e-ISJN: A4372-3114
p-ISJN: A4372-3115

ISSN: 2321-7782 (Online)
ISSN: 2347-1778 (Print)
Impact Factor: 7.327

Volume 8, Issue 7, July 2020

International Journal of Advance Research in Computer Science and Management Studies

Research Article / Survey Paper / Case Study

Available online at: www.ijarcsms.com

Framework of Project Appraisal – A Look at Indian Financial Institutions

Dr. Ragini Agrawal
Associate Professor,
Department of Commerce
College of Vocational Studies,
University of Delhi, India.

Abstract: The financial institutions were funding the long-term project requirements of the borrowers during Pre-liberalization period. Post-liberalization, there has been a dramatic change in the industry. The financial institutions need to take a critical look at the driving force behind most institutions. Evidently, the balance sheet size is the major driver behind most of the institutional actions. Project appraisal document should not merely be a statement of facts – it should also contain the opinion of the appraiser. The ability of the appraiser to pick out the wheat from the chaff, to focus on the critical success factors and to explain their movements, are what sets a good appraisal apart. In the following sections, an attempt is made to go through a normal appraisal document and proceed section-wise, to see the issue generally covered therein, along with suggestions for improvement. The methodology used by financial institutions for their appraisals is described.

Keywords: Project, Appraisal, Financial, Institutions.

I. INTRODUCTION

The evolution of banking industry in India has in many ways been quite unique. Pre-independent itself, India had well-functioning banks which were primarily used to finance and facilitate the international trading activities. Post-independence, government realized that for funding the industrial infrastructure in the country, there was a need for the creation of dedicated financial institutions, who can channelize the funds towards the deserving and viable projects. Thus, institutions like IDBI, ICICI and IFCI were set up. The nationalization of banks was an effort at increasing their reach towards all sections of our society – this in turn, increased the deployable funds with the banks, which they lent to the industry to meet its working capital needs. Thus, over the years, a clear distinction emerged in the funding of industry – institutions funding the long-term project requirements and banks taking care of the short-term working capital requirements.

The emphasis on detailed project appraisal was more in the case of institutions, since they had to commit their money for a longer period and without the benefit of continuous monitoring which banks have (sometimes, banks used to rely on institutional appraisals for their own facilities). However, in the controlled economy, project appraisal was not really the major factor in determining the finance ability of a project. Since demand was always greater than supply and projects were protected from international competition through high tariff barriers, mere receipt of license to produce was sufficient, in most cases, to ensure adequate profits and consequently, repayment of debt.

Post-liberalization, there has been a dramatic change in both the above scenarios. The economy is now much more open and most of industries have been relicensed, with the result that anybody who thinks that he can make money can set up a project in that industry. There is competition from global players. Demand and supply are influenced not only by local factors, but by international trends as well. In the financial sector, the concept of universal banking is being accepted. Mergers are allowed both in the public and private sector banks, even with financial institutions and non-banking financial companies to enlarge capital base and scale of operations, create competitive edge in the market, and to form efficient and strong financial system. For example, ICICI Limited got merged with ICICI Bank in 2002. Therefore, banks are, apart from the short-term financing, getting into and increasing their exposure to long-term project financing. A number of institutions and banks are now listed companies, increasing the gaze of public and analysts on their operations and forcing them to become more profit-oriented. Thus, project appraisal by institutions has acquired critical importance, and it is imperative that institutions change the way they conduct the same, in line with the changing times and the changing economic scenario.

To start with, one needs to take a look at the **driving force behind most institutions today**. It is increasingly evident that **balance sheet size** is the major driver behind most of the institutional actions. While size does signify more financial strength to withstand any shocks, it is at the same time necessary that in an effort to achieve bigger size, prudential due diligence norms are not given the go by. Love for size has been the reason for a number of international banks' downfall in the past, since it prompted them to take risks bigger than their inherent ability to bear them. Even though Indian financial system is still protected, so that bank insolvencies are still not norm here, in no case should the importance of comprehensive and critical appraisal be reduced, in an effort to do more and bigger amount of business. From the working of institutions, it sometimes appears that decision to fund a particular project is taken beforehand, on the basis of meetings between prompters and senior officials of FIs, on the basis of factors like reputation, past relationship, stated viability of the project, apparent favorable critical success factors etc. – and the detailed appraisal is more of a formality to ratify this decision. This mindset needs to be changed.

