 Production Programme

a) How much on order
b) How much on stock

6.08 Patents, licences, technical assistance contracts, held by company

6.09 Training Programme

VII. SALES AND SALES ORGANIZATION

7.01 Sales

a) Volume and value (net sales proceeds of Company sales) by major products in each of the last four (preferably more) years. Note importance of returns and cancellations.

b) Total sales of domestic industry and of importers of some products and the company's shares in the domestic market in each of the last .. years.

c) Export sales (volume, destination and proceeds) in each of the last .. years.

d) Backlog of unfilled orders at the end of each of the last .. years.

e) Any marked seasonal variations in company sales and receivables?

f) What percentage of sales are replacement parts?

g) Average domestic selling price of each major product at the factory, and at wholesale or retail in each of the last .. years.

h) What terms are allowed regarding to time of payment (discounts and commissions?)

i) Average export price of each major product at factory and f.o.b. home port or c.i.f. foreign port in each of last .. years.

j) Sales break down by ultimate users for last .. years.

7.02 Distribution:

a) Channels

(i) Own salesmen
(ii) Selling agent or broker
(iii) Middle men
(iv) direct to consumer
(v) what percentage of sales are made respectively to each of the above categories?

Note any important changes in distribution methods made in recent years or any changes contemplated for the future.

b) Contract Sales

(i) to whom
(ii) how long
(iii) price above or below market
(iv) percentage of total out-put

c) Note any franchises under which company operates.

7.03 Sales Organization.

a) Who is the Sales Manager, what is his experience?

b) Number of salesmen and territory covered by them

c) Advertizing and promotion (present and planned)

d) Budget of sales department (present and planned)

7.04 If a subsidiary or associated Company or individual person is the sole agent or intermediary for the sales of the company's products or for the procurement of goods, raw materials and supplies, what are the inter-company arrangements, in particular:

a) What sales prices are charged to the subisidiary and how do these compare to current market prices?

b) What prices are paid to it for goods and materials procured?

c) What are the subisidary's commisions, fees, share in profit etc?

7.05 Competitors

a) Principal competitors in the domestic market, their estimated annual sales and share of the market.

VIII. FINANCE

8.01 Accounts and Statements

a) Copies of last four (or more) published Annual Reports.

b) Copies of Balance Sheets and Income and Surplus Statements for the last four (preferably more) years and as of a more recent date. (If consolidated, obtain statements of subsidiaries).

c) Auditors report and certificate covering all financial statements furnished. Certificate should show:

(i) nature and scope of his audit
(ii) statement as to soundness and consistency of accounting principle applied.

8.02 Analysis of Statements

a) Prepare summary of comparative Balance Sheets and Income and Surplus Statements for the last ,. years and any more recent date.

b) Analyse important changes during the period under review in assets, liabilities, income or expense items. Use significant ratios to illustrate the position.

c) When a Parent Company/Subsidiary relation exists, a thorough investigation must be made of the inter-company relationship. Complete up-to-date financial statements must be obtained of each of the subsidiaries for an analysis of the company's over all position. The commercial, financial and managerial inter-relationship between the parent company and its subsidiaries must be properly explored.

8.03 Particulars of Balance Sheets

Analyse major categories of balance sheet - identify significant items - note any variations in accounting methods.

a) Receivables

(i) are receivables being financed by discounting or other means and at what terms?

(ii) amount of claims overdue as of date of last balance sheet.

(iii) amount of debt written off in last .. years.

b) Inventory:

(i) method of valuation (cost or market, LIFO, FIFO).

(ii) does it include any unsaleable or obsolete stock. (see para 8.05 c)

c) Fixed Assets

(i) changes in fixed assets in each of the last .. years specified as follows:

Book value of fixed assets at beginning of year (describe basis of valuation)

plus — acquisitions during the year, at cost

minus — retirements or sales during the year, at book value

minus — normal depreciation

minus — extraordinary depreciation or write-offs (or plus any shortfall below normal depreciation)

plus — revaluation of fixed assets

Book value of fixed assets at end of year.

