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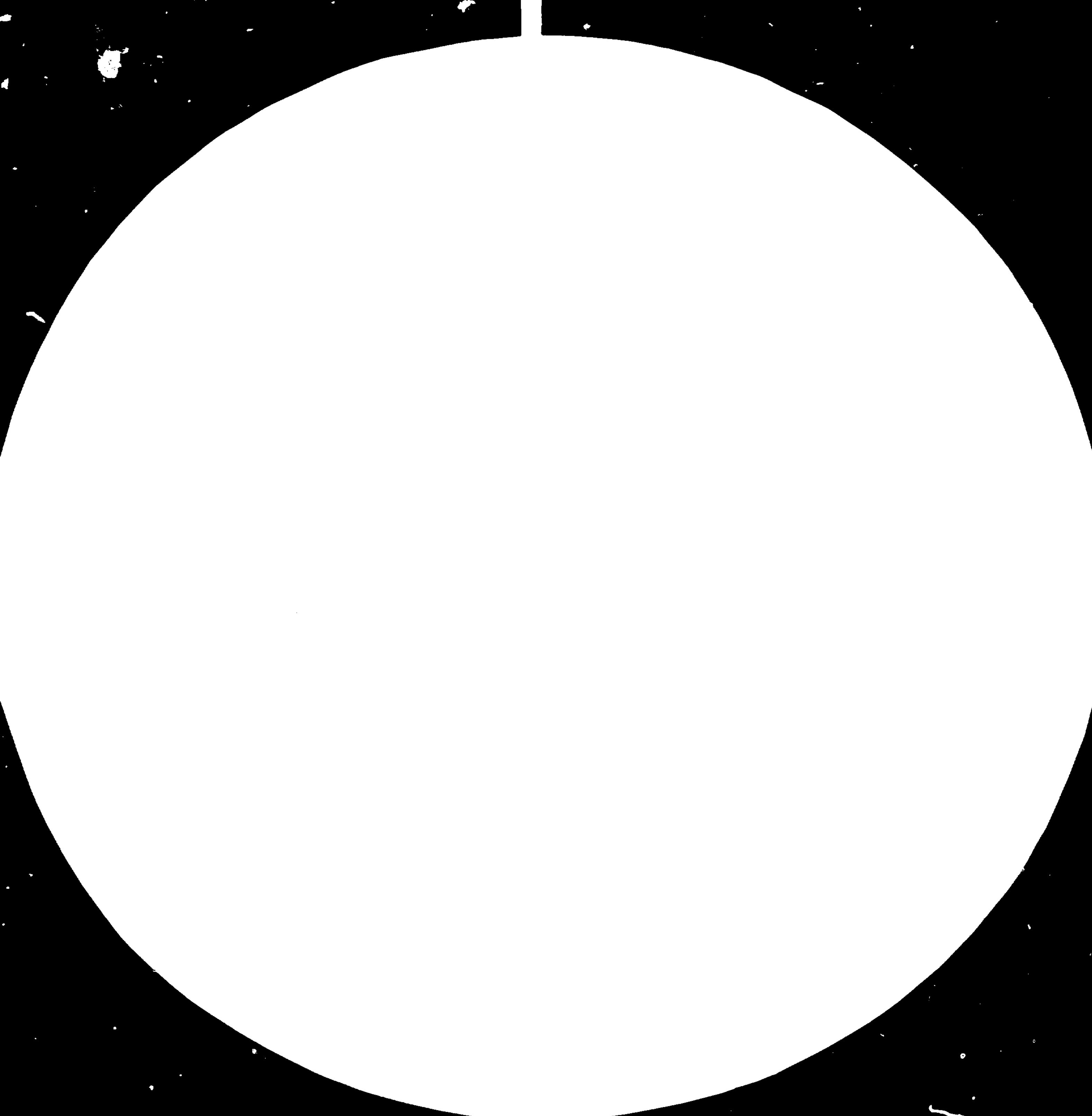

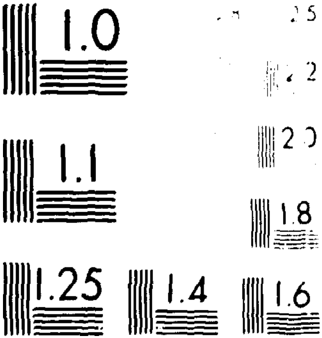
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INFORMATION PAPER

FINANCIAL EXPERTISE
FOR PROJECT NEGOTIATION*

by

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C O N T E N T S

I. INTRODUCTION

Relatively decreasing availability of adequate financing (amounts, terms, sources) for increasing finance requirements of industrial projects require more sophisticated expertise in project arrangements and implementation. This is supported through the increased utilization of commercial bank and export financing, as predominant financing sources for industrial projects, on one side and the increasing competition for these funds on the other side. Availability, amounts and terms of these financing sources are, to a large extent, subject to sophisticated project preparation and negotiation. Such expertise is not limited to arrangement and negotiation of financing. Adequate project preparation, project scope, institutional set up and consideration of political priorities are equally important for the successful development of any project.

