OCCASION

This publication has been made available to the public on the occasion of the 50th anniversary of the United Nations Industrial Development Organisation.

DISCLAIMER

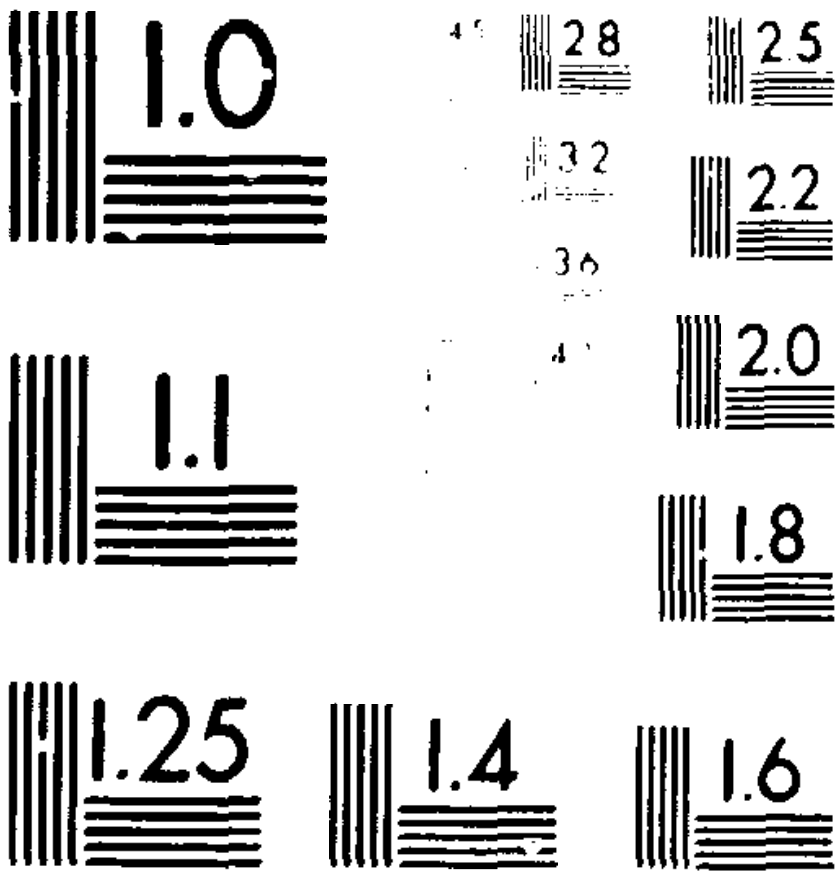
FAIR USE POLICY

CONTACT

Please contact publications@unido.org for further information concerning UNIDO publications.

For more information about UNIDO, please visit us at www.unido.org

UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org



14148

Distr.
LIMITED

UNIDO/IO.551/Rev.1
7 December 1984

ENGLISH

UNITED NATIONS
INDUSTRIAL DEVELOPMENT ORGANIZATION

Workshop on Financial Markets and
Project Financing*
Aden, Democratic Republic of Yemen, 15-20 Dec. 1984
Mogadiscio, Somalia, 22-27 Dec. 1984

PROJECT FINANCING AND THE EXPERIENCE OF UNIDO IN PROJECT PROMOTION**

Prepared by the

Investment Co-operative Programme

3252

---

* Organized by the Inter-Arab Investment Guarantee Corporation.
** This document has been reproduced without formal editing.

V.84-94033

C O N T E N T S *

* This paper draws extensively on United Nations and UNIDO publications, especially the "Manual for the Preparation of Industrial Feasibility Studies", Sales No. E.78.II.B.5.; and OPS/FAO/INF.3

Introduction: What is "Project Financing"?

The term "project financing" has been used to describe all the ways in which commercial ventures can be financed. Specialized financing institutions define project financing as.

> "Raising finance for a specific investment project (which may be a profit-oriented venture or an infrastructural investment, such as a power station) which is viable technically, commercially and financially and where it is expected that:
>
> (a) the project's cash flow and net earnings will be sufficient to cover, with a safety margin, the cost of the fixed capital investment, operating costs, debt servicing, and, for suppliers of equity funds, an adequate return on their investment; and
>
> (b) the assets of the project are sufficient security for the financiers.

Project financing as defined above is sometimes described as "off balance sheet financing," indicating that the project is expected to be self-supporting and not dependent upon the resources represented by the project sponsor's balance sheet or on his personal credit standing.

This definition of project financing may not always be applicable to project financing in developing countries where project sponsors usually provide additional guarantees over and above the project's assets, cash flow and net earnings.

The project development cycle

Assessing the technical, commercial and financial viability of an investment project requires the preparation of feasibility studies. The feasibility study is an element of one of the three phases of the investment project development cycle. These phases are (1) pre-investment (2) investment

and (3) operations (see Fig. 1). There may be considerable overlapping between these three phases. The pre-investment phase itself consists of several stages: identification of investment opportunities (opportunity studies); preliminary project selection and definition (pre-feasibility studies); project formulation (feasibility studies); and the final evaluation and decision whether to invest. Studies on such topics as size of market, sources of raw materials, plant location and optimum size, selection of plant and equipment, are prepared during the project formulation stage. Each of these is usually commissioned from a different individual or firm because of the special knowledge required.

Since most investment projects pass through a sequence of events between the conception of a project idea and the point of time at which implementation can commence, there are other ways of describing the project development cycle. One way, which is perhaps more suited to the operations of United Nations and other multilateral agencies, is to distinguish between four different phases: "identification", "preparation", "appraisal", and "implementation". Each phase of this project cycle frequently merges with the next, and the time period required to pass through each phase varies considerably.

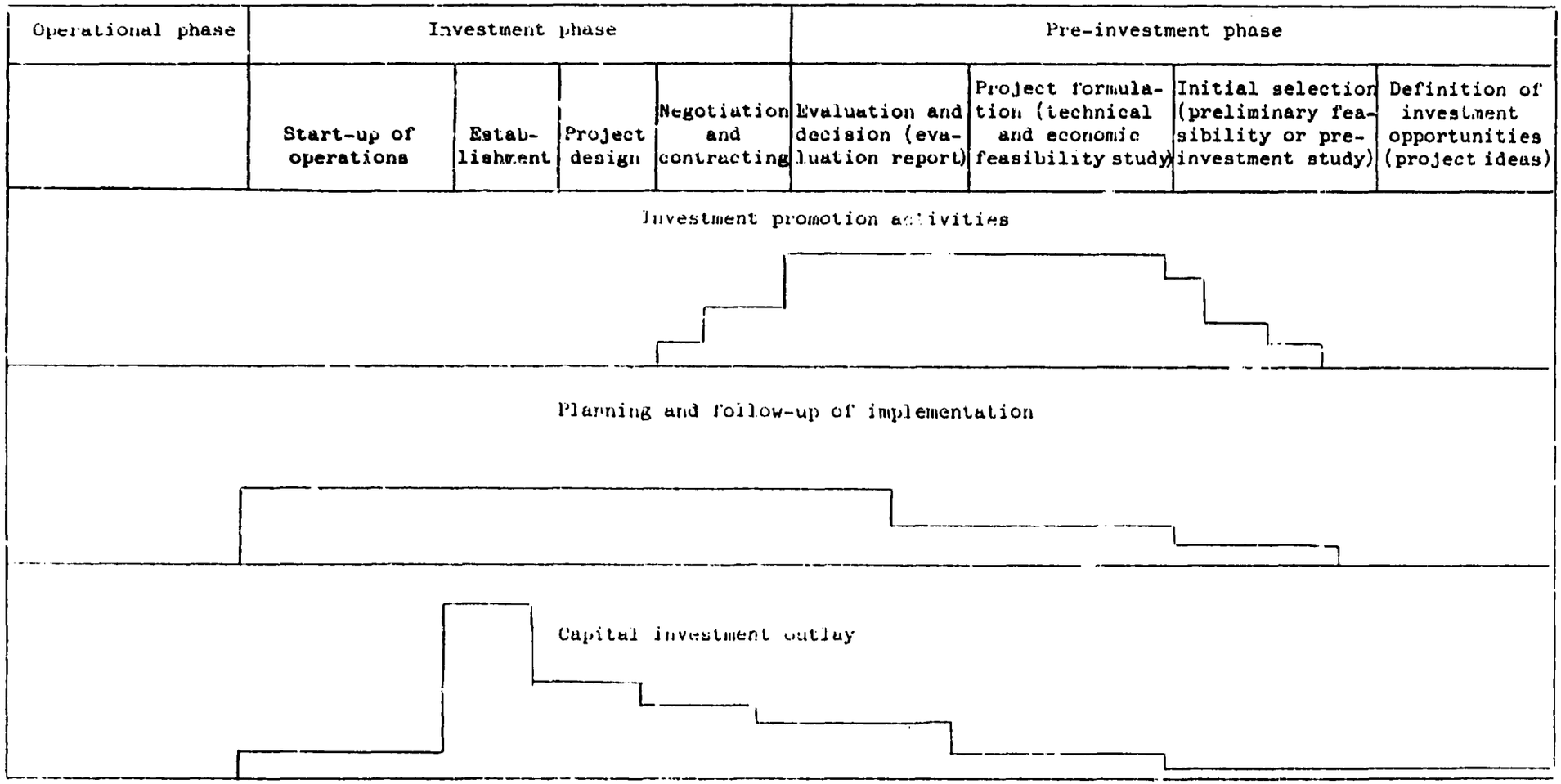
"Identification" means defining a project idea in the degree of detail necessary both to justify governments' and lending agencies' commitment of the resources needed to complete satisfactory feasibility studies, and to reveal the major issues that must be tackled before the project can be implemented.