(ii) Depreciation rates used. Is there any provision for accelerated or extraordinary depreciation? If so, how has it been calculated. Determine amount included in depreciation charges in each of the last .. years as well as amount included in depreciation reserve in each of the last ... balance sheets.

d) Investments

(i) Itemized list of investments at book value, giving for each name and nature of company, location, percentage of ownership and, if marketable, the current market value;

(ii) Copies of latest available accounts of any companies in which the present concern has a major interest.

e) Short-Term Debt

(i) Itemized list of short-term loans outstanding at date of latest balance sheet, showing for each the date of loan agreement, original amount, amount outstanding, unutilized balance available, interest rate, maturity and security provisions;

(ii) Total and unused balance of lines of credit, normal renewal procedures, any special provisions or understandings with respect to renewals.

f) Notes payable (average life at end of each of past years).

g) Long-Term Debt

Itemized list of issue outstanding at date of latest balance sheet, showing for each;

(i) date of issue
(ii) original amount and currency
(iii) amount outstanding
(iv) interest rate
(v) maturity

Description for each issue outstanding of redemption, security provisions and any other conditons and covenants (see par.4.02).

h) Deficiencies

(i) Debt interest and/or principal in arrears (amount and period of time for each issue)

(ii) Preferred dividends in arrears (number of periods behind).

i) Capital

Position as of date of latest balance sheet on Capital Account:

(i) for Shareholders Companies

Share Capital - authorised
- issued
- subscribed
- paid-up

(ii) for Private Firms

Capital Account - balance at beginning of year

plus: net profit for year, deposits during year

less: loss for year, withdrawal for capital, tax payments (specify) other withdrawals, balance at end of year.

j) Owners' Account

Amounts outstanding from or due to partners/directors

k) Surplus

Position as of date of latest balance sheet on Surplus Account:

(i) Earned

(ii) Unearned - appreciation of assets (revaluation, write up)
- premium on bonds or stocks
- other (specify)

l) Reserves

Purpose and principles of allocation to all reserves and adequacy of reserves

(i) Bad Debts
(ii) Depreciation
(iii) Inventory (see 3.03 b)
(iv) Tax
(v) Hidden

m) Other

Review transitory accounts, deferred charges and other assets and liabilities classified in the balance sheet as "Other".

n) Contingencies

(i) Notes and receivables discounted
(ii) Guarantees, endorsements
(iii) Contingent liabilities in regard to subsidiaries

o) Bad Debt

(i) average annual amount written off during the past .. years

(ii) total amount of claims overdue as of date of latest balance sheet and percentage of nominal value at which these claims are recorded.

8.04 Particulars of Income Statements

Analyze major categories of income and expenses, note variation (if any) in accounting methods:

a) Break down of cost of goods sold for the last four (preferably more) years in the form used for costs (see para 6.04)

b) Break down of "non operating income" and "expenses". Identify major items as to their nature and recurrence (sales proceeds of bonus vouchers, profits from write-up or sales of assets, premium on shares sold etc.)

c) Summary of Surplus and Reserves (appropriation account), for the past .. years, in break down.

8.05 Tax Position

Tax legislation applicable to company and rates and methods of calculation for:

a) production or turnover taxes

b) income tax

c) property tax

d) other taxes

8.06 Insurance

Insurance coverage of fixed assets, inventories etc. (amounts in force, types of risks).

8.07 Is there any pending litigation either by or against the company (details).

155. Questionnaire, part two:

The second part of the questionnaire deals with the new project, the requirements for the expandes operations. The information to be supplied will follow the pattern of the present appraisal report (XYZ Woollen Mills Ltd.). Market studies and price policy will be on the basis of the combined capacity of the old and the new plant. The additional production facilities, namely buildings, machinery and equipment to be specified and consolidated tables, showing existing and new assets are to be prepared. The financial calculations and the tables relating to working capital, cost of goods manufactured, cash flow and balance sheet will of course refer only to the increased production capacity and the increased sales volume.

THE BALANCE SHEET

156. Every project brings the development banker in contact with balance sheets, especially the financial analyst, the accountant or the loan follow-up officer. How much can they depend on balance sheets? How true and correct are they? Is it necessary to analyze in depth a balance sheet after the auditors have given their opinion 'it being a true and fair statement of the financial affairs of the enterprise'?

157. Balance sheets, by their nature and construction are not exclusively statements of facts, but present an amalgam of fact and opinion. Many figures rest upon estimation which may quite vary between wide limits. An authority on accounting stated: "Financial analysis of a balance sheet will not give an absolute answer to every question of doubt, but it can and will point to the direction in which further inquiries should be made."

158. It is not possible to go in the present "guide lines" into all details of "balance sheet probing". Loan officers, in particular financial analysts, will be interested to study "Balance Sheets and the lending Banker", written by J.H.Clemens and published by Europa Publications Ltd., London W.C.I., 18 Bedford Square.