The scope and merits of the financial expertise required have been neglected in the past. As compared to technical aspects of projects, institutional, organizational and financial aspects have not been properly emphasized, thereby resulting in (i) inadequate institutional arrangements (ii) poor financial structure (iii) substantial delays and (iv) poor project quality. Developing Countries (DC's) have suffered, projects were delayed or not undertaken at all. It has not been properly considered that these aspects form an integral part for a successful project, just as the technical part. Also, complying with requirements of potential lenders and optimizing financing from different lending sources (Cofinancing) has resulted in increased handling com-

<u>plexity of projects</u>. Such sophisticated financial expertise needs to be understood in the broadest sense, not just for loan arrangement and negotiation. In addition to technical aspects of projects, all other project aspects need to be evaluated and narrowed down during project preparation, in order to improve economic benefits of project and optimize financing. In case of financial participation of the international development banks, to some extent, such assistance or focus is being handled by these institutions. Therefore, financial expertise on projects in DC's is particularly required for commercial bank financing, export financing and a combination of lending sources (Cofinancing). Adequate financial expertise would not only improve projects and financing but would provide more continuity to project management, strengthen the development of the individual project and the negotiating position of the DC's. The detailed scope of the financial services has been presented in Annex 1. The following chapter summarizes the possibilities of improvement and the steps required for the different parties involved.

II. STEPS REQUIRED

A. Project Sponsor/DC Governments

1. Improved build-up and provision of staff with basic experience and potential, in order to acquire and develop financial expertise.

2. DC Governments and local development banks should be instrumental in promoting the build-up of financial expertise through adequate policies, financial support and institutional back up.

3. Proper attention on continuity and incentives for retaining qualified local staff should be established.

4. Temporary outside assistance from specialized companies and staff would be helpful. However, it can not replace local team; provision of counterpart team is essential for success of outside financial advise.

5. Proper financial expertise is a basic ingredient for the introduction, negotiation and implementation of any industrial project to the financial community, the Government and other parties involved in project.

6. Proper financial expertise would optimize project selection and development, thus substantially downgrading the question of "project quality". If a project is within an acceptable range and supported by Government, a highly skilled team should be in a position

(i) to taylor project in accordance to different needs

(ii) to obtain financing even if some of the mayor financing sources do not support project

(iii) to compete successfully in obtaining financing with other projects within country and other countries

(iv) to improve negotiating position for project and respective DC

(v) to eliminate procurement penalties

B. Local Development Banks

1. Build-up and establishment of financial expertise through permanent group of financial experts.

2. Such group would be involved in the design, negotiation and implementation of financial aspects of any large industrial project. It could also provide the nucleus and coordination of financial expertise with industrial entity.

3. Financial expertise unit could also be attached to the Central Bank or the Ministry of Finance and Economics. Close coordination with respective national debt management office would be required, in order to coordinate borrowing policy and conditions with actual project needs and potential funding sources.

4. Institutional and financial back-up of building-up and retaining financial expertise within local

development bank and project unit.

5. Depending on status of financial expertise in DC and complexity of tasks, outside financial advice may be required for specific problems of projects and/or the build-up period of local expertise.

6. Build-up of market related information system and increasing access to market information for use in contract negotiation would be developed in line with sophistication of financial team.

C. International Development Banks

1. Apart from general advice, international development banks cannot replace proper financial expertise in DC's. International development banks can normally also not provide the full service of a financial advisor, unless they are the only lending institution. The DC might also in this case prefer to have its own expertise or outside financial advisor.

2. International development banks can play a valuable role in reviewing and participating in the project development and financing process thereby promoting additional sophistication in this field.

3. As part of financing industrial projects, international development banks should promote to a much larger extent the build-up and provision of financial expertise for large industrial projects and for local development banks. International development banks could thereby support continuity and quality of staff

as well as providing financial and institutional assistance.

D. Commercial Banks

1. Large international commercial banks have been building-up financial advisory services in addition to their lending activities. However, in view of their conflicts of interests, commercial banks can only play a limited role as independent financial advisor.

2. Sophisticated financial expertise for the project sponsor is particularly required, when a combination of financing sources (commercial banks, export financing and international development banks) is envisaged.

3. Cooperation in provision of market data.

E. Investment Banks

Investment banks are normally not involved in lending activities itself. Their mandate has traditionally originated from the borrower, advising about the most suitable form of financing. In the past, investment banks have provided such services for public institutions and private companies in developed countries. In recent years, the involvement of investment banks in DC's has substantially increased, through their traditional clients and their project finance experience. In view of the high skills required, their services are usually costly but worthwhile in view of their worldwide reputation in the financial community.

1. Investment banks can effectively provide financial adivsory services, particularly for

a) large industrial projects,
b) assistance in building-up expertise at local development banks,
c) country borrowing programs and central bank operations.

F. UNIDO

1. Assistance in setting up and financing of financial advisory services for industrial projects, thereby providing

a) quality control of project development,
b) continuity in project preparation,
c) speeding up of implementation,
d) international contracting and financing through UN organisation would attract qualified staff at reasonable costs.