"Preparation" refers to the completion of feasibility studies on which lending institutions may base their appraisal of a project. The objective of project preparation is to demonstrate with a high degree of confidence that the project is:

- in accordance with the country's development objectives and immediate priorities;

- technically sound and representing the best of available alternatives within existing constraints;

Fig. 1 - Project development cycle



- administratively workable; and

- economically, financially and socially viable.

Feasibility studies should also provide sufficiently accurate estimates of costs and revenues to enable decisions to be taken on project financing. In addition, the description of the project should be detailed enough to permit the implementing agencies to use the study as an aid to implementation.

Project "appraisal" is a prerogative of the financing institutions and involves the critical review of the feasibility study.

"Implementation" is essentially a country responsibility but one which may be periodically supervised and ultimately evaluated by the financing institutions. Although the main implementation phase only starts after negotiations with and approval by the financing institution, certain activities, such as the completion of final designs and preparation of tender documents, frequently commence immediately after project appraisal.

When the sequence of events described above is followed, three main reports are produced on a project - an identification report, a preparation report and an appraisal report. Even though each of these reports must contain a description of the project as it is conceived or designed at each successive stage, the purpose, emphasis and context of the reports differ considerably. The most detailed is the project preparation report.

The feasibility study

The purpose of a feasibility study is to provide the information - technical, financial and commercial - needed for the decision whether to proceed with an industrial project. Such a study should define the project's parameters on the basis of reasoned assumptions regarding production capacity, plant location, level of technology, raw material supplies and other inputs, arrive at an estimate of the total fixed capital investment required and of the on-going operating costs. These forecasts, combined with a forecast of sales and other revenues makes it possible to determine an expected rate of return on investment.

To attain this objective, an iterative process has to be launched to consider the assumptions referred to above, finally selecting the ones resulting in the lowest fixed investment and operating costs that are compatible with the project's revenue and profit goals. If the option which emerges is not viable, the assumptions will require further investigation and refinement until the forecast rate of return on investment reaches an acceptable figure. The feasibility study should describe this optimization process, justify the assumptions made and the options selected. If however the project is still not viable, this should be pointed out and explained.

The term "feasibility study" is often misused by suppliers of equipment or know-how. Frequently, they describe outlines they have prepared to promote sales of their equipment as "feasibility studies." In other cases production forecasts and sales targets are derived from information obtained in an industrialized country and as such may not be applicable in a developing country. Such studies can and have resulted in the misapplication of resources. A feasibility study must incorporate the resource, market and production conditions in the country where the project will operate and this requires an analysis from which may be computed the expenses and revenues the project will generate.

The feasibility study must, of course, in addition to questions of production technology, analyse the project's financial aspects. Financial analysis has three major components:

- determining the amount of fixed investment, working capital and the level of operating costs;

- identifying the best sources of finance; and

- forecasting revenues and profits.

With regard to cost determination, a distinction must be made between the initial fixed investment, e.g. land, site development, construction, plant and machinery and know-how, and all other costs incurred prior to start-up including the initial working capital requirement on the one hand, and

on-going production costs, e.g. raw and semi-finished materials, labour and overheads on the other. The feasibility study should combine these components so as to obtain an estimate of the total investment required and total production, administrative and selling costs from which a forecast of the financial viability of the project can be derived.

Total investment is the sum of fixed investment and working capital, fixed investment being the funds required for construction at the site, equipping and starting up the project, while working capital is the cash resources needed to bridge the gap between incurring expenditure on such items as labour, materials and manufacturing, administrative and selling overheads, and receiving the sales revenues needed to meet such expenditures.

Total costs comprise five major categories of expenditure: factory costs, administrative costs, sales/distribution costs, loan servicing and depreciation. The first three categories of expenditure together constitute operating costs.

Profitability evaluation

In order to complete our introduction to project financing, let us now briefly examine questions of cash management and profitability evaluation.

To estimate the financial requirements of a new or expanding enterprise a "cash flow forecast" is prepared in addition to the forecasts of net income and assets at the end of each financial year. The cash flow forecast allows cash receipts and disbursements to be estimated at more frequent intervals, e.g. monthly, during the crucial initial stages of a project's life, when an unforeseen cash shortage could prove disastrous. As the cash flow forecast only deals with cash items, non-cash items such as depreciation will not appear on it.

The statement of projected income is used to forecast the net profit or loss of the project at regular intervals, e.g. yearly. It differs from the cash flow statement in that it matches revenues with the expenditures incurred to achieve those revenues during the period under consideration, ignoring the dates cash was actually received or disbursed. The projected losses or profits

derived from the statement of projected income are incorporated in the projected balance sheet to complete the picture of how the company's affairs are expected to develop.

The inputs and outputs of a capital investment project, expressed in money terms, are the expenditures and revenues of the project arising over a period of years. But when considering expenditures and revenues arising over a period of years it is important to know not only the amount but also the point in time of receipt or payment. This is because of the generally accepted principle that the value to an individual of one dinar today is greater than that of one dinar he will receive in, say, one year's time.

The fact that the value of income depends not only on the amount, but also upon when it is received, is recognized by the discounted cash flow method. Discounting recognizes that we do not have the amount of money today, but we expect to receive it in one or more years' time, and we want to know, given a specific rate of discount, what the amount of money we are going to receive in, say, a year's time is worth today, i.e. its present value.

The amount by which the present value is less than the future value at the date of actual receipt depends upon the rate of discount (which is the rate of interest in reverse) selected. Thus, at a rate of discount of 10% p.a., the sum of 10 dinars due in one year's time would have a present value of 10 dinars less 10%, i.e. 9 dinars. Applying the same rate of discount to 10 dinars due in two years' time would produce a present value of 8.1 dinars.

The discounted cash flow method is particularly useful when deciding which of several projects competing for limited investment resources is the most profitable. By expressing future profits in terms of their present values, the discounted cash flow method makes it possible to evaluate a project not only in terms of **how much** total profit it will generate over its lifetime, but also in terms of **when** such profits will arise. Thus a project which makes larger profits in the early years of operation can be compared with one where the profits arise mainly in later years, and a choice made by comparing the profits of each one discounted back to present day values.

When using the discounted cash flow method, three yardsticks are available for assessing the profitability of a project:

Net present value Profits expected in future years are discounted to their present day values, using the rate of discount most appropriate in the circumstances, e.g. equivalent to the firm's required rate of return on investment, or to the interest rate on borrowed funds.

Benefit/cost ratio This is the ratio of the expected future profits of a project, expressed at their net present values, to the fixed investment outlay.

Internal rate of return This is the rate of discount which, when applied to the profits expected in future years, will reduce the present value of such profits to zero.

Project promotion

The opportunity study or pre-feasibility study provides an initial technical, financial and commercial evaluation of the project; once its potential viability is confirmed, investment promotion activities can commence by seeking sources of finance, marketing opportunities, suitably qualified local sponsors, and partners from the public or private sector, in the country itself or abroad. and also by proceeding with a full feasibility study.