159. However, a few observations which may prove useful to loan department officers:

160. a) It is essential to understand the difference between a balance sheet of a sole proprietor, a partnership, or a corporation, the most common being a limited company.

161. The balance sheet of a sole proprietor will give a very incomplete picture as it shows only the assets employed in the business, but not his private ones (with which he guarantees) and only those liabilities, which arise directly out of it. The profit and loss statement will be more useful, as it will show the scale of operations and the years results.

162. The balance sheet of a partnership (a firm), if properly drawn up, will show all the assets and liabilities of the business. A creditor of the firm has recourse to the private means of all the partners.

163. The balance sheet of a limited company will show its complete position. All assets and liabilities are clearly and unequivocally stated.

164. To sum up, the balance sheet of a limited company is the most exact, that of a partnership most conservative and that of a sole proprietorship the least complete or reliable.

165. b) Current and liquid assets are often not sufficiently differentiated. Current assets are all the assets comprising the floating capital employed, liquid assets only those current assets which are cash and those which can be instantly turned into cash.

166. c) The amount of working capital is the excess of current assets over current liabilities. However, in the project appraisal report "XYZ Woollen Mills Ltd." the expression "working capital requirements" is used, meaning the minimum essential for maintaining operations which can be more or less of the working capital revealed in the balance sheet.

167. d) Of special interest in the balance sheet are the reserves. There are true reserves, backed by accumulated profits in the profit and loss account. Otherwise, when there appears in the balance sheet a reserve or any item with a similar general designation, then frozen capital may be suspected and a lack of ready cash.

168. Hidden reserves: On the left-hand side of the balance sheet, hidden reserves show often up as "sundry creditors and other credit balances" or "Creditors, including provisions for contingencies".

169. Secret reserves: are created

- by charging capital expenditure on fixed assets to revenue (example: building a factory extension with own labour)
- by making excessive provision for wear and tear, reducing value of fixed assets or for bad debts
- by undervaluation of stock or work in progress

170. e) The rate of turn-over shows up the marketing capabilities of management. It is computed by

$$\frac{\text{cost of [illegible] manufactured during the year}}{\text{average stock}}$$

Other things being equal, the faster the stock is turned over, the better for the finances of the company.

171. f) Consolidated accounts are prepared by amalgamated group of companies. Consolidated accounts are designed primarily for the information of shareholders. The development banker can only draw sound conclusions from the balance sheet if prepared individually for each company. In fact, these companies remain separate legal entities.

172. g) The break-up value from a balance sheet is to ascertain an insurance or salvage figure which should be realized if the enterprise fails. However, if a forced sale takes place, due to business failure during a worsened sales climate, the competition suffering equally, a prospective buyer will be discouraged to purchase the enterprise, except at a bargain price. The values of assets from the balance sheet, while the company is a going concern, will have in most cases no relation to their break-up value, if the undertaking fails. No rules exist for such cases, only a cautious sometimes pessimistic analysis can produce a reasonable break up value.

173. h) Over-trading, a most common feature found in developing countries, is simply a matter of trying to maintain a scale of operations with insufficient cash resources.

174. Reasons are attributed to:

- inflation and rising prices
- increased stocks
- heavy taxation
- depletion of working capital
- over expansion

175. The cure for over-trading is of course in finding sources for additional cash, or by reducing operations, reducing stocks, and other means.

176. Signs of over-trading can be found in the balance sheets, if

- there is a progressive fall of the debtors/creditors ratio
- without an increase in turnover the total loan amount increases, the creditor accounts increase or the stocks and work in progress increases
- new bills or promissory notes are issued
- bills receivables decrease
- there is a fall in the working capital ratio

i.e. $\frac{\text{Working Capital}}{\text{Cost of Production}}$ or $\frac{\text{Working Capital}}{\text{Sales Value}}$

- above all there is a reduction of the liquid resources and failure to raise fresh cash by borrowing, as one pledgeable asset after another is being mortgaged.

177. For the entrepreneur and the banker alike, however, better than any cure is prevention. The effects of over-trading can be disastrous and even lead to complete failure.

178. i) Financial interior reports and balance sheets are safeguards for the entrepreneur as well as for the development banker. The more frequently they are examined and analysed, the sooner troubles can be detected and a cure devised. Above all, LIQUIDITY is the main requirement for any business, cash must be available or obtainable in the right quantity and at the right time.