Basically, project appraisal document should not merely be a statement of facts – it should also contain the opinion of the appraiser (of course, based on some evidence). For far too long, institutions have been scared to express their opinion on paper, afraid that they may be pulled up by government, press or somebody else, for expressing opinions which may not be absolutely correct. The ability of the appraiser to pick out the wheat from the chaff, to focus on the critical success factors and to explain their movements, are what sets a good appraisal apart. If for instance, there have been past instances of a particular company diverting funds to other projects of group companies, it would not be sufficient to merely state that company's investments have increased – the appraiser should state that there appears to be a diversion of funds, which is a bad trend. This analysis will help the final deciding authority to take more informed decisions.

In the following sections, an attempt is made to go through a normal appraisal document and proceed section-wise, to see the issue generally covered therein, along with suggestions for improvement. The methodology currently used by financial institutions for their appraisals is described below:

1.1 EVALUATION OF PROJECT PROMOTERS

This can be looked at from two angles:

1.1.1 Where project is being promoted by promoters new/ unknown to institutions

1.1.2 Where project is being set up as part of an existing company, or even as a new company but by entities/ promoters known to institutions.

1.1.1 In the first case above, the evaluation entails an **examination of the existing economic activities** of the promoters - their other companies' size, financial performance and any other data pertaining to them. One of the most important tools is a report from their existing bankers – since all companies (even if small) necessarily have to deal with bankers for working capital finance, before they approach financial institutions for term loan assistance. Further, due to the fact that the banks provide working capital assistance, they are in *de-facto* regular touch with the company and are able to judge the credit discipline in a much better way than institutions.

However, institutions have observed that, in the first case, the proportion of projects going bad, is highest among the projects promoted by greenfield promoters, or those whose existing operations are very small compared to the proposed projects. In any case, the amount of time and effort spent in evaluation (and subsequent efforts at rehabilitation) of a small project are not materially lower from that spent on a much larger project. Hence, the **enthusiasm for new/ small promoters has gone down** considerably over the last few years.

A point worth mentioning here that promoters/ **group where the group companies are in default** to the banking sector, should not be financed – to inculcate a sense of credit discipline in them. This policy should be slowly enforced across-the-board, since today almost all the large groups have some sick companies, which are in default to the banking sector. Due to the lack of a group approach, promoters conveniently default to one particular bank/ FIs in a sick project and then borrow from some other bank/ FI for some other project. To prevent this, a robust information sharing mechanism should be established.

1.1.2 Existing (known) companies/ groups promoting new projects:

Unrelated diversifications: These were very common in 80’s and 90’s. Institutions do not have a concept of making a projected cash flow of the entire group, to find out the ability of the group to support the projects that it might be venturing into.

It must be admitted at this stage that due to complex tax laws, the personal wealth of most promoters is parked in various investment companies floated for this purpose – their contribution in projects is also through these investment companies. It is not possible for institutions to make a projected cash flow statement for the various investment companies and hence it is difficult to make a consolidated statement showing the ability of promoters to fund all projected investments. However, this exercise should be attempted to reach some conclusions at least and get a broad idea about the group’s projected cash flow.

The other indicators of the promoter’s company creditworthiness, like external credit rating, internal rating (prevalent in few institutions) are examined. In case of existing companies, institution’s past dealings with the company/ group and its present exposure is also taken into consideration. Institutions have **prudential norms** – exposure as a percentage of the borrower’s, as well as its own net worth/ total assets. In the case of small companies taking up large projects, the indicator of exposure as a percentage of borrower’s net worth, generally exceeds the norm – however, this ‘hurdle’ is sought to be overcome, by taking borrower’s net worth after completion of the project or even after the stabilization of operations. This is avoidable – either the norm should be changed so as to be not applicable for companies below as certain size or it should be defined more specifically and should be adhered to.

1.2 Detailed Financial Evaluation of the Promoter Company

1.2.1 Income Statement/ Balance Sheet

This comparative analysis is done over a period of the last few years, and is based almost wholly on the published figures. A lot of importance is given to the year-to-year change in figures – for instance of figures having changed from x to y, thereby demonstrating a variation of z%. A detailed analysis at this stage is very important, especially in the current context, to see how company has been coping with the economic changes in India in the recent past, say last two years.

1.2.2 Cash Flow

The past cash flow should also be analyzed in detail, with the emphasis on how much operating cash flow and free cash flow is being generated by the company.

1.2.3 Ratio Analysis

Institutions still rely mostly on traditional 'stock' ratios like debt-equity, asset coverage, current ratio etc. While these ratios are important, it is essential that emphasis should also be given to 'flow/ hybrid' ratios involving the cash flow during the year.