The promotion and implementation of industrial investment have suffered from a lack of attention to other elements of the project cycle, in particular, project identification and formulation. This has caused a number of promising feasibility studies either to remain unimplemented, or, if implemented, to result in unsuccessful ventures. The problem arises when endeavours to promote and finance a project are delayed until the full feasibility study has been completed. At this point suppliers of finance and other inputs required for the ultimate implementation of the project often find that the feasibility study's terms of reference should have taken account of additional data and assumptions which they feel are relevant.

In the case of projects which will be financed and managed by two or more partners it is essential that before a feasibility study is commissioned, all

future partners reach agreement regarding the terms of reference of the study and the parameters and assumptions on which it is to be based. Otherwise the resources invested in an initial feasibility study may be wasted if one of the potential partners or financiers later insists that a fresh study be prepared; the problem may be aggravated if, before the repeat study is carried out, agreement has not been reached between the parties involved on their respective roles in any subsequent jointly financed and managed project. One of the functions of efficient promotion is to bring about such agreement between all those concerned in implementing a project. The experience of UNIDO in the promotion of industrial investment projects is presented in a separate section of this paper.

A full feasibility study will of course be of great interest to potential partners, but where progress towards project implementation depends on their carrying out or financing further studies, it may be impeded by their unwillingness to do so. While the project is still at the pre-investment phase, this difficulty can often be overcome by ascertaining the requirements of all prospective partners regarding the first full feasibility study, for which it may be possible to obtain finance from Government, development agencies or other industrialists.

I. Types and Sources of Project Financing

There are several ways in which we can classify types and sources of project financing. This paper will present several of these classifications which are not necessarily mutually exclusive. They include:

(i) short, medium and long-term financing;

(ii) Islamic financing mechanisms;

(iii) domestic and foreign financing.

(i) Short, Medium and Long-term Financing

The sources of finance used by an enterprise should of course be matched to its capital requirements, e.g. long-term requirements should be financed from long-term sources with due regard to the costs and obligations associated with such sources. Medium and short-term requirements should be matched to the medium and short-term sources of finance available to the firm.

Short-term Finance

Short-term finance is usually available for periods of up to one year. The principal types of short-term finance include trade credit, bank overdrafts and commercial paper i.e. bills of exchange and promissory notes. Many firms use bank overdraft as their cash cushion, i.e. if for any reason the firm finds itself short of cash, it relie on bank overdraft to cover the situation. Bank overdraft facilities were originally intended to meet specific short-term borrowing needs.

It should be particularly noted that loans in respect of working capital are classified as short-term because of the problems inherent in forecasting a firm's working capital requirements over a period of more than 12 months. However, the need for such a loan may well continue for several years, if not indefinitely, and negotiations with the company's bankers should therefore be held in good time to ensure that funds for working capital continue to be available at the required level. Many projects have failed at an early stage because the supply of working capital was inadequate.

Bank overdraft is the most flexible source of finance, in that once the limit is agreed with the bank, the firm may borrow and repay money within that limit without formality. This flexibility is the main advantage of bank overdraft, a further advantage being that interest is charged only on the outstanding daily balance. However, the interest rate charged is often higher than that applied to other forms of bank lending.

A disadvantage of bank overdraft facilities is that they can be cancelled by the bank at short notice, and security for the loan in the form of a charge

on the company's assets is often required. This can hamper the business, particularly if the charge "floats" over all of the assets, i.e. all assets are subject to the charge and management may not further pledge them to raise additional finance without first repaying the bank overdraft or renegotiating its terms. In many instances banks do not require security but rely on the company's overall financial strength, and the reputation of its top management.

Commercial paper includes acceptance credits and bills of exchange, widely used in foreign trade, which enable a purchaser of goods (drawee) to postpone payment for an agreed term, commonly 90 days, while the seller (drawer) can receive his money immediately by discounting the bill with a bank. The advantages of commercial paper are:

- low cost, usually below bank overdraft rate;

- no requirements as to security.

Medium-term Finance

Loans for periods of between one and seven years are regarded as medium-term finance and generally used to purchase assets with an equivalent useful life, e.g. machinery, or to enable the borrower to establish a firm financial and operational base and thereby qualify for longer-term investment. We shall take a brief look at the main types of medium-term investment finance, bearing in mind that some of these may be arranged for periods longer than seven years.

Leasing is a source of finance for the acquisition of assets such as plant and machinery which has rapidly gained in acceptance in recent years. There are numerous different types of leasing arrangement, but the principle is always the same: the items are purchased by a lessor, who may be the manufacturer of the assets, or a leasing company with or without the involvement of a bank, and made available to the lessee in return for a monthly payment calculated to recoup within the initial contract the lessor's costs - the purchase price of the assets and his own financing costs - plus a margin of profit. The period may be from three to seven years, chosen by the

lessee to suit his own convenience.

A leasing contract does not make provision for the purchase of the asset by the lessee, although he may do so by agreement with the lessor after the contract expires. Some leasing arrangements include services such as repair, maintenance and insurance ("service leasing"), but in general the lessor restricts himself to supplying the items required by the lessee and ensuring that the lease payments are made on time. It is of course also his responsibility to dispose of the assets at the end of the lease if the lessee does not wish to purchase them or renew the arrangement.

Under a typical leasing contract, physical possession of the goods is transferred to the lessee while ownership remains with the lessor, who will have to take them back at the end of the lease if the lessee does not wish to renew the lease or purchase the assets.

Advantages of leasing

(a) The lessee acquires the use of an item of equipment without having to invest any of his own funds. This compares favorably with bank loans, which will not normally lend in excess of 70% of the purchase price.

(b) There may be benefits in terms of deferred taxation, since lease payments are a deduction from taxable profits, whereas when an asset is purchased outright, depreciation may only be charged at the rates permitted by the tax authorities. These may be based on a longer useful life than that adopted by the lessor.

(c) The onus of disposing of the leased items devolves on the lessor. This is of particular interest in areas of rapid technological development, e.g. computer hardware. The fact that lease contracts impel the equipment user to take a decision on whether to retain an item of equipment before the end of its useful life is another positive aspect of the leasing concept which promotes adaptation to technological change.

(d) For companies with a high gearing ratio[1/] and a shortage of liquid funds, raising additional loan finance may present a problem. Leasing offers a solution, since it does not affect the company's gearing.

(e) Under a leasing contract the lessee can normally select a contract with the duration that best suits his situation - anything between three and seven years. Having concluded the contract, he can be sure that his financial obligations will not change, regardless of possible increases in interest rates, and that the lessor cannot cancel the contract. This contrasts with bank loans, which normally provide for flexible interest rates and which can be called in at relatively short notice (usually six months).

Drawbacks of leasing

(a) Leasing items of plant and equipment is generally more expensive than financing their acquisition via a bank loan, because of the risks to the lessor, which are particularly high in the early part of the contract: if the lessee were to become insolvent, the lessor will have recouped only a small part of his investment and may therefore incur a loss in disposing of equipment designed to suit the lessee's individual requirements.

(b) In many countries the tax authorities grant generous special depreciation allowances on new equipment. These may enable purchasers to obtain greater tax benefits than by deducting leasing payments.

(c) Payments under a leasing agreement cannot be rescheduled in case of temporary financial difficulty on the part of the lessee. Leasing companies demand prompt payment, and will repossess the goods in cases of default. By contrast bank loans offer more flexibility in this respect, since banks usually have a broader relationship with the client and may have other forms of security to fall back on, e.g. a floating charge on all assets, a mortage on real estate, etc.

1/ The "gearing ratio" is the ratio of loan to equity capital. If the gearing ratio is high, the loan capital exceeds the equity capital.

Hire purchase is an arrangement under which ownership remains with the seller until after the final payment is made. The agreement provides for the rental of the subject goods with an option to the user to buy at a nominal price at the end of the hire period.

The range of goods that can be obtained through hire purchase is extensive. Motor vehicles form the largest category but there are other classes of importance such as industrial machinery, furniture, office equipment and contractors' plant.

Hire purchase agreements usually involve three parties: the purchaser, the seller and the finance company (usually a company engaged exclusively in hire purchase business). The hire charge includes the charge for interest which is calculated on the initial sum borrowed and not on the amount outstanding at any given time. The true rate of interest is therefore higher than the stated rate.

The advantages claimed for hire purchase as a source of finance are:

- it enables a firm to obtain the use of assets without a large financial outlay;

- the hire charges are tax-deductible;

- Annual wear and tear allowances plus initial allowances on the full retail price of the goods can sometimes be claimed.