(SPECIMEN)

FINANCIAL AND LEGAL CONDITIONS FOR

A PROPOSED LOAN

"XYZ Woollen Mills Ltd"
Agreement on the enclosed
conditions reached with the
sponsors of the proposed
on ..... 19..

CHAPTER IV.

FINANCIAL AND LEGAL CONDITIONS FOR THE LOAN

"A" SPONSORS AND CORPORATE SET-UP

179. "XYZ Woollen Mills Ltd" (proposed) will be a private limited company, to be incorporated at ..... with an authorized capital of C.U. 2,000,000 and a paid-up capital of C.U. 1,000,000 divided into ordinary shares of C.U. 100.- each.

180. The paid-up capital will be subscribed by the six proposed directors. Names and addresses of proposed directors along with their contributions towards paid-up capital and extent of shareholdings are:

	Name	Address	Amount C.U.	Percentage
1.	Mr. A	.....	250.000	25 %
2.	Mr. B	.....	200.000	20 %
3.	Mr. C	.....	150.000	15 %
4.	Mr. D	.....	150.000	15 %
5.	Mr. E	.....	150.000	15 %
6.	Mr. F	.....	100.000	10 %
		Total C.U.	1,000,000	100 %

181. In addition, the directors will provide a long-term loan to the company of C.U. 312.000. The loan will carry an interest of 6 % (1 % above the Bank Rate) per annum. The loan will not be repaid to the directors during the subsistance of the Development Bank's loan to the company.

"B" MANAGEMENT

182. The company will be controlled and managed by its Board of Directors, consisting of all six directors. All the members of the board have long commercial experience. Mr. A, being the largest shareholder, will assume the Managing Directorship. As a progressive and experienced businessman, he is considered to be able to manage successfully the affairs of the company.

Production management and technical supervision will be in the hands of Mr.C, who has had previous experience in the manufacture of woollen yarn. The other directors will look after finance, marketing and administration.

"C" SECURITY

183. The proposed development bank loan for foreign currency, equivalent to approx. C.U. 605.000 will be secured by mortgage/hypothecation by way of first charge on the fixed assets of the company, estimated at C.U. 1,572.000 on completion. Furthermore, the loan will be secured by personal guarantee of all the directors and an interim bank guarantee from a recognized commercial bank, to ensure timely completion of the project and the mortgaging of the assets to be created.

"D" RECOMMENDED CONDITIONS FOR THE LOAN

184. After consideration of all financial, market and technical aspects, the project "XYZ Woollen Mills Ltd" is feasible and suitable for the Bank's financing. The foreign currency loan may be sanctioned on the Bank's standard terms (credit agreement and agreement on hypothecation) and the following conditions:

1. Amount of Loan: Foreign currency loan, equivalent to approx. C.U. 605.000

2. Repayment: in 20 half-yearly instalments, beginning from date of establishment of Letter of Credit to equipment suppliers. Foreign exchange risk to be borne by borrowers.

3. Rate of Interest and other Charges:
   a) Interest at 8½ % per annum
   b) Half of 1 % per annum payable to the Government half-yearly to cover the exchange rate risk beyond the loan period.
   c) Commitment, commission and other charges as per rates in force from time to time and communicated to the borrowers.
   d) Additonal interest by way of liquidated damage at 2 % per annum shall be payable by the borrowers to the Bank on the instalments of the principal of the loan, interest, commission and any other cost, charges and expenses not paid when due.

4. Security: a) Before opening of letter of credit for the supply of machinery by the Bank, an agreement to mortgage/ hypothecate by way of first charge on the fixed assets of the project to be created, estimated at C.U.1,572.000 as under:

Land	C.U. 60,000
Buildings	C.U. 255.000
Machinery	C.U.1,251.000
Furniture + others	C.U. 6.000
Total	C.U.1,572.000

The valid mortgage to be created after installation of machinery.

b) An interim bank guarantee from a scheduled bank, acceptable to the lending development bank on the prescribed proforma, for the entire amount of the loan, plus interest and exchange rate risk. The bank guarantee will be released after:

(i) completion of the project to the satisfaction of the Bank and creation of fixed assets of C.U. 1,572.000 and the completed mortgage transaction,

(ii) the sponsors/directors have raised and paid-in in full the equity capital of C.U. 1,000.000, as well as the additional long-term loan of C.U. 312.000, carrying a 6 % interest per annum,

(iii) the sponsors/directors have deposited with the Bank 51 % of fully paid-up shares, out of the total issued capital of C.U. 1,000.000, along with blank signed transfer deed by all shareholders, as collateral security, which shares will not be sold/ transferred or assigned to any third party during the duration of the Bank's loan.

c) Personal guarantee of all the directors of the company, namely:

1. Mr. A .....
2. Mr. B .....
3. Mr. C .....
4. Mr. D .....
5. Mr. E .....
6. Mr. F .....

5. Capital Structure:

a) Before signing the loan agreement, the sponsors/ directors shall

(i) form a private limited company with an authorized capital of C.U. 2,000.000, divided into one class of ordinary shares only, of C.U. 100.- each, and submit the certificate of incorporation to the Bank.