2. UNIDO could supplement its technical assistance activities, thereby taking full advantage of its existing facilities. Furthermore, the technical assistance would be made more effective if it is complemented with financial adivisory assistance.

ANNEX 1

SCOPE OF FINANCIAL EXPERTISE

Many industrial projects in DC's are principally financed with the backing from the respective Government or Local Development Bank, thereby requiring only limited project considerations. However, particularly in case of larger industrial projects and in order to increase and improve the borrowing capacity of DC's, primary considerations need to be given to project financing, which may be supported by Government guarantees as required.

Depending on the specifics of the project, sophisticated financial expertise would particularly cover (i) development, (ii) analysis, (iii) negotiation and (iv) implementation of the following aspects during pre-feasibility, feasibility and implementation stage of the project. Such financial expertise (in addition to technical expertise) would not only improve project preparation and appeal for potential lenders or equity partners, but would also greatly facilitate project advancement with Governments, markets and technical partners. With the professional coverage and consideration of the following aspects during project preparation, chances for successful project advancement should greatly improve:

A. Project Feasibility

1. Feasibility

Potential lenders require complete documentation of technical feasibility by project sponsor:

a) Implementation Schedule
b) Project Scope
c) Technology
d) Resources
e) Transportation
f) Organization and Management
g) Capacity Constraints and Project Phasing
h) Location and Environmental Considerations.

2. Economics

a) Raw Material and Energy Supply:
   - Supply Agreements
   - Costs
b) Project Operations:
   - Start-up Schedule
   - Investment Costs
   - Reinvestments
c) Market Analysis
d) Marketing Organization
e) Sales Contracts and Commitments
f) Pricing
g) Transportation Costs
h) Competing Projects
i) Comparative Advantage of the Project
k) Foreign Exchange Risk

3. Financial Analysis

a) Evaluation of Assumptions:
   - Capital Costs
   - Operating Costs
   - Volume
   - Pricing
   - Demand Growth

b) Project Cash Flow
c) Debt/Equity Ratio
d) Projected Debt Service Coverage
e) Sensitivity Analysis of Rates of Return
   - Implementation Delays
   - Cost Overruns
   - Escalation in Operating Costs
   - Volume Variations
   - Price Variations
f) Breakeven Analysis
g) Ratio Analysis

B. Project Structure

A critical element of project preparation is the development of a sound project credit structure, which would permit access to all relevant lending sources and, at the same time, meet project, sponsor and DC Government objectives. To achieve this, the following issues need particular attention:

1. Business Form of Project Entity

a) Joint Venture
b) Corporation
c) Partnership
d) Other.

2. Financing Vehicle

a) Project Entity
b) Subsidiary of Project Entity
c) Other
d) Government Guaranty
e) Local Development Bank Guaranty.

3. Potential Use of Contracts

a) Form of Contracts
b) Currencies of Contracts
c) Term of Contracts
d) Minimum Volumes
e) Pricing Mechanism

4. Lending Sources and Requirements

a) International Development Banks
b) Export Credits
c) Commercial Banks
d) Capital Markets
e) Other

C. Financing Plan

Detailed consideration of above factors would form the basis for determining the appropriate elements of the Project's financing plan and for developing a strategy of its implementation. This would be done in a manner consistent with sponsor and DC Government objectives and would consist of an examination of the following:

1. Project Debt/Equity Ratio

a) Lender Precedents:
  - Industry Norms
  - Drawdown of Debt and Equity
  - Cost Overrun Provisions and Extent to which Lenders share in Overruns
  - Dividend Policy

b) Return on Investment:
- Local Shareholder
- Foreign Shareholder
- Government

c) Leverage Potential:
- Return on Investment vs. Cost of Debt
- Cash Flow Sensitivity
- Timing of Financing

2. Floating vs. Fixed-Rate Financing

a) Floating-Rate:
- Risk/Reward on Rates
- Variability of Cash Flow
- Usually Short-term
- Prepayment Flexibility

b) Fixed-Rate:
- Manageable Cash Flow
- Limited Sources

3. Currency

a) Hedged:
- Base Currency Financing
- Foreign Currency and Forward Contracts
- Cost of Hedging

b) Open:
- Interest Rate Differential
- Speculative
- Question of Timing (discounted Cash Flow)

4. Sources of Financing

a) Concessionary Sources:
- Export Buyer Credits
- Export Supplier Credits

- Import and Bilateral Credits
- Multilateral and other Development Agencies

b) Banks:
- Currency
- Maturities and Grace Periods
- Interest Rate
- Limited Recourse and Non-recourse Opportunities
- Negotiating Strategy

c) Capital Markets
- Fixed or Variable Interest Rate
- Eurobond or National Capital Markets
- Guarantees and Covenants

5. Pre-Committed vs. Tranche

a) Pre-Committed:
- Cost of Firm Commitment
- Length of Commitment
- Refinancing Risk

b) Tranche:
- Long Construction Period
- Interest Rate Outlook
- Project Phasing

6. Procurement

Procurement competitiveness, requirements and procedures from a project point of view need to be evaluated in detail as compared to the procurement restrictions of the different potential lending sources, in order to avoid procurement penalties as a result of financing source.