Relative to other sources, hire purchase finance is expensive. A further disadvantage is that in case of non-payment of instalments, the hirer can repossess the goods without any compensation to the hire-purchaser for that proportion of the hire charge already paid which represents instalments of the purchase price. For this reason it is mainly used as an instrument for financing consumer purchases.

Credit sales agreements transfer ownership to the purchaser on completion of the transaction. The purchaser agrees to pay for the goods over a specified period. The financing of the extended terms is the responsibility of the seller who must build the interest charge into the purchase price.

Term loans are for a fixed period of time with repayments of principal and interest according to an agreed time schedule.

Term loans are tailored to suit the convenience of the borrower and consequently their provisions are flexible, i.e. there may be a remission of all repayments of principal in the first year, large payments may be permitted at the end of the term, and so on. The rate of interest for term loans is usually variable, increasing and diminishing in line with the general level of interest rates in the country and will also depend on the type of lender, the credit standing of the borrower, and securities offered (if any).

As in the case of commercial bank loans, interest charges are tax deductible. In granting a term loan, the lender may require security in the form of a charge on some or all of the assets of the business. Term loans are suited to projects requiring immediate outlays of cash where the cash inflow will be spread over the term of the loan. They are particulary useful to firms not wanting to raise equity or long-term finance, and to those expanding rapidly with a time-lag between expenditure and the resultant cash inflows.

Long-Term Finance

Types of long-term finance include:

Sale and leaseback

Long-term debt

Equity capital: Ordinary and Preference shares, and retained earnings.

Some of these types of finance are only available in industrialized countries. It will however still be useful to take a brief look at each type, bearing in mind that the legal and institutional framework to utilize them may

not exist in all developing countries.

Sale and leaseback

Sale and leaseback is the term used to describe a scheme by which manufacturing firms can generate liquidity from the real estate - land and buildings - they own, while continuing to enjoy the use of such assets. Many firms own valuable real estate, but find themselves short of liquid resources. One method of raising finance would be a straight sale of these assets. However, this would leave the firm without premises and facilities unless alternative accommodation was readily available for rental. To avoid these problems, the sale and leaseback method of financing was developed.

The partners in the scheme are manufacturing companies which are seeking additional liquid funds to finance expansion, modernization and possibly the acquisition of companies for vertical or horizontal integration, and investment institutions such as life assurance companies or pension funds having excess liquidity for which they are seeking a secure investment producing a satisfactory return over a period of years.

Under the terms of a typical sale and leaseback agreement, the purchaser company will acquire a property owned by the manufacturing enterprise in which its production facilities are located at a price corresponding to their open market value. Instead of handing over the premises with vacant possession, the manufacturing enterprise concludes a long-term lease with the purchaser and continues to occupy them, paying a market rent for their use. The lease will normally contain provisions for the annual rental to be adjusted from time to time in line with changing economic conditions (e.g. every seven years).

This arrangement has a number of advantages for both parties: the life assurance company or pension fund acquires an asset which will provide a steady, inflation-proof income and may be expected to increase in value in the long term. This matches the long-term commitments of such institutions towards their own clients and their internal investment policies, which require them to diversify their portfolio to include ordinary shares, loan stock, and real estate.

From the manufacturing partner's point of view the arrangement has the value of releasing substantial liquid funds which in most countries will be either exempt from tax, or taxed as a capital gain at a lower rate than that applied to profits derived from normal trading. For example in the United Kingdom, capital gains are taxed at 30%, whereas corporation tax is currently 45%. The lease payments on the other hand are 100% tax deductible, which means that in a country with a tax rate of 50%, the effective cost to the company is only half the amount paid.

Instead of selling an existing building, a company may erect a new building on land it owns and sell it to an investment institution as part of a leaseback scheme. Here there is a further benefit to the manufacturing partner: it acquires a new building, tailor-made to suit its requirements, with virtually no capital outlay. This has a substantial tax advantage, since the tax law of most countries require that buildings be capitalized, i.e. their cost may not be treated as a deduction from profits for tax purposes. The annual depreciation allowance for tax purposes is usually low - between three and seven per cent - which means that constructing a building places a heavy burden on a manufacturing company's own resources. By selling the building to a financing institution and leasing it back, the manufacturing company can recoup the entire cost in return for an annual rental which is fully tax deductible.

Sale and leaseback arrangements by which a manufacturing company divests itself of valuable real estate are also a safeguard against the activities of "asset strippers", who are usually on the look-out for companies owning real estate which is more valuable than the company's total capitalization, based on current share prices. Having found such a company, they make an attractive offer to the shareholders to purchase the entire equity capital, and, having acquired control, liquidate the company in order to sell its real estate on the open market.

The disadvantages of sale and leaseback are:

- the loss of the capital appreciation over time, which normally occurs

with real estate;

- the loss of collateral for future borrowing owing to the sale of fixed assets; and

- a long term expenditure commitment which is independent of the company's fortunes.

Long-term debt

Long-term debt is the term used to describe a debt with a maturity in excess of seven years. Such debts are frequently incurred in the form of a debenture which is a certificate specifying the maturity of the loan, the annual interest charge, methods of repayment, provisions as to security, etc.

The main types of debenture by which a firm can raise long-term debt are:

(a) Unsecured or naked debentures

The lender has no security except the earning power of the firm. It is used when the finances of the borrower are exceptionally sound, or where the firm has no security to offer. If the latter is the case, the lender is likely to require a very high rate of interest.

(b) Secured debenture or mortgage debenture

The lender is protected by a charge on some or all of the assets of the borrower. The assets most commonly charged are land and buildings.

(c) Convertible debenture

The lender is given the right to convert the debt into ordinary shares of the firm at a pre-determined price on or before a specified date. In this way, the lender can share in the fortunes of the firm. If it is a publicly quoted company, and its shares appreciate rapidly, the debenture holder may buy its shares below their market value. If the business does not prosper and the value of its shares does not rise, the lender can retain his loan and receive interest payments and eventually repayment of the principal. Debentures such as these may or may not be protected by a mortgage.

(d) Debenture plus equity participation

Sometimes the debenture holder may also buy shares in a firm at a special valuation. If the firm expands to the point where it can "go public", then the debenture holder may sell his shares at a profit. This type of finance is used mainly for small to medium-sized private firms with good prospects. Merchant banks are the usual lenders of this type of debenture. In return for the risk they run, they are permitted to buy up to as much as thirty per cent of the total equity. They may also insist on the right to appoint one or more directors to represent their interests on the Board.

(e) Subordinated debenture

A subordinated debenture is an unsecured debt which is junior to all other debts, i.e. other lenders must be fully repaid before the subordinated debenture holder receives anything. This type of debt will have a higher interest rate than more senior debts and will often have rights of conversion into ordinary shares. It is a very useful method of finance in that it does not restrict further issues of debt because it will be subordinated to them.

Characteristics of long-term debt

Debt financing involves the firm in fixed annual commitments as to payments of interest and repayments of principal. It is therefore vital that the firm can earn at least an equivalent sum annually with the money it has borrowed. If a firm raises a loan at, say, nine per cent and uses this money in its own operations to yield fifteen per cent, the surplus is additional profit to its owners. However, if the firm is unable to earn any additional revenue from the borrowed funds, the loan is merely a burden and a drain on operating profits. One of the advantages of long-term debt is that it does not affect control of the firm: provided payments of interest and repayments of principal are made on schedule, lenders have no right to interfere in the running of the business.

For a profitable company, long-term debt is a relatively cheap source of finance, since the interest payments are deductible from taxable profits. In the industrialized countries, the life insurance companies and pension funds previously mentioned are among the main sources of long-term debt, since these institutions have substantial resources entrusted to them for long periods.

How much debt ?

Deciding on how much long-term debt to raise involves the weighing of risk, income and control aspects of the firm's operations. However, certain guidelines can be applied to determine the appropriate level of debt for a given business:

(a) Debt equity ratio

This is the ratio of the amount of long-term debt to the amount of ownership or "equity" in the business, otherwise known as the "gearing ratio", defined in the note on page 12.