(ii) issue share capital of C.U. 1,000.000, of which C.U. 300.000 shall be paid-up and an auditor's certificate produced to this effect

b) Before opening of letter of credit, the sponsors/ directors shall

(i) raise the paid-up capital to C.U. 500.000 and produce an auditor's certificate to this effect,

(ii) submit an undertaking from the directors of the company to advance a long term loan of C.U. 312.000 as well as any other amount arising from over-run of expenditures on fixed assets of the company, in order to complete the project. The loan from the directors shall carry interest at 6 % per annum, and shall not be repaid without the prior approval of the Bank during the subsistence of the Bank's loan.

(iii) submit an undertaking to raise the paid-up capital from C.U. 500.000 to C.U. 1,000.000 within 12 months following the opening of the letter of credit for the supply of machinery and to produce an auditor's certificate to this effect.

6. Special Condition:

The company shall submit a guarantee in writing to export at least 20 % of their production or such other percentage as may be fixed by Government from time to time.

Date: 19..

Chief Manager

Signatures:

Manager, Loan Dept.:

Project Officer:

"XYZ" CREDIT REPORT

STRICTLY CONFIDENTIAL

Credit Information on the Sponsors of "XYZ Rollen Mills Ltd" and their Reputation.

Investigating Officer: Mr. .....

185. Credit information on the directors of the above company (proposed) collected from commercial banks and other trade sources appears to be satisfactory from the financial angle.

186. The commercial bank A.B.C. states in their credit information:
. . . . . .
. . . . . .
In addition, the manager of the bank declared verbally: . . . . . .
. . . . . .

187. The commercial bank D.E.F. states in their credit information: . . . . . .
. . . . . .
In addition, the manager of the bank declared verbally: . . . . . .
. . . . . .

188. The following trading companies were contacted: ....., ..., ..., and their owners confirmed more or less the opinions of the bank managers.

189. As from the details above can be seen, the combined worth of all the sponsors, in properties, participation in business and bank accounts may be estimated at C.U. 3,500.000.

190. Other independent enquiries reveal that the sponsors/directors of the proposed company are considered successful business men, who so far have built up profitably any trading business they have undertaken. They have not been engaged in production, but being all-round men of long experience, it can be safely assumed that the new enterprise will prospor.

191. Their reputation, especially Mr. A. and C., has been characterised as "very sharp" and "extremely clever", who would not mind taking advantage of "legal loopholes", it is recommended to apply all safeguards to the conditions of the loan agreement.

Date: ..... 19..

COMMENTS AND OBSERVATIONS

on the Financial and Legal Conditions for a Proposed Loan

NEGOTIATIONS

192. After having received instructions from the Chief Executive of the Bank to proceed with the investigations, the project appraisal team consisting of the economist, the engineer, and the financial analyst, will study and discuss the loan application of the sponsors for the new project. The facts and figures of the application have to be checked, meetings with the sponsors arranged to clarify inconsistencies and omissions in the documentation, visits made to the site and the technical, marketing and financial aspects duly scrutinized.

193. As soon as the feasibility and the viability of the project appears to be auspicious, the team will inform the Chief Executive of their preliminary findings. Meanwhile, the credit officer will have given the Chief Executive a brief report on the financial standing and reputation of the sponsors. Either the Bank applies a set of standard financial and legal conditions to all loans or the Chief Executive indicates these conditions to the team, which will serve as the negotiation basis for the financial part of the loan agreement.

194. The project appraisal team, with or without the assistance of other executives, will then inform the sponsors of the financial and legal conditions of the loan agreement, as well as of the covenants to be observed by them.

195. Only after all details have been fully discussed and the conditions accepted by the sponsors of the project, will the team start to prepare the appraisal report, which will serve the board of directors or any other sanctioning authority as the main document for the approval of the loan.

RIGID FINANCIAL AND LEGAL CONDITIONS

196. The financial and legal conditions, quoted in the specimen agreement, are severe and rigid. They have been put together for an extreme case to show the variety of possible solutions.