1.3 Shareholding Pattern

The shareholding pattern is examined, especially the promoters' holding in the company. The trend in share price and the general behavior of the scrip should also be examined. These days, there are a number of equity research reports available in the market. Reference to these reports would make the appraisal reflect the viewpoints of equity analysts as well.

II. Analysis of the Project

The project is examined in a fair amount of detail. The main issues are strategies followed, location of the project, land and buildings, other miscellaneous fixed assets, technical details about the processes, details of plant and machinery, availability of raw material and manpower etc.

III. Cost of the Project

Based on the evaluation of various items in the project profile, the cost of project is drawn up, under various main heads.

IV. Means of Financing/Financial Plan

- Equity (break-up between sponsors)
- Term Loans - Rupees
  - Foreign Currency
- Internal Accruals (for projects within an existing company)
- Funding under any of the govt. schemes for new projects

Various terms of the debt, like upfront fee, interest rates, security, credit enhancement (if any), repayment schedule etc. are detailed here.

In case project is being taken up as a part of an existing company, the financial plan of the entire company for the period of the project implementation, is drawn up, detailing the various sources and uses thereof.

1.2 Security

This is one area where institutions generally do not pay very high attention, but which is one of the most important disciplining forces on the defaulting borrower. Relatively less tight security clauses should not be the variables on which institutions try to compete and attract business.

The normal security taken by institutions is a first *pari passu* charge on all the project's fixed assets, with second charge on the current assets. In addition, one or more of the following are generally taken as additional security:

- Personal guarantee of promoters
- Corporate guarantee of one of the strong group companies
- Pledge of some of the promoters' shareholding in the company
- Letter of comfort fr om the overseas parent/ majority promoter company

Undertakings:

- Non-disposal of shareholding
- Shortfall undertaking
- Management undertaking

1.2.1 Enforcement of Security

All these years, borrower companies have been merrily defaulting to institutions in spite of FIs having the security on the fixed assets. Though pusillanimity on the part of institutions in enforcing their rights is an important factor, the major reason is that in the Indian legal set up, it is extremely difficult and time-consuming for the lender to obtain a court decree against the defaulting borrower. As far as personal guarantees are concerned, Indian promoters generally don't keep wealth in their own names – all the assets are in the name of investment companies or in some other entities. Thus, the phenomenon of any bank/ institution having enforced personal guarantee of a defaulting promoter is almost unheard of.

1.2.2 The Ideal solution is that:

- Institutions should become more proactive in using the stick in case of defaulting companies;
- The legal framework should drastically improve so as to facilitate foreclosure and replacement of defaulting owners.

However, pending the occurrence of these (especially the second option, which currently appears a bit far-fetched), institutions need to have a close-relook at their security mechanisms. As mentioned in the earlier section on financial analysis, the focus should be more on cash flows and less on assets.

- As is done in various infrastructure projects internationally, lender should seek to capture the cash flow of a project through a mechanism of escrow accounts and cash traps. Thus, all inflows to the project should be channelized through a designated bank account, on which the lenders (all, long-term and short-term) have a charge. After meeting the operational expenses, the balance cash flow would be first applied for debt servicing and only the residual can be used for capital expenditure, dividend distribution, etc.
- **A pledge of the promoters' entire shareholding** should be taken in favor of the lenders, so that replacement of the defaulting owner is easier. This is very important, as the fear of losing control over the company is one of the biggest checks on a promoter with *mala fide* intentions.
- **Cross default:** A number of times, it is seen that companies default to one particular lender while the others are unconcerned since the servicing of their debt is till that time, regular. However, default to one lender should be taken as a sign of impending crisis and cross-default clauses should be incorporated in the loan agreement so that a particular lender can enforce his security in the event of the borrower defaulting to any of its lenders.
- **Financial covenants:** Here, limits are placed on certain critical ratios, based on the actual year-end figures, and if the company fails to achieve these, the lender have a right to either increase the interest rates, or impose some more strict conditions, or recall the loan itself. The covenants are stipulated keeping some cushion on the projections made at the time of the appraisal. Thus, the borrower is always under a pressure to maintain its financial performance so as to adhere to the covenants.

V. Market and Selling Arrangement

A market analysis of the project's output is attempted here. This part has become quite important after the opening of Indian economy, since the very definitions of market and competitors have changed. However, when international companies have started operating in India, ability to produce goods of the desired quality and at competitive prices has become a major issue for Indian companies.