(b) Times interest covered

This measures the cushion of earnings available to a prospective lender. For example:

Earnings before interest payments:	$10,180
Interest	$ 2,115
Times interest covered	4.8

(c) Times burden covered

It is common for debentures to be repaid by annual instalments rather than by lump sum payments at the end of the term. The total of interest and annual capital repayments is called the burden. A cover of two, i.e. earnings twice the annual burden, would normally be regarded as adequate.

Equity capital: Preference and Ordinary shares and retained earnings

Preference shares

Preference shares have preferential rights to a fixed rate of dividend and, in the event of liquidation, to repayment of capital, i.e. their claims must be met before those of the ordinary shareholders. While from the standpoint of a lender Preference shares are part of the equity, Ordinary shareholders expecting to receive dividend payments will regard the Preference share dividend much as a fixed charge, like interest payments. However, the

Preference dividend cannot be deducted from taxable profits, and, looked at in this light, Preference shares are an expensive form of long-term debt.

As a rule, control of a firm is not affected by issuing Preference shares, since the shares do not carry voting rights, except when the Preference dividend is in arrears, in which case management's freedom of action may be limited by the Preference shareholders.

Preference shares can be a useful method of expanding the equity base of a firm without diluting control. If management is considering an issue of debt which would adversely affect the debt equity ratio, it can raise part of the amount required in the form of Preference shares which, as we have already seen, are regarded as equity by debt holders. This means of financing lowers the gearing ratio but does not affect control of the firm.

Ordinary shares

Ordinary shares represent the risk or venture capital invested by the shareholders, who are the proprietors of the enterprise. It is useful to examine methods of increasing the Ordinary share capital and the factors that should be considered before taking this step. The Ordinary share capital may be increased by issuing new shares, which may be:

- for cash;

- partially for cash and partially by capitalizing retained earnings (a so-called "rights" issue); or

- exclusively by capitalizing retained earnings (a so-called "scrip" issue).

Retained earnings

Each year the directors of a company make a decision on the amount of the dividend, if any, they will recommend for payment to the Ordinary shareholders. Most firms do not however distribute all their earnings, but retain part of them in the business in the form of reserves for investments in more modern plant and equipment and for expansion.

When retaining profits in the business, the directors are taking the view that the shareholders' long-term interests will be better served than if the entire profit were distributed.

The advantages of retained earnings as a source of financing are:

1. Control of the firm is not diluted by introducing additional shareholders;

2. Retained earnings, being equity capital, impose no financial obligation on the firm but nevertheless increase the funds at its disposal;

3. The funds are available without the expense of a new issue of shares;

The disadvantages of retained earnings are:

Retained earnings may not be the most efficient use of these resources: if the firm achieves high returns it may make more sense to use debt finance. Furthermore if the company retains all its earnings rather than paying part of them in dividends the shareholders may be tempted to sell their shares, with a consequent fall in the share price, making the company an attractive prospect for a takeover bid.

Issues of new equity

One of the most important financial decisions made by management is whether to issue new equity shares for cash. The decision is important for two reasons:

- new shares carry rights to vote and may affect the control of the firm;

- except in special circumstances, equity shares are irredeemable and consequently share in all future dividends of the firm.

However, equity share issues as a source of new funds also offer advantages which may offset any loss of control or diminution in dividend. The

advantages are:

- the debt equity or gearing ratio is reduced, thereby making it easier for the company to raise further debt finance;

- equity funds do not impose any financial commitment on the company in terms of interest payments or repayments of principal.

It can be seen that in deciding whether to issue fresh equity, a number of factors have to be weighed. Many firms try to avoid the issue of fresh equity until all other sources have been exhausted. This decision may be incorrect in that it may retard the growth of the firm by increasing the cost of other sources tapped, e.g. a lender examining a proposal may charge higher interest rates if he feels that the firm is undercapitalized.

(ii) Islamic Financing Mechanisms

On the basis of the principle of interest-free finance and equitable risk sharing, a large number of Islamic banks, solidarity companies (insurance) and investment companies are now operating in several Muslim and non-Muslim countries. Some of the types of finance available from these Islamic financing institutions (IFI) may be summarized as follows:

Modaraba (participation financing)

Under the terms of the Modaraba, an IFI supplies all funds required and the client provides the management skills for a given project. The IFI receives in exchange a percentage share in a defined revenue stream, resulting from the project. The IFI does not receive the unconditional obligation of its clients to return the principal sum invested with a guaranteed profit but monitors the use of funds closely. Losses are born entirely by the IFI, and the client loses the value of his work.

Mosharaka (mutual participation financing)

The Mosharaka is identical to the Modaraba except that in addition to supplying management and other services, the client shares with the IFI in providing equity. The client, therefore, receives for such equity a defined

percentage participation in the same distributable revenue to which the IFI looks for the recovery of its investment plus profit. Project income and expenses are monitored through a controlled account at the IFI operated jointly by the partners. The IFI may participate as well in the management of the Mosharaka in cases where a new entity is to be established. Risks and rewards of capital investment are shared by both the client and the IFI.

Morabaha (financing resale of goods)

This type of financing is suitable for financing working capital rewquirements. Utilizing the Morabaha, a commercial or industrial client may acquire capital goods or raw materials. The IFI purchases the goods from a third party at the request of its client and resells the goods to the client on deferred payment terms at a higher price receiving its client's unconditional obligation to pay such higher price at a future date or dates.

Ijara (lease financing)

A client wishing to acquire the use of capital equipment may request an IFI to purchase such equipment and obligate itself to lease such equipment from the IFI when acquired. In an Ijara contract, the client looks only to the original supplier for warranties relating to the quality of goods leased. Ijara financing is based upon the client's financial status and the projected cash-flow to be derived from the utilization of the equipment. The client assumes all risk of loss relating to the goods when he takes possession under the Ijara contract. As a consequence, the client's obligations with respect to the periodic lease payments constitute a fixed commitment for the term of the Ijara contract.

Ijara Wa Iktina (lease purchase financing)

This is a lease agreement combined with an obligation of the client to purchase the goods leased. An Ijara Wa Iktina contract is substantially identical to the Ijara contract except for:

- the mandatory purchase price, which is equal to the cost to the IFI of acquiring the goods;

- the client's periodic rental obligation, which is computed to provide

to the IFI a reasonable return on the amount invested by the IFI to acquire the goods without allowing for the depreciation of such goods;

- the client's obligation to make prescribed periodic payments into a blocked investment account to secure his obligation to purchase the goods, the profit or loss of such account accruing to the benefit of the client.

Commercial loans

IFIs can also provide interest-free loans for financing socially desirable development oriented projects. Such loans may also be combined with any of the other above-mentioned types of financing for the purpose of limiting an IFI's risk or enhancing the chances of a project's success.

(iii) Domestic and Foreign Financing

Another way of classifying sources of finance is to distinguish between domestic and foreign financing. Some of the types of financing we have so far mentioned may be provided from domestic or foreign sources. Although a great deal of analytical work has been devoted to the mobilization of domestic financial resources and to the success of new and innovative mechanisms in increasing the mobilization of these sources, this paper will not deal with the subject.

Foreign financing may come from private or public sources and may be direct or portfolio investment. Foreign portfolio capital flows include government loans, loans by international agencies, the purchase of bonds and short-term lending, such as bank loans and export credits. Such flows may result from transactions effected directly between borrowers and lenders abroad or with other organisations acting as intermediaries. There are several important differences between such portfolio investment and direct investment by one company in another.

First, portfolio investment in credit instruments implies a fixed obligation to repay interest and principal, whereas direct investment implies a flexible repayment obligation directly geared to the success of the

investment. Second, portfolio flows tend to be more general in character than direct investment, which tends to be "industry specific". Third, portfolio investment does not directly affect local ownership and control, whereas direct investment gives rise to non-resident ownership and control, in many cases within the context of a large multinational enterprise. Fourth, portfolio investment normally implies a transfer of capital only, whereas direct investment usually comprises a transfer of not only capital but also a package of auxiliary factors such as technology, management etc.

The various forms of financing direct foreign investment (DFI) in developing countries include: equity participation, project loans, and transfer of equipment. Special forms of DFI financing include buy-back[1/] arrangements and leasing. DFI is tending to move away from fully owned subsidiaries and towards joint ventures with minority participation, licencing and management and marketing contracts. Investment laws and regulations in developing countries play an important part in attracting DFI. Potential foreign partners have also acquired greater risk awareness.

With regard to foreign financing, this paper will look at export credit schemes, financial intermediation (Euromoney market), foreign bilateral and multilateral providers of financing, and country risks.