197. In comparing financial and legal conditions for the loan agreement, as imposed by institutions in industrialized and in developing countries, it can be found that industrial development banks in developing countries impose more severe conditions than in the USA, Europe or Japan. This is even more noticeable with banks, which over the years have suffered losses on their investments or which have been involved in frequent litigation with their clients. Bad experience have made them overcautious.

198. The reasons for such rigid conditions are manifold:

199. The capability of management to operate the enterprise profitably has not yet been proven, therefore safeguards are necessary.

200. Legal procedures at court drag out sometimes for years, thus depriving the bank of needed funds. Meanwhile it is more than probable that the financial position of the company is worsening. If one assigned security fails, another might achieve the purpose of recovering the amounts due.

201. Other borrowers contend that the financing institution's only function is to provide the money for the project and that thereafter the bank will be repaid whenever the borrower thinks it convenient. They are also trying to exploit "loop-holes" in the agreement for their own gain and adopt a negative attitude of their commercial and financial obligations to the bank.

202. The observations in the following paragraphs may serve as an explanation for the severe conditions, some industrial development banks have to impose on their clients:

203. Fee to the Government for exchange risk (para 3, c)

The fee of ½ % p.a. is enforced by the Government to cover the exchange rate risk beyond the loan period. Government provides the foreign exchange for a development bank loan from a line of credit, granted

by a foreign Government or an international finance institution. Should the repayment of the foreign credit take place at a later date than that of the borrower's loan, the Government could be involved in an exchange rate risk.

204. Additional interest (para 3, 1)

The rate of interest charged by the banks in all developing countries lower than the going interest rate on the market. Borrowers, who have to repay other loans, to creditors or commercial banks, are tempted to delay the payment of instalments to the development bank over and above the due date and use thus the cheaper credit for their other financial transactions. In however the development bank has to budget the timely inflow and outflow of cash, it must protect itself against such practices by charging an additional rate of interest for all moneys not paid when due.

In case the delay in repayment has not been caused by a fault of the borrower, the bank usually waives the additional interest.

205. Interim bank guarantee (para 4, (ii))

At the time of opening the letter of credit by the development bank for the machinery, the bank insists on obtaining an interim bank guarantee from a scheduled and recognized bank, as at that time no other tangible security is yet in force. The interim bank guarantee will be released after the conditions a), b), and c) are fulfilled.

206. Deposit of 51 % of paid-up shares (para 4, (ii), c)

This condition is meant as a safeguard against deception. Some cases are known where certain sponsors formed a limited company and applied to the development bank for a long term loan. The bank refused the loan mainly on moral grounds and for reasons of previous shady deals of the directors. A new company is now formed with "straw-men" as directors, whose reputation is acceptable to the bank and the loan is granted to the new company. As soon as the project is completed, the shares of the company are sold to the group which in the first instance was unacceptable to the bank. The bank has no legal regress against

the company, which as a legal and impersonal entity can change hands through the sale of its shares.

207. Personal guarantee of the director (para 4, (iii))

The condition, that directors have to sign a personal guarantee for the loan amount is closely connected with what has been stated under "break-up" value of an enterprise (see "The Unlessed Sheet"). A forced sale of the fixed assets may or may not cover the outstanding debt of the company to the development bank, and the personal guarantee of the directors would assure the recovery of any difference, still due.

208. Pay-up of share capital (para 5, (i) and (ii))

The development bank must ensure that the share-capital is paid-up at times, when needed, to enable the company to pay for construction of buildings and installation of machinery. Otherwise, sponsors short of funds approach the bank for unscheduled advances and upset a pre-arranged budgetary plan which has to be avoided.

209. Assignment of life-insurance of the directors:

In certain cases, where the security provided by the sponsors is slightly below the required level (but the project has its merits) and no additional security can be arranged, the life insurances of the directors are assigned to the development bank.

CHAPTER V.

FEES AND COMMISSIONS

210. The financial and legal conditions of the agreement include already the obligatory ½ % fee for the exchange rate risk beyond the loan period, payable to the Government.

211. There are however other fees and commissions, which are usually payable by the sponsor/s to the industrial development bank. They have to be deposited with the bank at the time of negotiating the loan and are not specifically mentioned in the agreement. All the fees and commissions, as outlined below, will be refunded to the sponsor/s, with the exception of the technical examination fee, in case the loan applied for is not approved by the bank.