5.1 International Markets

Further, the projections of supply should not include only the producers in the domestic market – the suppliers can be any international manufacturer willing to supply to India. Also, in case the project is able to produce goods of reasonable quality and at competitive price, it may be able to export the product, even if the domestic market is limited. Thus, the analysis of projected demand and supply needs to be much more dynamic – it also needs to incorporate elements of scenario building, whereby the appraiser can gauge the resilience of the borrower in case a particular event happens in a particular adverse manner. In this manner, a few likely scenarios can be built and effect seen on the company's projected debt-servicing ability.

5.2 Maximum Stress Resistance

The scenario building exercise can be attempted in a reverse manner also. The effect of each of the critical levels can be seen on the company's profitability, up to the point where the company is just able to service debt. This would indicate the level of maximum stress resistance of the company. The appraiser can then use his judgment to indicate the likelihood of that critical variable to degenerate to such a level.

VI. Projections

This is essentially the output of all the analysis and inputs which have gone into the appraisal so far. The appraiser tries to construct the company's financials till the repayment of the loan, and based on that, tries to ascertain whether the company's and project's financials justify providing it a loan.

VII. Concluding Remarks

- Indian institutions have performed a yeoman's service in promoting industrial development in the country. They have assimilated a substantial body of knowledge about industry, and the promoters and manpower expertise in project analysis. Indian institutions have an almost negligible exposure in real estate and capital market activities, which renders them less susceptible to fluctuations in these activities.
- However, it is also well known fact that their level of non-performing assets is substantial, and are increasing every year. Even though the percentage may not be increasing so fast due to the faster increase in size of the total assets, the absolute amounts are growing rapidly. The actual level of such bad assets are reckoned by most observers as much higher than what have been disclosed by institutions – this is reflected in the abysmally low valuations that stock markets are giving to them.
- In the current and expected future economic scenario, it is imperative that institutional appraisal techniques are upgraded in line with environmental changes. Most international banks employ a much more critical and exhaustive credit appraisal process – the emphasis is much more on critical variables rather than mere collation of data.
- It is definitely not being advocated that the appraisal should incorporate all the suggestions listed above. However, the overall mechanism should be modified so that appraisal does not become a mechanical exercise, or a mere formality to be complied with.

- Indian institutions have always been complaining that one of the reasons for the high level of Non-Performing Assets (NPAs) is due to poor legal and regulatory mechanism for enforcement of security and throwing the defaulting promoters out of the company. In fact, this is all the more reason for them to tighten their appraisal and monitoring procedures, so as to reduce the chances of asset going bad, in the first place.

- There is also a myth propounded by institutions that most of the bad assets are the ones which were provided assistance in the regulated era, when capacities used to be set up at uneconomic levels and phenomenon of 'directed' lending was prevalent. Generally, in absolute terms, these loans were smaller. Post liberalization, the average size of institutional loans has loans rapidly. Further, with a normal project implementation period of 2=3 years, 1-2 years of initial start-up problems and further 1-2 years of financial engineering like reschedulement, 'ever greening' etc., it would take around 4-6 years for these projects to actually show up in the institutions' books as bad. Thus one can expect this phenomenon of large post-liberalization loans going bad, to start from the current year. Then, this myth of only the regulated era loans being bad, is likely to be nailed.

- In fact, there is a strong suspicion that the current obsession for size (by increasing the assets) is actually an attempt to postpone the problem and contain the percentage of NPAs as far as possible. Such strategies obviously cannot be pursued endlessly and it shall be in the interest of the country if the concerned parties (especially the regulatory authorities) wake up to these problems at the earliest and take some hard decisions.

References

1. Agrawal Rashmi, Mehra Yogita S, October 2017, Project Appraisal and Management, Taxman's Publications (P.) Ltd., New Delhi
2. Boardman Anthony E., Greenberg David H., Vining Aidan R., Weimer David L, 5th Ed. July 2018, Cost Benefit Analysis: Concepts and Practices, Cambridge University Press, UK
3. Amazon .com
4. Industrial Development Bank of India- Rushabh Infosoft Ltd.
5. http://www.rushabhinfosoft.com
6. IDBI Bank CEO and MD Kishor Kharat, 5 Nov. 2015, 'We have increased focus on retail business', News Report, The Financial Express
7. http://www.financialexpress.com
8. Edited by- Kirkpatrick Colin, Weiss John, 1996, Cost Benefit Analysis and Project Appraisal in Developing Countries, Edward Elgar Publishing
9. http://www.e-elgar.com/shop/isbn/9781858983462 (application/pdf)