Export credit schemes

Most developing countries import capital equipment from the industrially developed nations. To encourage their exports of capital equipment, most of the latter countries operate a system of export credit finance, which helps the purchaser to finance his purchases, often at a substantially reduced cost.

Export credit facilities include export credit insurance and export financing. Credit insurance policies are offered to exporters to cover losses sustained owing to default by a purchaser, repudiation or expropriation by a

---

1/ Buy-back arrangements cover the supply of a manufacturing plant or the granting of a licence (know-how) in return for semi- or finished products of the plant supplied or licence granted.

government, and exchange control restrictions. They are usually provided by the State or government-sponsored bodies.

Export financing is a service usually provided by the private banking system but also by government-sponsored bodies. It can take a number of forms including supplier credits, where finance is given to the exporter, and buyer credits, where the assistance is given directly to the importer to enable him to pay the exporter.

The use of "forfaiting", which is the discounting of commercial paper (such as bills of exchange) used to finance international trade in capital goods, has recently become much more widespread. The two main centres of this activity are London and Zürich.

Let us outline some of the export schemes operating in industrially developed countries.

In the United Kingdom, the ECGD (Export Credits Guarantee Department) provides credit insurance, export finance and overseas investment insurance which covers direct overseas investment by British companies against the risks of expropriation, war losses or restrictions on remittances. It is also reported that ECGD extends a bulk line of credit to local banks in developing countries for onward lending in smaller amounts to small importers of British goods.

In Germany, export credit insurance is provided by:

- Hermes Kreditversicherung AG; and

- Treuarbeit.

They work as a consortium, with Hermes taking the lead in export credit insurance and Treuarbeit in overseas investment guarantees. Export finance is provided by the commercial banks (up to one year) and by the AKA (Ausfuhrkredit-Gesellschaft) and KW (Kreditanstalt für Wiederaufbau) for medium and long-term export credits.

In France, export credit insurance is provided by COFACE (Compagnie Française d'Assurance pour le Commerce Exterieur) which offers guarantees for both commercial and political risks related to supplier's or buyer's credits. Similar credits are provided by: INA (Istituto Nazionale delle Assicurazioni) and other institutions in Italy; the Danish Export Credit Council in Denmark; the Office Nationale du Ducroire, Creditexport and others in Belgium; the Agency for Swiss Export Risk Guarantees (ERG) in Switzerland, and the Export-Import bank and the Private Export Funding Corporation (PEFCO) in the United States of America.

Financial intermediation

Financial intermediation is usually provided by bankers and brokers operating in an international market such as the market for Eurocurrencies, commonly known as the Eurodollar market. Eurocurrencies are convertible currencies, such as US dollars, German marks and French francs, held in banks by persons and institutions not resident in the country where the currency has been issued. This market has by tradition been dominated by transactions in US dollars.

Eurocurrency loans tend to be short to medium-term - in the range of three months to five years. For longer-term lending up to 15 years governments and large companies issue Eurobonds which are bought and sold in the market in the same way as bonds are traded on any national capital market. Eurobond issues are usually sold in more than one country simultaneously through an international syndicate of investment banks who underwrite the issue. The main attraction of borrowing in the Eurodollar market is the large pool of funds and the fact that all interest on Eurocurrency loans is paid free of tax. Interest rates tend to be lower than rates in national markets.

The main disadvantage is that loans have to be repaid in the currency borrowed, which exposes the borrower to foreign exchange risk. After 1974 the oil exporting countries began to invest surpluses of dollars and other currencies in the Eurodollar market, which led to the market's phenomenal expansion. It is worth noting that the flow of commercial capital within the Arab region is still limited and this is evidenced by the large and increasing volume of lending by Arab interests (governments and private institutions)

using the international financial markets, rather than through direct Arab contacts between the region's owners of surplus funds and the region's borrowers.

II. Country Risks

In any foreign lending or direct foreign investment the lender or investor carefully weighs the risks of doing business abroad. There are commercial risks arising from the credit standing of the borrower which can be assessed by means of normal banking procedures. There is a currency risk which is covered as far as possible by requiring repayment in the currency of the loan. The risks arising from political events and from restrictions on the repatriation of funds are usually subsumed under the heading of "country risk." One of the earliest evaluations of risks resulted in the BERI Index (Business Environment Risk Index) compiled by an American university (see Fig. 2). Various major banks have also formulated their own country risk evaluation systems. Banking publications, such as Institutional Investor (New York) and Euromoney[1/] (London) have developed their own individual systems. There is no universally accepted set of indicators for assessing country risks. It is basically a matter of judgment. The following quotation demonstrates how one banker from an industrially developed country assesses country risk.

"In order to evaluate the risk category for particular countries, a variety of factors are systematically taken into account. In the evaluation of credit risk for a corporation or country - one of the most important factors in both cases is the quality of management. The management of a company or the Government of a nation are in a way comparable. As in a particular company, the quality of its business policy is determined by management, in the same way for a nation, it is the control of currency and economic policy that is significant. If economic management is weak, exposure to such a country will be risky. There are, therefore, two types of risk which have to be considered

---

1/ In a special publication of Euromoney entitled "Country Risk: How to Assess, Quantify and Monitor It", each detail is included for use in the construction of a country rating system.

in such an evaluation: the political and the economic. In the controversial question of assessing political risk, one must consider three areas:

"(a) National Unity

"Is harmony seen to exist between nationalities, races or religious groupings?

"Is the history of the country typified by revolutions and extreme social conflict?

"Is the country subject to foreign political pressures?

"(b) Quality of the Government

"How stable is the Government and is the administration efficient, does it have integrity, or is it susceptible to corruption?

"Does the legislature seem fair and independent?

"Are different national factions equally represented?

"(c) The Level of Social Unrest

"Are there vast differences in the level of wealth?

"The foregoing questionnaire is by no means exhaustive. It only focuses upon the destabilising forces in a nation's political system. The analysis is relevant in its observation of the possibility of destabilising political events.

"In the same way, the investigation of economic factors, relating to economic stability, fall into three main categories:

"(a) The Strength of the Economy

"How high is the level of industrialisation? What is GNP per capita?

"Is the economic policy liberal or interventionist/dirigist?

"What is the attitude of the country in relation to foreign capital?

"What is the nature of the taxation and general fiscal policy?

"(b) State of the External Economy

"Does the country tend to have long-term surpluses or deficits in its trade balance and overall balance of payments?

"Is the proportion of output of the foreign sector high or low in relation to GNP? How are exports and imports directed in terms of geographical and product distribution (are they diversified or dependent on a few areas or products)?

"How high are the nation's foreign exchange reserves in relation to the country's annual imports? To what extent are the IMF quotas utilised? Is the nation's currency convertible?

"(c) Indebtedness

"Is the foreign debt high in relation to GNP and is it tending to rise or fall? Is the debt service ratio high, rising or falling? What is the general relationship between foreign investment in the country and the country's level of investments abroad? Has the country been able to successfully service its foreign debt up to this particular point?

"In analysing a country's economic position, one has to ask oneself whether the borrower has the economic power to punctually meet and to fully service its commitments. Additionally, since borrowing abroad from the point of view of the borrowing country is almost without exception in foreign currency,

repayment must depend on the capacity to obtain foreign exchange. Thus, we must try and investigate the power of the national economy to service its obligations, the development and state of its external economy as well as the level of debt and the nation's morality in credit matters. Significant points highlighting the strength of an economy are the level of industrialisation, the growth rate of real GNP as well as GNP per capita, which indicate the development level of the nation. Apart from this, the question of how liberal or interventionist the economic policy is, and what the country's attitude to foreign capital is, must be investigated.

" In order to determine the position of the external economy, it is necessary to determine in which direction the long-term position of the trade balance and balance of payments situation are tending: surpluses or deficits, to see whether exports and imports have a well diversified regional and qualitative structure or whether they are heavily directed towards a single area or type of product. Another important guide is the relationship between foreign exchange reserves and imports. The higher the ratio of foreign exchange reserves to imports, the greater the level of financial security, and, therefore, the likelihood that the country will remain creditworthy. The level of foreign debt is another indicator, albeit indirect, of the level of economic risk. More significant and probably more useful for the purpose of comparisons, is the 'debt service ratio'. This statistic reflects the amount of funds required to service external debt (interest and amortisation) against the level of earnings of foreign exchange from the export of goods and services. A useful rule of thumb is the theory that a rapidly rising debt service ratio, or an absolute level of over 20%, is a level which indicates the need for some caution. Analogous to this is the level and the development of the level of foreign debt in relation to GNP. The debt service record, demonstrating how a particular country has historically serviced its foreign obligations, is another important indicator."