212. Technical examination fee:

This fee is charged at the rate of ... % (usually ½ to 1 percent) on the loan amount applied for to compensate the bank for extensive investigation and examination of the project to be financed.

213. Documentation fee:

This fee is charged at the rate of ... % (usually ½ to 1 percent) of the amount of loan sanctioned to cover the legal expenses of the bank for the preparation of the loan agreement and related documents.

(The drawing up of the loan agreement and other legal documents is not handled uniformly in all developing countries; the laws and practices differ widely. Furthermore, the long established and larger development banks have their own legal department and prepare the documentation themselves. This practice is followed mainly by public (state-owned) development banks. Privately owned and "mixed" development finance institutions, as well as newly established and smaller banks, entrust normally a law firm with the preparation of all legal documents. The sponsor/s pay the legal expenses to the bank, which in turn re-imburses the law firm.)

214. Commitment charge:

A commitment charge at the rate of ... % (usually ½ to 1 percent) per year is payable to the bank on the amount of loan sanctioned, but not utilized by the sponsor/s. When a loan is sanctioned, the bank has to set apart necessary funds for disbursement. Such idle funds do not earn any interest. In order to compensate the bank for such loss of interest and to encourage the sponsor/s to utilize their loans quickly, the commitment charge is imposed.

215. Letter of credit charges:

Letter of credit charges are paid to the bank at the rate of ... % (usually one percent) of the loan amount for foreign currency loans. These charges are then adjusted against letter of credit commission, which is generally payable at the rate of ... % (usually from 1/8 to 1/4 percent) per quarter, with effect from the date the letter of credit is established and until the letter of credit expires.

CHAPTER VI.

STATISTICS, PROJECT PROTOTYPES AND EXCHANGE OF INFORMATION

RECOMMENDED SOURCES FOR STATISTICS

216. Statistics are an essential tool for the appraisal team, especially for the economist. Domestic statistics on imports, exports and commodities reveal valuable data and should be used to the best advantage. However, not all developing countries have well organized and well equipped statistical offices and often important data are not available from domestic sources.

217. The most complete range of versatile and world-wide statistics for the use of industrial development banks are published monthly and yearly by the

United Nations Organization in New York and the
Organisation for Economic Co-operation and Development
(OECD) in Paris.

218. Appraisal teams of industrial development banks will be particularly interested in:

United Nations Monthly Bulletin of Statistics, Order No.St/STAT/Ser.Q
United Nations Commodity Trade Statistics/Series D

219. For ordering the address is:

United Nations, Sales Section, New York 10017, N Y. U.S.A.

220. To select the required statistics from OECD, a "Catalogue of Publications" (giving a complete list of all monthly and yearly publications) has been issued and may be requested from:

OECD Publications Office, 2 rue André Pascal, 75, Paris 16e, France.

PROTOTYPES OF APPRAISAL

221. Of particular interest to all members of the appraisal team are the "profiles of manufacturing industries" (completed appraisals) and the "feasibility studies" (pre-investment surveys), which describe in detail the economic, technical and financial aspects of several hundreds various industrial enterprises. Much knowledge and expertise can be gained from their study.

222. Here are some of the recommended publications:

Medium and large-scale projects:

UNIDO, Profiles of manufacturing establishments

Vol.I, Sales No. 67. II. B. 17
Vol.II, Sales No. 68. II. B. 18

UNIDO, Extracts of feasibility studies

(to be published shortly)

The address: Industrial Documentation Unit
United Nations Industrial Development Organization
P.O.Box 707
A-1011 Vienna, Austria

Small-scale (light) industrial projects:

U.S. Agency for International Development has published "Fact Sheets" for over 300 small-scale projects, describing the machinery, process, investment and finance (on 8 pages).

For the "Index to the catalogue of Investment Information and Opportunities" write to:

Agency for International Development, DPT
Washington, D.C. 20523
U.S.A.

EXCHANGE OF INFORMATION ON PROJECTS

223. Scheme for exchange of information on industrial projects in developing countries among Development Financing Institutions:

224. UNIDO has established a mechanism to promote, on a permanent basis, the exchange of information on industrial projects among industrial development financing institutions, thus assisting banks in developing countries to obtain technical or financial information for the appraisal of new projects.