Some of the uncertainties expressed by foreign lenders and investors are attributable to the lack of reliable information on developing countries and their political and economic environment, including investment opportunities and incentives. It is therefore important that the appropriate agencies in developing countries should disseminate such information in an orderly fashion.

Fig. 2

Business Environment Risk Index (BERI)

Construction of the Index

	Weightings	
Political		
1. Political Stability	6	
2. Attitude Towards the Foreign Investor and Profits	5	
3. Nationalization	5	
4. Monetary Inflation	3	
5. Balance of Payments	3	
6. Bureaucratic Delays	3	25
Operations		
1. Economic Growth	5	
2. Currency Convertibility	5	
3. Enforceability of Contracts	4	
4. Professional Services and Contractors	3	
5. Communications - Telex, Telephone, Mail, Air, Local	3	
6. Labour Cost/Productivity	3	
7. Local Management and Partners	2	25
Financial		
1. Currency Convertibility	5	
2. Short-Term Credit	5	
3. Long-Term Loans/Venture Capital	5	
4. Monetary Inflation	3	
5. Balance of Payments	3	
6. Enforceability of Contracts	2	
7. Bureaucratic Delays	2	25
Nationalism		
1. Attitude Towards the Foreign Investor and Profits	8	
2. Nationalization	8	
3. Currency Convertibility	5	
4. Bureaucracy	4	25
		100

The categories below have been developed to assist in interpreting the indexes:

85-71 Typical for an industrialized economy

70-56 Moderate risk countries with complications in day to day operations

55-41 High risk for foreign owned businesses

below 41 Unacceptable business conditions

III. Co-financing; Bilateral and International Financing Agencies

The practice of co-financing, i.e. financing by two or more institutions, has been in existence for some time, and has become more common because of the fact that many financing institutions do not permit more than partial participation in the financing of the total costs of an industrial project in a foreign currency. The World Bank, for example, does not permit more than 50% participation.

Co-financing which involves commercial banks may be defined as a legal arrangement whereby a development financing institution, at the request of a developing country borrower, enters into a formal agreement with one or more banks to extend a loan to finance a specific project with the borrowing country which has been favourably evaluated by the technical staff of the Development Finance Institution. Under the World Bank's recently introduced co-financing scheme, one agreement is drawn up between the Bank and the private banks, and another separate agreement is drawn up between the private banks and the borrowing country. This co-financing scheme offers private banks a protective umbrella in their dealings with sovereign borrowers in developing countries, and may set the stage for new and more complex multilateral mechanisms which can result in increasing the flow of private capital to developing countries.

The tripartite nature of the World Bank's co-financing arrangement distinguishes this type of co-financing from "parallel" and "joint" financing. Under joint financing, each financier grants separate loans for a project, each of which is negotiated separately. By agreement among the financiers involved, one of them assumes the responsibility for administering and supervising the execution of the project. Parallel financing is the same as joint financing, except that each institution administers and supervises its own portion of the project. Parallel financing has been more commonly practiced, rather than joint financing. The reason for this is that parallel financing allows greater scope for activities related to various supplying and contracting operations. Arab and Islamic financial institutions have practised both these types of financing for many years.

While discussing project financing, mention must be made of the important and effective role played by bilateral and international financing agencies in the field of financial and economic aid and the development of the economies of developing countries. As it would be impossible to mention all these agencies here, the following have been selected as examples:

The World Bank Group

The Group is composed of three financial institutions: the World Bank, the International Development Association (IDA), and the International Finance Corporation (IFC).

The primary activity of the World Bank is assisting in financing infrastructure projects, in accordance with the terms dictated by international economic conditions. It provides loans only to governments and to organizations guaranteed by governments. IDA differs from the World Bank in that it provides financial assistance on "soft" terms[1/]. Loans are provided with a grace period of 10 years for terms of up to 50 years, at low interest rates or free of interest. Loans may be repaid in the currencies of the debtor.

The IFC assists economic development in its member countries by promoting the growth of the private sector of their economies. It provides technical assistance and contributes up to 25 per cent of the share capital of ventures, and provides them with credit for periods of 7-12 years.

The Co-ordination Group

This group consists of seven Arab-owned financing institutions, the State of Qatar, and two institutions of mixed Arab and non-Arab ownership, namely the Islamic Development Bank (IsDB) in Jeddah, Saudi-Arabia, and the OPEC Fund for International Development (OPEC Fund) in Vienna, Austria. The other seven Arab financing institutions are:

1/ Interest rates and repayments more favorable than those available for loans from purely commercial sources.

- Kuwait Fund for Arab Economic Development
- Abu Dhabi Fund for Arab Economic Development
- Saudi Fund for Development
- Iraqi Fund for External Development
- Libyan Arab Foreign Bank
- Arab Fund for Economic and Social Development
- Arab Bank for Economic Development in Africa.

Members of this group meet regularly for consultation and close co-ordination on matters related to their operations, such as co-financing.

This paper will briefly mention two members of this group.

1. The Islamic Development Bank (IsDB) is an international development finance institution which was established in 1975 as a result of the long persisting desire of Muslim countries to foster their socio-economic development and the well-being of their peoples through mutual financial and economic co-operation. Its present membership consists of 45 countries from Asia, Africa and the Arabian Peninsula.

IsDB's activities must both conform to the Islamic Shari'ah and be financially and socially rewarding. The major activities of the Bank, referred to as Ordinary Operations, include: loans, equity, lines of equity, leasing, lines of leasing, profit sharing and technical assistance. The other category of activities covers foreign trade financing operations, lines of foreign trade financing and special operations.

The IsDB co-operates with National Development Banks in member countries. These banks, acting on behalf of the IsDB, appraise and supervise projects financed from its lines of equity and lines of leasing.

IsDB is also supportive of the endeavours aiming at the application of the Islamic Shari'ah in the economic, financial and banking spheres. To date, IsDB has acquired equity participations in two national Islamic Banks and has

engaged in one joint project financing with a national Islamic Bank.

IsDB also participates in ventures in which other interests, including private commercial banks and other commercially oriented sources of funds, are involved. Here, as in other co-financing operations of the IsDB involving multilateral and bilateral sources, the main aim is catalytic and meant to induce the participation of other financial institutions in projects within member countries.

2. The OPEC Fund for International Development was created by OPEC member countries in 1976 to serve as a collective facility for providing financial assistance to other developing countries on concessionary terms. The objective of the Fund is to strengthen financial co-operation and to promote solidarity among developing countries, by extending untied financial assistance to them.

The Fund extends assistance to those countries most in need, as determined by a set of economic and financial criteria, and to international agencies which assist with the development of the economies of the Third World. The types of loans extended by the Fund include balance-of-payments support loans, project loans and programme loans. The Fund also extends grants, chiefly for technical assistance.

European Investment Bank, Luxembourg

The European Investment Bank (EIB) was created by the Treaty of Rome. Although the Bank's activities were initially confined to the member states of the EEC, it has expanded its activities since 1954 to include a large number of African, Arab and other developing countries. The Bank provides various forms of assistance to the developing countries, the most important of which is the provision of long-term loans (7-12 years for industrial projects, and up to 20 years for infrastructure projects).

German Development Company (DEG), Federal Republic of Germany

The German Development Company was established in 1962 to promote economic co-operation with developing countries by promoting partnerships between companies in the Federal Republic and enterprises in developing countries. DEG promotes investment in projects in developing countries through:

- making equity investments in and granting loans with equity features to companies in developing countries;

- providing technical assistance in planning and implementing projects in developing countries;

- providing guarantees in certain cases; and

- helping to procure additional funds from national and international development agencies.

The company relies on reasonable profits from its investments to cover its expenses, and therefore finances only those projects which it considers will provide an adequate overall return.

Overseas Private Investment Corporation (OPIC), United States of America

The Corporation aims to obtain capital and technical know-how from private sources in the United States in order to contribute to the economic and social development of friendly states. The Corporation has two basic programmes: firstly, to share the cost of feasibility studies and the financing of projects promoted by American investors in developing countries; and secondly, to provide guarantees for American investors in developing countries against political risks, e.g. expropriation, non-convertibility of local currencies and war risks.

Netherlands Investment Bank for Developing Countries, Netherlands

The Bank implements bilateral financial aid programmes involving the Netherlands and developing countries. It also provides loans and grants.

Netherlands Finance Company for Developing Countries (FMO), Netherlands

The goal of FMO is to assist the growth of the productive sector in developing countries, through participation in the share capital of projects, or by providing them with loans.

Commonwealth Development Finance Company (CDFC), United Kingdom

The Commonwealth Development Finance Company was established in 1953 to provide finance and advice to companies operating in developing countries both within and outside the British Commonwealth. CDFC usually participates in new projects by a minority shareholding and also makes loans to companies in which it already has an equity stake. It also provides guarantees to enable companies to borrow from local banks. CDFC activities include supplying economic information and advice, as well as introductions and contacts for companies that so desire. It provides assistance with problems of taxation, management and marketing.

Commonwealth Development Corporation (CDC), United Kingdom

The Commonwealth Development Corporation was established in 1948 with the aim of assisting developing countries in the Commonwealth in developing their economies, by investing its funds in viable projects that will strengthen the economies of the recipient countries and yield an economic return on the money invested.

CDC operations cover infrastructure improvements in areas such as water and power supplies, transportation and housing finance, primary production consisting of agriculture, forestry and mining, and investments in commercial and industrial projects, including manufacturing plants and hotels.

It should be noted that CDC is permitted by its statutes to invest in countries outside the Commonwealth, with United Kingdom ministerial approval.

Industrialization Fund for Developing Countries (IFU), Denmark

The purpose of IFU is to assist in promoting economic growth in developing countries, in co-operation with Danish trade and industry, and in agreement with national governments. IFU concentrates its efforts on equity participation or the provision of loans for the establishment of joint ventures in developing countries.

Although a non-profit institution, IFU operates along business lines. It also provides financial assistance to Danish firms for conducting feasibility studies. IFU withdraws from projects that have attained financial stability,

considering that its task has been accomplished once a project has proved successful.

IV. UNIDO Experience in Project Promotion

Because of their infrastructural, institutional and human resource constraints, developing countries by and large face difficulties in converting their national development plans into viable investment projects. Recently the President of the African Development Bank stated publicly that "at the moment, most of our member countries have very low capacity to generate projects; more resources should be channelled into this form of technical assistance". Similar views were expressed in the latest annual report of the Netherlands Finance Company for Developing Countries (FMO) which finds it remarkable that "while financing institutions generally have ample funds available, they seem to have trouble in investing these funds appropriately". The FMO finds it paradoxical that a great need for money exists side by side with a plentiful supply of it, and attributes this state of affairs to three problem areas:

- the gulf between financiers on the one hand, and industry and government on the other in the area of information on finance and investment opportunities;

- the inadequacy of the means available to cover political and economic risks; and

- the shortage of sound, well-prepared investment projects.

A universally acceptable definition of a "sound, well-prepared investment project" is hard to formulate. The simplest way of identifying such a project is to say that it is the one which succeeds in attracting the inputs required (but not available to the project's sponsors) to bring about its implementation, i.e. a project which is successfully "promoted".

A definition of the term project promotion is somewhat easier: it comprises all the efforts undertaken by project sponsors or persons acting on their behalf to secure the inputs needed to implement a specific project. Such

inputs are: money; plant and equipment and the knowledge to operate it effectively; technical know-how in the form of licences, patents, or simply manufacturing experience; experience of selling and distribution in the target markets, whether domestic or export; managerial skills, with particular emphasis on financial planning and reporting, and on handling the cash inflows and outflows resulting from business operations. In developing countries there is the additional requirement of imparting skills at all levels to locally recruited staff - the training input.

The need to involve the suppliers of these inputs from the very early stages of project preparation is especially true of the financial input. Potential financiers should be able to review, modify and approve all project preparation activities as they unfold in order that their concerns regarding such topics as source and quality of raw materials, appropriateness of proposed level of technology or size of plant, realism of assumptions on market penetration, to name but a few, may be fully incorporated into the feasibility study.

Realising the importance of effective project promotion to developing countries, UNIDO began several years ago to assist them by a programme with the following main components:

(1) identification and formulation of industrial investment projects (training courses, manuals on project evaluation and analysis, project preparation questionnaires, development of specialized software for project preparation and analysis using minicomputers - PROPSPIN[1/]); disseminating information on appropriate technology for new or modernised manufacturing facilities in developing countries (the Manufacturing Profiles series).

(2) publicizing developing countries' investment projects to as many of the suppliers of the required inputs as possible (maintaining and

---

1/ PROPSPIN: Project Profile Screening and Pre-appraisal Information System

updating the INPRIS[1/] computerized list of projects in developing countries and circulating details of them world-wide to potential investors).

(3) training government officials from developing countries in project promotion skills.

(4) collecting and disseminating information on topics relevant to project promotion, e.g.: information on investment conditions (legal, fiscal, financial, institutional) in developing countries as in the Industrial Investment Profile series; manufacturing plants available for redeployment from one country to another; prospective partners in industrialized countries for specific projects; sources, terms, and conditions of finance.

(5) organizing presentations by senior officials and industrialists from developing countries to their counterparts in the industrialized countries. The individual discussions which take place have proved most valuable to both sides.

(6) organizing "investment promotion" meetings in the developing countries, where project sponsors and potential foreign partners can meet bilaterally to discuss specific projects (the "Investors Forum" series of meetings held in Africa, Latin America and Asia). This activity has enabled several developing countries to acquire the necessary know-how to organize their own investment promotion programmes. For example, in some cases once an investment promotion forum had been organized jointly with the government of a developing country, the country subsequently organized its own forum at a multinational or bilateral level.

(7) financing or co-financing a limited number of feasibility studies for

---

1/ INPRIS: Investment Promotion Information System

projects in developing countries and itself preparing feasibility studies using the UNIDO COMFAR[1/] software.

The above-mentioned components of UNIDO's programme of assistance to project promotion are implemented by the UNIDO Investment Co-operative Programme in Vienna, and UNIDO's international network of investment promotion offices.[2/]

In its investment promotion work, UNIDO not only tries to bring about contacts between project sponsors in developing countries and possible foreign partners, but also to fulfil the role of a neutral body that safeguards the interests of the developing countries in appraising the relative financial and socio-economic merits of an industrial investment project for the host government on the one hand, and the local project sponsor and foreign partner on the other. In this context the step-by-step development of any given industrial investment project starting with a project idea, and proceeding via a project questionnaire substantiated by relevant information to opportunity, pre-feasibility and full-feasibility studies, has proved an effective methodology for project implementation. It has also averted the danger of UNIDO and governments' committing excessive time and money to comprehensive studies at a stage where a simple project analysis would suffice.

It is difficult to quantify the results of UNIDO's promotional activities, because the parties involved are usually reluctant to reveal details of the partnerships they may enter into. However, the fact that the number of requests for this type of assistance from developing countries continues to grow is an indication of the programme's usefulness to them. Expansion of the programme is however severely constrained by lack of funds. Another constraint is the sluggish response of project sponsors in developing countries to enquiries from UNIDO regarding their projects. The main constraint, however, continues to be the limited number and relatively poor quality of the

---

1/ COMFAR: Computer Model for Feasibility Analysis and Reporting.

2/ in Brussels, Cologne, New York, Paris, Tokyo, Vienna, Warsaw and Zürich.

industrial investment projects presented by the developing countries for promotion by UNIDO.

In the Arab region, the Inter-Arab Investment Guarantee Corporation, whose headquarters are in Kuwait, plays an important role in project promotion and dissemination, in addition to its valuable work in providing guarantees for Arab investments in Arab countries.

In addition to the above, UNIDO continues to design programmes which can better meet the needs of the developing countries. One such programme was recently introduced with the aim of improving the quality of investment projects identified by developing countries and thereby enhancing these projects' chances of being successfully implemented.

This programme is implemented for one industrial subsector at a time and seeks to bring together industrialists from developing and industrialized countries or from developing countries where the industrial subsector is at different stages of development. UNIDO facilitates co-operation between the industrialists by (a) preparing a series of practical investment and country oriented documents on the specific industrial subsector, (b) providing experts, (c) arranging for the exchange of visits between industrialists from different countries and (d) organizing national workshops on the specific subsector.