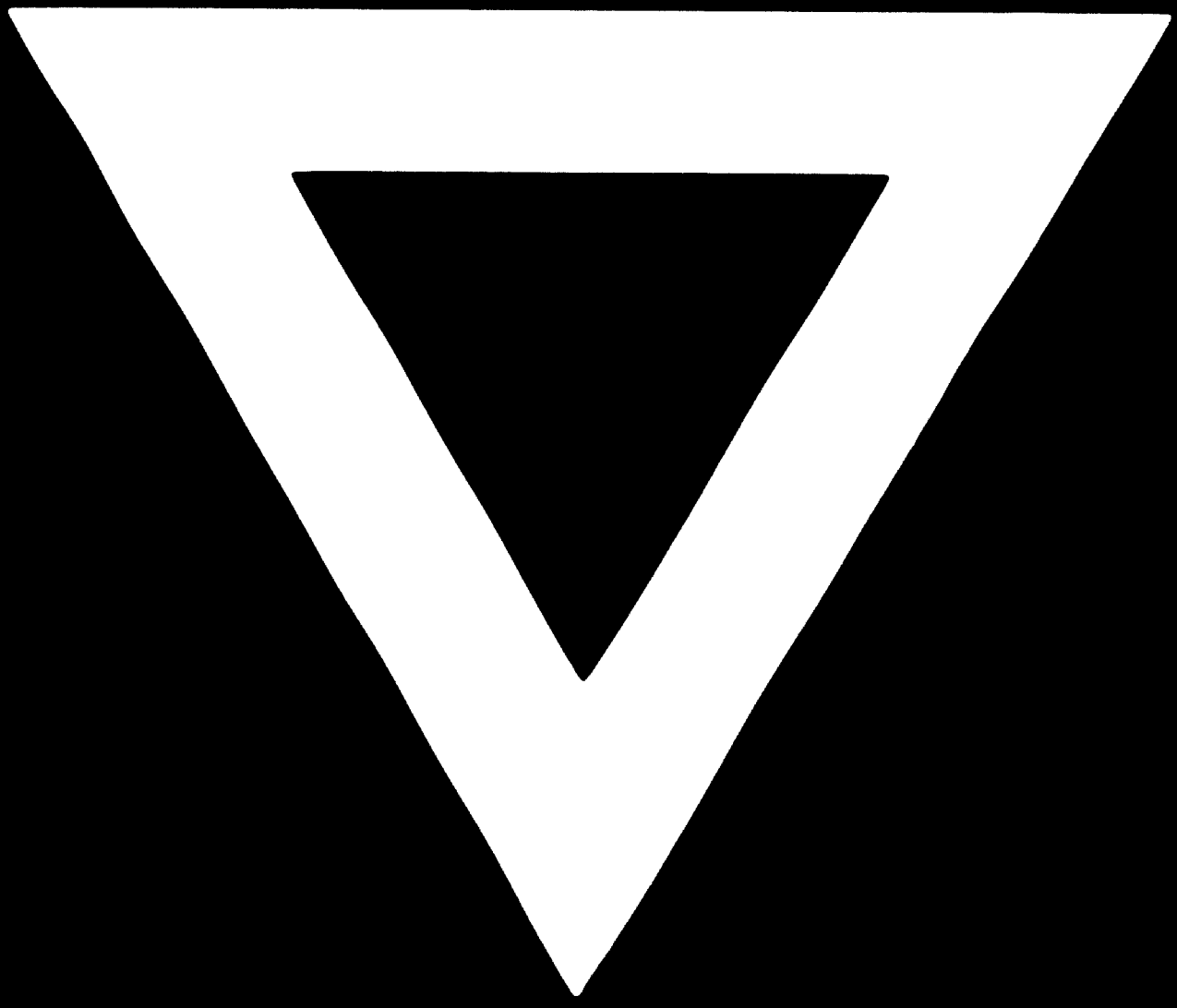
225. If, for instance, an industrial development bank requires a pertinent information on a particular industry for the feasibility study or appraisal, the type of industry, the yearly capacity, and the anticipated cost of investment is communicated to UNIDO. UNIDO will then indicate the names and addresses of those institutions which have financed a project of similar size.

226. In order to safeguard the confidentiality of individual project information, the exchange of information will be on a strictly bilateral basis; that is, detailed information on the problems involved in planning, construction and operation, and the lessons learned therefrom, will be passed on directly from one development financing institution to another without going through any intermediary. In this way, the financing institution having the information will give to another only what it considers to be appropriate and on the basis of a strictly private relationship.

227. The address to write to:

Industrial Financing and Investment
Promotion Section, IFI
United Nations Industrial Development Organization
P.O.Box 707
A-1011 Vienna, Austria

[redacted]



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